UNITED STATES DEPARTMENT OF DEFENSE

Agency Financial Report

November 2011

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER) / CFO

FOREWORD

The Department of Defense *Agency Financial Report* (AFR) for Fiscal Year 2011 provides an overview of the Department's financial information and performance goals and objectives. It also describes our priorities in response to challenges encountered in defense of our Nation.

For FY 2011, the Department has chosen to produce the *Agency Financial Report* as an alternative to the *Performance and Accountability Report* (PAR). The alternative report is intended to simplify and summarize information to increase transparency while utilizing the Internet for providing additional details. The Department's FY 2011 reporting consist of three components:

- Agency Financial Report – Published November 15, 2011
- Annual Performance Report – Published by February 6, 2012
- Summary of Performance and Financial Information – Published by February 15, 2012

All three reports will be available at the Comptroller's website: *http://comptroller.defense.gov/*

Agency Financial Report (AFR)

The AFR consists of the *Management's Discussion and Analysis* that provides executive-level information on the Department's history, mission, organization, key performance activities, analysis of the financial statements, controls and legal compliance and other challenges facing the Department.

Additional information is available in Addendum A, Other Accompanying Information of the AFR.

Annual Performance Report (APR)

The APR will be included in the Congressional Budget Justification and will provide the detailed performance information and description of results by performance measures.

Summary of Performance and Financial Information

This document will summarize the Department's financial and performance information from the AFR and APR, making the information more transparent and accessible to Congress, the public, and other key constituents.

Preparation of this study/report cost the Department of Defense a total of approximately $107,000 in Fiscal Years 2011 – 2012.

Generated on 20111110
RefID: 8-C1D0E60

Table of Contents

MESSAGE FROM THE DEPUTY SECRETARY OF DEFENSE

It is a privilege for me to introduce the Department of Defense (DoD) Agency Financial Report (AFR) for Fiscal Year 2011. The AFR contains the most complete information available concerning the Department's finances.

In these pages, the reader will find a summary of how, over the past year, the men and women of DoD managed the taxpayers' resources. These resources have been put to work in the fight against terrorist organizations in Afghanistan and elsewhere, in the drawdown of forces in Iraq, in providing relief to the victims of natural disasters, and in support of friends and allies around the world. The AFR also details the actions we have taken to provide for the needs of the All Volunteer Force and to acquire the equipment and technology that will be needed to provide for the nation's security in the years ahead.

In Fiscal Year 2011, the Department carried out its work in the midst of a challenging financial situation. Budgetary pressures, continuing resolutions, and possible shutdowns of the Federal government added an element of uncertainty through much of the fiscal year.

In recognition of the fiscal pressures the country is facing, the Department took the initiative and launched its own comprehensive review of strategic needs and costs. Across DoD, everyone understands that the measure of our success depends on efficiency as well as effectiveness.

In August, Congress upped the ante by passing the Budget Control Act of 2011 (BCA), which mandates $1.1 trillion in cuts to the discretionary part of the Federal budget over the next decade. As a result, we are now preparing for recommendations that could trim about $450 billion from the Defense budget.

Decisions have not been made, but it is clear that achieving these savings will be difficult but manageable. The challenge at Defense is to preserve essential capabilities even as we look for ways to trim costs. Above all, we must avoid hollowing out the force and breaking faith with the brave men and women who are fighting for us.

The BCA also created the Congressional Joint Select Committee on Deficit Reduction (JSCDR), which must find more than $1.5 trillion in additional reductions. If Congress fails to agree on the required savings, the BCA will trigger automatic cuts, half of which – roughly $600 billion over the next 10 years – will be taken from Defense, an amount that Secretary of Defense Leon Panetta has said would do "catastrophic damage to our military and its ability to protect the country." This possibility adds genuine urgency to the work of the JSCDR and DoD's own strategic review.

While we adjust our spending plans, we remain fully committed to improving financial management. Specifically, I fully support Secretary Panetta's goal to achieve audit readiness for the Statement of Budgetary Resources by the end of 2014.

As we go forward together, it is important that the American people understand our commitment both to responsible financial management and to an agile, ready, capable, and adaptable force. This report will aid that understanding.

Ashton B. Carter

Ashton B. Carter
Deputy Secretary of Defense

November 15, 2011

This Page Left Blank Intentionally

MANAGEMENT'S DISCUSSION AND ANALYSIS

FISCAL YEAR 2011 OVERVIEW

The Fiscal Year (FY) 2011 Department of Defense (DoD) budget was crafted to rebalance the priorities of America's defense establishment, institutionalizing successful wartime innovations to better enable success in today's wars while ensuring that our forces are prepared for a complex future. The DoD's budget in FY 2011 continued to use the defense strategy expressed in the 2010 *Quadrennial Defense Review* (QDR) Report, which contained four priority objectives:

- Prevail in today's wars,
- Prevent and deter future conflict,
- Prepare to defeat adversaries and succeed in a wide variety of contingencies, and
- Preserve and enhance the All-Volunteer Force.

We remain committed to the goal of disrupting, dismantling, and defeating al-Qaeda. While the strategic defeat of al-Qaeda is within reach, the broader challenge of combating terrorist and insurgent threats at their source will remain. We also must ensure the success of our forces fighting to bring stability and security to Afghanistan as we begin a process of responsible transition, as well as completing the drawdown in Iraq.

The Department continues to emphasize rebalancing the Joint Force towards the key mission areas articulated in the 2010 QDR:

- Defend the U.S. and support civil authorities at home,
- Succeed in counterinsurgency, stability and counterterrorism operations,
- Build the security capacity of partner states,
- Deter and defeat aggression in anti-access environments,
- Prevent proliferation and counter weapons of mass destruction, and
- Operate effectively in cyberspace.

We made adjustments in the Department's FY 2011 budget in line with these six mission areas, investing in the capabilities needed in current conflicts, including intelligence, surveillance and reconnaissance platforms, special operations forces, and cyber capabilities – including the stand-up of a new cyber command. Enhancements also were made to prepare for future conflicts, including investments in items such as mobility aircraft and space capabilities.

The FY 2011 budget also sought to advance reforms in the way we do business, to carve out efficiencies to help preserve and enhance key military capabilities in the face of the Nation's fiscal predicament and declining rates of budget growth. The FY 2011 budget supported initiatives to continue to reform the Department's institutions and processes to better support the urgent needs of the warfighter; buy weapons that are usable, affordable, and truly needed; and ensure that taxpayer dollars are spent wisely and responsibly. United States forces need the right mix of weapons and platforms to deal with the span of threats we will likely face in the future. The goal of our acquisition programs is to develop a mixture of capabilities with flexibility to allow us to respond to a spectrum of contingencies. The QDR guides us toward the right mix, and the FY 2011 budget moved us closer to achieving that mix.

During the formulation of the *FY 2012 President's Budget*, then-Department of Defense Secretary Gates directed a baseline review of how the Department was staffed, organized, and operated as a whole. As part of this review, efficiency savings were realized for the Defense-wide civilian workforce, service support contractors, and Departmental studies. The freeze on the civilian workforce retained all FY 2011 to FY 2013 Defense Agency civilian full-time equivalents at the same level as authorized in FY 2010. The Department's reliance on service support contractors was reduced by 10 percent per year from FY 2011 to FY 2013, for a cumulative 30 percent reduction. The Department's reliance on advisory studies was reduced by 25 percent below the FY 2010 actual levels and eliminated all non-essential, lesser-value reports, including all reports generated by DoD Issuances that were five years or older.

As a result of our efforts to prevail in today's conflicts and to prepare for the complex challenges ahead, America has asked much of its All-Volunteer Force and the civilians who support that force. Multiple and extended deployments have taken a toll on our people and their families. As a nation, we are obligated to take care of our people to the best of our ability. From wartime force management issues, to recruiting, retention, family support, and wounded warrior care, we must continue to tend to the health of the All-Volunteer Force.

In summary, during FY 2011 the Department sustained the military and provided necessary capabilities to prevail in today's conflicts and prepare for tomorrow's challenges. Throughout, the Department remained focused on taking care of its people and their families, and ensuring the best use of taxpayer dollars.

Athletes sprint across the finish line during the 100 Meter Dash at the Warrior Games track and field events in Colorado Springs, Colo., May 17, 2011. The track and field events are the first of the Warrior Games to take place through out the week.

U.S. Air Force photo
Staff Sgt. Christopher Griffin

MISSION

The mission of the Department of Defense is to protect the American people and advance our national interests. Key among American interests are security, prosperity, broad respect for universal values, and an international order that promotes cooperative action. These interests are inextricably linked to the integrity and resilience of the international system. Consistent with the President's vision, the United States will advance these interests by strengthening our domestic foundation and integrating all elements of national power; engaging abroad, based on mutual interest and mutual respect; and promoting an international order that reinforces the rights and responsibilities of all nations.

The soldiers move forward, almost shoulder to shoulder, with live ammunition while practicing team movement drills at an advanced marksmanship course on Camp Beuhring, Kuwait.

U.S. Army photo by Sgt. Travis Zielinski

The U.S. faces a complex and uncertain future security landscape in which the pace of change continues to accelerate. Terrorists continue to learn and adapt, posing a continuing threat to the security of the United States and to our allies and partners. In addition, the rise of new powers, the growing influence of non-sovereign entities that exercise significant influence at a national or international level, the spread of weapons of mass destruction and other destructive enabling technologies, and a series of enduring and emerging trends pose profound challenges to the international order.

America's interests and role in the world require armed forces with unmatched capabilities and a willingness on the part of the Nation to employ them in defense of our interests and the common good. The United States remains the only nation able to project and sustain large-scale operations over extended distances. This unique position generates an obligation to be responsible stewards of the power and influence that history, determination, and circumstance have provided.

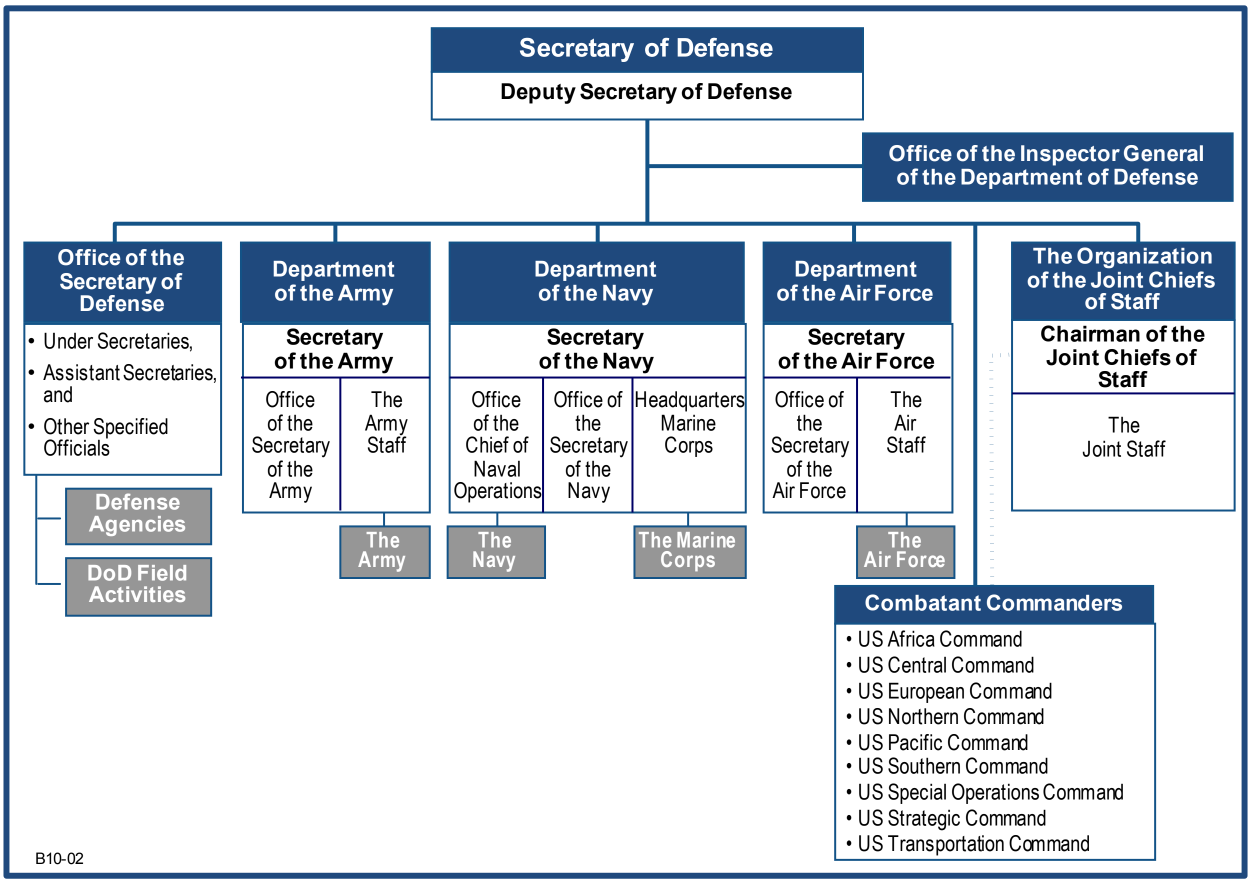
The role of the Department of Defense is to field, sustain, and employ the military capabilities needed to protect the United States and its allies and to advance our interests. In order to fulfill this role, the Department must continually assess how America's armed forces are evolving in relation to the wartime demands of today and the expected character of future challenges.

ORGANIZATION

Since the creation of America's first army in 1775, the Department and its predecessor organizations have evolved into a global presence of more than 3 million individuals stationed throughout the world, dedicated to defending the United States by deterring and defeating aggression and coercion in critical regions. The Department embraces the core values of leadership, professionalism, and technical knowledge; its employees are dedicated to duty, integrity, ethics, honor, courage, and loyalty.

Under the President, who also is Commander in Chief, the Secretary of Defense exercises authority, direction, and control over the Department. The *Department of Defense* (Figure 1-1) is composed of the Office of the Secretary of Defense; the separately organized military departments of the Army, Navy, and Air Force; the Joint Chiefs of Staff; the unified Combatant Commands; the Inspector General; the Defense Agencies; the DoD Field Activities; and such other offices, agencies, activities, and commands as may be established for specific purposes.

Figure 1-1. Department of Defense Organizational Structure



THE OFFICE OF THE SECRETARY OF DEFENSE

The Secretary of Defense and his principal staff are responsible for the formulation and oversight of defense strategy and policy.

The Office of the Secretary of Defense (OSD) supports the Secretary in policy development, planning, resource management, acquisition, and fiscal and program evaluation. The immediate OSD is comprised of several Under Secretaries of Defense (USD) and Assistant Secretaries of Defense (ASD) for various functional areas. Select OSD Principals also oversee the activities of various Defense Agencies and DoD Field Activities. The OSD organization chart is available at http://www.defense.gov/orgchart/

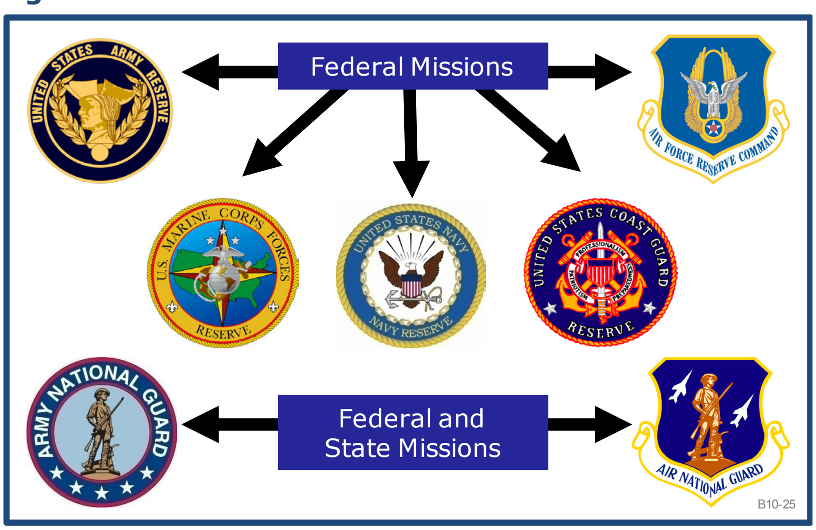
MILITARY DEPARTMENTS

Figure 1-2. DoD Military Services

The Military Departments consist of the *Army*, the *Navy* (of which the *Marine Corps* is a component), and the *Air Force* (Figure 1-2). In wartime, the U.S. Coast Guard becomes a special component of the Navy; otherwise, it is part of the Department of Homeland Security. The Military Departments organize, staff, train, equip, and sustain America's military forces. When the President and Secretary of Defense determine that military action is required, these trained and ready forces are assigned to a Combatant Command responsible for conducting military operations.

The Military Departments include Active Duty, Reserve, and *National Guard* forces. Active Duty forces are full-time Military Service members. The National Guard has a unique dual mission with both Federal and State responsibilities (see Figure 1-3). The Guard, commanded by the Governor of each state or territory, can be called into action during local or statewide emergencies, such as storms, drought, or civil disturbances. When ordered to active duty for mobilization or called into Federal service for national emergencies, units of the Guard are placed under operational control of the appropriate Combatant Commanders. The Guard and Reserve forces are recognized as indispensable and integral parts of the Nation's defense.

Figure 1-3. Reserve Forces and National Guard



DEFENSE AGENCIES

Seventeen Defense Agencies have evolved over time as a result of DoD-wide functional consolidation initiatives. Defense Agencies provide a variety of support services commonly used throughout the Department. For instance, the Defense Logistics Agency provides logistics support and supplies to all Department activities.

DEPARTMENT OF DEFENSE FIELD ACTIVITIES

Ten DoD Field Activities also have evolved over time as a result of DoD-wide functional consolidation initiatives. The DoD Field Activities perform missions more limited in scope than the Defense Agencies. For example, the Defense Media Activity serves as the DoD focal point for all Armed Forces information programs.

THE JOINT STAFF (JS)

The Chairman of the *Joint Chiefs of Staff* is the principal military advisor to the President, the National Security Staff, and the Secretary of Defense. The Chairman and his principal staff assist the President and the Secretary in providing for the strategic direction of the Armed Forces, including operations conducted by the Commanders of the Combatant Commands.

COMBATANT COMMANDS

Nine Combatant Commands are responsible for conducting the Department's military operational missions around the world (Figure 1-4).

Six commands have specific military operational mission objectives for geographic areas of responsibility:

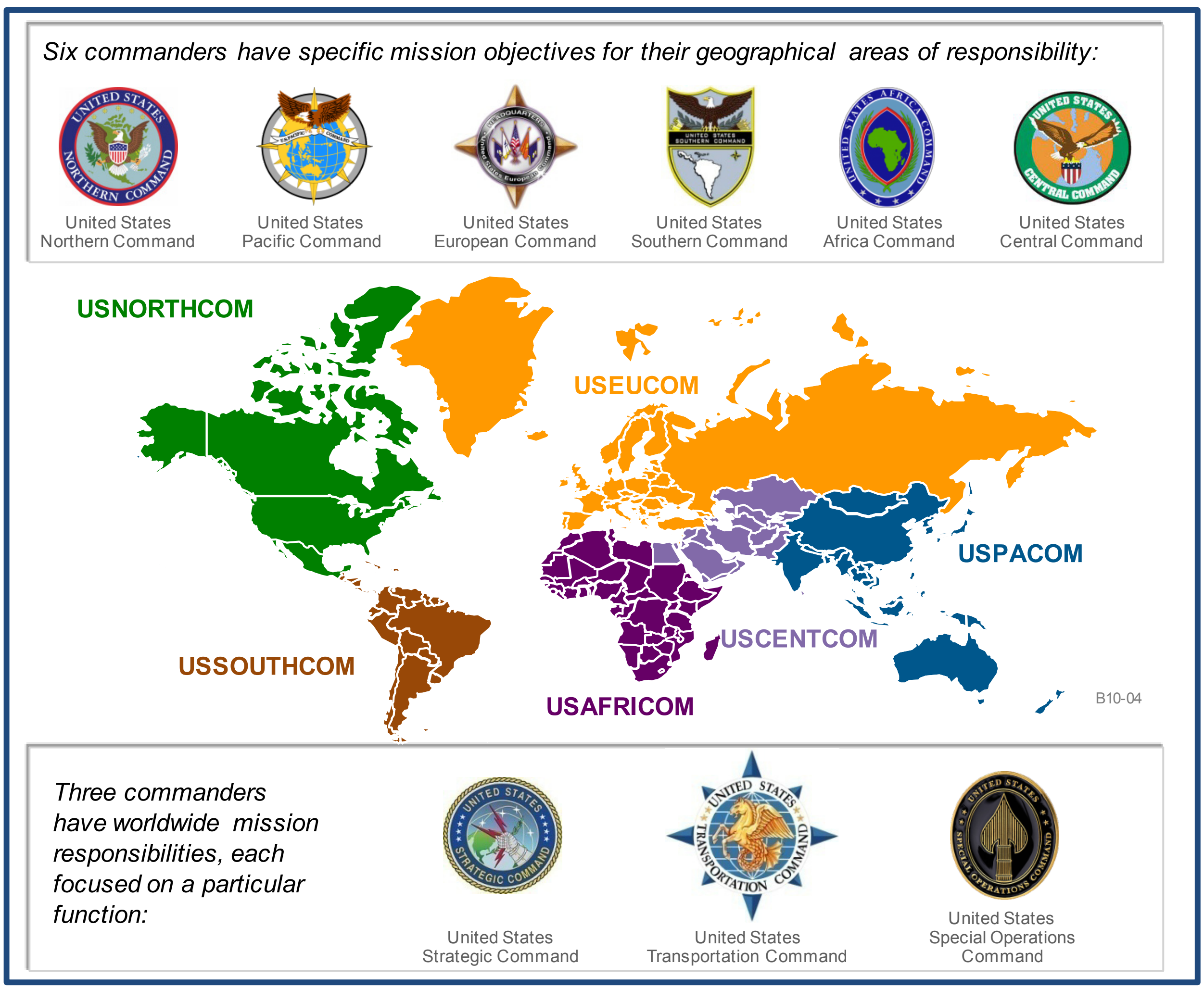
- *U.S. Northern Command* (USNORTHCOM) is responsible for North America, including Canada and Mexico.
- *U.S. Pacific Command* (USPACOM) is responsible for China, South and Southeast Asia, Australia, and the Pacific Ocean.
- *U.S. European Command* (USEUCOM) is responsible for activities in Europe, Greenland, and Russia.
- *U.S. Southern Command* (USSOUTHCOM) is responsible for Central and South America and the Caribbean.
- *U.S. Africa Command* (USAFRICOM) is responsible for the entire continent of Africa (except for Egypt).
- *U.S. Central Command* (USCENTCOM) is responsible for the Middle East, Egypt, and several of the former Soviet republics. This Command is primarily responsible for conducting Operation Enduring Freedom in Afghanistan and Operation New Dawn in Iraq.

Three Commands have worldwide mission responsibilities focused on a particular function(s):

- *U.S. Strategic Command* (USSTRATCOM) provides global deterrence capabilities, direction of Global Information Grid operations, and synchronizes Department efforts to combat weapons of mass destruction worldwide.
- *U.S. Transportation Command* (USTRANSCOM) moves military equipment, supplies, and personnel around the world in support of operations.
- *U.S. Special Operations Command* (USSOCOM) leads, plans, synchronizes, and as directed, executes global operations against terrorist networks.

The Military Departments supply the necessary capabilities to these Commands. As such, the operating costs of these commands (except the USSOCOM) are subsumed within each Military Department's budget. The USSOCOM is the only Combatant Command that has budget authority that resides outside of the control of the Military Departments and is reflected in the Department's Defense-wide accounts.

Figure 1-4. Combatant Commands Geographic and Functional Areas

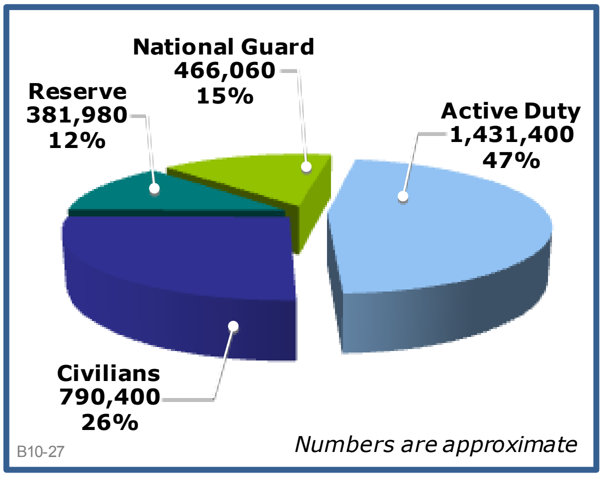


RESOURCES

The Department requires resources (personnel, facilities and infrastructure, and budget authority) to carry out key missions and execute management reforms. The strategic placement of our personnel, installations, and facilities are key for protecting our homeland and national resources. These resources have never been more important than they are today as the U.S. fights terrorists who plan and carry out attacks on our facilities and our people.

Our workforce consists of more than three million employees, both afloat and ashore, deployed throughout the world to meet mission requirements. Nearly half of the Department's workforce is comprised of men and women on Active Duty. To provide Americans with the highest level of national security, the Department consists of approximately 1,431,400 men and women on Active Duty, 848,040 Reserve and National Guard, and 790,400 civilians (Figure 1-5).

Figure 1-5. Staffing for FY 2011 (As of August 31, 2011)



During FY 2011, the Department mobilized approximately 92,100 Reserve Component members at any given time. The men and women of the Reserve and National Guard provided security and assistance in both the Afghanistan and Iraq theaters and maintained aircraft in the Horn of Africa, to name a few of their many missions. The skills and capabilities of the Reserve Component members match current and anticipated DoD requirements, thereby reducing the stress on the total force while increasing the capacity.

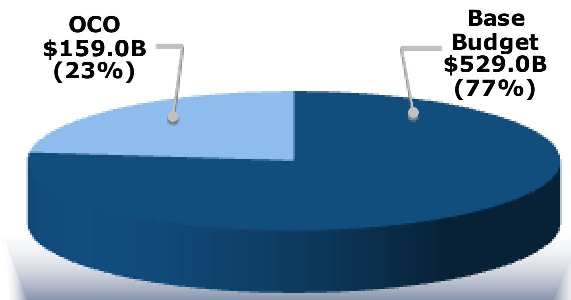
All Military Services and five of the six Reserve Components met or exceeded their numeric accession goals in FY 2011. The Army National Guard intentionally achieved 95 percent of their goal to stay within its Congressionally-authorized end strength. All Military Services and Reserve Components exceeded recruit quality benchmarks in FY 2011 – a remarkable achievement. The Nation can be proud of these achievements as well as the commitment of Service members and their families, as reflected in record high retention rates.

Throughout FY 2011, the civilian workforce continued to play a critical role in supporting the accomplishment of DoD's mission. In FY 2011, we witnessed their continued voluntary and enthusiastic participation in new and challenging roles, especially in support of DoD's wartime efforts. The *Civilian Expeditionary Workforce Program* has deployed volunteers to war zones to serve in career fields as far-reaching as intelligence, public affairs, policy development, and logistics. Thousands of civilians with in-demand expertise volunteer each year to support wartime missions in Afghanistan and Iraq. Before their one-year deployment begins, they first must undergo rigorous training on Muscatatuck Urban Training Center and Camp Atterbury, Indiana, where they learn everything from cultural sensitivities to military customs and courtesies – with a few live-fire exercises thrown into the mix. The remarkable people who comprise civilian and military teams are the Department's greatest asset in providing a strong and agile national security response.

The Department's worldwide infrastructure includes nearly 542,000 facilities (buildings and structures) located at more than 5,000 sites around the world on more than 28 million acres. These sites vary greatly in size. They range from the very small (an unoccupied site supporting a single navigational aid that sits on less than one-half acre of land) to the vast and immense, such as the Army's White Sands Missile Range in New Mexico (with over 3.6 million acres) or the Navy's large complex of installations in Norfolk, Virginia. To protect the security of the U.S., the Department operates 14,668 aircraft and 586 ships.

To support mission requirements, the Department continues to focus on investing financial resources effectively to meet the needs of the warfighter and the ever-changing battlefield. We continue to invest in weapon systems and capabilities to counter 21st Century threats, support the workforce, and accomplish mission requirements and objectives. During FY 2011, DoD's enacted budget authority amounted to $688 billion. Figure 1-6 depicts the composition of DoD's budget authority.

Figure 1-6. Department of Defense FY 2011 Enacted Budget ($688.0B)



Budget by Appropriation	$ in Billions
Military Personnel	154.0
Operation and Maintenance	307.9
Procurement	129.9
RDT&E	75.0
Military Construction	16.0
Family Housing	1.8
Revolving Funds	3.4
Total	**$688.0**

B10-17

The Overseas Contingency Operations (OCO) resources enable the Department to support and to fund efforts primarily in Afghanistan and Iraq. The Department continued activities under Operation New Dawn as it works to complete the military mission in Iraq. In Afghanistan, U.S. coalition and Afghan forces have arrested the Taliban's momentum in much of the country and reversed it in several key areas. U.S. troops continue to work with Afghan National Security Forces and international partners and have begun the process of transitioning the lead for security to Afghanistan, which is scheduled to be complete across the country by the end of 2014.

The Department's funding levels ensure the Nation can meet all national security objectives. Funding enabled the Department to maintain readiness to conduct missions abroad and a full spectrum of training, combat training center rotations, and recruiting and retention efforts. Modernization and recapitalization of equipment, focused on today's threats, greatly improved combat capabilities. These new capabilities included procurement and development of platforms, such as the fifth generation Joint Strike Fighter aircraft; the Littoral Combat Ship; unmanned aircraft systems, such as Global Hawk and Reaper; new generation ground vehicles, such as the Stryker; communications, navigation, missile warning, space situational awareness, and environmental monitoring satellites; and missile defense systems.

In FY 2011, resources funded the construction and maintenance of additional modernized housing, both government-owned and privatized. These constructed housing units support the Marine Corps' growth in ground forces. In addition, the Department built wounded warrior facilities and schools and recapitalized other medical facilities. The Department funded the operation of 254 commissaries and education for over 87,000 students in 194 schools.


U.S. Air Force Senior Airman greets children during a security halt in Qalat City, Afghanistan, Aug. 10, 2011. Assigned to the Provincial Reconstruction Team Zabul's security force.

U.S. Air Force photo by Senior Airman Grovert Fuentes-Contreras

In addition, during the first quarter of FY 2011, the Department completed its portion of the U.S. Government's response to the Government of Pakistan's call for humanitarian assistance and disaster relief following the flooding that started in July 2010. In March 2011, the Department deployed personnel, ships, and aircraft to augment the Government of Japan's disaster relief efforts in response to the devastating magnitude 9.0 earthquake that struck off Japan's main island of Honshu. Also during FY 2011, the Department provided humanitarian assistance relief, forces, and capabilities to augment and support coalition partners in the North Atlantic Treaty Organization (NATO)-led military operations to respond to Muammar Gaddafi's brutal behavior against the people of Libya.

The *Base Realignment and Closure* (BRAC) initiative continued with $2.4 billion in funding, which allowed the Department to satisfy its legal obligation to complete 220 recommendations before the September 15, 2011 statutory deadline.

To ensure the security of the U.S., the Department remains dedicated to obtaining the required resources and making the best use of them. Taking care of our people, reshaping and modernizing the force, and supporting our troops in the field also remains a high priority for the Department, which is committed to spending funds carefully and effectively.

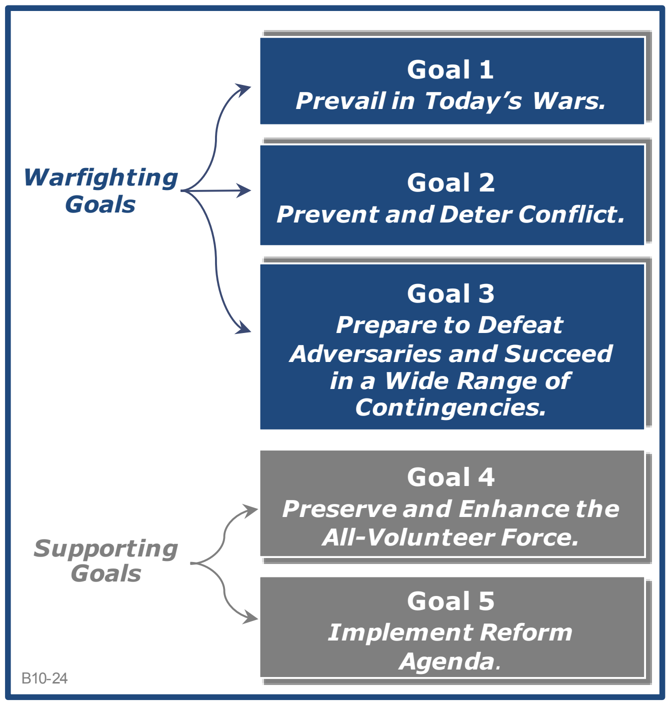
PERFORMANCE GOALS, OBJECTIVES, AND RESULTS

DEPARTMENT OF DEFENSE STRATEGIC PLAN

As discussed in the Overview section of this report, the Department examines America's defense needs by conducting the *Quadrennial Defense Review*. This review examines national defense strategy, force structure, force modernization plans, infrastructure, budget plans, and other elements of the defense program and policies of the United States, consistent with the most recent *National Security Strategy* and *National Military Strategy*. The 2010 Quadrennial Defense Review report (QDR) constitutes the DoD strategic plan.

In addition to the four QDR priorities, i.e., Prevail in today's wars; Prevent and deter conflict; Prepare to defeat adversaries and succeed in a wide range of contingencies; and Preserve and enhance the All-Volunteer Force, the QDR acknowledged that increased efficiency and effectiveness could be achieved by implementing an agenda that reforms how the DoD does business. Consequently, these five imperatives reflect the Department's Strategic Goals. Strategic goals 1 through 3 reflect DoD core warfighting missions and Strategic goals 4 and 5 focus on DoD infrastructure support (Figure 1-7).

Figure 1-7. DoD Strategic Goals



- Strategic Goal 1, "Prevail in Today's Wars," focuses on the ongoing conflict and extended stabilization campaigns in Afghanistan and Iraq.
- Strategic Goal 2, "Prevent and Deter Conflict," focuses on integrated security cooperation and reorienting the Armed Forces to deter and defend against transnational terrorists around the world.
- Strategic Goal 3, "Prepare to Defeat Adversaries and Succeed in a Wide Range of Contingencies," focuses on DoD's contributions to homeland defense, natural disasters, and other contingencies.
- Strategic Goal 4, "Preserve and Enhance the All-Volunteer Force," focuses on DoD personnel management, healthcare, and military families.
- Strategic Goal 5, "Implement Reform Agenda," focuses on improving and integrating DoD business operations to better support the warfighter.

Department of Defense Performance Hierarchy

The DoD Strategic Plan (i.e., the 2010 QDR) forms the basis for development of the Department's Annual Performance Plan. The FY 2011 Performance Plan reflects 5 overarching Department strategic goals, 20 strategic objectives, and 80 enterprise-level or DoD-wide performance goal priorities that are included in DoD's annual budget request. The Department will address final year-end results for all 80 performance goals in the DoD Annual Performance Report for FY 2011, which will be submitted with the FY 2013 Congressional Budget Justification on February 6, 2012.

Primary responsibility for performance improvement rests with the Deputy Secretary of Defense in his role as the Chief Management Officer (CMO). The Deputy Secretary is assisted by the Deputy CMO/DoD Performance Improvement Officer, who integrates performance information across the Department. The Principal Staff Assistants within the Office of the Secretary of Defense, in coordination with the Joint Staff, recommend the strategic objectives and performance goals determined to be the most relevant for DoD-wide management focus. The DoD strategic objectives and performance goals are subject to annual refinement based on changes in missions and priorities. Figure 1-8 highlights that every level within the Department is accountable for performance and delivering results.

FY 2011 Department of Defense Key Performance Results

The following information, organized by DoD Strategic Goal and Objective, depicts 23 key performance results for FY 2011. Unless otherwise stated, the tables report progress through the third quarter of FY 2011. Based on third quarter data, the Department is on track to meet 78 percent of these 23 performance goals.

Figure 1-8. Department of Defense Performance Budget Hierarchy

Strategic Goal 1: Prevail in Today's Wars.

As depicted below, four key performance results under Strategic Goal 1, "Prevail in Today's Wars," reflect that the Department is on track to meet its military operational objectives in Afghanistan and Iraq in FY 2011. The Department increased the size and improved the capability of Afghan forces and has begun the process of transferring responsibility of security to a capable Afghan partner. There has been a successful transition of three provinces and four municipalities to the Afghan National Security Force (ANSF) Lead in the first of several areas of transition. The Department is well on track to achieve its FY 2011 ANSF total goal of 305,600 personnel [171,600 Afghan National Army (ANA) and 134,000 Afghan National Policy (ANP)], with 301,672 personnel at the end of the third quarter, an increase of 30,826 since January 2011. As the ANSF develops, the Department has worked with other U.S government agencies to lay the groundwork for its sustainable future with a reduced U.S. presence (refer to Strategic Objective 1.1-OCO).

By the end of the third quarter, the Department also had exceeded its drawdown goals in terms of reducing its military presence in Iraq (Strategic Objective 1.2-OCO). United States Forces-Iraq will continue the directed drawdown in a manner that does not jeopardize our U.S. forces as we reset and leave a stable, secure, sovereign and self-reliant Iraq as a long-term strategic partner to the United States.

STRATEGIC GOAL 1: PREVAIL IN TODAY'S WARS				
Performance Measures	Strategic Plan Long-Term Performance Goals	Annual Performance Goals/Results		
		FY 2010 Results	FY 2011 Goals	FY 2011 3 Qtr Results
Strategic Objective 1.1-OCO: Degrade the Taliban to levels manageable by the Afghan National Security Force (ANSF), while increasing the size and capability of the ANSF.				
1.1.1-OCO: Cumulative number of Afghan National Army (ANA) end strength	1.1.1-OCO: By FY 2011, the ANA end strength will be 171,600 with intent to train and equip forces.	144,000	171,600	■171,050
1.1.2-OCO: Cumulative number of Afghan National Police (ANP) end strength	1.1.2-OCO: By FY 2011, the ANP end strength will be 134,000 with intent to train and equip forces.	115,000	134,000	■130,622
Strategic Objective 1.2-OCO: Execute a responsible drawdown of the U.S. military presence in Iraq.				
1.2.1-OCO: Cumulative number of U.S. military troops in Iraq	1.2.1-OCO: By the end of first quarter, FY 2012, the U.S. military presence in Iraq will be zero troops (except for a small number under Chief of Mission authority).	48,770	50,000	■46,000
1.2.2-OCO: Cumulative number of pieces of rolling stock in Iraq supporting U.S. military troops	1.2.2-OCO: By the end of first quarter, FY 2012, the number of pieces of rolling stock in Iraq supporting U.S. military troops, will be zero (except for a small number used by military personnel under Chief of Mission authority).	16,500	16,500	■12,569

Strategic Goal 2: Prevent and Deter Conflict.

Five performance results are key to satisfying the Department's deterrence missions and achieving its national security objectives. Our deterrent remains grounded in land, air, and naval forces capable of fighting limited and large-scale conflicts. As of third quarter, the Department surpassed its annual goals to increase DoD Special Operations personnel and rebalance Marine Corps Expeditionary Forces (Strategic Objective 2.1-1F1), equip ballistic missile defense-capable ships (Strategic Objective 2.3-1F3), and increase intelligence, surveillance, and reconnaissance (ISR) capacity (Strategic Objective 2.4-1X2). Increasing the number of ISR orbits provides more capabilities for general purpose and special operations forces and allows them to carry out their missions more effectively.

The Department did not achieve its FY 2011 nuclear safety inspection goal (Strategic Objective 2.2-1F2A), though first-time passing rates have consistently improved over the last three years. Maintaining a 100 percent passing rate on first-time Defense Nuclear Surety Inspections (DNSIs) may appear to be a good standard, but it could generate unrealistic expectations and a potential "zero tolerance" culture that is neither sustainable nor appropriate for achieving long-term excellence in the nuclear enterprise. The Department will re-examine this measure in FY 2012 to emphasize the value of reducing DNSI repeat deficiencies (critical and significant only) as a better indicator of the sustained Services' excellence and senior leadership focus on the nuclear enterprise.

STRATEGIC GOAL 2: PREVENT AND DETER CONFLICT				
Performance Measures	Strategic Plan Long-Term Performance Goals	Annual Performance Goals/Results		
		FY 2010 Results	FY 2011 Goals	FY 2011 3 Qtr Results
Strategic Objective 2.1-1F1: Extend a global posture to prevail across all domains by increasing capacity in general purpose forces and by enhancing stability operations and foreign security force competency.				
2.1.3-1F1: Cumulative percent increase in DoD Special Forces and Navy SEAL personnel achieved	2.1.3-1F1: By FY 2012, the DoD will increase its Special Forces and Navy SEAL personnel by 32 percent.	27%	28%	35%
2.1.6-1F1: Cumulative percent of unit initiatives completed to balance three Marine Corps Expeditionary Forces (MEFs)	2.1.6-1F1: By FY 2012, the DoD will have completed 100 percent of unit initiatives required to have balanced three MEFs.	84%	92%	95%
Strategic Objective 2.2-1F2A: Maintain a safe, secure, and effective nuclear arsenal to deter attack on the U.S. and on our allies and partners.				
2.2.2-1F2A: Passing percentage rate for Defense Nuclear Surety Inspections	2.2.2-1F2A: Beginning in FY 2011, the DoD will maintain a passing rate of 100 percent for all regular Defense Nuclear Surety Inspections.	73%	100%	85.7%
Strategic Objective 2.3-1F3: Strengthen cooperation with allies and partners to develop and field robust, pragmatic, and cost-effective missile defense capabilities.				
2.3.1-1F3: Cumulative number of Aegis Ballistic Missile Defense (BMD)-capable ships	2.3.1-1F3: By FY 2018, the DoD will have 43 Aegis ships that are BMD-capable.	Not available	23	23

STRATEGIC GOAL 2: PREVENT AND DETER CONFLICT				
Strategic Objective 2.4-1X2: Ensure sufficient Intelligence, Surveillance, and Reconnaissance (ISR) collection and analysis capacity for full spectrum operations and ensure resiliency of ISR operations.				
2.4.1-1X2: Cumulative number of MQ-1 (Predator) and MQ-9 (Reaper) intelligence, surveillance, and reconnaissance (ISR) orbits	2.4.1-1X2: By FY 2013, the DoD will achieve and maintain 65 MQ-1 (Predator) and MQ-9 (Reaper) orbits of ISR.	45	50	■55

Strategic Goal 3: Prepare to Defeat Adversaries and Succeed in a Wide Range of Contingencies.

The potential spread of weapons of mass destruction (WMD) poses a grave threat and continues to undermine global security, complicating efforts to sustain peace and prevent harmful arms races. As the ability to create and employ WMD spreads globally, so must our efforts to detect, interdict, and contain the effects of these weapons. As of third quarter, the Department is well on its way to achieve its annual goal of destroying treaty-declared category 1 chemical weapons. Deterrence of such threats and defense against them can be enhanced by securing and reducing dangerous materials, positioning forces to track lethal agents, and defeating the agents themselves.

STRATEGIC GOAL 3: PREPARE TO DEFEAT ADVERSARIES AND SUCCEED IN A WIDE RANGE OF CONTINGENCIES				
Performance Measures	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2010 Results	**FY 2011 Goals**	**FY 2011 3 Qtr Results**
Strategic Objective 3.2-1F2C: Enhance capacity to locate, secure, or neutralize weapons of mass destruction, key materials, and related facilities.				
3.2.1-1F2C: Cumulative percent of treaty-declared category 1 chemical weapons destroyed	3.2.1-1F2: By FY 2021, DoD will have destroyed 100 percent of treaty-declared category 1 chemical weapons.	79.8%	88.3%	■87.6%

Strategic Goal 4: Preserve and Enhance the All-Volunteer Force.

The Department is on track to achieve five of six key performance goals that affect its ability to maintain an "All Volunteer" military. The Services continue to meet their end-strength goals for both Active and Reserve components, and both recruiting and retention programs continue to succeed. End strength goals are critical to meeting mission requirements, maintaining national security, and retaining the skills necessary for future requirements. In addition, the Army has been able to eliminate the use of Stop Loss for deploying units well ahead of its goal (refer to Strategic Objective 4.2-2P).

Managing the deployment tempo remains among the most tangible demonstrations of commitment to our Service members and their families, and all Services have shown improvement in complying with the Department's planning objectives for time deployed and time at home. In particular, Army and Reserve Component members have shown substantive improvement for time deployed and time at home.

The only goal not achieved is in the area of civilian personnel management, where the Department is exceeding the cycle time for delegating examination of external civilian hires by 5 days (five percent) (Performance Measure 4.2.5-2P). Continued training of DoD managers to increase adoption and familiarity with automated staffing tools will allow the Department to achieve its long-term civilian hiring goal of 80 days by FY 2012.

STRATEGIC GOAL 4. PRESERVE AND ENHANCE THE ALL-VOLUNTEER FORCE.				
Performance Measures	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2010 Results	**FY 2011 Goals**	**FY 2011 3 Qtr Results**
Strategic Objective 4.2-2P: Ensure the Department has the right workforce size and mix, manage the deployment tempo with greater predictability, and ensure the long-term viability of the Reserve Component.				
4.2.1-2P: Percent variance in Active component end strength	4.2.1-2P: For each fiscal year, the DoD Active component end strength must be maintained at or not to exceed (NTE) three percent above the SECDEF/NDAA-prescribed end strength for that fiscal year.	0.4%	0-3%	0%
4.2.2-2P: Percent variance in Reserve component end strength	4.2.2-2P: For each fiscal year, the DoD Reserve component end strength will not vary by more than three percent from the SECDEF/NDAA-prescribed end strength for that fiscal year.	0.6%	+/-3%	0.2%
4.2.3-2P: Number of soldiers under stop loss	4.2.3-2P: By FY 2011, the Department will reduce the number of soldiers under stop loss to zero.	3,198	0	0
4.2.5-2P: Number of days for external civilian hiring (end-to-end timeline)	4.2.5-2P: By FY 2012, the Department will improve its external civilian hiring end-to-end timeline to 80 days.	116	101	106
4.2.6-2P: Percentage of the Department's active duty Army who meet the planning objectives for time deployed in support of combat operations versus time at home	4.2.6-2P: By FY 2015, 95 percent of active duty Army personnel will meet the deployment to dwell objective of 1:2.	Not available	75%	86.9%
4.2.10-2P: Percent of Reserve Component (RC) Service members mobilized in the evaluation period that have dwell ratios greater than or equal to 1:5	4.2.10-2P: By FY 2012, 68 percent of the RC Service members undergoing mobilization will have a dwell ratio of 1:5 or greater.	64.8%	60%	71.4%

Strategic Goal 5: Implement Reform Agenda.

The Department is on track to achieve four of seven key performance goals in other infrastructure areas, as reflected in Table 5. As of third quarter, the Department is on track to meet its mission assurance goal by having 90 percent of its information technology and National Security Systems certified and accredited (Strategic Objective 5.2-2C). In addition, the Department is exceeding its Perfect Order fulfillment goal in providing critical logistics support to forces abroad (Strategic Objective 5.4-2L), and as of third quarter, has met the FY 2011 goal to validate 9 percent of DoD's Fund Balance with Treasury (Strategic Objective 5.5-2U/V).

While the Department did not achieve its third quarter goal with regard to validating DoD appropriations received, this goal was subsequently met in August 2011 (Strategic Objective 5.5.1-2U), when the Army, Navy, and Air Force received unqualified opinions on their "Appropriations Received" audit readiness assertions based on Independent Public Accounting (IPA) firms' examinations. Specifically, the IPAs reported that the audit readiness assertions were fairly stated in all material respects. The Military Services continue to face significant challenges relative to overall audit readiness, as most business and financial legacy systems do not record all financial transactions at the transaction level and do not have the capability of system-to-system interface. In addition, supporting documentation for financial transactions is either not acceptable or not readily available to auditors; therefore, manual interfaces and "work-arounds" between systems are required to provide the entire transactions cycle from origination to financial reporting.

A U.S. Air Force F-22 Raptor fighter jet assigned to the 90th Fighter Squadron from Elmendorf Air Force Base, Alaska, approaches a KC-135 Stratotanker aircraft assigned to the 465th Air Refueling Squadron from Tinker Air Force Base, Okla., for aerial refueling.

(U.S. Air Force photo by Staff Sgt. Jacob N. Bailey)

While the Department is meeting its goal concerning Major Defense Acquisition Programs (MDAPs) cycle time (refer to Strategic Objective 5.3-2E), less progress has been made in the number of MDAP cost breaches and the percentage of contract obligations that are competitively awarded. By the third quarter, the Department had exceeded the projected number of MDAP cost breaches by 40 percent (from five to seven breaches) and is executing eight percent fewer competitively-awarded contracts than projected. Several events, including awards of legacy major weapon systems and Congressional Continuing Resolutions through April 2011, which fund Federal agencies when a formal appropriations bill has not been signed into law, adversely affected competition plans; however, the Department continues to stress the importance of competition through its policies such as the "Better Buying Power Initiative."

In addition, the Department is working to match requirements with mature technologies, maintain disciplined system engineering approaches, institutionalize rapid acquisition capabilities, and implement comprehensive testing. Several initiatives are underway to strengthen DoD's acquisition workforce, improve upfront cost estimates, prevent frequent changes in system requirements, and ensure proper contract oversight and program execution.

STRATEGIC GOAL 5: IMPLEMENT REFORM AGENDA				
Performance Measures	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2010 Results	**FY 2011 Goals**	**FY 2011 3 Qtr Results**
Strategic Objective 5.2-2C: Protect critical DoD infrastructure and partner with other critical infrastructure owners in government and the private sector to increase mission assurance.				
5.2.1-2C: Percent of applicable IT and National Security Systems (NSS) that are Certification and Accreditation (C&A)-compliant	5.2.1-2C: By FY 2013, 95 percent of applicable IT and National Security Systems (NSS) will be Certification and Accreditation (C&A) compliant.	90%	=/>90%	90%
Strategic Objective 5.3-2E: Improve acquisition processes, from requirements definition to the execution phase, to acquire military-unique and commercial items.				
5.3.1-2E: Number of Major Defense Acquisition Programs (MDAPs) breaches equal to or greater than 15 percent of current Acquisition Program Baseline (APB) unit cost or equal or greater than 30 percent of original APB unit cost	5.3.1-2E: Beginning in FY 2010, the DoD will ensure the number of breaches (significant cost overruns) for Major Defense Acquisition Programs (MDAPs) is equal to or less than the previous fiscal year.	8	</=5	7
5.3.2-2E: Percentage of contract obligations that are competitively awarded	5.3.2-2E: Beginning in FY 2010, the DoD will increase, by one percent annually, the amount of contract obligations that are competitively awarded.	62.5%	65%	56.7%
5.3.3-2E: Average percent increase from the Approved Program Baseline (APB) cycle time for Major Defense Acquisition Programs (MDAPs) starting in FY 2002 and after	5.3.3-2E: Beginning in FY 2011, the DoD will not increase by more than five percent from the Approved Program Baseline (APB) cycle time for Major Defense Acquisition Programs (MDAPs) starting in FY 2002 and after.	4.4%	</=5%	5%
Strategic Objective 5.4-2L: Provide more effective and efficient logistical support to forces abroad.				
5.4.1-2L: Perfect Order Fulfillment (POF) rate for Defense Logistics Agency (DLA) stock items	5.4.1-2L: Beginning in FY 2012, the DoD will maintain the DLA's (POF) rate for stock items at or above 85.4 percent.	84.8%	84.9%	86.1%

STRATEGIC GOAL 5: IMPLEMENT REFORM AGENDA				
Strategic Objective 5.5-2U/V: Improve financial management and increase efficiencies in headquarters and administrative functions, support activities, and other overhead accounts.				
5.5.1-2U: Percent of "Appropriations Received", as reported on DoD's Statement of Budgetary Resources, which are validated	5.5.1-2U: By FY 2013, 100 percent of "Appropriations Received," reported on DoD's Statement of Budgetary, will be reviewed, verified for accuracy, and validated or approved as audit-ready.	19%	80%	19%
5.5.2-2U: Percent of DoD Fund Balance with Treasury validated	5.5.2-2U: By FY 2016, 100 percent of DoD Fund Balance with Treasury will be validated as audit-ready.	9%	9%	9%

FINANCIAL PERFORMANCE

OVERVIEW

In FY 2011, the Department effectively invested over $688 billion in financial resources to meet the needs of the warfighter and the ever-changing battlefield. Our dedicated professional workforce of more than 60,000 financial management personnel, working with other DoD functional managers, accomplished this critical goal despite some daunting obstacles, including financing the war in Afghanistan, completing the military mission in Iraq, supporting operations in Libya, and maintaining a military that can meet future national security requirements. Their task was made much more difficult by late appropriations, especially the six-month continuing resolution that we experienced in FY 2011.

Although the Department cannot yet produce consolidated auditable financial statements, Defense financial managers maintained effective financial processes and controls in many areas. For example, DoD's payment processes continue to successfully ensure timely and accurate payments in a very high percentage of cases, including military and civilian payroll disbursement with a greater than 99 percent degree of accuracy. We have greatly reduced the number of abnormal balances beneath the appropriation detail level. In 2005, the Department had over 3,200 such abnormal balances; as of 2011, we've reduced these conditions by 99 percent to just 40 cases. The hands-free payment processing of invoices, receiving reports, contracts and modifications through the legacy systems increased from 18 percent in FY 2009 to 38 percent as of September 2011.

The Department is committed to attaining audit readiness by September 30, 2017, as mandated by Congress. In October 2011, Secretary Panetta directed the Under Secretary of Defense (Comptroller)/Chief Financial Officer (USD(C)/CFO)) to provide a revised plan, before the end of calendar year 2011, that accelerates audit readiness for the Statement of Budgetary Resources by the end of 2014, well before the Congressionally-mandated date of 2017.

Over the past year, the Department pursued its plan to meet audit goals. In August 2009, the Department instituted a new approach to audit readiness that emphasizes improvements in the quality, accuracy, and reliability of the information we use every day to manage the Department; specifically, budgetary information and existence and completeness of mission-critical assets. The budgetary information is critical to leadership at all levels, as people make operational and resource allocation decisions. Improving budgetary information will lead to audit readiness for the Department's Statements of Budgetary Resources (SBR). We also are focusing on the accuracy in the numbers and locations of our mission-critical assets. The financial audit elements of "existence and completeness" translate directly into knowing "what we have" and "where it is," so it is available for use when needed, and to ensure that our acquisition organizations are buying only what the Department needs.

We already have seen significant progress in implementing this new strategy. For example, Independent Public Auditors recently examined and issued unqualified opinions on the Army, Navy, and Air Force assertions of audit readiness for "Appropriations Received," a key

Aircraft carrier USS Ronald Reagan.

U.S. Navy photo by Petty Officer 3rd Class Dylan McCord

element in the SBR. The Department has sustained unqualified audit opinions on the financial statements of the U.S. Army Corps of Engineers (Civil Works), Defense Contract Audit Agency, Defense Commissary Agency, Defense Finance and Accounting Service, Office of the Inspector General (OIG), and the Military Retirement Fund. The Defense Information Systems Agency's FY 2011 Working Capital Fund financial statements are under audit. In addition, the U.S. Marine Corps (USMC), the first Military Component to undergo an audit of its SBR, is making significant progress. The audits of the USMC's SBR in FYs 2010 and 2011 are providing important "lessons learned" to the other Military Services.

At the same time, it is clear that major challenges remain, particularly the challenge of moving the Military Services toward auditability and resolving enterprise-wide weaknesses in DoD's financial management, which demand an enterprise-wide business response. These challenges are especially complex considering DoD's geographical dispersion and enormous size. Every business day, we obligate an average of $2 billion to $3 billion and handle hundreds of thousands of payment transactions in thousands of locations worldwide, including war zones. Given our size and mission requirements, we are not able to deploy the vast numbers of accountants that would be required to reconcile our books manually.

We recognize that the Department's policies and systems used to prepare its consolidated financial statements does not always allow for the achievement of reliable information. The

Financial Improvement and Audit Readiness Plan Status Report details the Department's financial improvement priorities, milestones, and measures of success that apply to the preparation of the financial statements, detail the planned improvements in the process, and provide an estimate of when each financial statement will convey reliable information.

We are committed to improving defense financial management as part of our overall commitment to providing the financial resources and business operations necessary to meet our national security objectives. Toward that end, we have developed a workable and promising partnership with the Deputy Chief Management Officer and her staff that will help with implementing necessary changes. The Department's new, focused approach to financial improvement and audit readiness has put us on the path to auditability.

Limitations of the FY 2011 Financial Statements

The Department's FY 2011 financial statements are presented in the Financial Information section of this report. The DoD management is responsible for the integrity of the financial information presented in these financial statements. At this time, management cannot provide reasonable assurance of effective internal management controls over financial reporting; however, DoD's financial improvement initiatives and systems modernization efforts continue to demonstrate progress. The Department's leadership is committed to improving internal controls and safeguarding the resources entrusted to us.

Financial Highlights and Analysis

For FY 2011, the financial statements for seven of the 33 reporting entities within the Department received unqualified audit opinions (see Figure 1-9).

Financial Analysis

The Defense Finance and Accounting Service (DFAS) prepared the accompanying consolidated financial statements to report the financial position and operational results for the Department. The statements were prepared from the books and records of the Department in accordance with U.S. generally accepted accounting principles (USGAAP), when possible, the *OMB Circular No. A-136*, entitled "Financial Reporting Requirements," and the *DoD Financial Management Regulation*.

Figure 1-9. Audit Opinions

DoD Reporting Entity	Audit Opinions
U.S. Army Corps of Engineers	Unqualified
Military Retirement Fund	Unqualified
Defense Commissary Agency	Unqualified
Defense Finance and Accounting Service	Unqualified
Defense Contract Audit Agency	Unqualified
Office of the Inspector General	Unqualified
TRICARE Management Activity – Contract Resource Mgmt	Unqualified

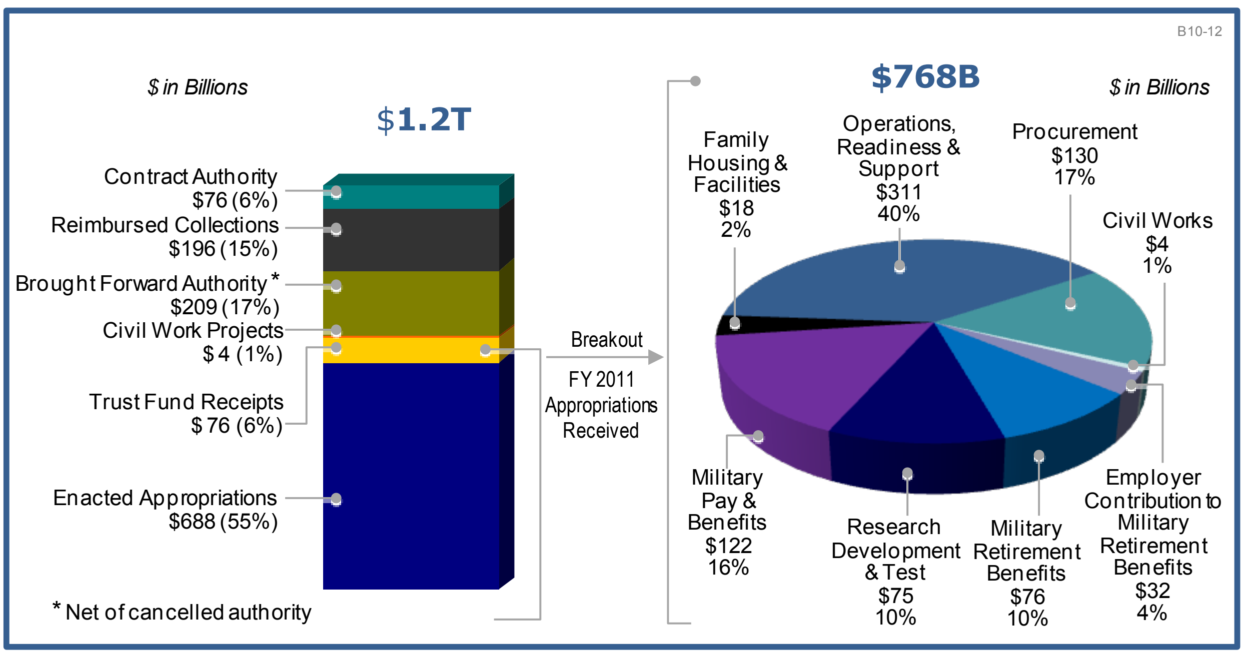
The financial statements have been prepared to report DoD's financial position and results of operations, and include the:

- Statement of Budgetary Resources
- Statement of Net Cost
- Balance Sheet
- Statement of Changes in Net Position

Budgetary Resources. In accordance with Federal statutes and implementing regulations, obligations may be incurred and payments made only to the extent that budgetary resources are available to cover such items. The Statement of Budgetary Resources presents the DoD's total budgetary resources, their status at the end of the year, and the relationship between the budgetary resources and the outlays made against them.

The Department's FY 2011 enacted appropriations total $688 billion, as depicted in Figure 1-6 in the Resources section of this report. The Department also received resources from the U.S. Treasury for retirement and health benefits and appropriations in support of civil work projects executed by the U.S. Army Corps of Engineers. In total, the Department received $768 billion in FY 2011 resources, as shown in Figure 1-10. Additional budgetary resources for the year include $209 billion (net of FY 2011 cancelled authority) for outstanding requirements carried forward from FY 2010, $196 billion in collections related to

Figure 1-10. FY 2011 Total Budgetary Resources



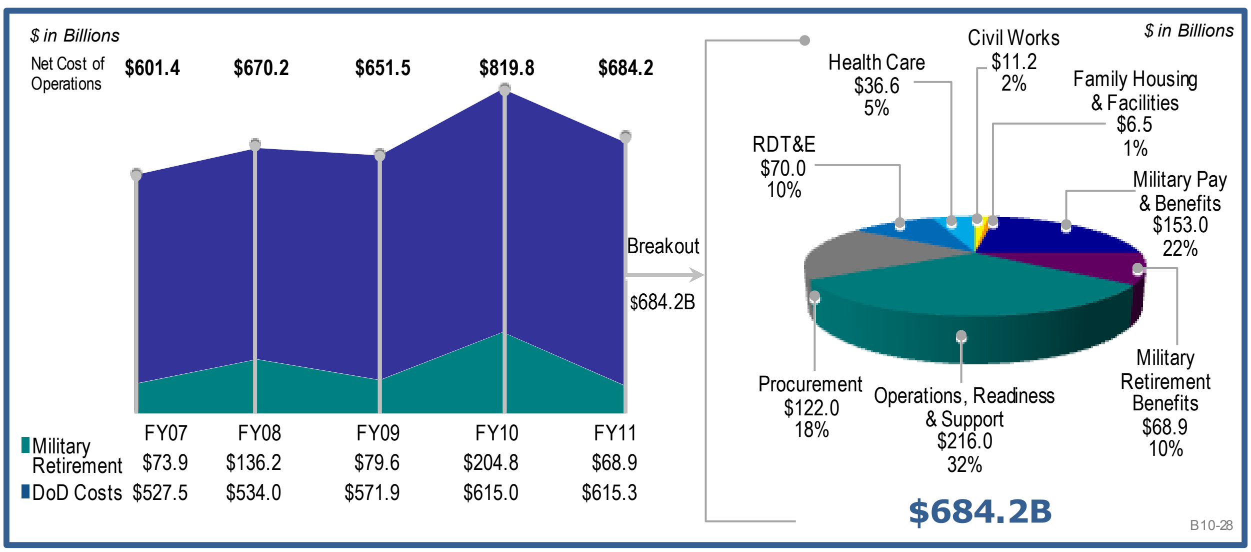
reimbursed activity, and $76 billion in contract authority. In total, the Department had $1.2 trillion in available budgetary resources.

Of the $1.2 trillion in total budgetary resources, $1.069 trillion were obligated and $1.017 trillion of obligations were disbursed. The remaining balance of unobligated budgetary resources relates to appropriations that are available to cover multi-year modernization projects, which require additional time to procure. Additionally, appropriations that are expired for purposes of new obligations must still remain available for valid upward adjustments to prior year obligations.

The Department obligated much of its FY 2011 resources to maintain readiness to conduct missions abroad as well as to modernize and recapitalize equipment that greatly improve combat capabilities. In addition, the Department used resources to responsibly draw down the military forces in Iraq. In Afghanistan, U.S. forces worked with Afghan Security Forces and international partners to build a country that will not be a safe haven for terrorists.

Net Cost of Operations. The Statement of Net Cost presents the net cost of all the Department's programs, including military retirement benefits. The statement reports total expenses incurred less the revenues earned from external sources to finance those expenses. Generally, the resulting balance of net cost is equivalent to the outlays reported on the Statement of Budgetary Resources, plus accrued liabilities, less the assets purchased and capitalized on the balance sheet. Differences between outlays of budgetary resources and net cost generally arise from the timing of expense recognition.

Figure 1-11. FY 2011 Net Cost of Operations



The Department's costs incurred relate primarily to operations, readiness, and support activities and military personnel cost. These costs were offset with investment earnings and contributions to support retirement and health benefit requirements, as well as earnings from reimbursed activities. This activity resulted in $684.2 billion in net costs of operations during the fiscal year.

As depicted in Figure 1-11, the $684.2 billion represents a $135.6 billion decrease (17 percent) since FY 2010. The change is largely attributable to the $130.5 billion reduction in the losses realized due to changes in the discount rate and demographic assumptions used to calculate the military retiree health benefits. During FY 2011, the Department implemented *SFFAS No. 33*, Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates, which reduced the actuarial liability and significantly impacted the net cost.

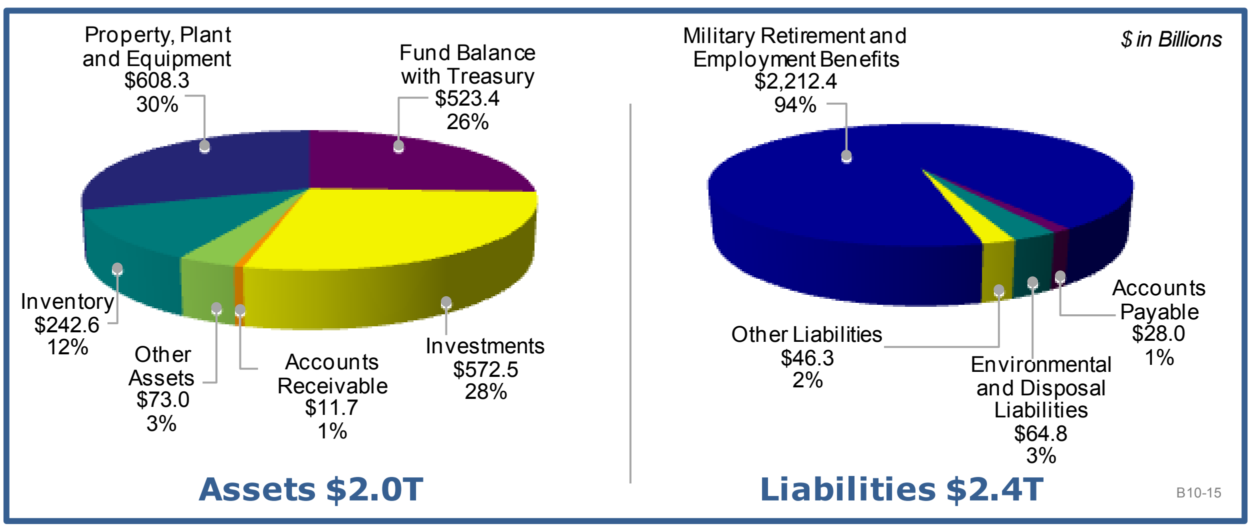
Figure 1-12. Net Assets and Liabilities

Balance Sheet		
		$ in Billions
Total Assets	$	2,031.5
Total Liabilities	$	2,351.5
Total Net Position	**$**	**(320.0)**

Balance Sheet. The Balance Sheet, which reflects the Department's financial condition as of September 30, 2011 (Figure 1-12), reports the DoD's resources (Assets), the amounts owed requiring use of assets available (Liabilities), and the difference between them (Net Position).

The $2.0 trillion in assets shown in (Figure 1-13) represents amounts the Department owns and manages. Fund Balance with Treasury, Investments, and General Property, Plant, and Equipment represent 84 percent of the Department's assets. General Property, Plant, and Equipment is largely comprised of military equipment, buildings, structures, and general equipment used to support the department's mission requirements.

Figure 1-13. Assets and Liabilities



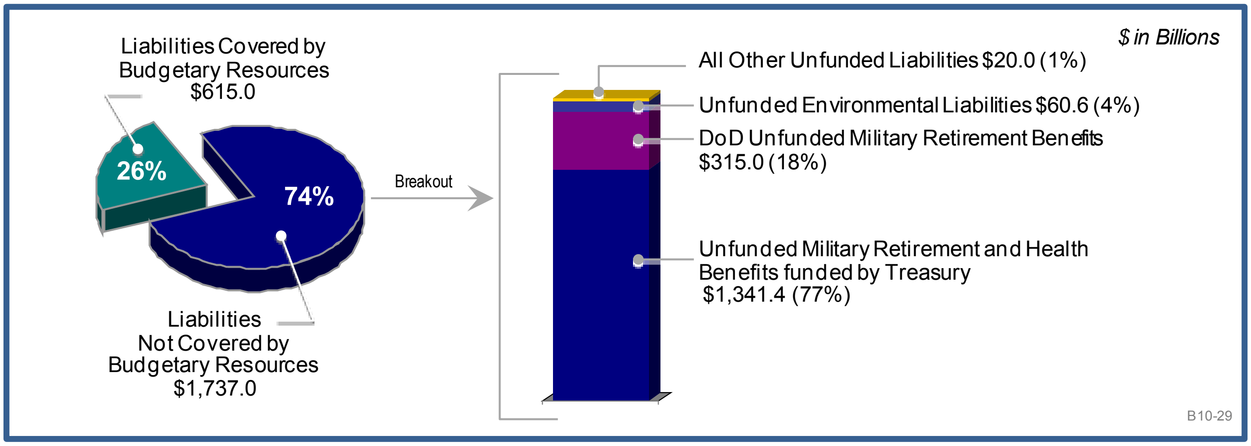
Assets increased $115.6 billion (6 percent) since FY 2010, largely due to increases in Investments in U.S. Treasury securities and General Property, Plant, and Equipment.

The $72.9 billion net increase in investments relate to the requirement to cover the expected normal growth of future military retirement and health benefits. Funds that are not needed to cover current benefits are invested in U. S. Treasury Securities. Under the Department's current strategy, invested balances will continue growing to cover the unfunded portions of future benefits.

The $27.0 billion increase in the Department's General Property, Plant, and Equipment is largely the result of the ongoing efforts to validate existence and completeness, and improve the valuation of its assets. In addition, the Department acquired additional Military Equipment to improve combat capabilities.

The Department's liabilities increased $29.1 billion (1 percent) primarily from growth in actuarial liabilities (Figure 1-14) related to the military retirement pension. The Department is confident in its ability to meet its financial obligations for the $2.4 trillion in liabilities it currently has. The U.S. Treasury is responsible for funding the actuarial liability that existed at the inception of the Military Retirement and Health programs, approximately $1.3 trillion (77 percent) of the total liabilities not covered by budgetary resources. Additionally, the Department has resources to cover approximately $615.0 billion (26 percent) of the remaining liabilities, including funds currently invested in U.S. Treasury securities to cover future military retirement pension and health care benefits. Figure 1-14 identifies the major categories of unfunded liabilities that will require future resources.

Figure 1-14. Unfunded Liabilities



SUMMARY

Although the financial statements are not auditable for FY 2011, the Department's financial managers are meeting warfighter needs for resources and financial services. The Department continues to resolve its financial management challenges by moving away from "stove-piped" financial and accounting systems and toward end-to-end business processes that cross multiple disciplines. The Department's top priority is to achieve audit readiness of the Statement of Budgetary Resources (SBR). Focusing on the financial information people use to manage and make day to day decisions, DoD can lay the groundwork for the broad business management requirements necessary for financial reform. This approach improves business operations, the quality and integrity of financial information, and ultimately allows DoD's financial statements to be reliable and auditable.

MANAGEMENT ASSURANCES

DEPUTY SECRETARY OF DEFENSE
1010 DEFENSE PENTAGON
WASHINGTON, DC 20301-1010

The leadership of the Department of Defense is responsible for establishing and maintaining effective internal controls and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA), the Federal Financial Management Improvement Act (FFMIA), and the Office of Management and Budget's (OMB) Circular A-127, "Financial Management Systems." The Department continues to focus on strengthening the Managers' Internal Control Program, not only to meet these objectives but to exceed them.

This past fiscal year, the Department conducted onsite validations of select internal control programs. The purpose of the validations was to determine the strength of the programs and to ensure there was a concerted effort to encourage risk-based self-reporting. The independent review team used benchmarks for validating the Components' internal control programs and provided suggested improvements.

The Department conducted its assessment of the effectiveness of internal controls over operations in accordance with OMB Circular A-123. Based upon the results of this assessment, the Department can provide qualified assurance that its internal controls over the effectiveness and efficiency of operations and compliance with applicable laws and regulations achieved the objectives of the FMFIA as of September 30, 2011. Details of the material weaknesses identified are available in Addendum A, Other Accompanying Information, of this report.

The Department conducted its assessment of the effectiveness of internal controls over financial reporting in accordance with OMB Circular A-123, Appendix A. This assessment determined that, while the Department continues to achieve measurable progress, it cannot provide reasonable assurance that internal controls over financial reporting were effective as of June 30, 2011. Related to this financial reporting weakness, as of September 30, 2011, the Department's financial systems are not in compliance with the FFMIA and OMB Circular A-127. Details of the material weaknesses also are available in Addendum A.

Improvements in the Department's financial processes remain the focus of the Department's Financial Improvement and Audit Readiness initiative and systems modernization efforts. We remain fully committed to developing a culture centered on an effective control environment for two principal reasons. The first is to ensure that America's Service members have the resources they need to carry out the mission of defending the United States. The second is to satisfy the Department's duty as a steward of the resources entrusted to it.

Ashton B. Carter

NOV 15 2011

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

MANAGERS' INTERNAL CONTROL PROGRAM

The Department is entrusted with great resources and even greater responsibilities in our mission to protect the American people and advance our Nation's interests. Federal managers play a key role in assuring that high standards of business and ethical practices permeate the organization and that effective internal controls are in place to ensure mission success, accurate financial reporting, and legal and regulatory compliance.

Effective internal controls are the foundation of an organizational framework predicated on accuracy and accountability. The Department is responsible for establishing, maintaining, and assessing internal controls in order to provide reasonable insurance that it meets the objectives of the *Federal Managers' Financial Integrity Act* (FMFIA), PL 97-255, sections 2 and 4; the *Federal Financial Management Improvement Act* (FFMIA), PL 104-208; and the *Office of Management and Budget's Circular (OMB) No. A-127* "Financial Management Systems."

The *OMB Circular No. A-123*, "Management's Responsibility for Internal Control in the Federal Government," requires agencies and individual Federal managers to take systematic and proactive measures to:

- Develop and implement appropriate, cost-effective internal controls,
- Assess the adequacy of internal controls in Federal programs and operations,
- Assess and document internal controls over financial reporting and financial management systems,
- Identify deficiencies and necessary improvements,
- Take corresponding corrective actions, and
- Report annually on internal controls through management assurance statements.

The Department developed and has oversight of a Managers' Internal Control Program (MICP), led by the OUSD (Comptroller) (OUSD(C)), to adhere to the responsibilities and requirements described above. The MICP is led by the Financial Improvement and Audit Readiness (FIAR) Directorate. Under this program, the OUSD(C) provides instructions, guidance, training, and annual conferences to:

- Share knowledge and insight to the Components on how to effectively execute an internal control program,
- Enhance the Department's knowledge and understanding of its audit readiness goals and priorities, and
- Disseminate best practices and lessons learned.

ACCOMPLISHMENTS

The following examples reflect just a few of the many improvements brought about through enhanced communication and improvement of the MICP along with monitoring and instituting strong and effective controls:

An F-22 Raptor aircraft, foreground, and a T-38 Talon aircraft taxi on the flight line as they arrive at Joint Base Langley-Eustis, Va., April 1, 2011. The T-38 is temporarily assigned to the 1st Fighter Wing to support combat readiness training.

(U.S. Air Force photo by Senior Airman Brian Ybarbo/Released)

- Communication. Established a blog and monthly conference calls to open critical dialogue within and outside the FM community to share information and facilitate an understanding of the Department's FY 2017 audit readiness goals, along with discussing successes and impediments within internal control programs.
- Aircraft Efficiencies. Reassigned (rather than retired) the T-38 Talon adversary trainers when the Lockheed F-117 Nighthawk retired from service in 2008, based on reviewing the aircraft use opportunities. The Air Force's decision to retain and reassign its fleet to train with the Lockheed F-22 Raptors resulted in approximately $72,000 in savings per flying hour.
- Onsite Validations. Assessed selected Components' internal control programs to identify best practices for Department-wide dissemination and evaluate the strength of the program's self-reporting of internal control weaknesses, prioritization of risk, and timely communication of issues to leadership.
- Army Banking Program. Streamlined business practices to increase the use of Stored Value Cards and Electronic Funds Transfers, decreasing the amount of US Dollar cash shipments into theater from an annual average of $1.9 billion to approximately $17 million and reducing the amount of US cash held in theatre from $272 million to $123 million. These changes immediately improved the Department's ability to track payments, reduced opportunities for illicit or terrorist financing, improved force protection, and improved the host countries' economy and banking infrastructure.
- Realigned Efforts. Merged the MICP and FIAR programs to align resources, improve effectiveness and efficiencies in the Internal Control Over Financial Reporting (ICOFR) reporting process, eliminate redundancies, and facilitate compliance with OMB Circular A-123, Appendix A.
- Government Purchase Card. Utilized preventive and detective controls over the Government Purchase Card to increase the use of mandated supply sources to 99 percent, resulting in lower cost to the government and streamlined processing of transactions.

- Lease Payment Reduction. Used controls to monitor vacancy rates at a leased property in the District of Washington resulted in the Air Force identifying high vacancy rates, leading directly to a negotiated lease-back agreement with the property owner and potential savings of approximately $40 million.
- Recovery of Funds. During 2011, an enterprise level project with the Army and several other Components found that funds recovered by the Courts and Department of Justice were being forwarded to DFAS without a case identifier, resulting in the funds placed in a suspense account pending further review. On average, unidentifiable funds remained in the suspense account for an average of 912 days before being resolved. The project established strong controls through a tracking mechanism from case creation through the Court to DFAS. To date, the project has returned over $14 million in funds to Army commands, collected $44 million in canceled funds from another court settlement, and DFAS has resolved over $92 million in the suspense accounts.

ASSESSMENT

The Department's management uses the following criteria to classify conditions as material weaknesses:

- Merits the attention of the Executive Office of the President and the relevant Congressional oversight committees;
- Impairs fulfillment of essential operations or mission;
- Significantly weakens established safeguards against waste, loss, unauthorized use or misappropriation of funds, property, other assets, or conflicts of interest;
- Constitutes substantial noncompliance with laws and regulations; or
- Nonconformance with government-wide, financial management system requirements.

Individual Component assurance statements serve as the primary basis for the Deputy Secretary's assurance statements. Information gathered from various sources including, but not limited to management initiated internal control testing, program reviews, and evaluations, are the basis for the assurance statements. In addition, the DoD OIG and the Government Accountability Office (GAO) conduct reviews, audits, inspections, and investigations, which are considered in the individual Component's assurance statements and provide the foundation for their individual assessments.

The Department has effective processes in many key areas. As a result, there has been significant progress toward improving both financial and operation internal controls; however, it remains clear that the most daunting of challenges remain ahead, and that more emphasis on effective and efficient operations are critical. In the upcoming fiscal year, the Department will continue to provide best practices and facilitate more validation assessments in order to meet the challenge.

In FY 2012, the Department plans to:

- Continue onsite validations;

- Develop and distribute a best practices guide for the development and implementation of risk assessments and assessable unit identifications; and
- Conduct evaluations to continue to improve on the successes of the past performance of the program.

MATERIAL WEAKNESSES

Listed in Figure 1-15 below is a summary of the outstanding material weakness for FY 2011. Additional details related to the material weaknesses reported in the table, such as corrective action plans and timelines, are included in Addendum A, "Managers' Internal Control Program" section of this report.

Figure 1-15. Department of Defense Outstanding Material Weaknesses FY 2011

	Areas of Material Weakness	Number of Material Weaknesses	Year Identified	Component	Target Correction Year
1	Financial Reporting	18	FY 2001	Department-wide	FY 2017
2	Financial Management Systems	1	FY 2001	Department-wide	FY 2017
3	Major Systems Acquisition	1	FY 2011	Department-wide	Reassessed annually based on incremental improvements
4	Communications, Intelligence and/or Security	4	FY 2006	OSD; Navy; Air Force; USAFRICOM	FY 2013
5	Comptroller and/or Resource Management	2	FY 2011	Department-wide	FY 2017
6	Contract Administration	1	FY 2006	Department-wide	Reassessed annually based on incremental improvements
7	Force Readiness	2	FY 2011	Air Force	FY 2012
8	Personnel and/or Organizational Management	3	FY 2009	Department-wide	FY 2014
9	Property Management	1	FY 2010	Department-wide	Reassessed annually based on incremental improvements
10	Supply Operations	1	FY 2011	Department-wide	Reassessed annually based on incremental improvements
	Total Material Weaknesses	**34**			

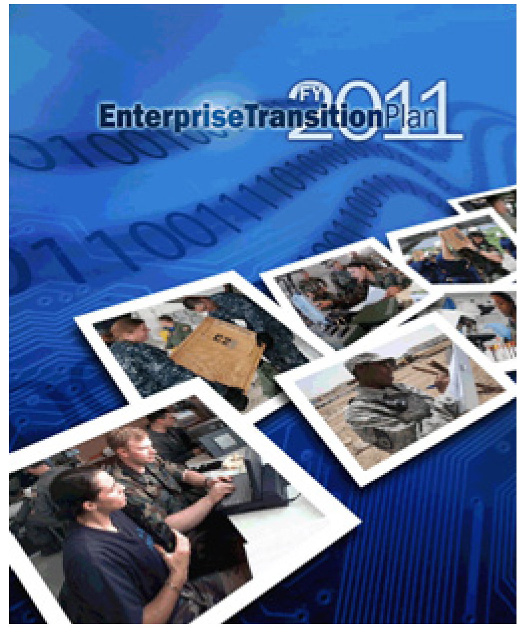
FINANCIAL MANAGEMENT SYSTEMS

The Department of Defense recognizes that improving its business systems, particularly its financial management systems, is an important component to successfully meeting its goal of achieving and sustaining auditable financial statements. Our goal is to deliver a streamlined, 21st-century systems environment comprised of Information Technology capabilities that seamlessly work together to support effective and efficient business processes and operations. Our current business environment does not always meet these objectives. Many of our systems are old and handle or exchange information in ways that do not readily support current audit standards. The systems were designed decades ago to meet budgetary rather than proprietary accounting standards, and they tend to be non-standard and sometimes do not include strong financial controls. Many of the legacy systems also do not record data at the transaction level, a capability essential to audit success.

To improve our financial systems, we have oriented them around end-to-end business processes that support audit goals, including Procure-to-Pay, Budget-to-Report, Order-to-Cash, Hire-to-Retire, Plan-to-Stock, and Acquire-to-Retire. Using this framework of end-to-end business processes, rather than an organizationally or functionally stovepiped approach, ensures that we think about our business in a holistic way, recognizing the connections and dependencies that each individual business area has on the others. Each of our end-to-end processes have been identified and documented in our Business Enterprise Architecture, which we are using to guide and constrain our investments in Defense Business Systems (DBS). These DBS include investments in new, modern systems, such as Enterprise Resource Planning (ERP) systems, include modernizing legacy systems, when necessary and supported by a business case, and aggressively sunsetting legacy systems that are obsolete, redundant, or not aligned with our business processes. This last point is critical, as it means replacing systems that do not support commercial audit standards with those that will enable Military Services and Defense Agencies to meet clean audit goals. This also will minimize the number of required data exchanges and system-to-system interfaces, thus reducing the potential for error, increasing the degree of process standardization, increasing process efficiency, and providing greater visibility of accurate financial information to make informed timely business decisions.

The Department also has taken steps to improve its acquisition process for DBS by streamlining the process and speeding delivery of capability to the users through incremental delivery. These important revisions were formally established as DoD policy on June 23, 2011, when the Principal Deputy Under Secretary of Defense for Acquisition, Technology & Logistics issued *Directive-Type Memorandum 11-009*, "Acquisition Policy for Defense Business Systems." These revisions will be included in an update to DoD's standard acquisition process for IT systems, DoD Instruction 5000.02, "Operation of the Defense Acquisition System," for IT systems. In addition to improving acquisition policy, the Department is working to improve specific acquisition outcomes of its business Major Automated Information System (MAIS) programs through more rigorous acquisition oversight and investment review. The Department is tying business outcomes to acquisition milestones and specifically requiring that individual programs, such as Army's General Fund Enterprise Business System and the Navy's ERP, define the role that they play in their organization's auditability efforts and end-to-end processes. Additional MAIS programs that are important to DoD audit efforts are the Air Force's Defense Enterprise Accounting and Management System and the Defense Agencies Initiative.

Improved systems alone, however, will not eliminate our weaknesses or guarantee auditable statements. Achieving auditability requires that we apply a consistent level of process controls that cross organizations and functional areas. Business and financial information that is passed from system to system also must be subject to a control environment to ensure that only authorized personnel are using the system, protect data quality and integrity, and maintain a compliant audit trail within the end-to-end business process. Controls within each process should begin at the transaction level and flow from source documents to general ledger postings, to produce accurate trial balances for proper period closeouts. Only by completing these steps can we prepare financial statements that an auditor can cost-effectively review and verify.



Additional information about the Department's DBS, including the plans for acquiring new systems and modernizing or retiring legacy systems, can be found in the statutorily mandated *Enterprise Transition Plan*.

MANAGEMENT CHALLENGES

The Office of Inspector General works to promote efficiency, effectiveness, and integrity in the programs and operations of the Department. The Reports Consolidation Act of 2000 requires the Inspector General (IG) summarize what he believes to be the most serious management and performance challenges facing the Department along with a brief assessment of the Department's progress in addressing these challenges.

A U.S. Air Force Major, an Inspector General team member, takes notes during a major accident response exercise at Keesler Air Force Base, Biloxi, Mississippi, Oct. 26, 2010. During the exercise a C-130J Super Hercules aircraft made a hard landing, lost engine power and crashed into a six-passenger van, coming to rest on the triangle track north of Alho Manor. The scenario also included a spill from chemicals on the aircraft, hydraulic fluid and JP-8 fuel.

(U.S. Air Force photo by Kemberly Groue/Released)

This year, the IG removed the previously-cited management challenge related to the American Recovery and Reinvestment Act (ARRA), often referred to as "The Recovery Act," based on the Department's performance and progress in addressing this challenge.

The IG identified the following management and performance challenges, which were previously cited in FY 2010:

- Financial Management
- Acquisition Processes and Contract Management
- Joint Warfighting and Readiness
- Information Assurance, Security, and Privacy
- Health Care
- Equipping and Training Iraq and Afghan Security Forces
- Nuclear Enterprise

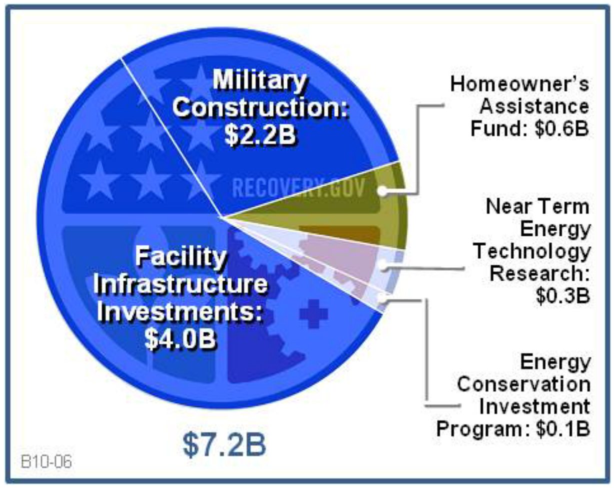
Detailed information regarding these challenges, along with the Department's management response, is included in the Other Accompanying Information (Addendum A) section of this report. The IG-identified challenges are in addition to those identified in the Government Accountability Office report, entitled "*High-Risk Series, An Update*," issued February 2011.

OTHER MANAGEMENT INFORMATION AND INITIATIVES

AMERICAN RECOVERY AND REINVESTMENT ACT

On February 17, 2009, the Congress passed the American Recovery and Reinvestment Act (ARRA), commonly known as "The Recovery Act," and appropriated $7.4 billion to the Department for military construction, facility repair, energy efficiency investments, near-term energy research, and assistance to certain military members and civilians, who experienced financial losses during the U.S. housing market downturn. In addition, the U.S. Army Corps of Engineers (USACE) received $4.6 billion for its civil works program, separate from DoD's $7.4 billion in ARRA funds.

Figure 1-16. Recovery Act Funds for the Department of Defense



In Public Law 111-226, the Congress rescinded $0.26 billion of the $7.4 billion appropriated ARRA funds, reducing DoD's Recovery Act funding to $7.2 billion (Figure 1-16). The purpose of the DoD ARRA investments was to preserve and create American jobs, care for U.S. Service members and their families, and improve the Department's energy efficiency.

As of September 30, 2011, the Department obligated $6.8 billion (95 percent) and disbursed $5.1 billion (72 percent) of the $7.2 billion (Figure 1-17) in authorized ARRA funds that accounted for over 4,500 projects at over 400 sites. The contract bidding climate was very competitive, resulting in $480 million in savings that the Department used to award over 330 additional construction and maintenance projects. Figure 1-17 describes the breakout of obligation and disbursements by major programs. Funds for Military Construction and Energy Conservation Investment Projects are available for obligation until FY 2013. The DoD OIG received $15 million in budget authority, which is included in the $4 billion of budget authority reported in Figure 1-17 for Facilities Sustainment, Restoration, and Modernization. The DoD OIG's obligations and expenditures as of September 30, 2011,

Figure 1-17. ARRA Program Obligations and Expenditures

PROGRAM	For Period Ended September 30, 2011		
Dollars in Billions	Authority	Obligations	Expenditures
Facilities Sustainment, Restoration, and Modernization	$ 4.01	$ 3.97	$ 3.47
Military Construction	$ 2.18	$ 1.86	$ 0.76
Energy Conservation Investment	$ 0.12	$ 0.12	$ 0.08
Near Term Energy-Efficient Technologies	$ 0.30	$ 0.29	$ 0.26
Home Owners Assistance Program	$ 0.56	$ 0.56	$ 0.56
TOTAL	**$ 7.17**	**$ 6.80**	**$ 5.13**

which are reported separately per ARRA requirements and therefore are not included in the respective columns above, are $14.9 million and $14.9 million, respectively.

For details regarding the Department's recovery act implementation and accountability, refer to the DoD website at *http://www.defense.gov/recovery*.

Financial Flexibility for Warfighters

The experience of war has taught us that new, unanticipated enemy weapons and tactics will emerge in times of conflict. In the traditional risk areas of cost, schedule, and performance, "schedule" often becomes the least acceptable risk. The speed at which something can be fielded, even if it is only a mitigating capability, is often the most relevant factor in reducing the Commander's operational risk and maintaining the tactical advantage.

The Department recognized the need for agility, for a flexible structure capable of quickly identifying emerging joint urgent operational needs (JUONS) and to rapidly adjust program and budgetary priorities to fill those needs within a tactically relevant timeframe. In June 2011, the Secretary established the Senior Integration Group (SIG), with the authority to prioritize and direct actions and resources to fill all JUONS. The SIG has successfully exercised available financial flexibilities to provide our forces with the best force protection, command and control, counter improvised explosive devices (IED), and intelligence, surveillance and reconnaissance (ISR) capabilities available.

U.S. Sailors drive a mine-resistant, ambush-protected vehicle during an individual augmentee combat training course at Joint Base McGuire-Dix-Lakehurst, N.J.

(U.S. Mass Communication Specialist 3rd Class Jonathan Chandler/Released)

Among the most responsive financial flexibilities available to the Department are the accounts appropriated for the Joint Improvised Explosive Device Defeat Fund, the Mine-Resistant, Ambush-Protected Vehicle Fund, and the Commander's Emergency Response Program. For urgent needs outside the scope of these appropriations, the Department exercises additional authorities granted by Congress, such as the Rapid Acquisition Authority provided under Public Law 108-375, entitled the "*Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005*." In FY 2011, the Secretary delegated "Rapid Acquisition Authority" to senior officials in the military services, enabling them to immediately execute six urgent projects. Among these was a forward Operating Base Counter Sniper System, "Boomerang," that gives early warning of sniper activity and enables our forces to rapidly engage and effectively counter enemy action. Using Rapid Acquisition Authority, funds were made immediately available and a contract executed to field these systems within two weeks of the funding decision. In addition to these authorities, the Congress also authorized the use of Contingency Construction Authority to enable flexible use of military construction funds to build wartime facilities at combat outposts, forward operating bases, and airfields.

Even with these flexibilities, however, the Department remains heavily dependent upon the transfer authorities contained within the annual appropriations act to fund urgent operational needs. In 2011, the Department fully exercised the $4 billion Special Transfer Authority authorized by Congress in the appropriations act for FY 2011. This transfer authority, with prior approval by the congressional defense committees, allowed the department to fund and deliver multiple force protection, ISR and counter-IED capabilities. These latter capabilities include the Persistent Surveillance System, a family of tethered aerostats that provide sophisticated day and night camera systems which detect enemy activity and are deployed at coalition force forward operating bases throughout Afghanistan.

Financial Management Workforce Improvement Initiative

The Department has initiated a multi-year effort to ensure it meets DoD-wide civilian financial management workforce and lifecycle management needs. The DoD Civilian Strategic Human Capital Plan process, which will be applied across the Department's financial management civilian community, involves both manpower and job requirements analysis. As part of this effort, the Department will establish common competencies within each financial management occupation, develop career paths, and identify training and education requirements.

The DoD Components are developing and supporting a functional community human capital plan that will ensure the right number of skilled employees is in the right place at the right time to meet mission requirements. Elements of this human capital plan will develop and institute ideas that will enhance the professional development of the financial management staff and provide intern opportunities for junior staff, mentoring and coaching, and a one-stop DoD financial management website for all financial management professional development opportunities.

Members of the financial management workforce have the responsibility to hone their skills throughout their careers and to embrace a culture of continuous improvement. The civilian financial management workforce improvement plan, coupled with a well-developed and trained workforce, will improve cost estimating and financial analysis throughout the Department and enable the Department to pursue new systems and innovations with confidence.

Financial Improvement and Audit Readiness (FIAR) Initiative

The Department is aggressively working to improve its business and financial processes, controls, and systems to achieve financial statement audit readiness by September 30, 2017, as required by Congress. In October 2011, Secretary Panetta directed the USD(C)/CFO to provide a revised plan to achieve audit readiness for the Statement of Budgetary Resources by the end of 2014. Due to the size and complexity of the Department and its many challenges to becoming auditable, the DoD's strategy employs an incremental approach that focuses first on improving the information most often used to manage the Department: Budgetary and Mission Critical Asset information. The USD(C)/CFO established these two priorities, which were incorporated in the Department's FIAR Plan in 2009 and were approved, endorsed, and/or acknowledged by the Inspector General of the Department of Defense, OMB, GAO, and Congress.

The goals of the Department's FIAR Plan are to:

- Improve the accuracy, reliability, and usefulness of business and financial information used for decision making, and
- Achieve an unqualified audit opinion on the Department's financial statements.

The Department is committed to achieving these goals by September 30, 2017, and has taken the following significant steps to ensure success:

- Visible Leadership and Department-wide Audit Readiness Goal.
- Accountability and Incentives.
- Broader Functional Community Support and Participation.
- Senior Leadership Oversight and Involvement.
- Resources to Accomplish FIAR Goals and Objectives.

The FIAR Plan Status Report ("FIAR Report"), a semi-annual report prepared in accordance with Section 1003 of the NDAA for FY 2010, addresses the issues affecting the reliability of Department of Defense (DoD) financial statements. The FIAR Report also serves as the Department's annual Financial Management Improvement Plan, required by Section 1008(a) of the NDAA for FY 2002.

PATH FORWARD

These are challenging times for our Nation. For decades, American leadership has been unwavering and indispensible in a changing world. For more than 70 years, the United States has taken a proactive approach to confronting threats from abroad, in support of the primary responsibility of any Administration: To provide the security and safety of the American people. Doing so requires our government to deter and defeat threats at home and abroad; to build alliances and coalitions aimed at promoting common interests; and to help create a safer, more stable international environment. America's military continues to play a critical role in global security and securing our country. In this era of increasing global interdependence, there remains no substitute for American leadership.

Moreover, we remain a nation at war. Terrorists continue to learn and adapt, posing an ongoing threat to the security of the United States and to our allies and partners. Efforts to disrupt, dismantle, and defeat al Qaeda and its extremist affiliates continue around the world, with the epicenter rooted in Afghanistan and Pakistan. We are on a path towards a responsible transition in Afghanistan and completing the drawdown in Iraq, but these efforts

U.S. Army soldiers air assault from a CH-47 Chinook helicopter into a village inside Jowlzak valley in Afghanistan's Parwan province, Feb. 3, 2011. The soldiers, assigned to the 101st Division's Special Troop Battalion, Company A, and Afghan police searched the village while soldiers provided security and met with leaders.

U.S. Army photo by Spc. Scott Davis

continue to require our resources and place continued strain on our most precious asset – our people.

We must ensure that our military has what it needs to protect our national security at a time of considerable fiscal challenge in our country. We cannot choose between fiscal discipline and national security – they are inter-connected. Our growing national debt, if not addressed, will imperil our prosperity, hurt our credibility and influence around the world, and ultimately put our national security at risk. As the Nation takes steps to get its finances in order, defense spending will be part of the solution. Achieving savings based on sound national security policy will serve our Nation's interests and will also prove more enforceable and sustainable over the long-term.

A U.S. Army Sergeant assigned to the 86th Special Troops Battalion, 86th Infantry Brigade Combat Team, plays with an Afghan child while visiting Durani, Afghanistan, Nov. 1, 2010. Soldiers visited the village to dismantle an old Russian tank, which the villagers will sell for scrap metal to buy food to get through the winter.

U.S. Army photo by Spc. Kristina L. Gupton

Spending choices must be based on sound strategy and policy. In the past, such as after the Vietnam War, our Government applied cuts to defense across the board, resulting in a force that was undersized and underfunded relative to its missions and responsibilities. This approach historically has led to outcomes that weaken rather than strengthen our national security – and which ultimately cost our Nation more when it must quickly reconstitute to confront new threats. Going forward, the Department will ensure that reductions in defense spending are not pursued in a hasty, ill-conceived way that would undermine the military's ability to protect America and its vital interests around the globe.

In order to help defend and advance our national interests in the face of the fiscal challenges ahead, the Department will continue to balance resources and risks. To create and maintain the right mix of forces and military capabilities, the Department must make hard, strategy-informed choices. We must maintain a broad portfolio of military capabilities with maximum versatility across a wide spectrum of potential conflict, while at the same time ensuring that we do not break faith with our All-Volunteer Force and with their families. We have a volunteer force that is the heart of our military strength, and we must protect that volunteer force.

The Department's established priorities, along with both the FY 2011 and FY 2012 budgets, reflect the Secretary's consistent emphasis on ensuring the Department does everything possible to enable success in today's wars while preparing for a complex and uncertain future.

UNITED STATES DEPARTMENT OF DEFENSE

Agency Financial Report

November 2011

Financial Information

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER) / CFO

Message from the Chief Financial Officer

I am pleased to present the Fiscal Year 2011 Agency Financial Report for the Department of Defense. This report explains how the Department managed the billions of dollars in taxpayer funds that Congress appropriated for the common defense. The information contained here will help interested citizens understand Defense spending.

By all measures, Fiscal Year 2011 was a challenging year in Federal financial management, especially at the Department of Defense. While fighting two wars and operating what is perhaps the largest and most complex financial organization in the world, the Department also had to manage for more than six months without a regular budget and with other uncertainties. Thanks to the professionalism of our financial management workforce, America's troops were still paid on time, and they had the resources needed to carry out their missions.

We are proud of these accomplishments. At the same time, we join the Government Accountability Office and other observers in recognizing that Defense financial management has enterprise-wide weaknesses, including inadequate controls and old systems that have prevented us from achieving auditable statements.

Now we have made audit readiness a priority across the Department. As required by Congress, we are committed to attaining audit readiness by September 30, 2017. Well before that deadline – by the end of 2014 – we will achieve audit readiness for the Statement of Budgetary Resources for general funds, as directed by Secretary of Defense Leon Panetta. We are focusing especially on the financial information most important for managing, providing the resources necessary to improve financial management, including audit goals in the performance plans of senior executives, and bringing in independent auditors to evaluate our progress in specific areas.

This report shows how far we've come over the past year. It is also an opportunity to reiterate our commitment to effective and efficient management of taxpayer resources. As Secretary Panetta has said, "We must be accountable to the American people for what we spend, where we spend it, and with what result."

That is our pledge. As the Department's Chief Financial Officer, I am personally committed to fulfilling that goal with top-quality financial information that fully records our financial activities. This report documents our progress in Fiscal Year 2011.

Robert F. Hale
Under Secretary of Defense (Comptroller)/
Chief Financial Officer

November 15, 2011

FINANCIAL INFORMATION

INDEPENDENT AUDITOR'S REPORT

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202–4704

November 15, 2011

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/CHIEF FINANCIAL OFFICER, DOD

SUBJECT: Independent Auditor's Report on the DoD Agency-Wide FY 2011 and FY 2010 Basic Financial Statements (Report No. DODIG-2012-021)

We are providing the subject report to be published in the FY 2011 Agency Financial Report in conjunction with the DoD Agency-Wide FY 2011 and FY 2010 Basic Financial Statements provided to us in draft on November 1, 2011. The report includes our disclaimer of opinion on the financial statements and our required Report on Internal Control and Compliance With Laws and Regulations. We are issuing our disclaimer of opinion to accompany the DoD Agency-Wide FY 2011 and FY 2010 Basic Financial Statements, and therefore, this audit report should not be disseminated separately from those statements.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5868 (DSN 329-5868).

Patricia A. Marsh

Patricia A. Marsh, CPA
Assistant Inspector General
Financial Management and Reporting

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202–4704

November 15, 2011

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/CHIEF FINANCIAL OFFICER, DOD

SUBJECT: Independent Auditor's Report on the DoD Agency-Wide FY 2011 and FY 2010 Basic Financial Statements (Report No. DODIG-2012-021)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2011 and 2010, and the Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, Combined Statement of Budgetary Resources, and related notes for the fiscal years then ended. The financial statements are the responsibility of DoD management. DoD is also responsible for implementing effective internal control and for complying with laws and regulations.

We are unable to express an opinion on the DoD Agency-Wide FY 2011 and FY 2010 Basic Financial Statements because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the financial statements, we are including the required Report on Internal Control and Compliance With Laws and Regulations (Report). The Report is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of our work.

Disclaimer of Opinion on the Financial Statements

The Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, acknowledged to us that the DoD Agency-Wide FY 2011 and FY 2010 Basic Financial Statements would not substantially conform to accounting principles generally accepted in the United States of America (U.S. GAAP) and that DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2011. Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to performing only those audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. Accordingly, we did not perform auditing procedures required by the U.S. Government Accountability Office, "Government Auditing Standards," and Office of Management and Budget (OMB) Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended,[1] to determine whether material amounts on the financial statements were presented fairly.

[1] OMB Memorandum No. 09-33, Technical Amendments to OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," September 23, 2009.

Prior audits have identified, and DoD has acknowledged, the long-standing material internal control weaknesses identified in the Summary of Internal Control. These pervasive material weaknesses may affect the reliability of certain information contained in the Basic Financial Statements. Therefore, we are unable to express, and we do not express, an opinion on the Basic Financial Statements. Additionally, the purpose of the audit was not to express an opinion on Management's Discussion and Analysis, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information presented with the Basic Financial Statements. Accordingly, we express no opinion on that information.

As discussed in Note 26 of its FY 2011 Agency Financial Report, DoD restated its financial statements as of September 30, 2010, to correct errors in assets, gross costs, and net position. We did not withdraw our auditor's report on the FY 2010 financial statements because we issued a disclaimer of opinion on those statements.

Summary of Internal Control

In planning our work, we considered DoD internal control over financial reporting and compliance with applicable laws and regulations. We did this to determine our procedures for auditing the financial statements and to comply with OMB guidance, but our purpose was not to express an opinion on internal control.

Accordingly, we do not express an opinion on internal control over financial reporting and compliance with applicable laws and regulations. However, previously identified material weaknesses continued to exist in the following areas.

- Financial Management Systems
- Fund Balance with Treasury
- Accounts Receivable
- Inventory
- Operating Materials and Supplies
- General Property, Plant, and Equipment
- Government Property in Possession of Contractors
- Accounts Payable
- Environmental Liabilities
- Statement of Net Cost
- Intragovernmental Eliminations
- Accounting Entries
- Reconciliation of Net Cost of Operations to Budget

A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We determined that Contingent Legal Liabilities continues to be a significant deficiency.

Internal control work that we conducted as part of our prior audits would not necessarily disclose all material weaknesses and significant deficiencies. The Attachment offers additional details on previously identified material weaknesses. The DoD reported the above material weaknesses in its FY 2011 Agency Financial Report.

Summary of Compliance With Laws and Regulations

We limited our work to determining compliance with selected provisions of applicable laws and regulations related to financial reporting because management acknowledged that instances of noncompliance identified in prior audits continued to exist. The Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, acknowledged to us that DoD financial management systems do not substantially comply with Federal financial management system requirements, U.S. GAAP, and the U.S. Government Standard General Ledger at the transaction level. Therefore, we did not determine whether DoD complied with all applicable laws and regulations related to financial reporting. Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit, and accordingly, we do not express such an opinion. See the Attachment for additional details on compliance with laws and regulations.

Management's Responsibilities

Management is responsible for:

- preparing the financial statements in conformity with U.S. GAAP;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met; and
- complying with applicable laws and regulations.

We provided a draft of this report to the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, who provided technical comments that we have incorporated as appropriate.

Patricia A. Marsh

Patricia A. Marsh, CPA
Assistant Inspector General
Financial Management and Reporting

Attachment:
As stated

Report on Internal Control and Compliance With Laws and Regulations

Internal Control

Management is responsible for implementing and maintaining effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly; that the requirements of applicable laws and regulations are met; and that assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting. However, we have identified the following 13 material weaknesses and 1 significant deficiency, which could adversely affect DoD financial management operations.

Previously Identified Material Weaknesses

Management acknowledged that previously identified material weaknesses continued to exist in the following areas.

Financial Management Systems

Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, "Objectives of Federal Financial Reporting," requires financial management system controls that are adequate to ensure that transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and recorded in accordance with Federal accounting standards. SFFAC No. 1 also requires that financial management system controls ensure that assets are properly safeguarded to deter fraud, waste, and abuse and that performance measurement information is adequately supported.

The Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, acknowledged that DoD financial management and feeder systems do not substantially comply with Federal financial management system requirements. The DoD financial management and feeder systems were not designed to adequately support various material amounts on the financial statements. These systemic deficiencies in financial management and feeder systems and inadequate DoD business processes prevent DoD from collecting and reporting financial and performance information that is accurate, reliable, and timely.

Fund Balance With Treasury

Statement of Federal Financial Accounting Standards (SFFAS) No. 1, "Accounting for Selected Assets and Liabilities"; the Treasury Manual; and DOD Regulation 7000.14-R, "DoD Financial Management Regulation," require DoD to resolve financial and accounting inconsistencies to accurately report Fund Balance with Treasury. However, inconsistencies continue to exist related to in-transit disbursements, unmatched disbursements, negative unliquidated obligations, and unreconciled differences between U.S. Treasury records and DoD accounting records.

Attachment
Page 1 of 6

Accounts Receivable

According to SFFAS No. 1, Federal entities should recognize a receivable when they establish a claim to cash or other assets against other entities, based on either legal provisions or goods and services provided. DoD acknowledged that it was unable to accurately record, report, collect, and reconcile intragovernmental accounts receivable as well as accounts receivable due from the public.

Inventory

SFFAS No. 3, "Accounting for Inventory and Related Property," requires DoD to use historical cost, the latest acquisition cost (adjusted for holding gains and losses), or moving average cost for valuing inventory. However, DoD acknowledged that the existing inventory value for most activities was not reported in accordance with U.S. GAAP, and the Department's legacy systems do not maintain the historical cost data necessary to comply with SFFAS No. 3. Additionally, DoD did not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale as required by SFFAS No. 3.

Operating Materials and Supplies

SFFAS No. 3 states that Operating Materials and Supplies must be expensed when the items are consumed. DoD acknowledged that significant amounts of Operating Materials and Supplies were expensed when purchased instead of when consumed. In addition, DoD could not accurately report the value of operating materials and supplies, which allows the potential for a misstatement in financial reporting.

General Property, Plant, and Equipment

SFFAS No. 6, "Accounting for Property, Plant, and Equipment," requires DoD to record General Property, Plant, and Equipment (General PP&E) at acquisition cost; capitalize improvement costs; and recognize depreciation expense. However, the cost and depreciation of DoD General PP&E was not reliably reported because of: (1) an accounting requirement that classified Military Equipment as General PP&E (such costs were previously expensed); (2) a lack of supporting documentation for aged General PP&E items; and (3) a failure to integrate most legacy property and logistics systems with acquisition and financial systems. In addition, DoD property and logistics systems were not designed to capture acquisition cost and the cost of modifications and upgrades, or to calculate depreciation.

DoD acknowledged that it did not meet U.S. GAAP for the financial reporting of personal property, and the documentation for personal property was neither accurate nor reliable. In addition, DoD did not have adequate internal controls in place to provide reasonable assurance that real property assets were identified and properly reported in its financial reports. DoD also acknowledged that its inability to accurately report the value of military equipment increases the risk that the financial statements are materially misstated.

Government Property in Possession of Contractors

SFFAS No. 11, "Amendments to Accounting for Property, Plant, and Equipment," requires that property and equipment in the possession of a contractor for use in accomplishing a contract be considered Government property. Such property should be accounted for based on the nature of the item, regardless of who has possession. DoD acknowledged that it was unable to comply with these requirements for Government Property in Possession of Contractors. As a result, the value of DoD property and material in the possession of contractors was not reliably reported.

Accounts Payable

According to SFFAS No. 5, "Accounting for Liabilities of the Federal Government," an entity recognizes a liability when one party receives goods or services in return for a promise to provide money or other resources in the future. DoD acknowledged that it did not meet accounting standards for the financial reporting of public accounts payable. DoD cannot support its accounts payable balances because it lacks standard procedures for recording, reporting, and reconciling the amounts between the financial, accounting, and reporting systems.

Environmental Liabilities

DoD acknowledged that its internal controls for reporting environmental liabilities did not provide reasonable assurance that cleanup costs for all of its ongoing, inactive, closed, and disposal operations were identified, consistently estimated, and appropriately reported. In addition, guidance and audit trails for estimating environmental liabilities were insufficient, and the inventory of ranges and operational activities was incomplete. DoD also acknowledged uncertainty regarding the accounting estimates used to calculate the reported Environmental Liabilities.

Statement of Net Cost

SFFAC No. 2, "Entity and Display," requires the Statement of Net Cost to provide an understanding of the net costs of each organization and each program. In addition, the Statement of Net Cost is to provide gross and net cost information that can be related to the amounts of outputs and outcomes for the programs and organization. DoD acknowledged the following deficiencies related to the Statement of Net Cost:

- The amounts presented for General Funds may not report actual accrued costs.
- Although the funds were generally recorded on an accrual basis for Working Capital Funds, the systems did not always capture actual costs in a timely manner.
- The Statement of Net Cost is not presented by programs that align with major goals and outputs described in DoD's strategic and performance plans as required by the Government Performance and Results Act.
- Revenues and expenses were reported by appropriation categories because financial processes and systems do not collect costs in line with performance measures.

Intragovernmental Eliminations

DoD disclosed that it could not accurately identify most of its intragovernmental transactions by customer because its systems do not track the buyer and seller data needed to match related transactions. In addition, DoD was unable to fully reconcile intragovernmental transactions with all Federal partners. DoD acknowledged that its inability to reconcile most intragovernmental transactions resulted in adjustments that cannot be fully supported.

Accounting Entries

DoD acknowledged that it continued to enter material amounts of unsupported accounting entries in its financial management systems because of inadequacies in the systems. The unsupported accounting entries present a material uncertainty regarding the reliability of the financial statements.

Reconciliation of Net Cost of Operations to Budget

SFFAS No. 7, "Accounting for Revenue and Other Financing Sources," requires a reconciliation of proprietary and budgetary information to assist users in understanding the relationship between the net cost of operations and the budgetary resources obligated by the entity during the period. DoD acknowledged that it was unable to reconcile budgetary obligations to net costs without making unsupported adjustments. Specifically, budgetary data do not agree with proprietary expenses and capitalized assets.

Previously Identified Significant Deficiencies

As part of our financial-related audits, we noted the following significant deficiency that continued to exist.

Contingent Legal Liabilities

SFFAS No. 5, as amended by SFFAS No. 12, "Recognition of Contingent Liabilities Arising from Litigation," requires contingent legal liabilities to be disclosed if there is at least a reasonable possibility that a loss may be incurred. We noted that significant deficiencies continued to exist relating to the DoD process for reporting contingent legal liabilities. For example:

- DoD excluded from its legal representation letters at least 114 pending cases, with a total claim amount of $5.6 billion that individually did not exceed the DoD Agency-wide individual reporting threshold, but in aggregate exceeded this threshold.
- The legal representation letters from the DoD Office of General Counsel showed that DoD General Counsel was unable to express an opinion on the likely outcome of 33 of the 44 pending legal actions, totaling $12.3 trillion.[2]

These financial management deficiencies may cause inaccurate management information. As a result, DoD management decisions based in whole or in part on this information may be adversely affected. Financial information reported by DoD may also contain misstatements resulting from these deficiencies.

[2] After our review of the legal representation letters, DoD Office of General Counsel sent us an e-mail stating that it was unable to express an opinion on the likely outcome of two additional pending legal actions totaling about $927.8 million. The two legal actions were not included in the final management schedule of information that was provided to us for our review.

Attachment
Page 4 of 6

Compliance With Laws and Regulations

Management is responsible for compliance with existing laws and regulations related to financial reporting. We limited our work to determining compliance with selected provisions of the applicable laws and regulations because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continued to exist. Therefore, we did not determine whether DoD complied with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on overall compliance with applicable laws and regulations.

Federal Financial Management Improvement Act of 1996

The Federal Financial Management Improvement Act of 1996 (FFMIA) requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. For FY 2011, DoD did not fully comply with FFMIA. DoD acknowledged that many of its critical financial management and feeder systems did not substantially comply with Federal financial management system requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2011.

Antideficiency Act

Section 1341, title 31, United States Code (31 U.S.C. § 1341 [1990]) limits DoD and its agents to making or authorizing only expenditures or obligations that do not exceed the available appropriations or funds. Additionally, DoD or its agents may not contract or obligate for the payment of money before an appropriation is made available for that contract or obligation unless otherwise authorized by law. As stated in 31 U.S.C § 1517 (2004), DoD and its agents are prohibited from making or authorizing expenditures of obligations exceeding an apportionment or the amount permitted by prescribed regulations. According to 31 U.S.C. § 1351 (2004), if an officer or employee of an executive agency violates the Antideficiency Act (ADA), the head of the agency must report immediately to the President and Congress all relevant facts and a statement of actions taken.

During FY 2011, DoD reported 16 cases of violation of ADA. Therefore, DoD did not comply with 31 U.S.C. § 1341 (1990) and 31 U.S.C § 1517 (2004).

DoD internal guidance limits the time from identification to reporting of ADA violations to 15 months. Nine investigations of potential ADA violations have been open for more than 15 months.

Audit Disclosures

The Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, acknowledged to us on April 18, 2011, that the DoD financial management and feeder systems could not provide adequate evidence supporting various material amounts on the financial statements and that previously identified material weaknesses continued to exist. Therefore, we did not perform detailed testing related to previously identified material weaknesses. In addition, we did not perform audit work related to these selected provisions of laws and regulations: Federal Credit Reform Act of 1990, Pay and Allowance System for Civilian Employees, Prompt Payment Act, Antideficiency Act, and Provisions Governing Claims of the United States Government (including provisions of the Debt Collection Improvement Act of 1996).

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance with laws and regulations because previous audit reports contained recommendations for corrective actions or because audit projects currently in progress will include appropriate recommendations.

PRINCIPAL FINANCIAL STATEMENTS AND NOTES

LIMITATIONS OF THE FINANCIAL STATEMENTS

The principal financial statements have been prepared to report the financial position and results of operations of the Department, pursuant to the requirements of 31 U.S.C. 3515(b). The statements are prepared from accounting records of the Department in accordance with *OMB Circular No. A-136* and, to the extent possible, U.S. generally accepted accounting principles (USGAAP). The statements, in addition to the financial reports, are used to monitor and control budgetary resources, which are prepared from the same records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

The financial statements of the Department include four principal statements listed in Figure 2-1.

The financial statements reflect the aggregate financial posture of the Department and include both the proprietary (federal accounting standards) and budgetary resources of the Department. The Department is large and complex with an asset base of $2.0 trillion, and more than 3 million military and civilian employees on installations in every state and around the world.

Figure 2-1. Four Principal Financial Statements

Statement	What Information It Provides
Balance Sheet	Reflects the Department's financial position as of the statement date (September 30, 2011). The assets are the amount of future economic benefits owned or managed by the Department. The liabilities are amounts owed by the Department. The net position is the difference between the assets and liabilities.
Statement of Net Cost	Shows separately the components of the net cost of the Department's operations for the period. Net cost is equal to the gross cost incurred by the Department less any exchange revenue earned from it's activities.
Statement of Changes in Net Position	Presents the sum of the cumulative results of operations since inception and unexpended appropriations provided to the Department that remain unused at the end of the fiscal year. The statement focuses on how the net cost of operations is financed. The resulting financial position represents the difference between assets and liabilities as shown on the consolidated balance sheet.
Statement of Budgetary Resources	Provides information about how budgetary resources were made available as well as their status at the end of the period. It is the only financial statement exclusively derived from the Department's budgetary general ledger in accordance with budgetary accounting rules.

Department of Defense Consolidated Balance Sheet Agency Wide		Dollars in Millions
	2011 Consolidated	Restated 2010 Consolidated
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$ 523,441.6	$ 521,641.7
Investments (Note 4)	569,342.2	497,136.9
Accounts Receivable (Note 5)	1,726.9	1,249.2
Other Assets (Note 6)	1,760.3	1,874.7
Total Intragovernmental Assets	**$ 1,096,271.0**	**$ 1,021,902.5**
Cash and Other Monetary Assets (Note 7)	1,720.3	2,066.7
Accounts Receivable, Net (Note 5)	9,961.4	9,756.2
Loans Receivable (Note 8)	814.4	522.3
Inventory and Related Property, Net (Note 9)	242,582.0	232,234.3
General Property, Plant and Equipment, Net (Note 10)	608,292.8	581,255.8
Investments (Note 4)	3,185.0	2,489.7
Other Assets (Note 6)	68,669.5	65,635.1
Stewardship Property, Plant & Equipment (Note 10)		
TOTAL ASSETS	**$ 2,031,496.4**	**$ 1,915,862.6**
LIABILITIES (Note 11)		
Intragovernmental:		
Accounts Payable (Note 12)	$ 1,893.1	$ 1,754.5
Debt (Note 13)	783.4	518.3
Other Liabilities (Note 15)	14,231.7	13,781.4
Total Intragovernmental Liabilities	**$ 16,908.2**	**$ 16,054.2**
Accounts Payable (Note 12)	26,103.9	31,135.4
Military Retirement and Other Federal Employment Benefits (Note 17)	2,212,359.6	2,176,698.9
Environmental and Disposal Liabilities (Note 14)	64,823.1	62,902.2
Loan Guarantee Liability (Note 8)	13.9	19.8
Other Liabilities (Note 15)	31,308.1	35,563.5
Commitments & Contingencies (Note 16)		
TOTAL LIABILITIES	**$ 2,351,516.8**	**$ 2,322,374.0**
NET POSITION		
Unexpended Appropriations - Earmarked Funds (Note 23)	$ 134.6	$ 304.8
Unexpended Appropriations - Other Funds	541,194.6	528,499.8
Cumulative Results of Operations - Earmarked Funds	(1,430,273.8)	(1,440,006.0)
Cumulative Results of Operations - Other Funds	568,924.2	504,690.0
TOTAL NET POSITION	**$ (320,020.4)**	**$ (406,511.4)**
TOTAL LIABILITIES AND NET POSITION	**$ 2,031,496.4**	**$ 1,915,862.6**

The accompanying notes are an integral part of these financial statements.

Department of Defense Consolidated Statement of Net Cost Agency Wide		*Dollars in Millions*
	2011 Consolidated	**Restated 2010 Consolidated**
Program Costs		
Gross Costs	**$ 759,884.5**	**$ 718,947.7**
Military Retirement Benefits	57,033.8	56,741.5
Civil Works	13,530.1	13,300.4
Military Personnel	153,881.4	154,374.9
Operations, Readiness & Support	313,367.5	276,976.4
Procurement	128,572.8	124,567.7
Research, Development, Test & Evaluation	79,158.7	82,877.5
Family Housing & Military Construction	14,340.2	10,109.3
(Less: Earned Revenue)	(115,039.9)	(63,242.2)
Net Cost before Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	**$ 644,844.6**	**$ 655,705.5**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	39,308.7	164,089.0
Net Cost of Operations	**$ 684,153.3**	**$ 819,794.5**

The accompanying notes are an integral part of these financial statements.

Department of Defense Consolidated Statement of Changes in Net Position
Agency Wide

Dollars in Millions

	2011 Earmarked Funds	2011 All Other Funds	2011 Eliminations	2011 Consolidated	2010 Earmarked Funds	Restated 2010 All Other Funds	2010 Eliminations	Restated 2010 Consolidated
Cumulative Results Of Operations								
Beginning Balances	$ (1,338,741.2)	$ 417,826.0	$ 0.0	$ (920,915.2)	$ (1,252,265.5)	$ 385,526.0	$ 0.0	$ (866,739.5)
Prior Period Adjustments:								
Changes in accounting principles	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Corrections of errors	0.0	(14,400.8)	0.0	(14,400.8)	(276.3)	1,722.7	0.0	1,446.4
Beginning balances, as adjusted	**$ (1,338,741.2)**	**$ 403,425.2**	**$ 0.0**	**$ (935,316.0)**	**$ (1,252,541.8)**	**$ 387,248.7**	**$ 0.0**	**$ (865,293.1)**
Budgetary Financing Sources:								
Appropriations used	206.9	747,758.5	0.0	747,965.4	23.9	738,746.2	0.0	738,770.1
Nonexchange revenue	2,764.4	(24.3)	0.0	2,740.1	2,960.9	(15.0)	0.0	2,945.9
Donations and forfeitures of cash and cash equivalents	30.3	0.1	0.0	30.4	46.3	0.0	0.0	46.3
Transfers(in/out without reimbursement)	(874.8)	964.0	0.0	89.2	(780.1)	983.2	0.0	203.1
Other	(1.8)	0.0	0.0	(1.8)	1.4	(810.5)	0.0	(809.1)
Other Financing Sources (Non-Exchange)								
Donations and forfeitures of property	0.3	7.3	0.0	7.6	0.0	6.4	0.0	6.4
Transfers(in/out without reimbursement)	(71.7)	(75.7)	0.0	(147.4)	(244.3)	810.5	0.0	566.2
Imputed financing	2.2	19,698.3	14,076.6	5,623.9	0.6	18,507.2	12,911.6	5,596.2
Other	12.7	1,799.6	0.0	1,812.3	29.0	2,417.5	0.0	2,446.5
Total Financing Sources	**$ 2,068.5**	**$ 770,127.8**	**$ 14,076.6**	**$ 758,119.7**	**$ 2,037.7**	**$ 760,645.5**	**$ 12,911.6**	**$ 749,771.6**
Net Cost of Operations	(11,025.6)	709,255.5	14,076.6	684,153.3	88,237.1	744,467.9	12,910.5	819,794.5
Net Change	**$ 13,094.1**	**$ 60,872.3**	**$ 0.0**	**$ 73,966.4**	**$ (86,199.4)**	**$ 16,177.6**	**$ 1.1**	**$ (70,022.9)**
Cumulative Results of Operations	**$ (1,325,647.1)**	**$ 464,297.5**	**$ 0.0**	**$ (861,349.6)**	**$ (1,338,741.2**	**$ 403,426.3**	**$ 1.1**	**$ (935,316.0)**
Unexpended Appropriations								
Beginning Balances	325.2	528,479.4	0.0	528,804.6	5.6	504,339.3	0.0	504,344.9
Prior Period Adjustments:								
Correction of Error	0.0	0.0	0.0	0.0	0.0	(945.0)	0.0	(945.0)
Beginning balances, as adjusted	**$ 325.2**	**$ 528,479.4**	**$ 0.0**	**$ 528,804.6**	**$ 5.6**	**$ 503,394.3**	**$ 0.0**	**$ 503,399.9**
Budgetary Financing Sources:								
Appropriations received	16.5	775,450.0	0.0	775,466.5	323.2	775,081.9	0.0	775,405.1
Appropriations transferred (in/out)	0.0	(781.2)	0.0	(781.2)	20.2	608.6	0.0	628.8
Other adjustments	(0.2)	(14,195.1)	0.0	(14,195.3)	0.1	(11,859.2)	0.0	(11,859.1)
Appropriations used	(206.9)	(747,758.5)	0.0	(747,965.4)	(23.9)	(738,746.2)	0.0	(738,770.1)
Total Budgetary Financing Sources	**$ (190.6)**	**$ 12,715.2**	**$ 0.0**	**$ 12,524.6**	**$ 319.6**	**$ 25,085.1**	**$ 0.0**	**$ 25,404.7**
Unexpended Appropriations	**$ 134.6**	**$ 541,194.6**	**$ 0.0**	**$ 541,329.2**	**$ 325.2**	**$ 528,479.4**	**$ 0.0**	**$ 528,804.6**
Net Position	**$ (1,325,512.5)**	**$ 1,005,492.1**	**$ 0.0**	**$ (320,020.4)**	**$ (1,338,416.0)**	**$ 931,905.7**	**$ 1.1**	**$ (406,511.4)**

The accompanying notes are an integral part of these financial statements.

Department of Defense Combined Statement Of Budgetary Resources Agency Wide Page 1 of 2 *Dollars in Millions*	**Budgetary Financing Accounts 2011 Combined**	**Budgetary Financing Accounts Restated 2010 Combined**	**Nonbudgetary Financing Accounts 2011 Combined**	**Nonbudgetary Financing Accounts 2010 Combined**
Budgetary Resources				
Unobligated balance, brought forward, October 1	$ 160,032.1	$ 146,116.6	$ 24.9	$ 23.6
Recoveries of prior year unpaid obligations	56,015.4	54,701.2	0.0	0.0
Budget authority				
Appropriation	913,129.4	899,278.4	0.0	0.0
Borrowing authority	0.0	0.0	229.8	26.8
Contract authority	75,760.9	73,059.7	0.0	0.0
Spending authority from offsetting collections				
Earned:				
Collected	189,639.2	184,468.6	102.6	69.6
Change in receivables from federal sources	2,113.5	(350.9)	0.1	0.0
Change in unfilled customer orders:				
Advance received	385.0	(81.9)	0.0	0.0
Without advance from federal sources	3,304.0	2,415.7	2.5	(34.9)
Expenditure transfers from trust funds	881.9	851.0	0.0	0.0
Subtotal	**$ 1,185,213.9**	**$ 1,159,640.6**	**$ 335.0**	**$ 61.5**
Nonexpenditure transfers, net, anticipated and actual	(604.8)	803.3	0.0	0.0
Temporarily not available pursuant to Public Law	(75,282.7)	(60,328.7)	0.0	0.0
Permanently not available	(93,883.2)	(87,872.7)	(16.9)	(13.9)
Total Budgetary Resources	**$ 1,231,490.7**	**$ 1,213,060.3**	**$ 343.0**	**$ 71.2**
Status of Budgetary Resources				
Obligations incurred:				
Direct	874,213.8	857,647.6	326.8	46.3
Reimbursable	195,004.4	195,380.6	0.0	0.0
Subtotal	**$ 1,069,218.2**	**$ 1,053,028.2**	**$ 326.8**	**$ 46.3**
Unobligated balance:				
Apportioned	137,148.5	137,738.3	0.1	24.8
Exempt from apportionment	4,180.4	6,106.9	0.0	0.0
Subtotal	**$ 141,328.9**	**$ 143,845.2**	**$ 0.1**	**$ 24.8**
Unobligated balance not available	20,943.6	16,186.9	16.1	0.1
Total status of budgetary resources	**$ 1,231,490.7**	**$ 1,213,060.3**	**$ 343.0**	**$ 71.2**

The accompanying notes are an integral part of these financial statements.

Department of Defense Combined Statement of Budgetary Resources Agency Wide Page 2 of 2 *Dollars in Millions*	**Budgetary Financing Accounts**		**Nonbudgetary Financing Accounts**	
	2011 Combined	**Restated 2010 Combined**	**2011 Combined**	**2010 Combined**
Change in Obligated Balance:				
Obligated balance, net				
Unpaid obligations, brought forward, October 1	458,620.6	453,958.7	619.4	770.4
Less: Uncollected customer payments from federal sources, brought forward, October 1	(69,766.8)	(67,702.3)	(97.3)	(132.2)
Total unpaid obligated balance	**$ 388,853.8**	**$ 386,256.4**	**$ 522.1**	**$ 638.2**
Obligations incurred net	1,069,218.2	1,053,028.2	326.8	46.3
Less: Gross outlays	(1,016,898.9)	(993,664.7)	(375.3)	(197.3)
Less: Recoveries of prior year unpaid obligations, actual	(56,015.1)	(54,701.2)	0.0	0.0
Change in uncollected customer payments from federal sources	(5,417.5	(2,064.7)	(2.6)	34.9
Obligated balance, net, end of period				
Unpaid obligations	454,924.8	458,621.0	570.9	619.4
Less: Uncollected customer payments from federal sources	(75,184.3)	(69,767.0)	(99.9)	(97.3)
Total, unpaid obligated balance, net, end of period	**$ 379,740.5**	**$ 388,854.0**	**$ 471.0**	**$ 522.1**
Net Outlays				
Net Outlays:				
Gross outlays	1,016,898.9	993,664.7	375.3	197.3
Less: Offsetting collections	(190,906.1)	(185,237.8)	(102.6)	(69.6)
Less: Distributed offsetting receipts	(83,198.6)	(77,722.2)	0.0	0.0
Net Outlays	**$ 742,794.2**	**$ 730,704.7**	**$ 272.7**	**$ 127.7**

The accompanying notes are an integral part of these financial statements.

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

1.A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations of the Department of Defense (DoD), as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the Department in accordance with, to the extent possible, U.S. generally accepted accounting principles (USGAAP) promulgated by the Federal Accounting Standards Advisory Board; the Office of Management and Budget (OMB) Circular No. A-136, Financial Reporting Requirements; and the *DoD Financial Management Regulation* (DoD FMR). The accompanying financial statements account for all resources for which the Department is responsible unless otherwise noted. Information relative to classified assets, programs, and operations is excluded from the statements or otherwise aggregated and reported in such a manner that it is not discernable.

The Department is unable to fully implement all elements of USGAAP and OMB Circular No. A-136, due to limitations of financial and nonfinancial management processes and systems that support the financial statements. The Department derives reported values and information for major asset and liability categories largely from nonfinancial systems, such as inventory and logistics systems. These systems were designed to support reporting requirements for maintaining accountability over assets and reporting the status of federal appropriations rather than preparing financial statements in accordance with USGAAP. The Department continues to implement process and system improvements addressing these limitations.

The Department has 13 auditor-identified material weaknesses: (1) Financial Management Systems; (2) Fund Balance with Treasury; (3) Accounts Receivable; (4) Inventory; (5) Operating Materials [sic] and Supplies; (6) General Property, Plant, and Equipment; (7) Government-Furnished Materials and Contractor-Acquired Materials; (8) Accounts Payable; (9) Environmental Liabilities; (10) Statement of Net Cost; (11) Intragovernmental Eliminations; (12) Other Accounting Entries; and (13) Reconciliation of Net Cost of Operations to Budget.

1.B. Mission of the Reporting Entity

The Department was established by the National Security Act of 1947. The Department provides the military forces needed to deter war and protect the security of our country. Since the creation of America's first army in 1775, the Department and predecessor organizations have evolved into a global presence with a worldwide infrastructure dedicated to defending the United States by deterring and defeating aggression and coercion in critical regions.

The Department includes the Military Departments and the Defense Agencies. The Military Departments consist of the Army, the Navy (of which the Marine Corps is a component), and the Air Force. The Defense Agencies provide support services commonly used throughout the Department.

1.C. Appropriations and Funds

The Department receives appropriations and funds as general, working capital (revolving), trust, special, and deposit funds. The Department uses these appropriations and funds to execute missions and subsequently report on resource usage.

General Funds are used for financial transactions funded by congressional appropriations, including personnel, operation and maintenance, research and development, procurement, and military construction. These general funds also include supplemental funds enacted by the American Recovery and Reinvestment Act (Recovery Act) of 2009. Details relating to Recovery Act appropriated funds are available on line at *DoD Information Related to the American Recovery and Reinvestment Act of 2009*.

Working Capital Funds (WCF) received funding to establish an initial corpus through an appropriation or a transfer of resources from existing appropriations or funds. The corpus finances operations and transactions that flow through the fund. The WCF resources the goods and services sold to customers on a reimbursable basis and maintains the corpus. Reimbursable receipts fund future operations and generally are available in their entirety for use without further congressional action. At various times, Congress provides additional appropriations to supplement WCF as an infusion of cash when revenues are inadequate to cover costs within the corpus.

Trust funds contain receipts and expenditures of funds held in trust by the government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute. Special fund accounts are used to record government receipts reserved for a specific purpose. Certain trust and special funds may be designated as earmarked funds. Earmarked funds are financed by specifically identified revenues, required by statute to be used for designated activities, benefits or purposes, and remain available over time. The Department is required to separately account for and report on the receipt, use and retention of revenues and other financing sources for earmarked funds.

Deposit funds are used to record amounts held temporarily until paid to the appropriate government or public entity. They are not Department funds, and as such, are not available for the Department's operations. The Department is acting as an agent or custodian for funds awaiting distribution.

The Department is a party to allocation transfers with other federal agencies as a transferring (parent) entity or receiving (child) entity. An allocation transfer is an entity's legal delegation of authority to obligate budget authority and outlay funds on its behalf. Generally, all financial activity related to allocation transfers (e.g., budget authority, obligations, outlays) is reported in the financial statements of the parent entity. Exceptions to this general rule apply to specific funds for which OMB has directed that all activity be reported in the financial statements of the child entity. These exceptions include U.S. Treasury-Managed Trust Funds, Executive Office of the President (EOP), and all other funds specifically designated by OMB. Based on an agreement with OMB, funds for Security Assistance programs are reported separately from the Department's financial statements and notes.

The Department receives allocation transfers from the following agencies: Departments of Agriculture, Interior, Energy, and Transportation; the Appalachian Regional Commission; and the Federal Highway Administration.

Additionally, the Department receives allocation transfers from certain funds meeting the OMB exception and all related activity is included in the Department's financial statements. The exceptions reported by the Department include South Dakota Terrestrial Wildlife Habitat Restoration, Inland Waterways and Harbor Maintenance, and the EOP other than funds executed by Defense Security Cooperation Agency for Security Assistance.

As a parent, the Department allocates funds to the Departments of Transportation and Agriculture, and reports all related activity in these financial statements.

1.D. Basis of Accounting

The Department's financial management systems are unable to meet all full accrual accounting requirements. Many of the Department's financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of USGAAP. These systems were not designed to collect and record financial information on the full accrual accounting basis as required by USGAAP. Most of the Department's financial and nonfinancial legacy systems were designed to record information on a budgetary basis.

The Department's financial statements and supporting trial balances are compiled from the underlying financial data and trial balances of the Military Services and Defense Agencies and their sub-entities. The underlying data is largely derived from budgetary transactions (obligations, disbursements, and collections), from nonfinancial feeder systems, and accruals made for major items such as payroll expenses, accounts payable, and environmental liabilities. Some of the sub-entity level trial balances may reflect known abnormal balances resulting largely from business and system processes. At the consolidated level, these abnormal balances may not be evident. Disclosures of abnormal balances are made in the applicable footnotes, but only to the extent that the abnormal balances are evident at the consolidated level.

The Department is determining the actions required to bring financial and nonfinancial feeder systems and processes into compliance with USGAAP. One such action is the current revision of accounting systems to record transactions based on the U.S. Standard General Ledger (USSGL). Until all of the Department's financial and nonfinancial feeder systems and processes are able to collect and report financial information as required by USGAAP, the Department's financial data will be derived from budgetary transactions, data from nonfinancial feeder systems, and accruals.

1.E. Revenues and Other Financing Sources

The Department receives congressional appropriations as financing sources for general funds that expire annually, on a multi-year basis, or do not expire. When authorized by legislation, these appropriations are supplemented by revenues generated by sales of goods or services. The Department recognizes revenue as a result of costs incurred for goods and services provided to other federal agencies and the public. Full-cost pricing is the Department's standard policy for services provided as required by *OMB Circular No. A-25*, User Charges. The Department recognizes revenue when earned within the constraints of its current system capabilities. In some instances, revenue is recognized when bills are issued.

Depot Maintenance and Ordnance WCF activities recognize revenue according to the percentage of completion method. Supply Management WCF activities recognize revenue from the sale of inventory items.

The Department does not include nonmonetary support provided by U.S. allies for common defense and mutual security in amounts reported in the Statement of Net Cost and Note 21, Reconciliation of Net Cost of Operations to Budget. The U.S. has cost sharing agreements with countries having a mutual or reciprocal defense agreement, where U.S. troops are stationed, or where the U.S. Fleet is in a port.

1.F. Recognition of Expenses

For financial reporting purposes, the Department's policy requires the recognition of operating expenses in the period incurred. Current financial and nonfinancial feeder systems were not designed to collect and record financial information on the full accrual accounting basis. Estimates are made for major items such as payroll expenses, accounts payable, environmental liabilities, and unbilled revenue. In the case of Operating Materiel and Supplies (OM&S), operating expenses are generally recognized when the items are purchased. Efforts are underway to transition to the consumption method for recognizing OM&S expenses. Under the consumption method, OM&S would be expensed when consumed. Due to system limitations, in some instances expenditures for capital and other long-term assets may be recognized as operating expenses. The Department continues to implement process and system improvements to address these limitations.

1.G. Accounting for Intragovernmental Activities

Accounting standards require that an entity eliminate intraentity activity and balances from consolidated financial statements in order to prevent overstatement for business with itself. However, the Department cannot accurately identify intragovernmental transactions by customer because the Department's systems do not track buyer and seller data at the transaction level. Generally, seller entities within the Department provide summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal accounting offices. In most cases, the buyer-side records are adjusted to agree with the Department's seller-side balances and are then eliminated. The Department is implementing replacement systems and a standard financial information structure which will incorporate the necessary elements that will enable the Department to correctly report, reconcile, and eliminate intragovernmental balances.

The Treasury Financial Manual Part 2 – Chapter 4700, "Agency Reporting Requirements for the Financial Report of the United States Government," provides guidance for reporting and reconciling intragovernmental balances. While the Department is unable to fully reconcile intragovernmental transactions with all federal agencies, the Department is able to reconcile balances pertaining to investments in federal securities, borrowings from the U.S. Treasury and the Federal Financing Bank, Federal Employees' Compensation Act transactions with the Department of Labor, and benefit program transactions with the Office of Personnel Management.

The Department's proportionate share of public debt and related expenses of the Federal government is not included. The Federal government does not apportion debt and related costs to federal agencies. The Department's financial statements do not report any public debt, interest, or source of public financing, whether from issuance of debt or tax revenues. Generally, financing for the construction of the Department's facilities is obtained through appropriations. To the extent this financing ultimately may have been obtained through the issuance of public debt, interest costs have not been capitalized since the U.S. Treasury does not allocate such costs to the Department.

1.H. Transactions with Foreign Governments and International Organizations

Each year, the Department sells defense articles and services to foreign governments and international organizations under the provisions of the Arms Export Control Act of 1976. Under the provisions of the Act, the Department has authority to sell defense articles and services to foreign countries and international organizations generally at no profit or loss to the Federal Government. Payment in U.S. dollars is required in advance.

1.I. Funds with the U.S. Treasury

The Department's monetary resources are maintained in U.S. Treasury accounts. The disbursing offices of Defense Finance and Accounting Service (DFAS), the Military Departments, the U.S. Army Corps of Engineers (USACE), and the Department of State's financial service centers process the majority of the Department's cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports to the U.S. Treasury on checks issued, electronic fund transfers, interagency transfers, and deposits.

In addition, DFAS sites and USACE Finance Center submit reports to the U.S. Treasury by appropriation on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records these transactions to the applicable Fund Balance with Treasury (FBWT) account. On a monthly basis, the Department's FBWT is adjusted to agree with the U.S. Treasury's accounts.

1.J. Cash and Other Monetary Assets

Cash is the total of cash resources under the control of the Department, which includes coin, paper currency, negotiable instruments, and amounts held for deposit in banks and other financial institutions. Foreign currency consists of the total U.S. dollar equivalent of both purchased and nonpurchased foreign currencies held in foreign currency fund accounts. Foreign currency is valued using the U.S. Treasury prevailing rate of exchange.

The majority of cash and all foreign currency is classified as "nonentity" and is restricted. Amounts reported consist primarily of cash and foreign currency held by disbursing officers to carry out their paying, collecting, and foreign currency accommodation exchange missions.

The Department conducts a significant portion of operations overseas. Congress established a special account to handle the gains and losses from foreign currency transactions for five general fund appropriations: (1) operations and maintenance; (2) military personnel;

(3) military construction; (4) family housing operation and maintenance; and (5) family housing construction. The gains and losses are calculated as the variance between the exchange rate current at the date of payment and a budget rate established at the beginning of each fiscal year. Foreign currency fluctuations related to other appropriations require adjustments to the original obligation amount at the time of payment. The Department does not separately identify foreign currency fluctuation transactions.

1.K. Accounts Receivable

Accounts receivable from other federal entities or the public include: accounts receivable, claims receivable, and refunds receivable. Allowances for uncollectible accounts due from the public are based upon an analysis of collection experience. The Department does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intragovernmental Business Rules published in the Treasury Financial Manual.

1.L. Direct Loans and Loan Guarantees

The Department operates a direct loan and loan guarantee program authorized by the *National Defense Authorization Act for FY 1996* (Public Law (PL) 104-106, Section 2801). The Act includes a series of authorities that allow the Department to work with the private sector to renovate military housing. The Department's goals are to obtain private capital to leverage government dollars, make efficient use of limited resources, and use a variety of private sector approaches to build and renovate military housing faster and at a lower cost to the American taxpayers.

The Act also provides the Department with a variety of authorities to obtain private sector financing and expertise to improve military housing. The Department uses these authorities individually or in combination. They include guarantees (both loan and rental), conveyance/leasing of existing property and facilities, differential lease payments, investments (both limited partnerships and stock/bond ownership), and direct loans.

The *National Defense Authorization Act for FY 2005* (PL 108-375, Section 2805) provided permanent authorities to the Military Housing Privatization Initiative (MHPI).

The Department operates the Armament Retooling and Manufacturing Support Initiative under Title 10 United States Code 4551-4555. This loan guarantee program is designed to encourage commercial use of inactive government facilities. The revenue generated from property rental offsets the cost of maintaining these facilities.

The Department administers the Foreign Military Financing program on behalf of the EOP. This program is authorized by sections 23 and 24 of the Arms Export Control Act of 1976, as amended, PL 90-629, as amended, and Section 503(a). This program provides loans to help countries purchase U.S. produced weapons, defense equipment, services, or military training. The direct loans and loan guarantees related to Foreign Military Sales are not included in these financial statements, per the Department's agreement with OMB; this information is provided separately as other accompanying information.

The Federal Credit Reform Act of 1990 governs all amended direct loan obligations and loan guarantee commitments made after FY 1991.

1.M. Inventories and Related Property

The Department values approximately 87 percent of resale inventory using the moving average cost method. An additional 9 percent (fuel inventory) is reported using the first-in-first-out method. The Department reports the remaining 4 percent of resale inventories at an approximation of historical cost using latest acquisition cost adjusted for holding gains and losses. The latest acquisition cost method is used because legacy inventory systems were designed for materiel management rather than accounting. Although these systems provide visibility and accountability over inventory items, they do not maintain historical cost data necessary to comply with Statement of Federal Financial Accounting Standards *(SFFAS) No. 3*, Accounting for Inventory and Related Property. Additionally, these systems cannot produce financial transactions using the USSGL, as required by the *Federal Financial Management Improvement Act of 1996 (PL 104-208)*. The Department is continuing to transition the balance of the inventories to the moving average cost method through the use of new inventory systems. Most transitioned balances, however, were not baselined to auditable historical cost and remain noncompliant with SFFAS No. 3.

The Department manages only military or government-specific materiel under normal conditions. Materiel is a unique term that relates to military force management, and includes items such as ships, tanks, self-propelled weapons, aircraft, etc., and related spares, repair parts, and support equipment. Items commonly used in and available from the commercial sector are not managed in the Department's materiel management activities. Operational cycles are irregular, and the military risks associated with stock-out positions have no commercial parallel. The Department holds materiel based on military need and support for contingencies. The Department is currently developing a methodology to be used to account for "inventory held for sale" and "inventory held in reserve for future sale."

Related property includes OM&S and stockpile materiel. The OM&S, including munitions not held for sale, are valued at standard purchase price. The Department uses both the consumption method and the purchase method of accounting for OM&S. Items that are centrally managed and stored, such as ammunition and engines, are generally recorded using the consumption method and are reported on the Balance Sheet as OM&S. When current systems cannot fully support the consumption method, the Department uses the purchase method. Under this method, materiel and supplies are expensed when purchased. During FY 2011 and FY 2010, the Department expensed significant amounts using the purchase method because the systems could not support the consumption method or management deemed that the item was in the hands of the end user. This is a material weakness for the Department and long-term system corrections are in process. Once the proper systems are in place, these items will be accounted for under the consumption method of accounting.

The Department determined that the recurring high dollar-value of OM&S in need of repair is material to the financial statements and requires a separate reporting category. Many high-dollar items, such as aircraft engines, are categorized as OM&S rather than military equipment.

The Department recognizes excess, obsolete, and unserviceable inventory and OM&S at a net realizable value of $0 pending development of an effective means of valuing such materiel.

Inventory available and purchased for resale includes consumable spare and repair parts, and repairable items owned and managed by the Department. This inventory is retained to support military or national contingencies. Inventory held for repair is damaged inventory that requires repair to make it suitable for sale. Often, it is more economical to repair these items rather than to procure them. The Department often relies on weapon systems and machinery no longer in production. As a result, the Department supports a process that encourages the repair and rebuilding of certain items. This repair cycle is essential to maintaining a ready, mobile, and armed military force. Work in process balances include: (1) costs related to the production or servicing of items, including direct material, labor, and applied overhead; (2) the value of finished products or completed services that are yet to be placed in service; and (3) munitions in production and depot maintenance work with associated costs incurred in the delivery of maintenance services.

1.N. Investments in U.S. Treasury Securities

The Department reports investments in U.S. Treasury securities at cost, net of amortized premiums or discounts. Premiums or discounts are amortized over the term of the investments using the effective interest rate method or another method that yields similar results. The Department's intent is to hold investments to maturity unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

The Department invests in nonmarketable, market-based U.S. Treasury securities, which are issued to federal agencies by the U. S. Treasury's Bureau of the Public Debt. They are not traded on any securities exchange but mirror the prices of particular U.S. Treasury securities traded in the government securities market.

The Department's net investments are held by various trust and special funds. These funds include the Military Retirement Fund; Medicare-Eligible Retiree Health Care Fund; Other Defense Organizations General Fund trust and special funds; donations (gift funds); and the U. S. Treasury managed trust funds reported by USACE including the South Dakota Terrestrial Habitat Restoration, Inland Waterways, and Harbor Maintenance Trust Funds.

Other investments represent joint ventures with private developers constructing or improving military housing on behalf of the Department under the authority of the MHPI, authorized by PL 104-106, Section 2801.

These investments do not require market value disclosure. The Department's potential losses on these ventures are limited to the amounts invested.

1.O. General Property, Plant and Equipment

The Department uses the estimated historical cost for valuing military equipment. The Department identified the universe of military equipment by accumulating information relating to program funding and associated military equipment, equipment useful life, program acquisitions, and disposals to establish a baseline. The military equipment baseline is updated using expenditure, acquisition, and disposal information.

The Department's General Property, Plant, and Equipment (PP&E) capitalization threshold is $100 thousand except for real property, which is $20 thousand. The Department has not fully implemented the threshold for real property; therefore, the Department is primarily using the capitalization threshold of $100 thousand for General PP&E, and most real property.

With the exception of USACE Civil Works and WCF, General PP&E assets are capitalized at historical acquisition cost when an asset has a useful life of two or more years and when the acquisition cost equals or exceeds the Department's capitalization threshold. The Department also requires the capitalization of improvements to existing General PP&E assets if the improvements equal or exceed the capitalization threshold and extend the useful life or increase the size, efficiency, or capacity of the asset. The Department depreciates all General PP&E, other than land, on a straight-line basis.

The WCFs capitalize all PP&E used in the performance of their mission. These assets are capitalized as General PP&E, whether or not they meet the definition of any other PP&E category.

The USACE Civil Works General PP&E is capitalized at acquisition cost plus capitalized improvements when an asset has a useful life of two or more years and the acquisition cost exceeds $25 thousand. The exception is buildings and structures related to hydropower projects, which are capitalized regardless of cost.

When it is in the best interest of the government, the Department provides government property to contractors to complete contract work. The Department either owns or leases such property, or it is purchased directly by the contractor for the government based on contract terms. When the value of contractor-procured General PP&E meets or exceeds the Department's capitalization threshold, federal accounting standards require that it be reported on the Department's Balance Sheet.

The Department developed policy and a reporting process for contractors with government furnished equipment that provides appropriate General PP&E information for financial statement reporting. The Department requires that entities maintain, in their property systems, information on all property furnished to contractors. These actions are structured to capture and report the information necessary for compliance with federal accounting standards. The Department has not fully implemented this policy primarily due to system limitations.

1.P. Advances and Prepayments

When advances are permitted by law, legislative action, or presidential authorization, the Department's policy is to record advances or prepayments in accordance with USGAAP. As such, payments made in advance of the receipt of goods and services should be reported as an asset on the Balance Sheet. The Department's policy is to expense and/or properly classify assets when the related goods and services are received. The Department has not fully implemented this policy primarily due to system limitations.

1.Q. Leases

Lease payments for the rental of equipment and operating facilities are classified as either capital or operating leases. When a lease is essentially equivalent to an installment purchase of property (a capital lease), and the value equals or exceeds the current capitalization threshold, the Department records the applicable asset as though purchased, with an offsetting liability, and depreciates it. The Department records the asset and liability at the lesser of the present value of the rental and other lease payments during the lease term (excluding portions representing executory costs paid to the lessor) or the asset's fair market value. The discount rate for the present value calculation is either the lessor's implicit interest rate or the government's incremental borrowing rate at the inception of the lease. The Department, as the lessee, receives the use and possession of leased property, for example real estate or equipment, from a lessor in exchange for a payment of funds. An operating lease does not substantially transfer all the benefits and risks of ownership. Payments for operating leases are expensed over the lease term as they become payable.

Office space and leases entered into by the Department are the largest component of operating leases and are based on costs gathered from existing leases, General Services Administration bills, and interservice support agreements. Future year projections use the Consumer Price Index.

1.R. Other Assets

Other assets include those assets, such as military and civil service employee pay advances, travel advances, and certain contract financing payments that are not reported elsewhere on the Department's Balance Sheet.

The Department conducts business with commercial contractors under two primary types of contracts: fixed price and cost reimbursable. To alleviate the potential financial burden on the contractor that long-term contracts can cause, the Department may provide financing payments. Contract financing payments are defined in the Federal Acquisition Regulation (FAR), Part 32, as authorized disbursements to a contractor prior to acceptance of supplies or services by the government. Contract financing payment clauses are incorporated in the contract terms and conditions and may include advance payments, performance-based payments, commercial advances and interim payments, progress payments based on cost, and interim payments under certain cost reimbursement contracts. It is the Department's policy to record certain contract financing payments as other assets. The Department has not fully implemented this policy primarily due to system limitations.

Contract financing payments do not include invoice payments, payments for partial deliveries, lease and rental payments, or progress payments based on a percentage or stage of completion. The Defense Federal Acquisition Regulation Supplement authorizes progress payments based on a percentage or stage of completion only for construction of real property, shipbuilding and ship conversion, alteration, or repair. Progress payments based on percentage or stage of completion are reported as Construction in Progress.

1.S. Contingencies and Other Liabilities

The SFFAS No. 5, Accounting for Liabilities of the Federal Government, as amended by SFFAS No. 12, Recognition of Contingent Liabilities Arising from Litigation, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. The Department recognizes contingent liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist, but there is at least a reasonable possibility of incurring a loss or additional losses. The Department's risk of loss and resultant contingent liabilities arise from pending or threatened litigation or claims and assessments due to events such as aircraft, ship and vehicle accidents; medical malpractice; property or environmental damages; and contract disputes.

Other liabilities also arise as a result of anticipated disposal costs for the Department's assets. Consistent with SFFAS No. 6, Accounting for Property, Plant, and Equipment, recognition of an anticipated environmental disposal liability begins when the asset is placed into service. Based on the Department's policy, which is consistent with SFFAS No. 5, Accounting for Liabilities of the Federal Government, nonenvironmental disposal liabilities are recognized when management decides to dispose of an asset. The Department recognizes nonenvironmental disposal liabilities for military equipment nuclear-powered assets when placed into service. These amounts are not easily distinguishable and are developed in conjunction with environmental disposal costs.

1.T. Accrued Leave

The Department reports liabilities for military leave and accrued compensatory and annual leave for civilians. Sick leave for civilians is expensed when taken. The liabilities are based on current pay rates.

1.U. Net Position

Net position consists of unexpended appropriations and cumulative results of operations.

Unexpended appropriations represent the amounts of budget authority that are unobligated and have not been rescinded or withdrawn. Unexpended appropriations also represent amounts obligated for which legal liabilities for payments have not been incurred.

Cumulative results of operations represent the net difference between expenses and losses, and financing sources (including appropriations, revenue, and gains) since inception. The cumulative results of operations also include donations and transfers in and out of assets that were not reimbursed.

1.V. Treaties for Use of Foreign Bases

The Department has the use of land, buildings, and other overseas facilities that are obtained through various international treaties and agreements negotiated by the Department of State. The Department purchases capital assets overseas with appropriated funds, however, the host country retains title to the land and capital improvements. Treaty terms generally allow the Department continued use of these properties until the treaties expire. In the event treaties or other agreements are terminated, use of the foreign bases is prohibited and losses are recorded for the value of any nonretrievable capital assets. The settlement due to the U.S. or host nation is negotiated and takes into account the value of capital investments and may be offset by the cost of environmental cleanup.

1.W. Undistributed Disbursements and Collections

Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to specific obligations, payables, or receivables in the source systems and those reported by the U.S. Treasury.

Supported disbursements and collections are evidenced by corroborating documentation. Unsupported disbursements and collections do not have supporting documentation for the transaction and most likely would not meet audit scrutiny.

The Department's policy is to allocate supported undistributed disbursements and collections between federal and nonfederal categories based on the percentage of distributed federal and nonfederal accounts payable and accounts receivable. Supported undistributed disbursements and collections are then applied to reduce accounts payable and receivable accordingly. Unsupported, undistributed disbursements are recorded as disbursements in transit and reduce nonfederal accounts payable. Unsupported, undistributed collections are recorded in nonfederal other liabilities.

1.X. Fiduciary Activities

Fiduciary cash and other assets are not assets of the Department and are not recognized on the balance sheet. Fiduciary activities are reported in the financial statement note schedules.

1.Y. Military Retirement and Other Federal Employment Benefits

The Department applies *SFFAS No. 33*, "Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates", in selecting the discount rate and valuation date used in estimating actuarial liabilities. In addition, gains and losses from changes in long-term assumptions used to estimate the actuarial liability are presented separately on the Statement of Net Cost. Refer to Note 17, Military Retirement and Other Federal Employment Benefits and Note 18, General Disclosures Related to the Statement of Net Cost, for additional information.

1.Z. Significant Events

None.

NOTE 2. NONENTITY ASSETS

Nonentity Assets *As of September 30*	2011		Restated 2010	
Intragovernmental Assets				
Fund Balance with Treasury	$	988.6	$	620.5
Accounts Receivable		0.0		0.5
Total Intragovernmental Assets	**$**	**988.6**	**$**	**621.0**
Nonfederal Assets				
Cash and Other Monetary Assets	$	1,643.2	$	2,001.0
Accounts Receivable		6,490.7		6,412.3
Other Assets		184.8		184.8
Total Nonfederal Assets	**$**	**8,318.7**	**$**	**8,598.1**
Total Nonentity Assets	**$**	**9,307.3**	**$**	**9,219.1**
Total Entity Assets	**$**	**2,022,189.1**	**$**	**1,906,643.5**
Total Assets	**$**	**2,031,496.4**	**$**	**1,915,862.6**

Dollars in Millions

Nonentity assets are assets for which the Department maintains stewardship accountability and reporting responsibility but are not available for the Department's normal operations.

Restatements

The Department corrected a $14.4 billion overstatement of General Property, Plant and Equipment to align the accounting records to the property accountability system. This is reflected in the Total Entity Assets balance. Refer to Note 26, Restatements, for further information.

Other Disclosures

Intragovernmental Fund Balance with Treasury (FBWT) consists of deposit funds. Deposit funds are generally used to record amounts held temporarily until paid to the appropriate party.

Intragovernmental Accounts Receivable consists of amounts associated with cancelled appropriations. Generally, the Department cannot use the collections related to cancelled appropriation and must return them to the U.S. Treasury.

Non-Federal Cash and Other Monetary Assets primarily consists of cash held by Disbursing Officers to carry out payment, collection, and foreign currency accommodation exchange missions.

Non-Federal Accounts Receivable consists of amounts due from canceled year appropriations; and interest, fines, and penalties due on debt. Generally, the Department cannot use the collections and must return them to the U.S. Treasury. Non-Federal Other Assets consists of an Advance Payment Pool Agreement with a nonprofit educational institution to finance research and development projects.

NOTE 3. FUND BALANCE WITH TREASURY

Fund Balance with Treasury		Dollars in Millions
As of September 30	**2011**	**2010**
Fund Balance		
Appropriated Funds	$ 509,337.0	$ 507,886.2
Revolving Funds	9,887.2	9,965.4
Trust Funds	2,494.4	2,400.9
Special Funds	697.7	716.3
Other Fund Types	1,025.3	672.9
Total Fund Balance	**$ 523,441.6**	**$ 521,641.7**
Fund Balance Per Treasury Versus Agency		
Fund Balance per Treasury	$ 530,849.7	$ 528,003.5
Fund Balance per Agency	523,441.6	521,641.7
Reconciling Amount	**$ 7,408.1**	**$ 6,361.8**

Other Fund Types primarily consists of deposit funds and receipt.

The Department shows a reconciling net difference of $7.4 billion with the U.S. Treasury. This includes canceling year authority of $6.5 billion, unavailable receipts of $599.7 million, and fiduciary activities of $234.9 million.

Status of Fund Balance with Treasury		Dollars in Millions
As of September 30	**2011**	**Restated 2010**
Unobligated Balances		
Available	$ 141,171.4	$ 143,816.8
Unavailable	583,913.4	503,114.4
Obligated Balance not yet Disbursed	455,495.4	459,240.3
Nonbudgetary FBWT	1,966.0	807.8
NonFBWT Budgetary Accounts	(659,104.6)	(585,337.6)
Total Fund Balance	**$ 523,441.6**	**$ 521,641.7**

Restatements

The Department corrected an $83.5 million understatement of Unobligated Balances: Apportioned due to improper recording of the liquidation of contract authority. This is reflected in the Unobligated Balances, Available and NonFBWT Budgetary Accounts balances. Refer to Note 26, Restatements, for further information.

Other Disclosures

The Status of Fund Balance with Treasury (FBWT) reflects the budgetary resources to support the FBWT and is a reconciliation between budgetary and proprietary accounts. It primarily consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current or future obligations.

Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. The unavailable balance consists primarily of funds invested in U.S. Treasury securities that are temporarily precluded from obligation by law. Certain unobligated balances are restricted for future use and are not apportioned for current use. Unobligated balances for trust fund accounts are restricted for use by the public law that established the funds.

Obligated Balance not yet Disbursed represents funds that have been obligated for goods and services not received and those received, but not paid.

Nonbudgetary FBWT includes accounts that do not have budgetary authority, such as deposit funds, unavailable receipt accounts, clearing accounts, and nonentity FBWT.

NonFBWT Budgetary Accounts reduces the Status of FBWT and consists of investments in U.S. Treasury securities, unfilled customer orders without advance, contract and borrowing authority, and receivables.

NOTE 4. INVESTMENTS AND RELATED INTEREST

Investments and Related Interest					*Dollars in Millions*
	2011				
As of September 30	Cost	Amortization Method	Amortized (Premium) / Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities					
Nonmarketable, Market-Based					
Military Retirement Fund	$ 376,420.2	See Below	$ (8,209.2)	$ 368,211.0	$ 432,741.4
Medicare-Eligible Retiree Health Care Fund	191,058.7	See Below	(5,136.4)	185,922.3	221,620.5
US Army Corps of Engineers	6,495.1	See Below	(37.3)	6,457.8	6,171.8
Other Funds	3,448.3	See Below	(57.9)	3,390.4	3,611.4
Total Nonmarketable, Market-Based	$ 577,422.3		$ (13,440.8)	$ 563,981.5	$ 664,145.1
Accrued Interest	5,360.7			5,360.7	5,360.7
Total Intragovernmental Securities	$ 582,783.0		$ (13,440.8)	$ 569,342.2	$ 669,505.8
Other Investments					
Total Other Investments	$ 3,185.0	See Below	$ 0.0	$ 3,185.0	N/A
Amortization Method Used: Effective Interest					

Investments and Related Interest					*Dollars in Millions*
	2010				
As of September 30	**Cost**	**Amortization Method**	**Amortized (Premium) / Discount**	**Investments, Net**	**Market Value Disclosure**
Intragovernmental Securities					
Nonmarketable, Market-Based					
Military Retirement Fund	$ 325,124.5	See Below	$ (6,559.6)	$ 318,564.9	$ 351,050.7
Medicare-Eligible Retiree Health Care Fund	168,568.9	See Below	(4,134.2)	164,434.7	182,212.1
US Army Corps of Engineers	5,716.8	See Below	(11.2)	5,705.6	5,987.4
Other Funds	3,525.3	See Below	(39.3)	3,486.0	3,670.9
Total Nonmarketable, Market-Based	$ 502,935.5		$ (10,744.3)	$ 492,191.2	$ 542.921.1
Accrued Interest	4,945.7			4,945.7	4,945.7
Total Intragovernmental Securities	$ 507,881.2		$ (10,744.3)	$ 497,136.9	$ 547,866.8
Other Investments					
Total Other Investments	$ 2,489.7	See Below	$ 0.0	$ 2,489.7	$ N/A
Amortization Method Used: Effective Interest					

The Department invests primarily in non-marketable, market-based securities. The value of these securities fluctuates in tandem with the selling price of the equivalent marketable security. The securities are purchased with the intent to hold until maturity, thus balances are not adjusted to market value.

The U.S. Treasury securities are issued to the earmarked funds as evidence of its receipts and are an asset to the Department and a liability to the U.S. Treasury. The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash generated from earmarked funds is deposited in the U.S. Treasury, which uses the cash for general government purposes. Since the Department and the U.S. Treasury are both part of the Federal Government, these assets and liabilities offset each other from the standpoint of the Federal Government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Governmentwide financial statements.

The U.S. Treasury securities provide the Department with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When the Department requires redemption of these securities to make expenditures, the Government will finance them from accumulated cash balances, by raising taxes or other receipts, borrowing from the public or repaying less debt, or curtailing other expenditures. The Federal Government uses the same method to finance all other expenditures.

Other Funds consists of $2.2 billion in investments of the DoD Education Benefits Trust Fund, $841.7 million in investments of the Host Nation Support for U.S. Relocation Activities Trust Fund, and $363.9 million in investments of the Voluntary Separation Incentive Trust Fund.

Note 5. Accounts Receivable

Accounts Receivable			*Dollars in Millions*
	2011		
As of September 30	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	$ 1,726.9	N/A	$ 1,726.9
Nonfederal Receivables (From the Public)	10,644.6	(683.2)	9,961.4
Total Accounts Receivable	**$ 12,371.5**	**$ (683.2)**	**$ 11,688.3**

Accounts Receivable			*Dollars in Millions*
	2010		
As of September 30	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	$ 1,249.2	N/A	$ 1,249.2
Nonfederal Receivables (From the Public)	10,411.4	(655.2)	9,756.2
Total Accounts Receivable	**$ 11,660.6**	**$ (655.2)**	**$ 11,005.4**

Accounts receivable represent the Department's claim for payment from other entities. The Department only recognizes an allowance for uncollectible amounts from the public. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules.

Note 6. Other Assets

Other Assets		*Dollars in Millions*
As of September 30	2011	2010
Intragovernmental Other Assets		
Advances and Prepayments	$ 1,634.2	$ 1,749.8
Other Assets	126.1	124.9
Total Intragovernmental Other Assets	**$ 1,760.3**	**$ 1,874.7**
Nonfederal Other Assets		
Outstanding Contract Financing Payments	$ 66,713.5	$ 63,420.7
Advances and Prepayments	1,756.4	1,810.7
Other Assets (With the Public)	199.6	403.7
Total Nonfederal Other Assets	**$ 68,669.5**	**$ 65,635.1**
Total Other Assets	**$ 70,429.8**	**$ 67,509.8**

Intragovernmental Other Assets represents the Department's right to approximately 6.4 million barrels of crude oil held by the Department of Energy.

The balance of Other Assets (With the Public) includes an Advance Payment Pool Agreement with a nonprofit institution.

Contract terms and conditions for certain types of contract financing payments convey rights to the Government that protect the contract work from state or local taxation, liens or attachment by contractor's creditors, transfer of property, or disposition in bankruptcy. However, these rights should not be misconstrued to mean that ownership of contractor's work has transferred to the Federal Government. The Federal Government does not have the right to take the work, except as provided for in contract clauses related to termination or acceptance, and the Department is not obligated to make payment to contractors until delivery and acceptance.

The balance of Outstanding Contract Financing Payments includes $64.5 billion in contract financing payments and an additional $2.2 billion in estimated future payments to contractors upon delivery and government acceptance of satisfactory product. (See additional discussion in Note 15, Other Liabilities).

Note 7. Cash and Other Monetary Assets

Cash and Other Monetary Assets		*Dollars in Millions*
As of September 30	**2011**	**2010**
Cash	$ 472.9	$ 634.8
Foreign Currency	1,247.4	1,431.9
Other Monetary Assets	0.0	0.0
Total Cash, Foreign Currency, and Other Monetary Assets	**$ 1,720.3**	**$ 2,066.7**

Cash (except for $77.0 million in undeposited collections and imprest funds) and Foreign Currency represent nonentity assets and are restricted and unavailable to fund the Department's mission.

Note 8. Direct Loan and Loan Guarantees

Direct Loan and Loan Guarantee Programs

The Department operates the following direct loan and/or loan guarantee programs:

- Military Housing Privatization Initiative (MHPI) and
- Armament Retooling and Manufacturing Support Initiative (ARMS)

The Federal Credit Reform Act of 1990 governs all new and amended direct loan obligations and loan guarantee commitments made after FY 1991.

Direct loans are reported at the net present value of the following projected cash flows:

- Loan disbursements;
- Repayments of principal; and
- Payments of interest and other payments over the life of the loan after adjusting for estimated defaults, prepayments, fees, penalties, and other recoveries.

Loan guarantee liabilities are reported at the net present value. The cost of the loan guarantee is the net present value of the following estimated projected cash flows:

- Payments by the Department to cover defaults and delinquencies, interest subsidies, or other payments; offset by payments to the Department including origination and other fees, penalties, and recoveries.

Military Housing Privatization Initiative

The MHPI includes both direct loan and loan guarantee programs. The programs are authorized by the National Defense Authorization Act for FY 1996 (PL 104-106, Section 2801) and includes a series of authorities that allow the Department to work with the private sector to renovate and build military family housing. The MHPI accelerates the construction of new housing built to market standards and leverages private sector capital. One of the goals of the Department is to obtain private sector capital to leverage government dollars. The Department provides protection to the private sector partner against specific risks, such as base closure or member deployment.

Armament Retooling and Manufacturing Support Initiative

The ARMS Initiative, Title 10 United States. Code 4551-4555, is a loan guarantee program designed to encourage commercial use of the Army's inactive ammunition plants through incentives for businesses willing to locate to a government ammunition production facility. The production capacity of these facilities is greater than current military requirements, however; this capacity may be needed by the military in the future. Revenues from property rentals are used to help offset the overhead costs for the operation, maintenance and environmental cleanup at the facilities.

In an effort to preclude any additional loan liability, the Army instituted an ARMS loan guarantee moratorium in FY 2004. The Army continues to operate under the moratorium and does not anticipate new loans.

Summary of Direct Loans and Loan Guarantees		*Dollars in Millions*
	2011	**2010**
Loans Receivable		
Direct Loans:		
Military Housing Privatization Initiative	814.4	522.3
Total Direct Loans	**$ 814.4**	**$ 522.3**
Defaulted Loan Guarantees:		
Military Housing Privatization Initiative	0.0	0.0
Armament Retooling & Manufacturing Support Initiative	0.0	0.0
Total Default Loan Guarantees	**0.0**	**0.0**
Total Loans Receivable	**$ 814.4**	**$ 522.3**
Loan Guarantee Liability		
Military Housing Privatization Initiative	13.7	16.2
Armament Retooling & Manufacturing Support Initiative	0.2	3.6
Total Loan Guarantee Liability	**$ 13.9**	**$ 19.8**

Direct Loans Obligated		*Dollars in Millions*
	2011	**2010**
Direct Loans Obligated After FY 1991 (Present Value Method):		
Military Housing Privatization Initiative		
Loans Receivable Gross	$ 953.8	$ 651.5
Interest Receivable	0.0	0.0
Foreclosed Property	0.0	0.0
Allowance for Subsidy Cost (Present Value)	(139.4)	(129.2)
Value of Assets Related to Direct Loans	**814.4**	**522.3**
Total Direct Loans Receivable	**$ 814.4**	**$ 522.3**

Loans receivable, net, or value of assets related to loans, is not the same as the proceeds the Department would expect to receive from selling the loans.

Interest receivable is calculated using the interest earned method.

Total Amount of Direct Loans Disbursed		*Dollars in Millions*
	2011	**2010**
Direct Loan Programs		
Military Housing Privatization Initiative	$ 304.8	$ 151.0
Total	**$ 304.8**	**$ 151.0**

Subsidy Expense for Direct Loan by Program					*Dollars in Millions*
2011	Interest Differential	Defaults	Fees	Other	Total
New Direct Loans Disbursed:					
Military Housing Privatization Initiative	$ 30.3	$ 27.3	$ 0.0	$ 0.0	$ 57.6
Total	**$ 30.3**	**$ 27.3**	**$ 0.0**	**$ 0.0**	**$ 57.6**
2010	Interest Differential	Defaults	Fees	Other	Total
New Direct Loans Disbursed:					
Military Housing Privatization Initiative	$ 18.7	$ 16.2	$ 0.0	$ 0.0	$ 34.9
Total	**$ 18.7**	**$ 16.2**	**$ 0.0**	**$ 0.0**	**$ 34.9**
2011	Modifica-tions	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Direct Loan Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ (5.5)	$ (30.8)	$ (36.3)	$ (36.3)
Total	**$ 0.0**	**$ (5.5)**	**$ (30.8)**	**$ (36.3)**	**$ (36.3)**
2010	Modifica-tions	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Direct Loan Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ (4.0)	$ (7.7)	$ (11.7)	$ (11.7)
Total	**$ 0.0**	**$ (4.0)**	**$ (7.7)**	**$ (11.7)**	**$ (11.7)**
	2011	**2010**			
Total Direct Loan Subsidy Expense:					
Military Housing Privatization Initiative	$ 21.3	$ 23.2			
Total	$ 21.3	$ 23.2			

Subsidy Rate for Direct Loans by Program					*Dollars in Millions*
As of September 30	Interest Differential	Defaults	Fees and other Collections	Other	Total
Budget Subsidy Rates for Direct Loans					
Military Housing Privatization Initiative	4.11%	12.55%	0.00%	0.00%	16.66%

Subsidy rates pertain to the loan agreements contracted during the current fiscal year. These rates cannot be applied to the direct loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new loans disbursed in the current year results from disbursements of loans from current and prior year loan agreements. The subsidy expense reported in the current year also includes reestimates.

Schedule for Reconciling Subsidy Cost Allowance Balances for Post FY 1991 Direct Loans				*Dollars in Millions*
	2011		2010	
Beginning Balance, Changes, and Ending Balance:				
Beginning Balance of the Subsidy Cost Allowance	**$**	**129.2**	**$**	**112.5**
Add: Subsidy Expense for Direct Loans Disbursed during the Reporting Years by Component				
Interest Rate Differential Costs		30.3		18.7
Default Costs (Net of Recoveries)		27.3		16.2
Fees and Other Collections		0.0		0.0
Other Subsidy Costs		0.0		0.0
Total of the above Subsidy Expense Components	**$**	**57.6**	**$**	**34.9**
Adjustments				
Loan Modifications	$	0.0	$	0.0
Fees Received		0.0		0.0
Foreclosed Property Acquired		0.0		0.0
Loans Written Off		0.0		0.0
Subsidy Allowance Amortization		(11.1)		(6.5)
Other		0.0		0.0
Total of the above Adjustment Components	**$**	**(11.1)**	**$**	**(6.5)**
Ending Balance of the Subsidy Cost Allowance before Reestimates	**$**	**175.7**	**$**	**140.9**
Add or Subtract Subsidy Reestimates by Component				
Interest Rate Reestimates		(5.5)		(4.0)
Technical/Default Reestimate		(30.8)		(7.7)
Total of the above Reestimate Components	**$**	**(36.3)**		**(11.7)**
Ending Balance of the Subsidy Cost Allowance	**$**	**139.4**	**$**	**129.2**

Defaulted Guaranteed Loans				*Dollars in Millions*
As of September 30	2011		2010	
Defaulted Guaranteed Loans from Post-FY 1991 Guarantees (Present Value Method):				
Military Housing Privatization Initiative				
Defaulted Guaranteed Loans Receivable, Gross	$	00	$	0.0
Interest Receivable		0.0		0.0
Foreclosed Property		0.0		0.0
Allowance for Subsidy Cost (Present Value)		0.0		0.0
Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net	**$**	**0.0**	**$**	**0.0**
Armament Retooling & Manufacturing Support Initiative				
Defaulted Guaranteed Loans Receivable, Gross	$	0.7	$	0.7
Interest Receivable		0.0		0.0
Foreclosed Property		0.0		0.0
Allowance for Subsidy Cost (Present Value)		(0.7)		(0.7)
Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net	**$**	**0.0**	**$**	**0.0**
Total Value of Assets Related to Defaulted Guaranteed Loans Receivable	**$**	**0.0**	**$**	**0.0**

Guaranteed Loans Outstanding				*Dollars in Millions*
As of September 30	**Outstanding Principal of Guaranteed Loans, Face Value**		**Amount of Outstanding Principal Guaranteed**	
2011				
Guaranteed Loans Outstanding				
Military Housing Privatization Initiative	$	464.7	$	464.7
Armament Retooling & Manufacturing Support Initiative		2.4		2.1
Total	**$**	**467.1**	**$**	**466.8**

2010				
Guaranteed Loans Outstanding				
Military Housing Privatization Initiative	$	461.6	$	461.6
Armament Retooling & Manufacturing Support Initiative		2.7		2.3
Total	**$**	**464.3**	**$**	**463.9**

2011				
New Guaranteed Loans Disbursed				
Military Housing Privatization Initiative	$	0.0	$	0.0
Armament Retooling & Manufacturing Support Initiative		0.0		0.0
Total	**$**	**0.0**	**$**	**0.0**

2010				
New Guaranteed Loans Disbursed				
Military Housing Privatization Initiative	$	0.0	$	0.0
Armament Retooling & Manufacturing Support Initiative		0.0		0.0
Total	**$**	**0.0**	**$**	**0.0**

Liabilities for Loan Guarantees				*Dollars in Millions*
As of September 30	**2011**		**2010**	
Liabilities for Loan Guarantee from Post 1991 (Present Value)				
Military Housing Privatization Initiative	$	13.7	$	16.2
Armament Retooling & Manufacturing Support Initiative		0.2		3.6
Total Loan Guarantee Liability (Post FY 1991)	**$**	**13.9**	**$**	**19.8**
Total Loan Guarantee Liability	**$**	**13.9**	**$**	**19.8**

Subsidy Expense for Loan Guarantees by Program

As of September 30 — *Dollars in Millions*

2011	Interest Differential	Defaults	Fees	Other	Total
New Loan Guarantees Disbursed					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	0.0	0.0	0.0
Total	**$ 0.0**	**$ 0.0**	**$ 0.0**	**$ 0.0**	**$ .0**
2010	Interest Differential	Defaults	Fees	Other	Total
New Loan Guarantees Disbursed					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	0.0	0.0	0.0
Total	**$ 0.0**	**$ 0.0**	**$ 0.0**	**$ 0.0**	**$ 0.0**
2011	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ (1.1)	$ (2.2)	$ (3.3)	$ (3.3)
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	(3.6)	(3.6)	(3.6)
Total	**$ 0.0**	**$ (1.1)**	**$ (5.8)**	**$ (6.9)**	**$ (6.9)**
2010	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ (1.1)	$ (2.4)	$ (3.5)	$ (3.5)
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	0.0	0.0	0.0
Total	**$ 0.0**	**$ (1.1)**	**$ (2.4)**	**$ (3.5)**	**$ (3.5)**
	2011	**2010**			
Total Loan Guarantee:					
Military Housing Privatization Initiative	$ (3.3)	$ (3.5)			
Armament Retooling & Manufacturing Support Initiative	(3.6)	0.0			
Total	**$ (6.9)**	**$ (3.5)**			

There are no new loan guarantees in FY 2011.

Subsidy Rates for Loan Guarantees by Program					
As of September 30	Interest Supplements	Defaults	Fees and other Collections	Other	Total
Budget Subsidy Rates for Loan Guarantees					
Military Housing Privatization Initiative	0.00%	0.00%	0.00%	0.00%	0.00%
Armament Retooling & Manufacturing Support Initiative	0.00%	0.00%	0.00%	0.00%	0.00%

There are no new loan guarantees in FY 2011.

Schedule for Reconciling Loan Guarantee Liability Balances for Post-FY 1991 Loan Guarantees		*Dollars in Millions*
As of September 30	**2011**	**2010**
Beginning Balance, Changes, and Ending Balance:		
Beginning Balance of the Loan Guarantee Liability	$ 19.8	$ 21.1
Add: Subsidy Expense for Guaranteed Loans Disbursed during the Reporting Years by Component		
Interest Supplement Costs	$ 0.0	$ 0.0
Default Costs (Net of Recoveries)	0.0	0.0
Fees and Other Collections	0.0	0.0
Other Subsidy Costs	0.0	0.0
Total of the above Subsidy Expense Components	**$ 0.0**	**$ 0.0**
Adjustments		
Loan Guarantee Modifications	$ 0.0	$ 0.0
Fees Received	0.0	0.0
Interest Supplements Paid	0.0	0.0
Foreclosed Property and Loans Acquired	0.0	0.0
Claim Payments to Lenders	0.0	0.0
Interest Accumulation on the Liability Balance	1.0	1.1
Other	0.0	1.1
Total of the above Adjustments	**$ 1.0**	**$ 2.2**
Ending Balance of the Loan Guarantee Liability before Reestimates	**$ 20.8**	**$ 23.3**
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimate	$ (1.1)	$ (1.1)
Technical/Default Reestimate	(5.8)	(2.4)
Total of the above Reestimate Components	**$ (6.9)**	**$ (3.5)**
Ending Balance of the Loan Guarantee Liability	**$ 13.9**	**$ 19.8**

Administrative Expenses

Administrative Expenses are limited to separately identified expenses for administering pre-FY 1992 and post-FY 1991 Direct Loans and Loan Guarantee Programs. The Department does not maintain a separate program to capture the expenses related to direct loans and loan guarantees for MHPI. Administrative expenses for the ARMS Initiative represent a fee paid to the U.S. Department of Agriculture, Rural Business Cooperative Service for servicing the loan guarantee program.

NOTE 9. INVENTORY AND RELATED PROPERTY

Inventory and Related Property		*Dollars in Millions*
As of September 30	2011	2010
Inventory, Net	$ 94,280.2	$ 84,625.0
Operating Materiel & Supplies, Net	147,731.5	147,011.2
Stockpile Materiel, Net	570.3	598.1
Total Inventory and Related Property	**$ 242,582.0**	**$ 232,234.3**

Inventory, Net				*Dollars in Millions*
	2011			
As of September 30	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	Valuation Method
Inventory Categories				
Available and Purchased for Resale	$ 65,084.4	$ 590.1	$ 65,674.5	LAC,MAC
Held for Repair	30,748.1	(3,805.1)	26,943.0	LAC,MAC
Excess, Obsolete, and Unserviceable	7,776.0	(7,776.0)	0.0	NRV
Raw Materiel	1,373.7	0.0	1,373.7	MAC,SP,LAC
Work in Process	289.0	0.0	289.0	AC
Total Inventory, Net	**$ 105,271.2**	**$ (10,991.0)**	**$ 94,280.2**	

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses
SP = Standard Price
AC = Actual Cost
NRV = Net Realizable Value
MAC = Moving Average Cost

Inventory, Net				Dollars in Millions
	2010			
As of September 30	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	Valuation Method
Inventory Categories				
Available and Purchased for Resale	$ 81,226.4	$ (18,648.9)	$ 62,577.5	LAC,MAC
Held for Repair	28,950.1	(7,947.2)	21,002.9	LAC,MAC
Excess, Obsolete, and Unserviceable	8,443.0	(8,443.0)	0.0	NRV
Raw Materiel	710.6	0.0	710.6	MAC,SP,LAC
Work in Process	334.0	0.0	334.0	AC
Total Inventory, Net	**$ 119,664.1**	**$ (35,039.1)**	**$ 84,625.0**	

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses
SP = Standard Price
AC = Actual Cost
NRV = Net Realizable Value
MAC = Moving Average Cost

Abnormal Balances

The Revaluation Allowance for Inventory Available and Purchased for Resale includes an abnormal balance of $590.1 million. The inventory allowance includes losses incurred as a result of converting inventory carried at Latest Acquisition Cost (LAC) to Moving Average Cost (MAC). The Department will address these abnormal balances in FY 2012 during the conversion of retail inventory from LAC to MAC.

Restrictions

The following are restrictions on the use, sale, or disposition of inventory.

- War reserve materiel valued at $532.3 million;
- Commissary items valued at $399.7 million held for purchase by authorized patrons; and
- Dispositions pending litigation or negotiation valued at $67.7 million.

There are no known restrictions on inventory disposition related to environmental or other liabilities.

General Composition of Inventory

Inventory includes spare and repair parts, clothing and textiles, and fuels held for sale. Inventory is tangible personal property that is:

- Held for sale, or held for repair and eventual sale;
- In the process of production for sale; or
- To be consumed in the production of goods for sale or in the provision of service for a fee.

The Department assigns inventory items to a category based upon the type and condition of the asset.

Operating Materiel and Supplies, Net				*Dollars in Millions*
	2011			Valuation Method
As of September 30	OM&S, Gross Value	Revaluation Allowance	OM&S, Net	
OM&S Categories				
Held for Use	$ 131,405.5	$ 0.0	$ 131,405.5	SP, LAC, MAC
Held for Repair	17,561.7	(1,235.7)	16,326.0	SP, LAC, MAC
Excess, Obsolete, and Unserviceable	2,225.1	(2,225.1)	0.0	NRV
Total OM&S	**$ 151,192.3**	**$ (3,460.8)**	**$ 147,731.5**	

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses
SP = Standard Price
NRV = Net Realizable Value
MAC = Moving Average Cost

Operating Materiel and Supplies, Net				*Dollars in Millions*
	2010			Valuation Method
As of September 30	OM&S, Gross Value	Revaluation Allowance	OM&S, Net	
OM&S Categories				
Held for Use	$ 131,524.9	$ 0.0	$ 131,524.9	SP, LAC, MAC
Held for Repair	17,532.2	(2,045.9)	15,486.3	SP, LAC, MAC
Excess, Obsolete, and Unserviceable	2,631.6	(2,631.6)	0.0	NRV
Total OM&S	**$ 151,688.7**	**$ (4,677.5)**	**$ 147,011.2**	

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses
SP = Standard Price
NRV = Net Realizable Value
MAC = Moving Average Cost

Restrictions

Some munitions included in Operating Materiel and Supplies (OM&S) are restricted due to condition. Restricted munitions are considered obsolete or unserviceable when they cannot meet performance requirements. However, obsolete and unserviceable OM&S may be used in emergency combat situations in which no other suitable munitions are immediately available.

General Composition of OM&S

OM&S includes spare and repair parts, ammunition, tactical missiles, aircraft configuration pods, and centrally-managed aircraft engines held for consumption. The Department assigns OM&S items into a category based upon the type and condition of the asset.

Stockpile Materiel, Net				Dollars in Millions
	2011			
As of September 30	Stockpile, Materiel Amount	Allowance for Gains (Losses)	Stockpile Materiel, Net	Valuation Method
Stockpile Material Categories				
Held for Sale	$ 541.0	$ 0.0	$ 541.0	AC, LCM
Held in Reserve for Future Sale	29.3	0.0	29.3	AC, LCM
Total Stockpile Material	**$ 570.3**	**$ 0.0**	**$ 570.3**	
Legend for Valuation Methods:				
AC = Actual Cost		*LCM = Lower of Cost or Market*		

Stockpile Materiel, Net				Dollars in Millions
	2010			
As of September 30	Stockpile, Materiel Amount	Allowance for Gains (Losses)	Stockpile Materiel, Net	Valuation Method
Stockpile Material Categories				
Held for Sale	$ 568.8	$ 0.0	$ 568.8	AC, LCM
Held in Reserve for Future Sale	29.3	0.0	29.3	AC, LCM
Total Stockpile Material	**$ 598.1**	**$ 0.0**	**$ 598.1**	
Legend for Valuation Methods:				
AC = Actual Cost		*LCM = Lower of Cost or Market*		

Restrictions

Materiel held by the National Defense Stockpile (NDS) is restricted unless released by congressional action and made available for sale on the open market. Stockpile materiel may not be disposed except for: (1) necessary upgrading, refining, or processing; (2) necessary rotation to prevent deterioration; (3) determination as excess with potential financial loss if retained; or (4) authorization by law.

Before selling any materiel, Congress must enact specific enabling legislation (e.g., the National Defense Authorization Act). When authorized to offer materiel for sale, NDS removes the materiel from Materiel Held in Reserve and reclassifies these items as Materiel Held for Sale. The estimated market price of the stockpile materiel held for sale as of 4th Quarter, FY 2011, is $1.4 billion

General Composition of Stockpile Materiel

Due to statutory requirements, the Department holds strategic and critical stockpile materiel for use in national defense, conservation, or national emergencies.

NOTE 10. GENERAL PP&E, NET

General PP&E, Net			2011		Dollars in Millions
As of September 30	Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value
Major Asset Classes					
Land	N/A	N/A	$ 10,577.1	N/A	$ 10,577.1
Buildings, Structures, and Facilities	S/L	20 or 40	230,160.8	(118,526.4)	111,634.4
Leasehold Improvements	S/L	Lease term	1,032.2	(452.7)	579.5
Software	S/L	2-5 or 10	10,027.4	(6,932.4)	3,095.0
General Equipment	S/L	5 or 10	92,368.7	(64,943.0)	27,425.7
Military Equipment	S/L	Various	852,735.0	(445,894.4)	406,840.6
Assets Under Capital Lease[1]	S/L	Lease term	1,182.3	(748.6)	433.7
Construction-in-Progress	N/A	N/A	46,507.2	N/A	46,507.2
Other			1,201.4	(1.8)	1,199.6
Total General PP&E			**$ 1,245,792.1**	**$ (637,499.3)**	**$ 608,292.8**

[1] *Note 15 for additional information on Capital Leases*
Legend for Valuation Methods: S/L = Straight Line N/A = Not Applicable

General PP&E, Net			Restated 2010		Dollars in Millions
As of September 30	Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value
Major Asset Classes					
Land	N/A	N/A	$ 10,502.8	N/A	$ 10,502.8
Buildings, Structures, and Facilities	S/L	20 or 40	207,363.3	(111,929.1)	95,434.2
Leasehold Improvements	S/L	Lease term	976.0	(402.2)	573.8
Software	S/L	2-5 or 10	9,440.1	(6,148.3)	3,291.8
General Equipment	S/L	5 or 10	91,773.8	(58,654.1)	33,119.7
Military Equipment	S/L	Various	813,621.5	(415,431.7)	398,189.8
Assets Under Capital Lease[1]	S/L	Lease term	957.0	(642.2)	314.8
Construction-in-Progress	N/A	N/A	38,604.1	N/A	38,604.1
Other			1,226.0	(1.2)	1,224.8
Total General PP&E			**$ 1,174,464.6**	**$ (593,208.8)**	**$ 581,255.8**

[1] *Note 15 for additional information on Capital Leases*
Legend for Valuation Methods: S/L = Straight Line N/A = Not Applicable

Restatements

The Department corrected a $14.4 billion overstatement of General Property, Plant and Equipment to align the accounting records to the property accountability system. Refer to Note 26, Restatements, for further information.

Other Disclosures

The Department has use of overseas land, buildings, and other facilities obtained through international treaties and agreements negotiated by the Department of State. Treaty covenants restrict the Department's use and disposal of real property (land and buildings) located outside the United States.

The Department does not have the acquisition value for all General PP&E and uses several cost methodologies to provide General PP&E values for financial statement reporting purposes.

Other consists of assets awaiting disposal.

Heritage Assets and Stewardship Land

The Department's policy is to preserve its heritage assets, which are items of historical, cultural, educational, or artistic importance.

The mission of the Department is to provide the military forces necessary to deter war and protect the security of the United States. In that mission, the Department, with minor exceptions, uses most of the buildings and stewardship land in its daily activities and includes the buildings on the Balance Sheet as multi-use heritage assets (capitalized and depreciated).

Differences in the heritage assets and stewardship land quantities from the FY 2010 ending to the FY 2011 beginning unit counts resulted from efforts to improve quality of reported data.

Heritage assets within the Department consist of buildings and structures, archeological sites, and museum collections. The Department defines these as follows:

- Buildings and Structures. Buildings and structures that are listed, or eligible for listing, on the National Register of Historic Places, including Multi-Use Heritage Assets.
- Archeological Sites. Sites that have been identified, evaluated, and determined to be eligible for or are listed on the National Register of Historic Places in accordance with Section 110 National Historic Preservation Act.
- Museum Collection Items. Items which are unique for one or more of the following reasons: historical or natural significance; cultural, educational, or artistic importance; or significant technical or architectural characteristics.

The Department is unable to identify all quantities of heritage assets and stewardship land added through donation or devise in FY 2011 due to limitations of the Department's financial and nonfinancial management processes and systems that feed the financial statements. Currently, the Department has identified 3,899 Objects, not including Fine Art and 108 Fine Art Objects acquired through donation FY 2011.

Categories	Measure Quantity	As of 9/30/10	Additions	Deletions	As of 9/30/11
Buildings and Structures	Each	72,754	470	14,621	58,603
Archeological Sites	Each	28,581	3,500	1,444	30,637
Museum Collection Items (Objects, not including fine art)	Each	1,341,538	30,798	2,723	1,369,613
Museum Collection Items (Objects, fine art)	Each	44,100	876	21	44,955

Stewardship land is land and land rights owned by the Department, but not acquired for, or in connection with, items of General Property, Plant, and Equipment. All land provided to the Department from the public domain or at no cost, regardless of its use, is classified as Stewardship Land.

Stewardship land is presented in context of all categories of the Department's lands and reported in acres based on the predominant use of the land. The three categories of Stewardship land held in public trust are: State-Owned Land, Withdrawn Public-Land, and Public Land.

The Department's stewardship land consists mainly of mission essential land.

The Department held the following acres of land as of September 30, 2011.

Facility Code	Predominant Land Use Categories	As of 9/30/10 *(Acres in Thousands)*	Additions	Deletions	As of 9/30/11
9110	Government Owned Land	6,590	400	485	6,505
9111	State Owned Land	12	7	12	7
9120	Withdrawn Public Land	16,140	108	113	16,135
9130	Licensed and Permitted Land	2,349	446	434	2,361
9140	Public Land	203	11	12	202
9210	Land Easement	377	28	29	376
9220	In-leased Land	270	62	106	226
9230	Foreign Land	479	0	25	454
	Grand Total				**26,266**
	Total – All Other Lands				**9,922**
	Total – Stewardship Lands				**16,344**

Assets Under Capital Lease		*Dollars in Millions*
As of September 30	**2011**	**2010**
Entity as Lessee, Assets Under Capital Lease		
Land and Buildings	$ 538.8	$ 759.8
Equipment	643.5	197.2
Accumulated Amortization	(748.6)	(642.2)
Total Capital Leases	**$ 433.7**	**$ 314.8**

NOTE 11. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

Liabilities Not Covered by Budgetary Resources		Dollars in Millions
As of September 30	2011	2010
Intragovernmental Liabilities		
Accounts Payable	$ 9.2	$ 13.2
Debt	5.1	5.6
Other	2,142.1	2,184.4
Total Intragovernmental Liabilities	**$ 2,156.4**	**$ 2,203.2**
Nonfederal Liabilities		
Accounts Payable	$ 692.2	$ 1,057.1
Military Retirement and Other Federal Employment Benefits	1,656,021.3	1,691,538.8
Environmental Liabilities	60,567.0	58,671.4
Other Liabilities	17,186.6	16,493.5
Total Nonfederal Liabilities	**$ 1,734,467.1**	**$ 1,767,760.8**
Total Liabilities Not Covered by Budgetary Resources	**$ 1,736,623.5**	**$ 1,769,964.0**
Total Liabilities Covered by Budgetary Resources	**$ 614,893.3**	**$ 552,410.0**
Total Liabilities	**$ 2,351,516.8**	**$ 2,322,374.0**

Liabilities Not Covered by Budgetary Resources includes liabilities for which congressional action is needed before budgetary resources can be provided.

Intragovernmental Accounts Payable represents subsidy payments for the Military Housing Privatization Initiative and liabilities in canceled appropriations that, if paid, will be disbursed using current year funds.

Nonfederal Accounts Payable primarily represents liabilities in canceled appropriations that, if paid, will be disbursed using current year funds.

Debt consists primarily of borrowing from the U.S. Treasury for capital improvements to the Washington Aqueduct Project. Arlington County and Falls Church, Virginia, will complete reimbursement to the Department by 2023.

Environmental Liabilities represents the Department's liability for existing and anticipated environmental clean up and disposal.

Intragovernmental Liabilities Other primarily consists of unfunded Federal Employees Compensation Act liabilities, unfunded unemployment liabilities, and unfunded Judgment Fund liabilities.

Nonfederal Liabilities, Other primarily consists of unfunded annual leave, contingent liabilities, and expected expenditures for disposal of conventional munitions.

Military Retirement and Other Federal Employment Benefits consists of various employee actuarial liabilities not due and payable during the current fiscal year. These liabilities primarily consist of pension liabilities and health benefit liabilities. Refer to Note 17, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

NOTE 12. ACCOUNTS PAYABLE

Accounts Payable *As of September 30*	2011 *Dollars in Millions*		
	Accounts Payable	Interest, Penalties, and Administrative Fees	Total
Intragovernmental Payables	$ 1,893.1	N/A	$ 1,893.1
Nonfederal Payables (To the Public)	26,102.4	1.5	26,103.9
Total Accounts Payable	**$ 27,995.5**	**$ 1.5**	**$ 27,997.0**

Accounts Payable *As of September 30*	2010 *Dollars in Millions*		
	Accounts Payable	Interest, Penalties, and Administrative Fees	Total
Intragovernmental Payables	$ 1,754.5	N/A	$ 1,754.5
Nonfederal Payables (To the Public)	31,129.0	6.4	31,135.4
Total Accounts Payable	**$ 32,883.5**	**$ 6.4**	**$ 32,889.9**

Accounts Payable includes amounts owed to federal and nonfederal entities for goods and services received by the Department. The Department's systems do not track intragovernmental transactions by customer at the transaction level. Buyer-side accounts payable are adjusted to agree with interagency seller-side accounts receivable. Accounts Payable was adjusted by (1) reclassifying amounts between federal and nonfederal accounts payable or (2) accruing additional accounts payable and expenses.

NOTE 13. DEBT

Debt			*Dollars in Millions*
	2011		
As of September 30	**Beginning Balance**	**Net Borrowing**	**Ending Balance**
Agency Debt (Intragovernmental)			
Debt to the Treasury	$ 518.3	$ 265.1	$ 783.4
Debt to the Federal Financing Bank	0.0	0.0	0.0
Total Agency Debt	**$ 518.3**	**$ 265.1**	**$ 783.4**

Debt			*Dollars in Millions*
	2010		
As of September 30	**Beginning Balance**	**Net Borrowing**	**Ending Balance**
Agency Debt (Intragovernmental)			
Debt to the Treasury	$ 391.7	$ 126.6	$ 518.3
Debt to the Federal Financing Bank	0.0	0.0	0.0
Total Agency Debt	**$ 391.7**	**$ 126.6**	**$ 518.3**

The Department's debt consists of interest and principal payments due to the U.S. Treasury. The Department borrows funds for the Military Housing Privatization Initiative and the Washington Aqueduct Project.

The Department must pay the debt on direct loans if borrowers (e.g. county or city governments, or housing builders) default. For loan guarantees, the Department must pay the amount of outstanding principal guaranteed.

NOTE 14. ENVIRONMENTAL LIABILITIES AND DISPOSAL LIABILITIES

Environmental Liabilities and Disposal Liabilities *As of September 30*	2011	2010
	Dollars in Millions	
Environmental Liabilities–Nonfederal		
Accrued Environmental Restoration Liabilities		
Active Installations—Installation Restoration Program (IRP) and Building Demolition and Debris Removal (BD/DR)	$ 11,043.3	$ 8,065.3
Active Installations—Military Munitions Response Program (MMRP)	4,120.0	4,646.6
Formerly Used Defense Sites-IRP & BD/DR	3,295.4	3,426.3
Formerly Used Defense Sites--MMRP	10,990.0	11,811.9
Other Accrued Environmental Liabilities—Non-BRAC		
Environmental Corrective Action	500.2	429.2
Environmental Closure Requirements	1,968.6	2,162.5
Environmental Response at Operational Ranges	95.2	127.2
Asbestos	1,485.0	1,335.8
Non-Military Equipment	548.2	113.5
Other	1,079.9	1,201.6
Base Realignment and Closure Installations (BRAC)		
Installation Restoration Program	3,743.0	3,936.4
Military Munitions Response Program	707.3	1,015.5
Environmental Corrective Action / Closure Requirements	309.9	329.5
Environmental Disposal for Military Equipment / Weapons Programs		
Nuclear Powered Military Equipment / Spent Nuclear Fuel	13,637.3	13,290.9
Non-Nuclear Powered Military Equipment	36.4	36.4
Other Weapons Systems	161.0	183.6
Chemical Weapons Disposal Program		
Chemical Demilitarization – Chemical Materials Agency (CMA)	4,592.0	5,286.9
CAMD Demilitarization – Assembled Chemical Weapons Alternatives (ACWA)	6,510.4	5,503.1
Total Environmental Liabilities	**$ 64,823.1**	**$ 62,902.2**

Other Accrued Environmental Liabilities, Non-Base Realignment and Closure (BRAC), Other primarily consists of remediation related to Formerly Utilized Sites Remedial Action Program (FUSRAP). The Department is responsible for FUSRAP, which remediates radiological contamination from the Department of Energy's U.S. Atomic Energy and Weapons Program.

The unrecognized portion of the estimated total cleanup costs associated with General Property, Plant & Equipment (PP&E) is $2.9 billion for FY 2011. Not all Components of the

Department are able to compile the necessary information for this disclosure, thus the amount reported may not accurately reflect the Department's total unrecognized costs associated with General PP&E. The Department is implementing procedures to address these deficiencies.

OTHER DISCLOSURES

Types of Environmental Liabilities and Disposal Liabilities Identified

The Department has cleanup requirements for Defense Environmental Restoration Program (DERP) sites at active installations, BRAC installations, Formerly Used Defense Sites, sites at active installations that are not covered by DERP, weapons systems programs, and chemical weapons disposal programs. The weapons systems programs consist of chemical weapons disposal, nuclear-powered aircraft carriers, nuclear-powered submarines, and other nuclear ships. All clean-up is performed in coordination with regulatory agencies, other responsible parties, and current property owners.

Applicable Laws and Regulations for Cleanup Requirements

The Department is required to clean up contamination resulting from past waste disposal practices, leaks, spills, and other past activity that created a public health or environmental risk. The Department accomplishes this effort in coordination with regulatory agencies and, if applicable, other responsible parties and current property owners. The Department is also required to recognize closure and post-closure costs for its General PP&E and environmental corrective action costs for current operations. Each of the Department's major reporting entities is responsible for tracking and reporting all required environmental information related to environmental restoration costs, other accrued environmental costs, disposal costs of weapons systems, and environmental costs related to BRAC actions that have taken place.

The Department follows the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), Superfund Amendment and Reauthorization Act, Resource Conservation and Recovery Act (RCRA) or other applicable federal or state laws to clean up contamination. The CERCLA and RCRA require the Department to clean up contamination in coordination with regulatory agencies, current owners of property damaged by the Department, and third parties that have a partial responsibility for the environmental restoration. Failure to comply with agreements and legal mandates puts the Department at risk of incurring fines and penalties.

The clean-up requirements for nuclear-powered aircraft carriers, submarines, and other nuclear ships are based on laws that affect the Department's conduct of environmental policy and regulations. The Atomic Energy Act of 1954, as amended, assures the proper management of source, special nuclear, and byproduct materiel.

As in all cases with nuclear power, the Department coordinates actions with the Department of Energy. The Nuclear Waste Policy Act of 1982 requires all owners and generators of high-level nuclear waste and spent nuclear fuel to pay their respective shares of the full cost of the program.

Finally, the Low-Level Radioactive Waste Policy Amendments Act of 1986 provides for the safe and efficient management of low-level radioactive waste.

The Chemical Weapons Disposal Program is based on FY 1986 National Defense Authorization Act (PL 99-145, as amended) that directed the Department to destroy the unitary chemical stockpile in accordance with the requirements of the Chemical Weapons Convention Treaty.

Methods for Assigning Total Cleanup Costs to Current Operating Periods

The Department uses engineering estimates and independently validated models to estimate environmental costs. The models include the Remedial Action Cost Engineering Requirements application and the Normalization of Data System. The Department validates the models in accordance with *DoD Instruction 5000.61* and uses the models to estimate the liabilities based on data received during a preliminary assessment and initial site investigation. The Department primarily uses engineering estimates after obtaining extensive data during the remedial investigation/feasibility phase of the environmental project.

Once the environmental cost estimates are complete, the Department complies with accounting standards to assign costs to current operating periods. The Department has already expensed the costs for cleanup associated with General PP&E placed into service before October 1, 1997, unless the costs are intended to be recovered through user charges. If the costs are to be recovered through user charges, the Department expenses cleanup costs associated with that portion of the asset life that has passed since the General PP&E was placed into service. The Department systematically recognizes the remaining cost over the remaining life of the asset.

For General PP&E placed into service after September 30, 1997, the Department expenses associated environmental costs systematically over the life of the asset using two methods: physical capacity for operating landfills and life expectancy in years for all other assets. The Department expenses the full cost to clean up contamination for Stewardship PP&E at the time the asset is placed into service.

Nature of Estimates and the Disclosure of Information Regarding Possible Changes Due to Inflation, Deflation, Technology, or Applicable Laws and Regulations

The Department had changes in estimates resulting from overlooked or previously unknown contaminants, reestimation based on different assumptions, and other changes in project scope. Environmental liabilities may change in the future due to changes in laws and regulation, changes in agreements with regulatory agencies, and advances in technology.

Uncertainty Regarding the Accounting Estimates Used to Calculate the Reported Environmental Liabilities

The environmental liabilities for the Department are based on accounting estimates, which require certain judgments and assumptions that are reasonable based upon information available at the time the estimates are calculated. The actual results may materially vary from the accounting estimates if agreements with regulatory agencies require remediation to a different degree than anticipated when calculating the estimates. Liabilities can be further affected if investigation of the environmental sites reveals contamination levels that differ from the estimate parameters.

The Department has a liability to take environmental restoration and corrective action for buried chemical munitions and agents; however, it is unable to estimate at this time because the extent of the buried chemical munitions and agents is unknown. The Department is also unable to provide a complete estimate for FUSRAP. The Department has ongoing studies and will update its estimate as additional liabilities are identified. In addition, not all components of the Department recognize environmental liabilities associated with General PP&E due to process and system limitations.

The Department has the potential to incur costs for restoration initiatives in conjunction with returning overseas Defense facilities to host nations. The Department is unable to provide a reasonable estimate at this time because the extent of required restoration is unknown.

Note 15. Other Liabilities

Other Liabilities			*Dollars in Millions*
	2011		
As of September 30	Current Liability	Noncurrent Liability	Total
Intragovernmental			
Advances from Others	$ 1,548.6	$ 0.0	$ 1,548.6
Deposit Funds and Suspense Account Liabilities	1,799.8	0.0	1,799.8
Disbursing Officer Cash	1,828.9	0.0	1,828.9
Judgment Fund Liabilities	260.6	0.0	260.6
FECA Reimbursement to the Department of Labor	607.1	776.4	1,383.5
Custodial Liabilities	3,949.3	2,533.8	6,483.1
Employer Contribution and Payroll Taxes Payable	352.2	0.0	352.2
Other Liabilities	575.0	0.0	575.0
Total Intragovernmental Other Liabilities	**$ 10,921.5**	**$ 3,310.2**	**$ 14,231.7**
Nonfederal			
Accrued Funded Payroll and Benefits	$ 5,703.1	$ 0.0	$ 5,703.1
Advances from Others	4,279.2	0.0	4,279.2
Deferred Credits	0.00	0.0	0.0
Deposit Funds and Suspense Accounts	164.8	0.0	164.8
Temporary Early Retirement Authority	0.0	0.0	0.0
Nonenvironmental Disposal Liabilities			
Military Equipment (Nonnuclear)	12.8	207.6	220.4
Excess/Obsolete Structures	3.2	535.4	538.6

Other Liabilities *As of September 30*		*Dollars in Millions* **2011**	
	Current Liability	**Noncurrent Liability**	**Total**
Conventional Munitions Disposal	0.0	2,752.4	2,752.4
Accrued Unfunded Annual Leave	10,211.5	0.0	10,211.5
Capital Lease Liability	208.1	29.6	237.7
Contract Holdbacks	806.2	0.3	806.5
Employer Contribution and Payroll Taxes Payable	373.9	0	373.9
Contingent Liabilities	1,581.1	4,288.3	5,869.4
Other Liabilities	150.1	0.5	150.6
Total Nonfederal Other Liabilities	**$ 23,494.0**	**$ 7,814.1**	**$ 31,308.1**
Total Other Liabilities	**$ 34,415.5**	**$ 11,124.3**	**$ 45,539.8**

Other Liabilities			*Dollars in Millions*
	2010		
As of September 30	**Current Liability**	**Noncurrent Liability**	**Total**
Intragovernmental			
Advances from Others	$ 1,473.1	$ 0.0	$ 1,473.1
Deposit Funds and Suspense Account Liabilities	906.0	0.0	906.0
Disbursing Officer Cash	2,190.3	0.0	2,190.3
Judgment Fund Liabilities	261.2	0.0	261.2
FECA Reimbursement to the Department of Labor	621.4	780.9	1,402.3
Custodial Liabilities	3,806.2	2,595.4	6,401.6
Employer Contribution and Payroll Taxes Payable	530.1	0.0	530.1
Other Liabilities	616.8	0.0	616.8
Total Intragovernmental Other Liabilities	**$ 10,405.1**	**$ 3,376.3**	**$ 13,781.4**
Nonfederal			
Accrued Funded Payroll and Benefits	$ 10,375.8	$ 0.0	$ 10,375.8
Advances from Others	4,498.7	0.0	4,498.7
Deferred Credits	0.00	0.0	0.0
Deposit Funds and Suspense Accounts	430.1	0.0	430.1
Nonenvironmental Disposal Liabilities			
Military Equipment (Nonnuclear)	8.8	245.2	254.0
Excess/Obsolete Structures	105.8	131.3	237.1
Conventional Munitions Disposal	0.0	2,072.3	2,072.3
Accrued Unfunded Annual Leave	10,977.1	0.0	10,977.1
Capital Lease Liability	12.1	63.4	75.5
Contract Holdbacks	733.6	0.2	733.8
Employer Contribution and Payroll Taxes Payable	588.5	0	588.5
Contingent Liabilities	1,255.6	3,793.2	5,048.8
Other Liabilities	271.3	0.5	271.8
Total Nonfederal Other Liabilities	**$ 29,257.4**	**$ 6,306.1**	**$ 35,563.5**
Total Other Liabilities	**$ 39,662.5**	**$ 9,682.4**	**$ 49,344.9**

Capital Lease Liability				Dollars in Millions
	2011 — Asset Category			
As of September 30	Land and Buildings	Equipment	Other	Total
Future Payments Due				
2012	$ 46.2	$ 0.1	$ 9.7	$ 56.0
2013	22.8	0.1	2.8	25.7
2014	18.9	0.0	2.6	21.5
2015	18.9	0.0	0.0	18.9
2016	19.1	0.0	0.0	19.1
After 5 Years	138.6	0.0	0.0	138.6
Total Future Lease Payments Due	**$ 264.5**	**$ 0.2**	**$ 15.1**	**$ 279.8**
Less: Imputed Interest Executory Costs	42.1	0.0	0.0	42.1
Net Capital Lease Liability	**$ 222.4**	**$ 0.2**	**$ 15.1**	**$ 237.7**
Capital Lease Liabilities Covered by Budgetary Resources				**237.7**
Capital Lease Liabilities Not Covered by Budgetary Resources				**0.0**

Capital Lease Liability				Dollars in Millions
	2010 — Asset Category			
As of September 30	Land and Buildings	Equipment	Other	Total
Future Payments Due				
2011	$ 41.3	$ 0.1	$ 0.0	$ 41.4
2012	15.5	0.1	0.0	15.6
2013	11.1	0.0	0.0	11.1
2014	8.8	0.0	0.0	8.8
2015	8.7	0.0	0.0	8.7
After 5 Years	0.0	0.0	0.0	0.0
Total Future Lease Payments Due	**$ 85.4**	**$ 0.2**	**$ 0.0**	**$ 85.6**
Less: Imputed Interest Executory Costs	10.1	0.0	0.0	10.1
Net Capital Lease Liability	**$ 75.3**	**$ 0.2**	**$ 0.0**	**$ 75.5**
Capital Lease Liabilities Covered by Budgetary Resources				**70.4**
Capital Lease Liabilities Not Covered by Budgetary Resources				**5.1**

Intragovernmental Other Liabilities primarily consists of unemployment compensation liabilities.

Nonfederal Other Liabilities primarily consist of accrued estimates for repairs; accrued moving allowance and miscellaneous expenses; and accrued liabilities for inventory owned and managed on behalf of foreign governments.

The Department has two delinquent Federal Employees' Compensation Act bills in the amount of $1.4 million.

Contingent Liabilities includes $2.2 billion related to contracts authorizing progress payments based on cost as defined in the Federal Acquisition Regulation (FAR). In accordance with contract terms, specific rights to contractors' work vests with the Federal Government when a specific type of contract financing payment is made. This action protects taxpayer funds in the event of contract nonperformance. These rights should not be misconstrued as rights of ownership. The Department is under no obligation to pay contractors for amounts greater than the amounts authorized in contracts until delivery and government acceptance. Due to the probability the contractors will complete their efforts and deliver satisfactory products, and because the amount of potential future payments are estimable, the Department has recognized a contingent liability for estimated future payments which are conditional pending delivery and government acceptance.

Total contingent liabilities for progress payments based on cost represent the difference between the estimated costs incurred to date by contractors and amounts authorized to be paid under progress payments based on cost provisions within the FAR. Estimated contractor-incurred costs are calculated by dividing the cumulative unliquidated progress payments based on cost by the contract-authorized progress payment rate. The balance of unliquidated progress payments based on cost is deducted from the estimated total contractor-incurred costs to determine the contingency amount.

NOTE 16. COMMITMENTS AND CONTINGENCIES

Legal Contingencies

The Department is a party in various administrative proceedings and legal actions related to claims for environmental damage, equal opportunity matters, and contractual bid protests. The Department has accrued contingent liabilities for legal actions where the Office of General Counsel (OGC) considers an adverse decision probable and the amount of loss is measurable. In the event of an adverse judgment against the Government, some of the liabilities may be payable from the U.S. Treasury Judgment Fund.

The Department has 44 legal actions with individual claims greater than the Department's FY 2011 materiality threshold of $136.3 million. The total of the 44 actions is approximately $12.4 trillion. Of this amount, the OGC determined that claims totaling approximately $7.6 billion are classified "reasonably possible," $59.3 billion are classified "remote," and $12.3 trillion are classified "unable to determine the probability of loss." The Department also had a number of potential claims that individually did not meet the Department's materiality threshold but did meet the individual Components' thresholds. These claims are disclosed in the Components' financial statements.

Other Commitments and Contingencies

The Department is a party in numerous individual contracts that contain clauses, such as price escalation, award fee payments, or dispute resolution, that may result in a future outflow of expenditures. Currently, the Department has limited automated system processes by which it captures or assesses these potential contingent liabilities, therefore, the amounts reported may not fairly present the Department's contingent liabilities. Contingencies considered both measurable and probable have been recognized as liabilities. Refer to Note 15, Other Liabilities, for further information.

Note 17. Military Retirement and Other Federal Employment Benefits

Military Retirement and Other Federal Employment Benefits			Dollars in Millions
	2011		
As of September 30	Liabilities	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Pension and Health Actuarial Benefits			
Military Retirement Pensions	$ 1,360,922.5	$ (368,236.0)	$ 992,686.5
Military Retirement Health Benefits	305,985.0	0.0	305,985.0
Military Medicare-Eligible Retiree Benefits	533,667.7	(184,914.3)	348,753.4
Total Pension and Health Actuarial Benefits	**$ 2,200,575.2**	**$ (553,150.3)**	**$ 1,647,424.9**

Military Retirement and Other Federal Employment Benefits			Dollars in Millions
	2011		
As of September 30	Liabilities	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Other Actuarial Benefits			
FECA	$ 6,366.4	$ 0.0	$ 6,366.4
Voluntary Separation Incentive Programs	770.1	(348.6)	421.5
DoD Education Benefits Fund	1,773.6	(1,773.6)	0.0
Other	2,874.3	(1,065.8)	1,808.5
Total Other Actuarial Benefits	**$ 11,784.4**	**$ (3,188.0)**	**$ 8,596.4**
Total Military Retirement and Other Federal Employment Benefits	**$ 2,212,359.6**	**$ (556,338.3)**	**$ 1,656,021.3**

Actuarial Cost Method Used: Aggregate Entry-Age Method
Assumptions: Effective Interest
Market Value of Investments in Market-based and Marketable Securities: $662.4 billion

Military Retirement and Other Federal Employment Benefits			Dollars in Millions
	2010		
As of September 30	Liabilities	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Pension and Health Actuarial Benefits			
Military Retirement Pensions	$ 1,258,463.1	$ (314,380.5)	$ 944,082.6
Military Retirement Health Benefits	329,492.1	0.0	329,492.1
Military Medicare-Eligible Retiree Benefits	572,995.2	(163,587.6)	409,407.6
Total Pension and Health Actuarial Benefits	**$ 2,160,950.4**	**$ (477,968.1)**	**$ 1,682,982.3**

Military Retirement and Other Federal Employment Benefits			*Dollars in Millions*
	2010		
As of September 30	Liabilities	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Other Actuarial Benefits			
FECA	$ 6,418.7	$ 0.0	$ 6,418.7
Voluntary Separation Incentive Programs	959.3	(397.0)	562.3
DoD Education Benefits Fund	1,900.5	(1,900.5)	0.0
Other	6,470.0	(4,894.4)	1,575.6
Total Other Actuarial Benefits	**$ 15,748.5**	**$ (7,191.9)**	**$ 8,556.6**
Total Military Retirement and Other Federal Employment Benefits	**$ 2,176,698.9**	**$ (485,160.0)**	**$ 1,691,538.9**

Actuarial Cost Method Used: Aggregate Entry-Age Method
Assumptions: Effective Interest
Market Value of Investments in Market-based and Marketable Securities: $541.0 billion

Military Retirement and Other Federal Employment Benefits					*Dollars in Millions*
	2011				
As of September 30	Military Retirement Pensions	Military Pre-Medicare Eligible Retiree Health Benefits	Military Medicare – Eligible Retiree Health Benefits	Voluntary Separation Incentive Programs	DoD Education Benefits Fund
Beginning Actuarial Liability	$ 1,258,463.1	$ 329,492.1	$ 572,995.2	$ 959.3	$ 1,900.5
Normal Cost Liability	28,780.5	11,616.2	12,127.5	0.0	436.4
Plan Amendment Liability	0.0	(3,168.4)	(12,807.9)	0.0	0.0
Assumption Change Liability	61,970.0	6,170.6	0.0	10.8	(112.9)
Benefit Outlays	(51,012.4)	(11,717.2)	(9,455.7)	(136.2)	(441.2)
Interest Cost	62,587.4	16,766.0	29,022.6	36.6	85.4
Actuarial (gains)/losses due to changes in experience	133.9	(14,660.7)	(8,890.0)	(100.4)	(92.0)
Actuarial (gains)/losses due to changes in trend assumptions	0.0	(31,084.1)	(68,961.1)	0.0	0.0
Actuarial (gains)/losses due to other factors	0.0	2,570.5	19,637.1	0.0	(2.6)
Ending Actuarial Liability	**$ 1,360,922.5**	**$ 305,985.0**	**$ 533,667.7**	**$ 770.1**	**$ 1,773.6**
Change in Actuarial Liability	**$ 102,459.4**	**$ (23,507.1)**	**$ (39,327.5)**	**$ (189.2)**	**$ (126.9)**

The Department complies with *SFFAS No. 33*, "Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates." The standard requires the separate presentation of gains and losses from changes in long-term assumptions used to estimate liabilities associated with pensions, other retirement and postemployment benefits.

The SFFAS No. 33 also provides a standard for selecting the discount rate and valuation date used in estimating these liabilities.

Military Retirement Pensions

The Military Retirement Fund is a defined benefit plan authorized by Public Law (PL) 98-94 to provide funds used to pay annuities and pensions to retired military personnel and their survivors. The Department of Defense (DoD) Board of Actuaries approves the long-term economic assumptions for inflation, salary, and interest. The actuaries calculate the actuarial liabilities annually using economic assumptions and actual experience (e.g., mortality and retirement rates). Due to reporting deadlines, the current year actuarial present value of projected plan benefits rolls forward from the prior year's valuation results. The actuaries used the following assumptions to calculate the FY 2011 roll-forward amount:

Military Retirement Pensions	Inflation	Salary	Interest
Fiscal Year 2011	0.0% (actual)	1.4% (actual)	4.8%
Fiscal Year 2012	2.8% (estimated)	1.6% (estimated)	4.8%
Long Term	2.5%	3.3%	4.8%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Market Value of Investments in Market-Based and Marketable Securities: $436.1 billion* *Assumed Interest Rate: 4.8 percent*			

Historically, the initial unfunded liability of the program was amortized over a 50-year period. Effective FY 2008, the initial unfunded liability is amortized over a 42-year period to ensure the annual payments cover the interest on the unfunded actuarial liability, with the last payment expected to be made October 1, 2025. All subsequent gains and losses experienced are amortized over a 30-year period.

Actuarial Cost Method Used: Aggregate Entry-Age Normal Cost Method

Market Value of Investments in Market-Based and Marketable Securities: $436.1 billion

Assumed Interest Rate: 4.8 percent.

Military Retirement Health Benefits (MRHB)

The MRHB are post-retirement benefits the Department provides to non-Medicare-eligible military retirees and other eligible beneficiaries through private sector health care providers and the Department's medical treatment facilities. The actuaries calculate the actuarial liabilities annually using assumptions and actual experience. For the FY 2011 actuarial liability calculation, the actuaries used the following assumptions:

MRHB Medical Trend	FY 2010 – FY 2011	Ultimate Rate FY 2035
Medicare Inpatient (Direct Care)	3.38%	5.25%
Medicare Outpatient (Direct Care)	3.26%	5.25%
Medicare Prescriptions (Direct Care)	2.00%	5.25%
Non-Medicare Inpatient (Direct Care)	4.00%	5.25%
Non-Medicare Outpatient (Direct Care)	4.00%	5.25%
Non-Medicare Prescriptions (Direct Care)	1.00%	5.25%
Non-Medicare Inpatient (Purchased Care)	7.27%	5.25%
Non-Medicare Outpatient (Purchased Care)	5.99%	5.25%
Non-Medicare Prescriptions (Purchased Care)	6.13%	5.25%
U.S. Family Health Plan (USFHP) (Purchased Care)	5.67%	5.25%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Assumed Interest Rate: 4.9 percent*		

Actuarial Cost Method Used: Aggregate Entry-Age Normal Cost Method

Assumed Interest Rate: 4.9 percent

Medicare-Eligible Retiree Health Care Fund (MERHCF) Benefits

In accordance with PL 106-398, MERHCF accumulates funds to finance the health care program liabilities of Medicare-eligible retirees for all the Uniformed Services and specific Medicare-eligible beneficiaries. The DoD Board of Actuaries approves the long-term assumptions for medical trends and interest. The actuaries calculate the actuarial liabilities annually using actual experience (e.g., mortality and retirement rates, direct care costs, purchased care). Due to reporting deadlines, the current year actuarial present value of projected plan benefits rolls forward from the prior year's results. The actuaries used the following assumptions to calculate the FY 2011 roll-forward amount:

MERHCF Benefits — Medical Trend	FY 2010 – FY 2011	Ultimate Rate FY 2035
Medicare Inpatient (Direct Care)	3.38%	5.25%
Medicare Inpatient (Purchased Care)	4.38%	5.25%
Medicare Outpatient (Direct Care)	3.26%	5.25%
Medicare Outpatient (Purchased Care)	4.26%	5.25%
Medicare Prescriptions (Direct Care)	2.00%	5.25%
Medicare Prescriptions (Purchased Care)	5.82%	5.25%
Medicare USFHP (Purchased Care)	5.67%	5.25%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Market Value of Investments in Market-Based and Marketable Securities: $223.5 billion* *Assumed Interest Rate: 4.9 percent*		

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The $533.7 billion liability includes $521.8 billion for the Department, $10.7 billion for the Coast Guard, $1.1 billion for the Public Health Service, and $76.9 million for National Oceanic and Atmospheric Administration (NOAA). The FY 2011 contributions from each of the Uniformed Services were $11.0 billion from the Department, $265.3 million from the Coast Guard, $38.1 million from the Public Health Service, and $1.8 million from NOAA.

Actuarial Cost Method Used: Aggregate Entry-Age Normal Cost Method

Market Value of Investments in Market-Based and Marketable Securities: $223.5 billion

Assumed Interest Rate: 4.9 percent

Federal Employees Compensation Act (FECA)

The Department of Labor (DOL) annually determines the liability for future workers' compensation benefits, which includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred-but-not-reported claims. The liability is determined using historical benefit payment patterns related to a specific incurred period to predict the final payment related to that period. Consistent with past practice, these projected annual benefit payments have been discounted to present value using the Office of Management and Budget's economic assumptions for 10-year U.S. Treasury notes and bonds. A 3.54 percent interest rate was assumed for year one and 4.03 percent was assumed for year two and thereafter.

The DOL calculates this liability using wage inflation factors (cost of living adjustments or COLAs) and medical inflation factors (consumer price index medical or CPIM). The actual rates for these factors for charge back year (CBY) 2011 were also used to adjust the methodology's historical payments to current year constant dollars. The compensation COLAs and CPIMs used in the projections for various charge back years were as follows:

Federal Employees — Compensation Act (FECA)		
CBY	COLA	CPIM
2012	2.10%	3.07%
2013	2.53%	3.62%
2014	1.83%	3.66%
2015	1.93%	3.73%
2016+	2.00%	3.73%

The model's resulting projections were analyzed by DOL to ensure the estimates were reliable. The analysis was based on four tests: (1) a sensitivity analysis of the model of economic assumptions, (2) a comparison of the percentage change in the liability amount to the percentage change in the actual incremental payments, (3) a comparison of the incremental paid losses per case (a measure of case-severity) in CBY 2011 to the average pattern observed during the prior three charge back years, and (4) a comparison of the estimated liability per case in the 2011 projection to the average pattern for the projections for the most recent three years.

Voluntary Separation Incentive (VSI) Program

The VSI Program was established by PL 102-190 to reduce the number of military personnel on active duty. The DoD Board of Actuaries approved the assumed annual interest rate of 3.8 percent used to calculate the actuarial liability. Since the VSI Program is no longer offered, the actuarial liability calculated annually is expected to continue to decrease with benefit outlays and increase with interest cost.

Market Value of Investments in Market-based and Marketable Securities: $387.5 million

DoD Education Benefits Fund (EBF)

The EBF program was established by PL 98-525 to recruit and retain military members and aid in the readjustment of military members to civilian life. The actuaries calculate the actuarial liability annually based on the assumed interest rate of 4.5 percent that was approved by the DoD Board of Actuaries.

Market Value of Investments in Market-based and Marketable Securities: $2.4 billion

Other Federal Employment Benefits

Other Federal Employment Benefits primarily consists of accrued pensions and annuities, and an estimated liability for incurred-but-not-reported medical claims not processed prior to fiscal year end.

NOTE 18. GENERAL DISCLOSURES RELATED TO THE STATEMENT OF NET COST

Costs and Exchange Revenue		*Dollars in Millions*
As of September 30	**2011**	**Restated 2010**
Military Retirement Benefits		
1. Gross Cost		
A. Intragovernmental Cost	$ 0.0	$ 0.0
B. Nonfederal Cost	$ 57,033.8	$ 56,741.5
C. Total Cost	$ 57,033.8	$ 56,741.5
2. Earned Revenue		
A. Intragovernmental Revenue	$ (27,456.7)	$ (16,037.8)
B. Nonfederal Revenue	$ 0.0	$ 0.0
C. Total Revenue	$ (27,456.7)	$ (16,037.8)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 63,132.0	$ 148,535.6
Total Net Cost	**$ 92,709.1**	**$ 189,239.3**
Civil Works		
1. Gross Cost		
A. Intragovernmental Cost	$ 1,466.4	$ 1,399.4
B. Nonfederal Cost	$ 12,063.7	$ 11,901.0
C. Total Cost	$ 13,530.1	$ 13,300.4

Costs and Exchange Revenue *As of September 30*		**2011**		**Restated 2010** *Dollars in Millions*
2. Earned Revenue				
A. Intragovernmental Revenue	$	(1,623.6)	$	(1,082.6)
B. Nonfederal Revenue	$	(694.6)	$	(715.4)
C. Total Revenue	$	(2,318.2)	$	(1,798.0)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$	0.0	$	0.0
Total Net Cost	**$**	**11,211.9**	**$**	**11,502.4**
Military Personnel				
1. Gross Cost				
A. Intragovernmental Cost	$	35,115.5	$	31,171.8
B. Nonfederal Cost	$	118,765.9	$	123,203.1
C. Total Cost	$	153,881.4	$	154,374.9
2. Earned Revenue				
A. Intragovernmental Revenue	$	(804.3)	$	(998.0)
B. Nonfederal Revenue	$	(77.3)	$	(25.1)
C. Total Revenue	$	(881.6)	$	(1,023.1)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	**$**	0.0	**$**	0.0
Total Net Cost	**$**	**152,999.8**	**$**	**153,351.8**
Operations, Readiness & Support				
1. Gross Cost				
A. Intragovernmental Cost	$	(55,748.9)	$	(50,243.5)
B. Nonfederal Cost	$	369,116.4	$	327,219.9
C. Total Cost	$	313,367.5	$	276,976.4
2. Earned Revenue				
A. Intragovernmental Revenue	$	11,470.3	$	12,607.3
B. Nonfederal Revenue	$	(73,595.3)	$	(36,841.4)
C. Total Revenue	$	(62,125.0)	$	(24,234.1)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$	(23,823.3)	$	15,553.4
Total Net Cost	**$**	**227,419.2**	**$**	**268,295.7**
Procurement				
1. Gross Cost				
A. Intragovernmental Cost	$	29,956.9	$	29,727.8
B. Nonfederal Cost	$	98,615.9	$	94,839.9
C. Total Cost	$	128,572.8	$	124,567.7
2. Earned Revenue				
A. Intragovernmental Revenue	$	(3,150.6)	$	(2,646.3)
B. Nonfederal Revenue	$	(3,015.0)	$	(1,380.3)

Costs and Exchange Revenue		Dollars in Millions
As of September 30	**2011**	**Restated 2010**
C. Total Revenue	$ (6,165.6)	$ (4,026.6)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 122,407.2**	**$ 120,541.1**
Research, Development, Test & Evaluation		
1. Gross Cost		
A. Intragovernmental Cost	$ 22,993.7	$ 22,770.5
B. Nonfederal Cost	$ 56,165.0	$ 60,107.0
C. Total Cost	$ 79,158.7	$ 82,877.5
2. Earned Revenue		
A. Intragovernmental Revenue	$ (7,916.6)	$ (8,163.8)
B. Nonfederal Revenue	$ (251.7)	$ (212.9)
C. Total Revenue	$ (8,168.3)	$ (8,376.7)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 70,990.4**	**$ 74,500.8**
Family Housing & Military Construction		
1. Gross Cost		
A. Intragovernmental Cost	$ 1,734.3	$ 1,071.0
B. Nonfederal Cost	$ 12,605.9	$ 9,038.3
C. Total Cost	$ 14,340.2	$ 10,109.3
2. Earned Revenue		
A. Intragovernmental Revenue	$ (7,547.4)	$ (7,152.1)
B. Nonfederal Revenue	$ (377.1)	$ (593.8)
C. Total Revenue	$ (7,924.5)	$ (7,745.9)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 6,415.7**	**$ 2,363.4**
Consolidated		
1. Gross Cost		
A. Intragovernmental Cost	$ 35,517.9	$ 35,897.0
B. Nonfederal Cost	$ 724,366.6	$ 683,050.7
C. Total Cost	$ 759,884.5	$ 718,947.7
2. Earned Revenue		
A. Intragovernmental Revenue	$ (37,028.9)	$ (23,473.3)
B. Nonfederal Revenue	$ (78,011.0)	$ (39,768.9)
C. Total Revenue	$ (115,039.9)	$ (63,242.2)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 39,308.7	$ 164,089.0

Costs and Exchange Revenue *As of September 30*	2011		Restated 2010	
4. Costs Not Assigned to Programs	$	0.0	$	0.0
5. (Less: Earned Revenues) Not Attributed to Programs	$	0.0	$	0.0
Total Net Cost	**$**	**684,153.3**	**$**	**819,794.5**

Dollars in Millions

Abnormal Balances

Nonfederal Earned Revenue on the Statement of Net Cost (SNC) includes an abnormal balance of $243.9 million in USSGL account 5909 (Contra Revenue for Other Revenue). In September 2010, the Department recorded transactions in this account for work along the Louisiana coast. After completion of the financial statements, it was determined that the transactions should not have been processed. The abnormal balance reflects the reversal entry to correct the transaction.

Operations, Readiness & Support Intragovernmental Gross Cost on the SNC has an abnormal balance of $55.7 billion. The current business practice is to include elimination reporting in this program group.

Operations, Readiness & Support Intragovernmental Earned Revenue on the SNC has an abnormal balance of $11.5 billion. The current business practice is to include elimination reporting in this program group.

Restatements

The Department identified an overstatement of General Property, Plant and Equipment. This correction increased the FY 2010 net cost by $17.0 billion. This prior period adjustment is reflected in the schedule above as Nonfederal Gross Cost in Procurement; Research, Development, Test and Evaluation; and Operations, Readiness and Support. See Note 26, Restatements, for additional information.

Other Disclosures

The SNC represents the net cost of programs and organizations of the Department that are supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity. The Department's current processes and systems capture costs based on appropriation groups as presented in the schedule above. The lower level costs for major programs are not presented as required by the Government Performance and Results Act. The Department is in the process of reviewing available data and developing a cost reporting methodology as required by the SFFAS No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government", as amended by SFFAS No. 30, "Interentity Cost Implementation".

Intragovernmental costs and revenue represent transactions made between two reporting entities within the Federal Government. Public costs and revenues are exchange transactions made between the reporting entity and a nonfederal entity.

The Department's systems do not track intragovernmental transactions by customer at the transaction level. Buyer side expenses are adjusted to agree with internal seller side revenues. Expenses are generally adjusted by reclassifying amounts between federal and nonfederal expenses. Intradepartmental revenues and expenses are then eliminated.

The SNC presents information based on budgetary obligation, disbursement, and collection transactions, as well as data from nonfinancial feeder systems. Amounts are adjusted for accruals, such as payroll expenses, accounts payable, and environmental liabilities. The General Fund data is primarily derived from budgetary transactions (obligations, disbursements, and collections), data from nonfinancial feeder systems, and accruals made for major items. While Working Capital Funds primarily record transactions on an accrual basis, the systems do not always capture actual costs in a timely manner.

The Department's accounting systems generally do not capture information relative to heritage assets separately and distinctly from normal operations.

The Department implemented SFFAS No. 33, "Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates". The standard requires the separate presentation of gains and losses from changes in long term assumptions used to estimate liabilities associated with pensions, other retirement benefits, and other postemployment benefits on the SNC. The SFFAS No. 33 also provides a standard for selecting the discount rate and valuation date used in estimating these liabilities.

NOTE 19. DISCLOSURES RELATED TO THE STATEMENT OF CHANGES IN NET POSITION

Abnormal Balance

Earned Revenue on the Statement of Net Cost includes an abnormal balance of $243.9 million in USSGL account 5909 (Contra Revenue for Other Revenue). In September 2010, the Department recorded transactions in this account for work along the Louisiana coast. After completion of the financial statements, it was determined that the transactions should not have been processed. The abnormal balance reflects the reversal entry to correct the transactions.

Restatements

The Department corrected a $14.4 billion overstatement of General Property, Plant and Equipment to align the accounting records to the property accountability system. Refer to Note 26, Restatements, for further information.

Other Disclosures

Other Financing Sources, Other consists primarily of nonexchange gains and losses necessary to reconcile the proprietary and budgetary amounts, as well as gains and losses on disposition of assets. Due to financial system limitations, the Department adjusts for these unreconciled differences.

Earmarked Cumulative Results of Operations ending balance on the Statement of Changes in Net Position (SCNP) does not agree with the Earmarked Cumulative Results reported on the Balance Sheet because the cumulative results on the Balance Sheet are presented net of eliminations. In the SCNP, all offsetting balances (e.g. transfers-in and transfers-out, revenue, and expenses) for intraentity activity between Earmarked Funds and All Other Funds are reported on the same lines. The Eliminations column contains all appropriate elimination entries, which net to zero within each respective line, except for intraentity imputed financing costs.

Appropriations Received on the SCNP does not agree with Appropriations on the Statement of Budgetary Resources (SBR). The difference of $137.7 billion is primarily related to the Military Retirement Fund and the Medicare-Eligible Retiree Health Care Fund appropriations. In order to preserve visibility with the President's Budget, these appropriations are effectively reported twice on the SBR. They are reported once by the Military Departments and Defense Agencies as appropriated and once by the individual trust funds as receipts. Refer to Note 20, Disclosures Related to the SBR, for further information.

NOTE 20. DISCLOSURES RELATED TO THE STATEMENT OF BUDGETARY RESOURCES

Disclosures Related to the Statement of Budgetary Resources		Dollars in Millions
As of September 30	2011	Restated 2010
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period.	$ 478,054.4	$ 467,972.2

Restatements

The Department corrected $83.5 million in misstated contract authority, impacting the Unobligated Balance, Brought Forward, 1 October, on the Statement of Budgetary Resources (SBR). Refer to Note 26, Restatements, for further information.

Reconciliation Differences

Appropriations on the SBR exceeds Appropriations Received on the Statement of Changes in Net Position by $137.7 billion. This difference represents trust and special fund receipts reported as exchange revenue on the Statement of Net Cost and included in appropriations on the SBR. In accordance with Office of Management and Budget (OMB) guidance, $108.5 billion of General Fund appropriations received by the Department are also recognized on the SBR as appropriations received for trust and special funds. The difference is primarily due to duplicate reporting in the SBR of the Military Services' contributions and U.S. Treasury's payments to the Military Retirement Trust Fund and the Department of Defense Medicare-Eligible Retiree Health Care Fund.

The SBR FY 2010 column includes $104.9 billion more in budget authority than reported in the 2010 actual column of the President's FY 2012 Budget. The difference is primarily due to duplicate reporting in the SBR of the Military Services' contributions and U.S. Treasury's payments to the Military Retirement Trust Fund and the Department of Defense Medicare-Eligible Retiree Health Care Fund.

The SBR FY 2010 column includes $19.8 million less in obligations than reported in the 2010 actual column of the President's FY 2012 Budget. The difference is primarily due to the timing of the recognition of obligations.

The SBR FY 2010 column includes $77.7 billion less in net outlays than reported in the 2010 actual column of the President's FY 2012 Budget. The SBR reduces net outlays by the distributed offsetting receipts. The President's Budget does not reduce the Department's outlays by the distributed offsetting receipts.

Permanent Indefinite Appropriations

The Department of Defense (DoD) received the following permanent indefinite appropriations:

- Department of the Army General Gift Fund (10 USC 2601(C)(1))
- Department of the Navy General Gift Fund (10 USC 2601(C)(2))
- Department of the Air Force General Gift Fund (10 USC 2601 (C)(3))
- Department of Defense General Gift Fund (10 USC 2601)
- Disposal of Department of Defense Real Property (40 USC 485(h)(2)(A)(B))
- Lease of Department of Defense Real Property (40 USC 485(h)(2)(A)(B))
- Foreign National Employees Separation Pay Account, Defense (10 USC 1581)
- United States Naval Academy Gift and Museum Fund (10 USC 6973-4)
- Ship Stores Profits, Navy (10 USC 7220, 31 USC 1321)
- Burdensharing Contributions (10 USC 2350j)
- Forest Program (10 USC 2665)
- Medicare Eligible Retiree Health Care Fund (10 USC 1111)
- Military Retirement Fund (10 USC 1461)
- Education Benefits Fund (10 USC 2006)
- Host Nation Support for U.S. Relocation Activities (10 USC 2350k)
- Hydraulic Mining Debris Reservoir (33 USC 683)
- Maintenance and Operation of Dams and Other Improvements of Navigable Waters (16 USC 810(a))
- Payments to States (33 USC 701c-3)
- Wildlife Conservation (16 USC 670-670(f))
- Ainsworth Bequest (31 USC 1321)
- DoD Family Housing Improvement Fund (10 USC 2883 (a))
- DoD Military Unaccompanied Housing Improvement Fund (10 USC 2883 (a))
- Voluntary Separation Incentive Fund (10 USC 1175(h))

- Rivers & Harbors Contributed Funds (33 USC 560, 701h)
- Concurrent Receipt Accrual Payments to the Military Retirement Fund 10 USC 1466(b)(1)
- Rocky Mountain Arsenal, Restoration (100 Statute, 4003 SEC 1367)
- DoD Family Housing Improvement Fund, Direct Loan, Financing Account (2 USC 661d)
- DoD Family Housing Improvement Fund, Guaranteed Loan, Financing Account (2 USC 661d)
- Homeowners Assistance Fund (10 USC 4551-4555; 42 USC 3374(d), Title United States Code; Public Law 111-5)
- Payments to Military Retirement Fund, Defense (10 USC, 1466)
- Payment to Department of Defense Medicare-Eligible Retiree Health Care Fund (10 USC 1116(a))
- ARMS Initiative, Guaranteed Loan Financing Account, Army (10 USC 2501, 10 USC 4551-4555)
- Medicare-Eligible Retiree Health Fund Contribution, Navy (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, Marine Corps (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, Reserve Personnel, Navy (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, Reserve Personnel, Marine Corps (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, Army (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, Reserve Personnel, Army (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, National Guard Personnel, Army (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, Air Force (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, Reserve Personnel, Air Force (10 USC 1116)
- Medicare-Eligible Retiree Health Fund Contribution, National Guard Personnel, Air Force (10 USC 1116)
- Department of Defense Vietnam War Commemoration Fund, Defense (P.L. 110-181, 122 Stat. 141 (Sec. 598))

The above permanent indefinite appropriations cover a wide variety of purposes to help the Department accomplish its missions. These purposes include: (1) military retirees' health care benefits, retirement and survivor pay, and education benefits for veterans; (2) wildlife habitat restoration and water resources maintenance; (3) relocation of armed forces within a host nation; (4) separation payments for foreign nationals; and (5) upkeep of libraries and museums.

Apportionment Categories for Obligations incurred

The Department reported the following amounts of direct obligations: (1) $520.0 billion in category A, (2) $225.4 billion in category B, and (3) $128.6 billion in exempt from apportionment. The Department reported reimbursable obligations of (1) $22.7 billion in category A, (2) $173.1 billion in category B, and (3) $190.0 thousand in exempt from apportionment. Category A relates to appropriations for a specific period of time (e.g., Military Personnel appropriation), and category B relates to appropriations for a specific project (e.g., Military Construction appropriation).

Legal Arrangements Affecting the Use of Unobligated Balances

A portion of the Department's unobligated balances represent trust fund receipts collected in the current fiscal year that exceed the amount needed to pay benefits or other valid obligations. These receipts are temporarily precluded from obligation by law due to a benefit formula or other limitation. The receipts, however, are assets of the funds and are available for obligation as needed in the future. The Department operates within the constraints of fiscal law and has no additional legal arrangements affecting the use of unobligated balances.

Other Disclosures

The SBR includes intraentity transactions because the statements are presented as combined.

The Department utilizes borrowing authority for the Military Housing Privatization Initiative and the Armament Retooling and Manufacturing Support Initiative. Borrowing authority is used in accordance with *OMB Circular No. A-129*, "Managing Federal Credit Programs."

The Department received additional funding of $159.0 billion to cover obligations incurred above baseline operations in support of contingency operations.

NOTE 21. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

Reconciliation of Net Cost of Operations to Budget		*Dollars in Millions*
As of September 30	**2011**	**Restated 2010**
Resources Used to Finance Activities		
Budgetary Resources Obligated:		
Obligations incurred	$ 1,069,545.0	$ 1,053,074.5
Less: Spending authority from offsetting collections and recoveries (-)	(252,444.2)	(242,038.4)
Obligations net of offsetting collections and recoveries	**$ 817,100.8**	**$ 811,036.1**
Less: Offsetting receipts (-)	(83,198.6)	(77,722.2)
Net obligations	**$ 733,902.2**	**$ 733,313.9**
Other Resources:		
Donations and forfeitures of property	$ 7.6	$ 6.4
Transfers in/out without reimbursement (+/-)	(147.4)	566.2
Imputed financing from costs absorbed by others	5,623.9	5,596.2

Reconciliation of Net Cost of Operations to Budget *As of September 30* (*Dollars in Millions*)	**2011**	**Restated 2010**
Other (+/-)	1,812.3	2,446.5
Net other resources used to finance activities	**$ 7,296.4**	**$ 8,615.3**
Total resources used to finance activities	**$ 741,198.6**	**$ 741,929.2**
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided:		
Undelivered Orders (-)	$ (10,081.1)	$ (17,234.8)
Unfilled Customer Orders	3,691.4	2,298.9
Resources that fund expenses recognized in prior Periods (-)	(74,469.2)	(7,004.9)
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	2,507.9	2,599.2
Resources that finance the acquisition of assets (-)	$ (127,712.0)	$ (125,255.3)
Other resources or adjustments to net obligated resources that do not affect Net Cost of Operations:		
Less: Trust or Special Fund Receipts Related to exchange in the Entity's Budget (-)	$ 0.0	$ 0.0
Other (+/-)	(1,672.7)	(3,008.2)
Total resources used to finance items not part of the Net Cost of Operations	**$ (207,735.7)**	**$ (147,605.1)**
Total resources used to finance the Net Cost of Operations	**$ 533,462.9**	**$ 594,324.1**
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in Future Period:		
Increase in annual leave liability	$ 363.7	$ 2,688.6
Increase in environmental and disposal liability	3,667.8	873.4
Upward/Downward reestimates of credit subsidy expense (+/-)	8.3	4.7
Increase in exchange revenue receivable from the public (-)	(552.3)	(295.0)
Other (+/-)	112,105.1	166,438.4
Total components of Net Cost of Operations that will Require or Generate Resources in future periods	**$ 115,592.6**	**$ 169,710.1**
Components not Requiring or Generating Resources:		
Depreciation and amortization	$ 55,865.2	$ 39,672.7
Revaluation of assets or liabilities (+/-)	(8,286.9)	4,119.3
Other (+/-)		
Trust Fund Exchange Revenue	(55,336.7)	(46,694.0)
Cost of Goods Sold	72,938.9	67,434.1
Operating Materiel and Supplies Used	33,442.2	28,690.0
Other	(63,524.9)	(37,461.8)

Reconciliation of Net Cost of Operations to Budget		*Dollars in Millions*
As of September 30	**2011**	**Restated 2010**
Total Components of Net Cost of Operations that will not Require or Generate Resources	**$ 35,097.8**	**$ 55,760.3**
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	**$ 150,690.4**	**$ 225,470.4**
Net Cost of Operations	**$ 684,153.3**	**$ 819,794.5**

Restatements

The Department corrected an overstatement of General Property, Plant and Equipment to align the accounting records to the property accountability system. This correction increased the FY 2010 Gross Costs on the Statement of Net Costs by $17.0 billion. See Note 26, Restatements, for further information.

Other Disclosures

Due to the Department's financial system limitations, budgetary data does not agree with proprietary expenses and capitalized assets. The difference between budgetary and proprietary data is a previously identified deficiency. The following adjustments (absolute value) were made to balance the Reconciliation of Net Cost of Operations to the Statement of Net Cost:

	(Amounts in millions)
Resources that Finance the Acquisition of Assets	$ 11,658.8
Other Components not Requiring or Generating Resources	$ 2,691.7
Total Amount	**$ 14,350.5**

The following Reconciliation of Net Cost of Operations to Budget lines are presented as combined instead of consolidated due to intraagency budgetary transactions not being eliminated:

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

Other Resources, Other primarily consists of nonexchange gains and losses necessary to reconcile the proprietary and budgetary amounts, as well as gains and losses on disposition of assets.

Other Resources or Adjustments to Net Obligated Resources that Do Not Affect Net Cost of Operations, Other primarily consists of nonexchange gains and losses necessary to reconcile the proprietary and budgetary amounts, financing sources transferred in and out without reimbursement, and gains and losses from disposition of assets.

Components Requiring or Generating Resources in Future Period, Other consists primarily of future funded expenses for other federal employment benefits.

Components not Requiring or Generating Resources, Other primarily consists of cost capitalization offsets and other expenses not requiring budgetary resources.

NOTE 22. DISCLOSURES RELATED TO INCIDENTAL CUSTODIAL COLLECTIONS

The Department collected $15.0 million of incidental custodial revenues generated primarily from forfeitures of unclaimed money and property. These funds are not available for use by the Department. At the end of each fiscal year, the accounts are closed and the balances rendered to the U.S. Treasury.

NOTE 23. EARMARKED FUNDS

Earmarked Funds					*Dollars in Millions*
	2011				
As of September 30	Military Retirement Fund	Medicare-Eligible Retiree Health Care Fund	Other Earmarked Funds	Eliminations	Total
Balance Sheet					
Assets					
Fund balance with Treasury	$ 370.3	$ 227.2	$ 2,730.6	$ 0.0	$ 3,328.1
Investments	371,616.3	187,826.1	9,899.7	0.0	569,342.1
Accounts and Interest Receivable	233.5	498.0	1,415.6	(201.5)	1,945.6
Other Assets	0.0	0.0	1,398.9	0.0	1,398.9
Total Assets	**$ 372,220.1**	**$ 188,551.3**	**$ 15,444.8**	**$ (201.5)**	**$ 576,014.7**
Liabilities and Net Position					
Military Retirement Benefits and Other Federal Employment Benefits	$ 1,361,267.8	$ 534,379.7	$ 2,543.7	$ 0.0	$1,898,191.2
Other Liabilities	1.9	422.9	3,112.6	(120.6)	3,416.8
Total Liabilities	**$ 1,361,269.7**	**$ 534,802.6**	**$ 5,656.3**	**$ (120.6)**	**$1,901,608.0**
Unexpended Appropriations	$ 0.0	$ 0.0	$ 134.6	$ 0.0	$ 134.6
Cumulative Results of Operations	(989,049.6)	(346,251.3)	9,653.9	(104,626.8)	(1,430,273.8)
Total Liabilities and Net Position	**$ 372,220.1**	**$ 188,551.3**	**$ 15,444.8**	**$ (104,747.4)**	**$ 471,468.8**
Statement of Net Cost					
Program Costs	$ 153,446.3	$ (30,507.5)	$ 2,939.4	$ (2,863.1)	$ 123,015.1
Less Earned Revenue	(105,322.4)	(30,253.8)	(1,327.8)	108,427.4	(28,476.6)
Net Program Costs	48,123.9	(60,761.3)	1,611.6	105,564.3	94,538.5
Net Cost of Operations	**$ 48,123.9**	**$ (60,761.3)**	**$ 1,611.6**	**$ 105,564.3**	**$ 94,538.5**
Statement of Changes in Net Position					
Net Position Beginning of the Period	$ (940,925.7)	$ (407,012.6))	$ 9,522.3	$ 0.0	$(1,338,416.0)
Net Cost of Operations	48,123.9	(60,761.3)	1,611.6	105,564.3	94,538.5
Budgetary Financing Sources	0.0	0.0	1,934.4	922.7	2,857.1
Other Financing Sources	0.0	0.0	(56.6)	14.8	(41.8)
Change in Net Position	**$ (48,123.9)**	**$ (60,761.3)**	**$ 266.2**	**$ (104,626.8)**	**$ (91,723.2)**
Net Position End of Period	**$ (989,049.6)**	**$ (346,251.3)**	**$ 9,788.5**	**$ (104,626.8)**	**$(1,430,139.2)**

Earmarked Funds As of September 30	2010 Military Retirement Fund	Medicare-Eligible Retiree Health Care Fund	Other Earmarked Funds	Eliminations	Total (Dollars in Millions)
Balance Sheet					
Assets					
Fund balance with Treasury	$ 25.4	$ 196.0	$ 3,181.0	$ 0.0	$ 3,402.4
Investments	321,686.8	166,203.5	9,246.4	0.0	497,136.7
Accounts and Interest Receivable	37.0	562.9	1,107.8	(42.5)	1,665.2
Other Assets	0.0	0.0	1,441.1	0.0	1,441.1
Total Assets	**$ 321,749.2**	**$ 166,962.4**	**$ 14,976.3**	**$ (42.5)**	**$ 503,645.4**
Liabilities and Net Position					
Military Retirement Benefits and Other Federal Employment Benefits	$ 1,262,672.9	$ 573,671.3	$ 2,859.8	$ 0.0	$1,839,204.0
Other Liabilities	2.0	303.7	2,594.2	(118.3)	2,781.6
Total Liabilities	**$ 1,262,674.9**	**$ 573,975.0**	**$ 5,454.0**	**$ (118.3)**	**$1,841,985.6**
Unexpended Appropriations	$ 0.0	$ 0.0	$ 325.2	$ (20.4)	$ 304.8
Cumulative Results of Operations	(940,925.7)	(407,012.6)	9,197.1	(101,264.8)	(1,440,006.0)
Total Liabilities and Net Position	**$ 321,749.2**	**$ 166,962.4**	**$ 14,976.3**	**$ (101,403.5)**	**$ 402,284.4**
Statement of Net Cost					
Program Costs	$ 136,098.0	$ 71,579.4	$ 2,302.9	$ (2,497.6)	$ 207,482.7
Less Earned Revenue	(93,929.7)	(26,420.1)	(1,393.4)	104,871.0	(16,872.3)
Net Program Costs	42,168.3	45,159.3	909.5	102,373.4	190,610.4
Net Cost of Operations	**$ 42,168.3**	**$ 45,159.3**	**$ 909.5**	**$ 102,373.4**	**$ 190,610.4**
Statement of Changes in Net Position					
Net Position Beginning of the Period	$ (898,757.4)	$ (361,576.6)	$ 8,074.1	$ 0.0	$(1,252,259.9)
Net Cost of Operations	42,168.3	45,159.3	909.5	102,373.4	190,610.5
Budgetary Financing Sources	0.0	0.0	2,572.0	1,088.2	3,660.2
Other Financing Sources	0.0	(276.7)	(214.3)	0.0	(491.0)
Change in Net Position	**$ (42,168.3)**	**$ 45,436.0**	**$ 1,448.2**	**$ (101,285.2)**	**$ (187,441.3)**
Net Position End of Period	**$ (940,925.7)**	**$ (407,012.6)**	**$ 9,522.3**	**$ (101,285.2)**	**$(1,439,701.2)**

Abnormal Balances

Earned Revenue on the Statement of Net Cost, Net Cost of Operations on the Statement of Changes in Net Position, and Cumulative Results of Operation on the Balance Sheet includes abnormal balances of $243.9 million in USSGL account 5909 (Contra Revenue for Other Revenue). In September 2010, the Department recorded transactions in the accounts for work along the Louisiana coast. After completion of the financial statements, it was determined that the transactions should not have been processed. The abnormal balances reflect the reversal entry.

Other Disclosures

The SFFAS No. 27, "Identifying and Reporting Earmarked Funds," requires the disclosure of Earmarked Funds separate from All Other Funds on the Statement of Changes in Net Position (SCNP) and Balance Sheet. Funds must meet three criteria to be classified as earmarked: (1) a statute committing use of specifically-identified revenues for designated purposes, (2) explicit authority to retain the revenues, and (3) a requirement to account and report on the revenues. The Department's earmarked funds are either special or trust funds and use both receipt and expenditure accounts to report activity to the U.S. Treasury. There have been no changes in legislation that significantly changed the purposes of the funds.

The SFFAS No. 27 also requires the presentation of gross amounts of Earmarked Funds separate from All Other (nonearmarked) Funds. Cumulative Results of Operations ending balances for Earmarked Funds on the SCNP do not agree with the Cumulative Results of Operations for Earmarked Funds reported on the Balance Sheet because the Cumulative Results of Operations on the Balance Sheet are presented net of eliminations, whereas the SCNP presents gross Cumulative Results of Operations.

The Total column is shown as consolidated and relates only to Earmarked Funds. The Eliminations column includes eliminations associated with Earmarked Funds and excludes the offsetting eliminations from All Other Funds. This exclusion causes assets to not equal liabilities and net position in the note. However, the amounts in the Total column equal the amounts reported for Earmarked Funds on the Balance Sheet.

Military Retirement Fund (MRF), 10 United States Code (USC) 1461. The MRF accumulates funds in order to finance, on an actuarially sound basis, the liabilities of the Department's military retirement and survivor benefit programs. Financing sources for the MRF are interest earnings on Fund assets, monthly Department contributions, and annual contributions from the U.S. Treasury. The monthly Department contributions are calculated as a percentage of basic pay. The contribution from the U.S. Treasury represents the amortization of the unfunded liability for service performed prior to October 1, 1984, plus the amortization of actuarial gains and losses that have arisen since then. The U.S. Treasury annual contribution also includes the normal cost amount for the concurrent receipt provisions of the FY 2004 National Defense Authorization Act.

Medicare-Eligible Retiree Health Care Fund (MERHCF), 10 USC 1111. The MERHCF accumulates funds to finance, on an actuarially sound basis, liabilities of the Department and the uniformed services health care programs for qualified Medicare-eligible beneficiaries. Financing sources for MERHCF are provided primarily through an annual actuarial liability payment from the U.S. Treasury, annual contributions from each Uniformed Service (Army, Navy, Air Force, Marine Corps, U.S. Coast Guard, National Oceanic and Atmospheric Administration, and U.S. Public Health Service) and interest earned from the Fund's investments.

Other Earmarked Funds

Special Recreation Use Fees, 16 USC 4061-6a note. The United States Army Corps of Engineers (USACE) is granted the authority to charge and collect fair and equitable Special Recreation Use Fees at campgrounds located at lakes or reservoirs that are under the jurisdiction of USACE. Types of allowable fees include daily use fees, admission fees, recreational fees, annual pass fees, and other permit type fees. The receipts are used for the operation and maintenance of the recreational sites.

Hydraulic Mining in California, Debris, 33 USC 683. Operators of hydraulic mines through which debris flows in part or in whole to a body restrained by a dam or other work erected by the California Debris Commission are required to pay an annual tax as determined by the Commission. Taxes imposed under this code are collected and expended under the supervision of USACE and the direction of the Department of the Army. The funds are used for repayment of funds advanced by the Federal government or other agencies for construction, restraining works, settling reservoirs, and maintenance.

Payments to States, Flood Control Act of 1954, 33 USC 701c-3. Seventy-five percent of all funds received and deposited from the leasing of lands acquired by the United States for flood control, navigation, and allied purposes (including the development of hydroelectric power) are returned to the state in which the property is located. USACE collects lease receipts into a receipt account. Funds are appropriated for the amount of receipts the following fiscal year. The funds may be expended by the states for the benefit of public schools and public roads of the counties in which such property is situated, or for defraying any of the expenses of county government.

Maintenance and Operation of Dams and Other Improvements of Navigable Waters, 16 USC 803(f) and 810. When a reservoir or other improvement is constructed by the U.S., the Federal Energy Regulatory Commission (FERC) assesses charges against licensees directly benefited. The statute requires all proceeds from any Indian reservation be placed to the credit of the Indians of the reservation. All other charges arising from licenses, except those charges established by the FERC for administrative reimbursement, are paid to the U.S. Treasury and allocated for specific uses. The Army is allocated 50 percent of charges from all licenses, except licenses for the occupancy and use of public lands and national forests. These funds are deposited in a special fund and used for maintenance, operation, and improvement of dams and other navigation structures that are owned by the United States, or in construction, maintenance, or operation of headwater, or other improvements to navigable waters of the United States.

Fund for NonFederal Use of Disposal Facilities (for dredged material), 33 USC 2326. Any dredged material disposal facility under the jurisdiction of, or managed by, the Secretary of the Army may be used by a nonfederal interest if the Secretary determines that such use will not reduce the availability of the facility for project purposes. Fees may be imposed to recover capital, operation, and maintenance costs associated with such use. Any monies received through collection of fees under this law shall be available to, and used by, the Secretary of the Army for the operation and maintenance of the disposal facility from which the fees were collected.

South Dakota Terrestrial Wildlife Habitat Restoration Trust Fund, Public Law 106-53 Sec. 603. Yearly transfers are made from the General Fund of the U.S. Treasury to the Trust Fund for investment purposes. Investment activity is managed by the Bureau of the Public Debt (BPD). The BPD purchases and redeems nonmarketable market-based securities. Investments include one-day certificates, bonds, and notes. When the fund reaches the aggregate amount of $108 million, withdrawals may be made by USACE for payment to the State of South Dakota. The state uses the payments to fund annually-scheduled work for wildlife habitat restoration.

Costal Wetlands Restoration Trust Fund and Costal Wetlands Planning, Protection, and Restoration Act, 16 USC 3951-3956. USACE (along with the Environmental Protection Agency, and the Fish and Wildlife Service) is granted the authority to work with the State of Louisiana to develop, review, evaluate, and approve a plan to achieve a goal of "no net loss of wetlands" in coastal Louisiana. USACE is also responsible for allocating funds among the named task force members. Federal contributions are established at 75 percent of project costs or 85 percent if the state has an approved Coastal Wetlands Conservation Plan.

Rivers and Harbors Contributed and Advance Funds, 33 USC 701h, 702f, and 703. Whenever any state or political subdivision offers to advance funds for a flood control project duly adopted and authorized by law, the Secretary of the Army may, in his discretion, receive such funds and expend them in the immediate prosecution of such work. The funding may be used to construct, improve, and maintain levees, water outlets, flood control, debris removal, rectification and enlargement of river channels, etc. in the course of flood control and river and harbor maintenance.

Inland Waterways Trust Fund, 26 USC 9506. This law made the Inland Waterways Trust Fund available for USACE expenditures for navigation, construction, and rehabilitation projects on inland waterways. Collections for excise taxes from the public are made into the Trust Fund. The collections are invested and investment activity is managed by the BPD. The BPD purchases and redeems nonmarketable market-based securities. Investments include one-day certificates, bonds, and notes.

Harbor Maintenance Trust Fund, 26 USC 9505. The USACE Civil Works mission is funded by the Energy and Water Development Appropriations Act. The Water Resources Development Act of 1986 covers a portion of USACE operations and maintenance costs for deep draft navigation. The Harbor Maintenance Trust Fund is available for making expenditures to carry out the functions specified in the Act and for the payment of all expenses of administration incurred by the U.S. Treasury, USACE, and the Department of Commerce. Collections are made into the Trust Fund from taxes collected from imports, domestics, passengers, and foreign trade. The collections are invested and investment activity is managed by the BPD.

Foreign National Employees Separation Pay Account Trust Fund, 10 USC 1581. This fund makes payments from amounts obligated by the Secretary of Defense that remain unexpended for separation pay for foreign national employees of the Department. The foreign national employees' separation pay funded by Foreign Military Sales administrative funds is maintained as a separate fund.

Defense Commissary Agency Surcharge Trust Fund, 10 USC 2685. This fund was established as the repository for the surcharge on sales of commissary goods paid for by authorized patrons to finance certain operating expenses and capital purchases of the Commissary System, which are precluded by law from being paid with appropriated funds. Most surcharge revenue is generated by the 5 percent surcharge applied to each sale. These funds may be used to pay for commissary store-related information technology investments, to purchase commissary equipment, to finance advance design modifications to prior year projects, for both minor and major construction projects, and to maintain and repair commissary facilities and equipment.

Education Benefit Fund, 10 USC 2006. This fund was established to finance, on an actuarially sound basis, the liabilities of the Department's education benefit programs for current and former active duty, guard, and reserve members of the armed forces, and members of the Coast Guard. Financing sources for the Education Benefit Fund are interest earnings on Fund assets and monthly Department contributions.

Voluntary Separation Incentive Fund, 10 USC 1175. This fund was established to finance, on an actuarially sound basis, the liabilities of the Department's incentive program for early separation from military service. Financing sources for the Voluntary Separation Incentive Fund are interest earnings on Fund assets and annual Department contributions

Military Housing Privatization Initiative, Public Law 104-106, Section 2801. The MHPI includes both direct loan and loan guarantee programs, is authorized by the National Defense Authorization Act for FY 1996, and includes a series of authorities that allow the Department to work with the private sector to renovate and build military family housing. The MHPI accelerates the construction of new housing built to market standard and leverages private sector capital with government dollars. The Department provides protection to the private sector partner against specific risks, such as base closure or member deployment.

Armament Retooling and Manufacturing Support Initiative, 10 USC 4551-4555. The Armament Retooling and Manufacturing Support Initiative is a loan guarantee program designed to incentivize commercial use of the Army's inactive ammunition plants for businesses willing to locate to a government ammunition production facility. The production capacity of these facilities is greater than current military requirements, however, this capacity may be needed in the future. Revenue from property rentals are used to pay for the operation, maintenance and environmental cleanup at the facilities.

NOTE 24. FIDUCIARY ACTIVITIES

Schedule of Fiducìary Activity *As of September 30*	**2011**	**2010**
Fiduciary net assets, beginning of year	$ 178.9	$ 187.4
Contributions	282.5	256.7
Investment earnings	$ 18.0	$ 17.2
Distributions to and on behalf of beneficiaries	(279.9)	(282.4)
Increase/(Decrease) in fiduciary net assets	20.6	(8.5)
Fiduciary net assets, end of period	**$ 199.5**	**$ 178.9**

Dollars in Millions

Schedule of Fiduciary Net Assets *As of September 30*	**2011**	**2010**
Fiduciary Assets		
Cash and cash equivalents	**$ 199.5**	**$ 178.9**
Total Fiduciary Net Assets	**$ 199.5**	**$ 178.9**

Dollars in Millions

Fiduciary activities exist when the Department has collected, received, held, or made disposition of assets on behalf of an individual or nonfederal entity. Fiduciary assets are not recognized on the Balance Sheet.

Public Law 89-538 authorized the Department, through the Savings Deposit Program, to collect voluntary contributions from members of the Armed Forces serving outside the United States or its possessions in designated areas. These contributions and earned interest are deposited in the U.S. Treasury on behalf of the members.

NOTE 25. OTHER DISCLOSURES

Other Disclosures *As of September 30*	**2011— Asset Category**			
	Land and Buildings	**Equipment**	**Other**	**Total**
Entity as Lessee – Operating Leases				
Future Payments Due				
Fiscal Year 2012	$ 539.8	$ 22.6	$ 140.7	$ 703.1
Fiscal Year 2013	522.2	22.4	147.5	692.1
Fiscal Year 2014	551.4	22.5	143.6	717.5
Fiscal Year 2015	560.9	22.3	144.9	728.1
Fiscal Year 2016	576.2	22.3	146.2	744.7
After 5 Years	1,039.5	0.3	139.8	1,179.6
Total Future Lease Payments Due	**$ 3,790.0**	**$ 112.4**	**$ 862.7**	**$ 4,765.1**

Dollars in Millions

Operating leases are leases that do not transfer all the benefits and risks of ownership of capital leases. Payments are charged as expenses over the lease term. Office space is the largest component of land and building leases. Other leases are generally one-year leases that are not building or equipment leases. Future year cost projections use the Consumer Price Index.

NOTE 26. RESTATEMENTS

The Department restated its financial statements as of September 30, 2010 to correct errors in assets, gross costs, and net position identified during ongoing audit readiness efforts.

Adjustment #1: The Department corrected a $14.4 billion overstatement of General Property, Plant and Equipment to align the accounting records to the property accountability system. This correction decreased General Property, Plant and Equipment, Net; and Cumulative Results of Operations on the Balance Sheet and Cumulative Results of Operations on the Statement of Changes in Net Position; while increasing Gross Costs on the Statement of Net Costs. Note 2, Nonentity Assets; Note 10, General Property, Plant and Equipment; Note 18, General Disclosures Related to the Statement of Net Cost; Note 19, Disclosures Related to the Statement of Changes in Net Position; and Note 21, Reconciliation of Net Cost of Operations to Budget were restated.

Adjustment #2: The Department corrected an $83.5 million understatement of Unobligated Balances: Apportioned due to improper recording of the liquidation of contract authority. This correction decreased Unobligated Balance, Brought Forward, October 1, Budgetary Resources Permanently Not Available, and Unobligated Balances: Apportioned on the Statement of Budgetary Resources. Note 3, Fund Balance with Treasury; and Note 20, Disclosures Related to the Statement of Budgetary Resources were restated.

Effect on FY 2011 beginning Comparative Results and Unexpended Appropriations

FY 2011 Statement of Changes in Net Position	*Dollars in Billions*
Cumulative Results of Operations	
Correction of Errors (+/-) Adjustment #1	$ (14.4)
Beginning balance adjustments	**$ (14.4)**

FY 2011 Statement of Budgetary Resources	*Dollars in Millions*
Budgetary Resources	
Unobligated Balance, Brought Forward, October 1 - Adjustment #2	$ (83.5)
Beginning balance adjustments	**$ (83.5)**

Effect on Comparative Balances

FY 2010 Balance Sheet		*Dollars in Billions*
General Property, Plant and Equipment, Net – Adjustment #1	$	(14.4)
Total Assets	**$**	**(14.4)**
Cumulative Results of Operations – Other – Adjustment #1	$	(14.4)
Net Position	**$**	**(14.4)**
Total Liabilities and Net Position	**$**	**(14.4)**
FY 2010 Statement of Net Cost		*Dollars in Billions*
Gross Costs – Adjustment #1	$	17.0
Net Cost of Operations	**$**	**17.0**
FY 2010 Statement of Changes in Net Position		*Dollars in Billions*
Cumulative Results of Operations		
Correction of Errors (+/-) Adjustment #1	$	2.6
Beginning balance adjustments	**$**	**2.6**
Other Financing Sources:		
Net Cost of Operations – Adjustment #1	$	17.0
Net Change	**$**	**(17.0)**
Cumulative Results of Operations	**$**	**(14.4)**

FY 2010 Statement of Budgetary Resources		*Dollars in Millions*
Budgetary Resources:		
Unobligated Balance, brought forward, October 1 – Adjustment #2	$	(75.6)
Permanently Not Available – Adjustment #2	$	(7.9)
Total Budgetary Resources	**$**	**(83.5)**
Status of Budgetary Resources		
Unobligated Balance: Apportioned – Adjustment #2	$	(83.5)
Total Status of Budgetary Resources	**$**	**(83.5)**
Net Position	**$**	**(14.4)**

REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION

Federal financial reporting requires DoD to report on its stewardship over certain resources that cannot be measured in traditional financial reports. These resources do not meet the criteria for assets and liabilities required to be reported in the financial statements, but are important to understand the operations and financial condition of DoD at the date of the financial statements and in subsequent periods.

The Department's stewardship investments are comprised of, and are measured in terms of, expenses incurred for: 1) Nonfederal Physical Property (federally-financed, but not federally owned), and 2) federally-financed Research and Development (R&D). Information on additional reporting requirements for Nonfederal Physical Property and R&D follows.

NONFEDERAL PHYSICAL PROPERTY

The Nonfederal Physical Property investments support the purchase, construction, or major renovation of physical property owned by state and local governments. In addition, Nonfederal Physical Property investments include federally-owned physical property transferred to state and local governments. The Department participates in cost-sharing agreements with nonfederal sponsors which are governed under numerous Water Resources Development Acts. The Department's transferred assets include expenditures supporting the design, build, and construction services/management for the missions of commercial navigation, flood/storm damage reduction, hydropower, regulatory, environmental, recreation and water supply.

Nonfederal Physical Property
Department of Defense Consolidated – Nonfederal Physical Property

Yearly Investments in State and Local Governments
For Fiscal Years 2011 through 2007
Dollars in Millions

Categories	2011	2010	2009	2008	2007
Transferred Assets:					
National Defense Mission Related	$ 2,304.5	$ 2,126.2	$ 1,224.7	$ 1,169.2	$ 1,051.0
Funded Assets:					
National Defense Mission Related	12.0	0.0	26.7	19.6	2.8
Total	**$ 2,316.5**	**$ 2,126.2**	**$ 1,251.4**	**$ 1,188.8**	**$ 1,053.8**

INVESTMENTS IN RESEARCH AND DEVELOPMENT

Investment values included in this report are based on R&D expenses. The R&D programs are classified in the following categories: Basic Research, Applied Research, and Development. The amounts reported in the Investments in R&D table show outlays from FY 2007 – FY 2011 for all DoD Components. The definition for each type of R&D Category and Subcategories are explained below.

Basic Research is the systematic study to gain knowledge or understanding of the fundamental aspects of phenomena and of observable facts without specific applications, processes, or products in mind. Basic Research involves the gathering of a fuller knowledge or understanding of the subject under study. Major outputs are scientific studies and research papers.

Applied Research is the systematic study to gain knowledge or understanding necessary for determining the means by which a recognized and specific need may be met. It is the practical application of such knowledge or understanding for the purpose of meeting a recognized need. This research points toward specific military needs with a view toward developing and evaluating the feasibility and practicability of proposed solutions and determining their parameters. Major outputs are scientific studies, investigations, research papers, hardware components, software codes, or limited construction of a weapon system component, to include non-system-specific development efforts. Development takes what has been discovered or learned from basic and applied research and uses it to establish technological feasibility, assessment of operability, and production capability. Development consists of the five stages defined in the Investments in R&D table.

Advanced Technology Development is the systematic use of the knowledge or understanding gained from research and directed toward proof of concept and feasibility rather than directed toward the development of hardware for service use. It employs demonstration activities intended to test a technology or method.

Advanced Component Development and Prototypes evaluates integrated technologies in an operating environment as realistic as possible to assess the performance or cost reduction potential of advanced technology. Programs in this phase are generally system specific. Major outputs of Advanced Component Development and Prototypes are hardware and software components and complete weapon systems ready for operational and developmental testing and field use.

System Development and Demonstration concludes the program or project and prepares it for production. It consists primarily of preproduction efforts, such as logistics and repair studies. Major outputs are weapons systems finalized for complete operational and developmental testing.

Research, Development, Test, and Evaluation Management Support bolsters installations and operations for general research and development use. This category includes costs associated with test ranges, military construction maintenance support for laboratories, operation and maintenance of test aircraft and ships, and studies and analyses furthering the Research and Development program.

Operational Systems Development finances projects, programs or upgrades in engineering and manufacturing development stages which have received approval for production, including production funds that have been budgeted in subsequent fiscal years.

Investments in Research and Development (R&D)
Department of Defense Consolidated

Yearly Investments in Research and Development
For the Current and Four Preceding Fiscal Years *Dollars in Millions*

Categories	2011	2010	2009	2008	2007
Basic Research	$ 1,816.6	$ 1,805.5	$ 821.0	$ 1,346.4	$ 1,445.7
Applied Research	4,875.7	4,927.0	1,944.0	3,812.3	4,647.1
Development					
Advanced Technology Development	6,024.3	6,353.4	2,263.2	5,977.9	6,019.7
Advanced Component Development and Prototypes	13,964.2	14,304.6	12,148.3	15,410.6	14,109.6
System Development and Demonstration	13,882.0	15,156.7	21,501.9	18,052.9	16,737.8
Research, Development, Test and Evaluation Management Support	5,659.2	5,503.6	5,141.3	5,471.0	4,705.4
Operational Systems Development	23,861.3	23,986.2	42,450.6	20,246.7	13,535.1
Totals:	**$ 70,083.4**	**$ 72,037.0**	**$ 86,270.3**	**$ 70,317.8**	**$ 61,200.4**

REQUIRED SUPPLEMENTARY INFORMATION

REAL PROPERTY DEFERRED MAINTENANCE AND REPAIRS

This section includes the deferred maintenance and repairs information and Statement of Disaggregated Budgetary Resources.

Real Property Deferred Maintenance and Repairs *For Fiscal Year Ended September 30, 2011*			*Dollars in Millions*
	Current Fiscal Year (CFY)		
Property Type	**1. Plant Replacement Value**	**2. Required Work (Deferred Maintenance & Repair)**	**3. Percentage**
1. Category 1	**$ 600,007**	**$ 95,031**	**16%**
2. Category 2	**$ 30,731**	**$ 6,176**	**20%**
3. Category 3	**$ 19,430**	**$ 1,118**	**6%**

The deferred maintenance and repairs amount is based on facility Q-ratings found in the Department's real property inventory. Q-ratings represent work needed to bring a facility to a fully serviceable condition with no repair needs. The reported deferred maintenance is the difference between the facility Q-rating and the target Q-rating that represents the acceptable operating condition established by each Component within the Department. The percentage column reflects the percent of total plant replacement value for each category represented by deferred maintenance.

Facility Categories are as follows:

- Category 1: Buildings, Structures, and Utilities that are enduring and required to support an ongoing mission, including multi-use Heritage Assets.
- Category 2: Buildings, Structures, and Utilities that are excess to requirements or planned for replacement or disposal, including multi-use Heritage Assets.
- Category 3: Buildings, Structures, and Utilities that are Heritage Assets.

MILITARY EQUIPMENT DEFERRED MAINTENANCE AND REPAIRS

Depot maintenance requirements for military equipment are developed during the annual budget process. The table below shows the deferred unfunded requirements for the depot maintenance program.

Military Equipment Deferred Maintenance and Repairs *For Fiscal Year Ended September 30, 2011*	*Dollars in Millions*
Major Categories	**Amounts**
1. Aircraft	$ 1,017.8
2. Automotive Equipment	$ 140.0
3. Combat Vehicles	$ 154.4
4. Construction Equipment	$ 37.2
5. Electronics and Communications Systems	$ 494.5
6. Missiles	$ 160.1
7. Ships	$ 14.3
8. Ordnance Weapons and Munitions	$ 158.3
9. General Purpose Equipment	$ 79.5
10. All Other Items Not Identified to above Categories	$ 193.5
Total	**$ 2,449.6**

Statement Of Disaggregated Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	2011								
	Military Personnel	Procurement	Research, Development, Test and Evaluation	Family Housing /Military Construction	Military Retirement Benefits	Civil Works	Operations, Readiness, & Support	2011 Combined	Restated 2010 Combined
Budgetary Financing Account									
Budgetary Resources									
Unobligated balance, brought forward, October 1	$ 1,730.4	$ 79,290.0	$ 15,951.4	$ 15,693.5	$ 0.0	$ 11,069.2	$ 36,297.6	$ 160,032.1	$ 146,116.6
Recoveries of prior year unpaid obligations	10,776.3	10,398.1	952.5	2,736.7	0.0	117.2	31,034.6,	56,015.4	54,701.2
Budget authority									
Appropriation	154,001.3	125,273.8	72,235.2	13,396.1	134,971.6	5,218.9	408,032.5	913,129.4	899,278.4
Contract authority	0.0	0.0	0.0	0.0	0.0	0.0	75,760.9	75,760.9	73,059.7
Spending authority from offsetting collections									
Earned									
Collected	1,172.4	3,309.8	8,924.5	8,038.5	0.0	11,087.2	157,106.7	189,639.2	184,468.6
Change in receivables from Federal sources	29.0	172.7	113.5	(55.2)	0.0	96.0	1,757.5	2,113.5	(350.9)
Change in unfilled customer orders									
Advance received	0.1	77.0	(116.3)	(240.5)	0.0	(104.7)	769.4	385.0	(81.9)
Without advance from Federal sources	18.1	(273.9)	140.0	1,420.4	0.0	(63.7)	2,063.1	3,304.0	2,415.7
Expenditure transfers from trust funds	0.0	0.0	0.0	0.0	0.0	881.9	0.0	881.9	851.0
Subtotal	155,220.9	128,559.5	81,296.9	22,559.3	134,971.6	17,115.6	645,490.1	1,185,213.9	1,159,640.6
Nonexpenditure transfers, net, anticipated and actual	(358.1)	4,314.3	1,800.1	(539.9)	0.0	173.9	(5,995.1)	(604.8)	803.3
Temporarily not available pursuant to Public Law	0.0	0.0	0.0	0.0	(75,218.3)	0.0	(64.4)	(75,282.7)	(60,328.7)
Permanently not available	(935.7)	(3,115.4)	(1,615.0)	(623.3)	0.0	(206.9)	(87,386.9)	(93,883.2)	(87,872.7)
Total Budgetary Resources	$ 166,433.8	$ 219,446.5	$ 98,385.9	$ 39,826.3	$ 59,753.3	$ 28,269.0	$ 619,375.9	$ 1,231,490.7	$ 1,213,060.3

Status Of Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	2011								
	Military Personnel	Procurement	Research, Development, Test and Evaluation	Family Housing /Military Construction	Military Retirement Benefits	Civil Works	Operations, Readiness & Support	2011 Combined	Restated 2010 Combined
Obligations incurred:									
Direct	$ 163,551.5	$ 140,553.8	$ 72,615.1	$ 12,751.2	$ 59,753.3	$ 8,943.9	$ 416,045.0	$ 874,213.8	$ 857,647.6
Reimbursable	1,240.8	3,313.1	7,757.9	11,257.8	0.0	10,796.6	160,638.2	195,004.4	195,380.6
Subtotal	**164,792.3**	**143,866.9**	**80,373.0**	**24,009.0**	**59,753.3**	**19,740.5**	**576,683.2**	**1,069,218.2**	**1,053,028.2**
Unobligated balance:									
Apportioned	375.7	72,512.6	16,392.5	14,964.1	0.0	7,632.9	25,270.7	137,148.5	137,738.3
Exempt from apportionment	0.0	0.0	0.0	0.0	0.0	844.1	3,336.3	4,180.4	6,106.9
Subtotal	375.7	**72,512.6**	**16,392.5**	**14,964.1**	**0.0**	**8,477.0**	**28,607.0**	**141,328.9**	**143,845.2**
Unobligated balance not available	1,265.8	3,067.0	1,620.4	853.2	0.0	51.5	14,085.7	20,943.6	16,186.9
Total status of budgetary resources	166,433.8	**219,446.5.6**	**98,385.9**	**39,826.3**	**59,753.3**	**28,269.0**	**619,375.9**	**1,231,490.7**	**1,213,060.3**
Change in Obligated Balance:									
Obligated balance, net									
Unpaid obligations, brought forward, October 1	$ 11,462.7	$ 141,340.2	$ 44,135.7	$ 27,963.3	$ 4,576.9	$ 13,134.6	$ 216,007.2	$ 458,620.6	$ 453,958.6
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(107.9)	(4,365.8)	(4,873.1)	(10,446.4)	0.0	(3,065.4)	(46,908.2)	(69,766.8)	(67,702.3)
Total unpaid obligated balance	**$ 11,354.8**	**$ 136,974.4**	**$ 39,262.6**	**$ 17,516.9**	**$ 4,576.9**	**$ 10,069.2**	**$ 169,099.2**	**$ 388,853.8**	**$ 386,256.4**
Obligations incurred net	164,792.3	143,866.9	80,373.0	24,009.0	59,753.3	19,740.5	576,683.2	1,069,218.2	1,053,028.2
Less: Gross outlays	(157,830.5)	(127,670.3)	(80,102.6)	(19,991.0)	(63,462.0)	(22,352.4)	(545,490.1)	(1,016,898.9)	(993,664.7)
Obligated balance transferred, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	(10,776.3)	(10,398.1)	(952.5)	(2,736.7)	0.0	(117.2)	(31,034.3)	(56,015.1)	(54,701.2)
Change in uncollected customer payments from Federal sources	(47.1)	101.2	(253.5)	(1,365.2)	0.0	(32.3)	(3,820.6)	(5,417.5)	(2,064.7)
Obligated balance, net, end of period									
Unpaid obligations	7,648.2	147,138.7	43,453.6	29,244.6	868.2	10,405.5	216,166.0	454,924.8	458,621.0
Less: Uncollected customer payments (+/-) from Federal sources	(155.0)	(4,264.6)	(5,126.6)	(11,811.6)	0.0	(3,097.7)	(50,728.8)	(75,184.3)	(69,767.0)
Total, unpaid obligated balance, net, end of period	**$ 7,493.2**	**$ 142,874.1**	**$ 38,327.0**	**$ 17,433.0**	**$ 868.2**	**$ 7,307.8**	**$ 165,437.2**	**$ 379,740.5**	**$ 388,854.0**
Net									
Net Outlays:									
Gross outlays	$ 157,830.5	$ 127,670.3	$ 80,102.6	$ 19,991.0	$ 63,462.0	$ 22,352.4	$ 545,490.1	$ 1,016,898.9	$ 993,664.7
Less: Offsetting collections	(1,172.4)	(3,386.8)	(8,808.1)	(7,798.1)	0.0	(11,864.4)	(157,876.3)	(190,906.1)	(185,237.8)
Less: Distributed Offsetting receipts	0.0	0.0	0.0	0.0	(80,207.4)	(333.5)	(2,657.7)	(83,198.6)	(77,722.2)
Net Outlays	**$ 156,658.1**	**$ 124,283.5**	**$ 71,294.5**	**$ 12,192.9**	**$ (16,745.4)**	**$ 10,154.5**	**$ 384,956.1**	**$ 742,794.2**	**$ 730,704.7**

Combined Statement Of Budgetary Resources ***For the Years Ended September 30*** *Dollars in Millions*	**Non Budgetary**		
	Other	**2011 Combined**	**2010 Combined**
Non Budgetary Financing Accounts			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 24.9	$ 24.9	$ 23.6
Recoveries of prior year unpaid obligations	0.0	0.0	0.0
Budget authority			
Borrowing authority	229.8	229.8	26.8
Spending authority from offsetting collections			
Earned			
Collected	102.6	102.6	69.6
Change in receivables from Federal sources	0.1	0.1	0.0
Change in unfilled customer orders			
Without advance from Federal sources	2.5	2.5	(34.9)
Subtotal	335.0	335.0	61.5
Permanently not available	(16.9)	(16.9)	(13.9)
Total Budgetary Resources	**$ 343.0**	**$ 343.0**	**$ 71.2**

Statement of Disaggregated Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	**Non Budgetary**		
	Other	**2011 Combined**	**2010 Combined**
Non Budgetary Financing Accounts			
Obligations incurred:			
Direct	$ 326.8	$ 326.8	$ 46.3
Subtotal	**$ 326.8**	**$ 326.8**	**$ 46.3**
Unobligated balance:			
Apportioned	0.1	0.1	24.8
Subtotal	0.1	0.1	24.8
Unobligated balance not available	16.1	16.1	0.1
Total status of budgetary resources	**$ 343.0**	**$ 343.0**	**$ 71.2**
Change in Obligated Balance:			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 619.4	$ 619.4	$ 770.4
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(97.3)	(97.3)	(132.2)
Total unpaid obligated balance	**$ 522.1**	**$ 522.1**	**$ 638.2**
Obligations incurred net	326.8	326.8	46.3
Less: Gross outlays	(375.3)	(375.3)	(197.3)
Less: Recoveries of prior year unpaid obligations, actual	0.0	0.0	0.0
Change in uncollected customer payments from Federal sources	(2.6)	(2.6)	34.9
Obligated balance, net, end of period			
Unpaid obligations	570.9	570.9	619.4
Less: Uncollected customer payments (+/-) from Federal sources	(99.9)	(99.9)	(97.3)
Total, unpaid obligated balance, net, end of period	**$ 471.0**	**$ 471.0**	**$ 522.1**
Net			
Net Outlays:			
Gross outlays	$ 375.3	$ 375.3	$ 197.7
Less: Offsetting collections	(102.6)	(102.6)	(69.6)
Net Outlays	**$ 272.7**	**$ 272.7**	**$ 127.7**

APPENDIX A: Glossary of Acronyms and Abbreviations

Acronym	Definition
AFB	Air Force Base
AFPC	Air Force Personnel Center
AFR	Agency Financial Report
ANA	Afghan National Army
ANP	Afghan National Police
ANSF	Afghan National Security Forces
APB	Acquisition Program Baseline
APR	Annual Performance Report
ARRA	American Recovery and Reinvestment Act of 2009 (Recovery Act)
ASD	Assistant Secretary of Defense
BAMC	Brooke Army Medical Center
BCA	Budget Control Act of 2011
BCL	Business Capability Lifecycle
BMD	Ballistic Missile Defense
BRAC	Base Realignment and Closure
CAPS-Windows	Computerized Accounts Payable System-Windows
CDS	Contract Debt System
CEFMS	Corps of Engineers Financial Management System
CFO	Chief Financial Officer
CMO	Chief Management Officer
COR	Contracting Officer Representative
DBS	Defense Business Systems
DBSMC	Defense Business Systems Management Committee
DCMO	Deputy Chief Management Officer
DFAS	Defense Finance and Accounting Service
DIRSSP	Director, Strategic Systems programs
DLA	Defense Logistics Agency
DNSI	Defense Nuclear Surety Inspection
DoD	Department of Defense
DSB	Defense Science Board
DSS	Defense Security Service
DTM	Directive-type Memorandum
DTS	Defense Travel System
EBF	Education Benefits Fund
EHR	Electronic Health Record
EOP	Executive Office of the President
ERP	Enterprise Resource Planning
FAR	Federal Acquisition Regulations
FASAB	Federal Accounting Standards Advisory Board

Acronym	Definition
FBWT	Fund Balance With Treasury
FFMIA	Federal Financial Management Improvement Act of 1996
FIAR	Financial Improvement and Audit Readiness
FMFIA	Federal Managers' Financial Integrity Act of 1982
FMS	Foreign Military Sales
FTE	Full Time Equivalent
FY	Fiscal Year
GAO	Government Accountability Office
GPRA	Government Performance and Results Act of 1993
HIDS	Host-based Intrusion Detection System
IAPS	Integrated Accounts Payable System
ICBM	Intercontinental Ballistic Missile
ICOFR	Internal Control Over Financial Reporting
IDES	Integrated Disability Evaluation System
IED	Improvised Explosive Devices
IG	Inspector General
IJC	ISAF Joint Command
IPA	Independent Public Accounting
IPERA	Improper Payments Elimination and Recovery Act
IPIA	Improper Payment Information Act of 2002
IPOD	Improper Payment On-Line Database
ISAF	International Security Assistance Force
ISF	Iraq Security Forces
ISR	Intelligence, Surveillance and Reconnaissance
IT	Information Technology
JROC	Joint Requirements Oversight Council
JSCDR	Joint Select Committee on Deficit Reduction
JTF-CAPMED	Joint Task Force Capital Area, Medical
JUONS	Joint Urgent Operational Needs
LEP	Life Extension Program
M&IE	Meals & Incidental Expenses
MAIS	Major Automated Information System
MDAP	Major Defense Acquisition Program
MEF	Marine Corps Expeditionary Force
METC	Medical Enlisted Training Center
MHPI	Military Housing Privatization Initiative
MHS	Military Health System
MICP	Managers' Internal Control Program
MOCAS	Mechanization of Contract Administrative Services
MRC	Marine Corps Casualty Branch
MRF	Military Retirement Fund

Acronym	Definition
MTF	Military Treatment Facility
NATO	North Atlantic Treaty Organization
NDAA	National Defense Authorization Act
NDS	National Defense Stockpile
NGA	National Geospatial-Intelligence Agency
NMPC	Naval Military Personnel Command
NNMC	National Naval Medical Center
NSS	National Security Systems
NTM-A/CSTC-A	NATO Training Mission – Afghanistan / Combined Security Transition Command – Afghanistan
OCO	Overseas Contingency Operations
OEF	Operation Enduring Freedom
OGC	Office of General Counsel
OIF	Operation Iraqi Freedom
OIG	Office of the Inspector General
OM&S	Operating Materiel and Supplies
OMB	Office of Management and Budget
OND	Operation New Dawn
OSC-I	Office of Security Cooperation – Iraq
OSD	Office of the Secretary of Defense
OUSD	Office of the Under Secretary of Defense
OUSD(C)	Office of the Under Secretary of Defense (Comptroller)
PAR	Performance and Accountability Report
PCMH	Patient Centered Medical Home
PCS	Permanent Change of Station
POF	Perfect Order Fulfillment
PP&E	Property, Plant, and Equipment
PSC	Private Sector Care
PTSD	Post Traumatic Stress Disorder
PWS	Performance Work Statement
QASP	Quality Assurance Surveillance Plan
QDR	Quadrennial Defense Review
R&D	Research and Development
RFP	Request for Proposal
rIDES	Remodeled Integrated Disability Evaluation System
SBR	Statement of Budgetary Resources
SEAL	Sea, Air, and Land Teams
SECDEF	Secretary of Defense
SFFAS	Statement of Federal Financial Accounting Standards
SIG	Senior Integration Group
SNC	Statement of Net Cost

Acronym	Definition
START	Strategic Arms Reduction Treaty
TDY	Temporary Duty
TRICARE	Triple option benefit health care plan for military families
U.S.	United States
USACE	U.S. Army Corps of Engineers
USAFRICOM	United States African Command
USC	United States Code
USCENTCOM	United States Central Command
USD	Under Secretary of Defense
USD(AT&L)	Under Secretary of Defense for Acquisition, Technology and Logistics
USD(C)/CFO	Under Secretary of Defense (Comptroller)/Chief Financial Officer
USEUCOM	United States European Command
USF-I	United States Forces – Iraq
USGAAP	U.S. Generally Accepted Accounting Principles
USMC	United States Marine Corps
USNORTHCOM	United States Northern Command
USPACOM	United States Pacific Command
USSGL	U.S. Standard General Ledger
USSOCOM	United States Special Operations Command
USSOUTHCOM	United States Southern Command
USSTRATCOM	United States Strategic Command
USTRANSCOM	United States Transportation Command
VA	Department of Veterans Affairs
VLER	Virtual Lifetime Electronic Record
VSI	Voluntary Separation Incentive
WAWF	Wide Area Work Flow
WII	Wounded, Ill, and Injured Service Members
WinIATS	Windows Integrated Automated Travel System
WMD	Weapons of Mass Destruction
WRAMC	Walter Reed Army Medical Center
WRNMMC	Walter Reed National Military Medical Center

APPENDIX B: USEFUL WEB SITES FOR RELEVANT INFORMATION

Web Address and Report Description
http://www.defense.gov/ • Main DoD Web site, and links to other DoD Web sites.
http://comptroller.defense.gov/ The DoD Comptroller Web site includes: • Agency Financial Report Reports DoD's financial condition, financial execution, plans, and accomplishments. • Annual Performance Plan Describes DoD's strategic goals and objectives and the respective performance measures and targets used to assess progress. • Annual Performance Report Contains details of DoD's performance results and progress in achieving its strategic goals as required by the Government Performance and Results Act (GPRA). • Summary of Performance and Financial Information / Citizen's Report Summarizes DoD's mission, key goals, budget allocation, and progress on key performance goals linking to the strategic goals. • Congressional Budget Justification The Department of Defense's budget request to the Congress. • Financial Improvement and Audit Readiness Plan Describes DoD's strategy for improving financial management and reports progress in achieving financial statement audit readiness.
http://dcmo.defense.gov/ The Office of the Deputy Chief Management Officer Web site includes: • Business Enterprise Architecture Blueprints DoD standard process, data, data standards, business rules, operating requirements, and information exchanges for the Department's business and financial management activities. • Enterprise Transition Plan Sets the defense business systems modernization strategy and defines the target systems environment.
http://www.defense.gov/qdr • Quadrennial Defense Review Dated February 2010, provides DoD's strategic plan.

UNITED STATES DEPARTMENT OF DEFENSE

Agency Financial Report

November 2011

Addendum A

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER) / CFO

ADDENDUM A, OTHER ACCOMPANYING INFORMATION

Other Accompanying Information provides additional details that support the Fiscal Year (FY) 2011 Department of Defense (DoD) Agency Financial Report (AFR). This addendum includes the following sections:

- Inspector General's (IG) summary of the most significant management and performance challenges facing the Department, its assessment of the Department's progress in addressing these challenges, and the Department's response to the IG's assessments.
- Managers' Internal Control Program and Financial Statement Audit Material Weaknesses;
- Improper Payment and Payment Recapture Programs Reporting

IG-IDENTIFIED MANAGEMENT AND PERFORMANCE CHALLENGES

As discussed in the Management Discussion and Analysis section of this Report, the *Reports Consolidation Act of 2000* requires that the Agency Financial Report include a statement, prepared by the Department's Inspector General (IG) that summarizes what he considers to be the most serious management and performance challenges facing the Department, along with a brief assessment of the Department's progress made in addressing those challenges. The DoD IG identified the following seven management and performance challenges facing the Department in FY 2011:

1. Financial Management
2. Acquisition Processes and Contract Management
3. Joint Warfighting and Readiness
4. Information Assurance, Security, and Privacy
5. Health Care
6. Equipping and Training Iraq and Afghan Security Forces
7. The Nuclear Enterprise

The IG no longer cites the *American Recovery and Reinvestment Act (ARRA) of 2009* as a serious management challenge due to the Department's performance and progress in addressing this challenge.

The following is a summary of the seven challenges, the IG's assessment of the Department's progress in addressing these challenges, and the Department's management response. The Department has opted to provide a summary-level response for the challenges related to Acquisition Processes and Contract Management and the Nuclear Enterprise.

1. IG-Identified Challenge: Financial Management

1-1A. Financial Management	IG Summary of Challenge

The Department continues to face financial management challenges that adversely affect its ability to provide reliable, timely, and useful financial and managerial data needed to support operating, budgeting, and policy decisions. Gaps in the financial framework impact the accuracy, reliability and timeliness of budgetary and accounting data and financial reporting, thereby reducing the effectiveness of decision making by leaders at all levels.

Congress requires the Department ensure that the DoD financial statements are validated as audit ready by September 30, 2017. The most significant challenge for the Department will be in meeting that date. Further, Public Law 111-383, entitled the "*Ike Skelton National Defense Authorization Act for Fiscal Year 2011*," Section 881, dated January 7, 2011, requires the Department to establish interim milestones to achieve audit readiness of its financial statements by September 30, 2017. These interim milestones for Military Departments and Defense Components call for the achievement of audit readiness for each major element of the Statements of Budgetary Resources (SBR), such as civilian pay, military pay, supply orders, contracts, and the entity's Funds Balance with the Treasury. Also, the interim milestones must address the existence and completeness of each major category of DoD assets, which includes military equipment, real property, inventory, and operating material and supplies. Additionally, Section 881 requires the Department examine the costs and benefits of alternative approaches to valuing its assets, develop remediation plans when interim milestones cannot be met, and identify incentives to achieve auditability by September 30, 2017. The Department must aggressively pursue the development and implementation of comprehensive improvement initiatives and monitor progress according to interim milestones. The Department may need to revise these initiatives and milestones as additional deficiencies and corrective actions identified as a result of DoD's Financial Improvement and Audit Readiness (FIAR) process.

In an attempt to standardize and develop an effective financial management process throughout the Department, DoD embarked on various efforts to implement new financial management systems and associated business processes. These efforts involved implementing new commercial off-the-shelf Enterprise Resource Planning (ERP) systems that were capable of handling financial transactions throughout an event's life cycle. These ERP systems should provide the integration needed to minimize system interface problems and provide greater DoD financial visibility.

1-1B. Financial Management	IG Assessment of Progress

A significant measure of DoD's ongoing progress in the area of financial management is the ability to obtain an unqualified opinion on its financial statements. The Defense Commissary Agency, Defense Contract Audit Agency, Defense Finance and Accounting Service, Military Retirement Fund, U.S. Army Corps of Engineers, and DoD IG financial statements all have received unqualified audit opinions. However, in the FY 2010 audit opinion on DoD's consolidated financial statements, the DoD IG reported the same 13 material internal control weaknesses as the previous year. These pervasive and longstanding financial management issues directly affect DoD's ability to obtain an unqualified opinion on its financial statements. These weaknesses affect the safeguarding of assets, proper use of funds, and impair the prevention and identification of fraud, waste, and abuse.

Although DoD is far from reaching an unqualified opinion on its consolidated financial statements, the Department has demonstrated improvement. In FY 2010, the DoD IG audited the SBR for the U.S. Marine Corps (USMC), the first Military Component to undergo such an audit. The USMC encountered many challenges during this first-time audit, which resulted in a disclaimer of opinion; however, the USMC and the Department are learning from this audit experience. The FY 2011 USMC SBR is again under audit in FY 2011, and the USMC is working to provide auditable data to support its financial transactions. While some improvements have occurred, many of the same challenges encountered during the FY 2010 audit have affected the FY 2011 audit.

The Department must continue to conduct comprehensive reviews of its business processes. The DoD IG recently identified deficiencies in DoD's estimate of high-dollar overpayments that caused it to under-report the amount of improper payments made. Further, DoD's controls over the acquisition and development of systems are crucial to providing accurate, timely, and meaningful financial management information. The Department continues to implement ERP systems in the effort to modernize the business and financial systems; however, systems implementation has resulted in incurred cost and schedule growth and has lacked appropriate senior level governance over their development, test, and implementation. The Department will continue to struggle to improve its processes to ensure accurate, timely, and meaningful financial management information for the users, both internally and externally, and long-term sustainability of the financial management improvements.

1-1C. Financial Management	**Department Response**

With the exception of the IG's assertion that the Department has deficiencies in its estimate of high-dollar overpayments, which resulted in under-reporting the amount of improper payments, for the most part the Department agrees with the DoD IG's assessment of progress to improve financial management and resolve the DoD IG-identified 13 material weaknesses. Although the Department has struggled for many years to improve its business and financial processes, controls, and systems that prevent it from producing auditable financial statements; the Department's commitment to resolve these problems and produce auditable financial statements is stronger than ever. Our commitment is backed by recent significant actions that enable meaningful progress, to include the ability to achieve the goal of auditable financial statements.

These actions are:

- Visible Leadership and Department-wide Audit Readiness Goal. Secretary Panetta directed the Under Secretary of Defense (Comptroller) to provide a revised plan to achieve audit readiness for the Statement of Budgetary Resources by the end of 2014. The Secretary informed all DoD employees that the lack of auditable financial statements is unacceptable.
- Accountability and Incentives. Senior executives across the Department, both financial and functional, are held accountable for meeting audit readiness milestones and outcomes through organizational and individual performance plans and evaluations.
- Broad Functional Community Support and Participation. A streamlined approach, with well-defined, short- and long-term milestones that focus first on the information most often used to manage the Department (budgetary and mission-critical asset information), has better engaged the functional community.
- Senior Leadership Oversight and Involvement. Progress is reported and monitored by a formal and regularly scheduled FIAR governance process that involves the Deputy Secretary of Defense/Chief Management Officer (CMO), USD(Comptroller), DoD Deputy CMO, Military Department CMOs and Financial Management/Comptrollers, and senior leaders from the functional communities.
- Integrated, Audit Ready Systems Environment Work**.** The modernization of the Department's business and financial systems through the deployment of ERP systems that utilize process reengineering and business best practices is taking place concurrently with the FIAR Plan and has been integrated into the Components' financial improvement plans.
- Resources to Accomplish FIAR Goals and Objectives**.** Resources of approximately $300 million are being applied annually on Component FIAR activity (excludes ERP resources).

The above actions clearly are impacting the Department's progress, as evidenced by the following:

While the Department did not achieve its third quarter goal with regard to validating DoD appropriations received, this goal subsequently was met in August 2011 (Strategic

Objective 5.5.1-2U), when the Army, Navy, and Air Force received unqualified opinions on their "Appropriations Received" audit readiness assertions based on Independent Public Accounting (IPA) firms' examinations. Specifically, the IPAs reported that the audit readiness assertions were fairly stated in all material respects.

Audit readiness assertions by the Navy and the Air Force on key elements of the SBR;

Audit readiness assertion by the Air Force on the existence and completeness of its military equipment assets; the Navy has asserted audit readiness on certain classes of military equipment;

Significant progress made by the U.S. Marine Corps toward an auditable SBR that also is providing important lessons learned to the other Military Services; and

Sustainment of unqualified audit opinions by Independent Public Auditors on the financial statements of the U.S. Army Corps of Engineers, Defense Contract Audit Agency, Defense Commissary Agency, Defense Finance and Accounting Service, Office of the Inspector General, and the Military Retirement Fund.

Unqualified audit opinion on the FY 2011 financial statements for TRICARE Management Activity – Contract Resource Management.

Additional information regarding the DoD FIAR Plan can be found in the semi-annual *FIAR Plan Status Report*.

The Department does not agree that deficiencies in the methods used to estimate high dollar overpayments resulted in under-reporting the amount of improper payments. The IG's conclusion is based, in part, on its claim that the Department did not review approximately $167.5 billion in quarterly disbursements for Quarter 1, FY 2010. Our review disclosed that more than two thirds of these disbursements either were not subject to review or public reporting, per OMB guidance, or were not individually material in amount. The Department continues to work closely with the IG to ensure accurate reporting of improper payments.

2. IG-Identified Challenge: Acquisition Processes and Contract Management

The Department's summary-level response to the IG's challenge and its assessment of the Department's progress on acquisition processes and contract management is reported in paragraph 2-3C of this section.

2-1A. Acquisition Workforce	IG Summary of Challenge

The Department continues to struggle with its efforts to rebuild an acquisition workforce that is sufficient in size and adequately trained and equipped to oversee DoD acquisitions. The DoD acquisition workforce has not kept pace with DoD's increased contracting requirements. Throughout the 1990s, the Department reduced its acquisition workforce by about 50 percent, but the workload was not proportionately reduced. To the contrary, DoD's spending on goods and services since 2001 has more than doubled, from approximately $145.2 billion to $367.3 billion in FY 2010. To further complicate matters, the Department challenged its workforce when the wars in Afghanistan and Iraq began and the workload and responsibilities placed on them significantly increased. Although the Defense budget is declining, with the budget request of $670.9 billion in FY 2012 compared to the $708.2 billon requested in FY 2011, it is not likely that the vital role the acquisition workforce plays in providing the warfighters with new capabilities will decrease.

2-1B. Acquisition Workforce	IG Assessment of Progress

The Department continues to recognize the importance of a workforce sufficient to manage and oversee DoD acquisition and contracting. To successfully accomplish the acquisition mission, DoD is placing greater emphasis on developing a higher-quality workforce that has the right competencies and skill sets at the right place at the right time. The Department's hiring initiatives appear to be on track, as efforts were made to continue to grow the workforce to a desired level of 147,000 by 2015. The Defense Acquisition Workforce Development Fund budget estimate of $305.5 million in FY 2012 further demonstrates DoD's sustained commitment to increase the end strength and quality of the acquisition workforce; however, current budget constraints raise questions as to whether the department will be able to sustain this projected growth and support related initiatives.

The Defense Acquisition Strategic Workforce Plan, dated April 2010, outlines additional strategies the Department is employing to support an acquisition workforce that has the capacity and ability to appropriately manage and oversee acquisitions. Specifically, the Department is working to improve the certification process, placing greater emphasis on qualifications and experience, and assessing the critical skills and competencies of the acquisition workforce to identify gaps and improve training. They are closely partnering with the Defense Acquisition University to expand the training available to acquisition professionals so that forecasted demand is met.

2-1C. Acquisition Workforce	**Department Response**

The Department's summary-level response to the IG's challenge and its assessment of the Department's progress may be found in paragraph 2-3C of this section.

2-2A. Weapon System Acquisition	IG Summary of Challenge

The Department remains challenged in its management of major acquisition programs. In FY 2012 the Department requested $553.1 billion in base and $117.8 billion in Overseas Contingency Operations (OCO) funding to ensure warfighters have weapon systems that provide the best capabilities. The number of Major Defense Acquisition Programs (MDAPs), now at 111 in FY 2011, has increased despite the prospects of a flat or slowly decreasing defense budget. While the performance of no two acquisition programs is the same and a good number of them operate within their cost and schedule constraints, there are still too many programs that are experiencing significant cost growth and delay in delivering capabilities. DoD needs to continue to look for a better balance between its limited resources and the capabilities needed to be successful in current conflicts and to prepare for possible future conflict. As budgets come under increasing scrutiny, the Department will be challenged to evaluate the merits of all programs as to their usefulness versus cost.

2-2B. Weapon System Acquisition	IG Assessment of Progress

Through leadership at the highest levels, the Department has demonstrated its commitment to addressing shortcomings identified in the management of weapon system acquisitions. The Department has begun to reprioritize and rebalance its investments in weapon systems and has made strides towards improving efficiency. Over the last two to three years, the Department has cancelled more than $300 billion in acquisition programs, some of which were not performing, were too costly, or were duplicative of capabilities DoD already had.

The Department continues its efforts to implement changes resulting from the passage of *Weapon Systems Acquisition Reform Act of 2009* and is still revamping the bureaucracy of DoD acquisition, as well as making process and oversight changes that will aid the Department in achieving better outcomes.

On September 14, 2010, the Under Secretary of Defense for Acquisition, Technology and Logistics (USD(AT&L)) issued a directive geared at obtaining better buying power through greater efficiencies and productivity in defense spending. This objective will be accomplished by pursuing initiatives in targeting affordability and controlling cost growth; incentivizing productivity and innovation in industry; promoting competition; improving tradecraft in services acquisition; and reducing non-productive processes and bureaucracy.

Most recently, the USD(AT&L), as part of his Better Buying Power initiative to buy more for less money, established a new position focused on defense pricing. Specifically, with the establishing of this position, the Department will concentrate on how much it pays for the things it buys, looking beyond program cost estimates and determining what a program should cost. In an attempt to become better at buying, emphasis will be placed on developing the workforce so it has better negotiating skills when dealing with a company on a contract's pricing strategy.

Audits continue to identify oversight and pricing problems that show the Department's need to prudently evaluate contractors in the fast-paced environment of war. The Department is beginning to apply extra scrutiny to weapon systems that are behind schedule and over cost as it continues the process of making the hard decisions about what is and is not affordable.

2-2C. Weapon System Acquisition	**Department Response**

The Department's summary-level response to the IG's challenge and its assessment of the Department's progress may be found in paragraph 2-3C of this section.

2-3A. Contract Management	IG Summary of Challenge

The Department continues to experience inefficiencies and wasteful use of funds in its contracting efforts. The DoD's continuing contracting challenges include obtaining adequate competition in contracts, defining contract requirements, overseeing contract performance, creating and maintaining adequate contract documentation files for critical contract decisions, and recurring validation of contract requirements.

The Department continues to face challenges when it comes to contract oversight and administration. These challenges are significant, and the impact is heightened by the need to support contingency operations in Iraq and Afghanistan. In FY 2010, the Department obligated approximately $367.3 billion for contracts for goods and services, yet despite the billions spent, the Department managed these contracts without sufficient resources.

With a smaller, less experienced, and insufficiently trained workforce, the Department has experienced problems in managing the complexities of its acquisitions and the increasing volume of business. Consequently, the Department continues to rely heavily on contractors to provide acquisition management and contract support functions, which oftentimes includes acquisition planning, requirement determinations, contract award, performance review, bid analysis, cost assessment, and contract monitoring functions. The Department's increased use of contractors as acquisition support highlights DoD's shortcomings. Our audits continue to identify that without proper oversight, the Department cannot be certain that contractors are performing in accordance with contract requirements, cannot support payments of award or incentive fees, cannot support the certification of invoices for services performed, and cannot ensure that services are performed, thus leaving the Department vulnerable to increased fraud, waste, abuse and misuse of taxpayer monies.

2-3B. Contract Management	IG Assessment of Progress

At the direction of Congress, the Department stood up the Panel on Contracting Integrity comprised of senior leaders from a cross section of DoD for the purpose of reviewing its progress in eliminating high-risk areas and vulnerabilities in defense contracting. In its fourth annual report to Congress, the Panel identified 25 actions for implementation in FY 2010 and additional actions for consideration and implementation in FY 2011. During 2010, the Panel developed policy directives and memoranda, published articles, case studies, and training guides, all related to improving DoD's contracting system. Some of the work that the Panel accomplished included developing recommendations for a standardized contracting officer warranting program, a "back-to-basics," on-the-job-training for new contracting workforce members, and tools that contracting officers could use in determining fair and reasonable prices. The Panel specifically addressed requirements imposed by the *Weapons Systems Acquisition Reform Act of 2009*.

As a follow on to his June 28, 2010 memorandum, entitled "Better Buying Power: Mandate for Restoring Affordability and Productivity in Defense Spending," the USD(AT&L) released another memorandum on September 14, 2010, entitled "Better Buying Power: Guidance for Obtaining Greater Efficiency and Productivity in Defense Spending." This memorandum outlined 23 principal actions to improve efficiencies in five major areas, in which the panel assessed how to contribute and support these areas in potential actions for FY 2011.

The Department continues its work to improve contingency contracting. Some initiatives include:

- Developing joint contingency contracting doctrine;
- Improving DoD business processes;
- Formulating a single training plan for contingency contracting operations;
- Creating a Contingency Contracting Corps; and
- Maintaining an open, user-friendly source for studies, reports, and lessons learned.

Additionally, during the past year the Department has pressed forward in its effort to strengthen DoD contracting and has issued policy, procedures, and guidance addressing defense acquisition workforce improvement initiatives, source selection procedures, and improving competition in defense procurements.

2-3C. Acquisition Processes and Contract Management	**Department Summary-Level response**

The Department agrees with the IG's summary of challenges and assessment of progress and continues to work aggressively to resolve the long-standing material weaknesses.

The Secretary of Defense established a 23-point plan of action to improve acquisition efficiency in five areas: Target Affordability and Control Cost Growth; Incentivize Productivity and Innovation in Industry; Promote Real Competition; Improve Tradecraft in Services Acquisition; and Reduce Non-Productive Processes and Bureaucracy. The Department is institutionalizing these initiatives and policy implementation. The Department's Senior Integration Group (SIG) tracks the implementation and progress of these initiatives.

Between 1998 and 2008, the core acquisition workforce size fluctuated from approximately 146,000 to a low of 125,879, respectively. Since 2009, DoD leadership has reversed this decline by hiring and filling over 9,000 "new capacity" positions under a DoD-wide initiative. As supported by the President's FY 2012 budget request to Congress, the Department is continuing targeted growth as an exception to DoD constraints on overall civilian budgeted full-time equivalents (FTE) levels. The DoD's progress has helped rebuild capacity in contracting, pricing, engineering, program management, contract management (Defense Contract Management Agency), and audit (Defense Contract Audit Agency) capability. The Department also is bolstering acquisition workforce capability through increased training, development, and performance support tools.

Consistent with the plan of action, the Department has implemented a number of policies designed to improve weapons systems cost, schedule and performance outcomes.

Key policies include:

- Mandating affordability as a requirement: We will set dollar limits for our programs to ensure they are constrained by the resources the department can afford to allocate to the capability. The approved affordability requirement will not be exceeded without formal executive review.

Conducting a systems engineering tradeoff analysis before program initiation: The purpose of the analysis is to determine how cost varies as major design parameters and time to complete are varied. The intent is to determine how systems can be made less expensive without loss of important capability.

- Implementing "Should-Cost" Management: The "Should Cost" initiative challenges Program Managers to find specific ways to control the cost of what they are doing and expect to do. The objective is to eliminate non-value added overhead from program costs without trading away essential design and engineering activities. It reflects a concerted effort to lower costs where it makes sense to do so.
- Improving milestone process effectiveness: New policies ensure that the Department reviews program requirements, schedule, content, and funding prior to releasing final Request for Proposals (RFP). By conducting the review at this point, the Department will ensure that the Department's business arrangements, as specified in the RFP, are aligned with the approved program.

The Department also has implemented a number of initiatives designed to improve contract management. These key initiatives include:

- Continued use of "peer reviews" to improve the quality of contracting processes across the Department and facilitate cross-sharing of best practices and lessons learned.
- Improved tradecraft in the acquisition of services by the creation of a senior manager (General Officer/Flag Officer/Senior Executive Service level) within each Military Department to govern, execute and manage service acquisitions and the adoption of a uniform taxonomy for different types of services to provide a standard approach for measuring productivity.
- Developed the *Automated Requirements Roadmap Tool* (ARRT). The ARRT provides a structured approach for defining requirements and performance standards as well as how the results will be inspected. This process results in a draft of the Performance Work Statement (PWS) and Quality Assurance Surveillance Plan (QASP).
- Published a comprehensive "Guidebook for the Acquisition of Services."
- Directed improvements in competition for the acquisition of services. Policy now requires contracting officers to take additional steps to secure competition in certain cases where only one offeror responds to a competitive solicitation.
- Published the *Joint Contingency Contracting Officer Representative (COR) Handbook* to supplement official training and policy and serves as a handy pocket guide that provides CORs, who are supporting contingency operations with basic tools and knowledge.

In addition, the USD(AT&L)'s commitment to restoring affordability and productivity in Defense spending includes other initiatives, such as leveraging real competition, involving dynamic small business, improving audits, and protecting the technology base.

3. IG-Identified Challenge: Joint Warfighting and Readiness

3-1A. Joint Warfighting and Readiness	IG Summary of Challenge

The challenge of joint warfighting and readiness continues to be: Provide the right force, the right personnel, and the right equipment and supplies in the right place, at the right time, and in the right quantity, across the full range of military operations. The challenges facing the Department at this moment in time have a greater sense of urgency. The responsible drawdown of forces from Iraq and the ongoing counterinsurgency efforts in Afghanistan highlight the need to reset the personnel and equipment of the armed forces. This reset must be balanced, though, by the need to maintain a force able to address ongoing security commitments in Afghanistan and other areas, such as supporting the North Atlantic Treaty Organization (NATO) operations. All of these challenges are set against a backdrop of a decreasing budget for the Department as the country comes to grips with domestic and fiscal issues. The mission of maintaining readiness, resetting the force, structuring the force to meet future threats, and taking care of the service members and their families will require significant resources and continuous management attention. The completion of the drawdown of troops in Iraq and the initial drawdown in Afghanistan will require continued management visibility over assets and equipment. Management will have increased pressure to ensure accountability, visibility, and redistribution of excess equipment and proper transfer, reset, or disposal of assets in conjunction with the responsible drawdown of U.S. Forces. The ongoing efforts in Afghanistan, fighting insurgents and training the Afghanistan National Security Forces, and the realignment of forces in other geographical areas, such as the Pacific theater, present their own set of challenges, including ensuring the Department can maintain its overall readiness posture against the threats it faces.

3-1B. Joint Warfighting and Readiness	IG Assessment of Progress

The Department is making progress, but that progress must be monitored to ensure it continues. The Department cannot afford to ignore new and, in some cases, recurring situations that will require attention. For example, although the drawdown from Iraq is underway and the President has outlined his plan for a gradual drawdown in Afghanistan, those actions must be monitored to ensure all equipment and personnel are properly accounted for, and that only those items approved for transfer are transferred and those approved for disposal are demilitarized and disposed of correctly. With the increased fiscal constraints, resetting and modernization of equipment will be more critical to ensure more funds are available for equipment that is adaptable, expansible, interoperable, and protects the warfighter.

The Department has lacked adequate policies and procedures that address the use of DoD inventory before entering into contractor logistics support and performance-based logistics arrangements or contracts. The Department must ensure effective use of existing inventory, and when procurement is warranted, it must ensure fair and reasonable prices are paid for the parts procured.

While the Department has ensured that deployed units are trained, manned, and equipped to accomplish missions, this deployment has impacted the readiness of the Reserve Components. As Operation New Dawn (OND) and Operation Enduring Freedom (OEF) wind down, the Department must ensure the reserve components have the equipment and training necessary to ensure readiness and the ability to meet their various missions. The ongoing efforts to relocate service members to Guam and other locations around the globe will enable the armed forces to better shape and focus their force structure in a way that will provide greater flexibility in responding to threats. The Government of Guam is experiencing shortcomings in several areas of their infrastructure that fall outside of DoD funding authority, which could adversely impact the realignment. The Department needs to ensure that interagency planning and execution occur, as these concerns will need to be addressed with additional non-DoD funding.

3-1C. Joint Warfighting and Readiness	**Department Response**

Despite our consistently high operations tempo, the Department remains committed to ensuring deployed forces around the globe are trained, equipped, and ready to perform their assigned missions. Deploying capable and ready forces for current operations continues to impact the non-deployed forces' ability to prepare for full spectrum operations. Non-deployed forces are focusing their available training time to prepare for their next mission in support of OEF or other named operations, hedging against execution of other potential contingencies. The continued withdrawal of forces from Iraq, combined with Presidential directives to reduce deployed numbers in Afghanistan, is expected to reduce the stress on forces for the short term; however, the expected fiscal constraints looming on the horizon that may result in tough decisions on materiel, manpower, and infrastructure could negate the positive aspects expected from the reductions in operational stress. The Department is continually developing and refining comprehensive plans for both resetting and rebalancing the total force, which includes all reserve component forces, in the most effective and efficient manner possible. We recognize the most important part of maintaining joint warfighting capability and readiness is caring for the all-volunteer force. Finding the proper balance between maintaining readiness, force structure, modernization, fiscal realities, and future threats remains the highest priority of the Department's leadership.

4. IG-Identified Challenge: Information Assurance, Security, and Privacy

4-1A. Cyber Security	IG Summary of Challenge

One of the major challenges the Department faces is in addressing cyber security and the threat posed by computer network attacks. According to recent reports from the Department of Homeland Security, Federal agencies suffered 41,776 cyber attacks in 2010. As reported in numerous reports on cyber security, attacks come from a variety of sources, including criminal groups, hackers, other nations, terrorists, and insiders. A variety of exploits used by these attackers to breach/impact DoD networks include worms, war driving, intrusion tools, and denial of service. In fact, as previously noted by the Commander, U.S. Cyber Command, DoD networks are probed approximately 250,000 times per hour. In today's information assurance security environment, the Department faces significant challenges in securing approximately 15,000 different computer networks across 4,000 military installations around the world.

4-1B. Cyber Security	IG Assessment of Progress

It has been approximately one year since the Secretary of Defense directed the establishment of the U.S. Cyber Command. The focus of the Cyber Command is to plan, coordinate, integrate, synchronize, and conduct activities to lead the day-to-day defense and protection of DoD information networks. While the Department has made progress in combating cyber attacks and breaches, it still faces a challenge in recruiting and hiring cyber specialists. In addition, the Department has made progress in implementing its host-based intrusion detection system (HIDS), which is installed at the individual workstation/server level (host) and monitors systems for network-based attacks and host-specific events. Phased implementation and evaluation of the Host-Based Implementation System (DoD's primary HIDS) is continuing and adjustments are being made. While the Department has taken strides to improve its cyber security efforts, it must continue to be ever diligent in preparing for the next threat. The DoD IG has several on-going audits looking at DoD efforts to ensure the information/cyber security of its networks and data.

4-1C. Cyber Security	**Department Response**

The Department continues to strengthen cyber security and address the threat posed by network attacks. We have taken steps to effectively isolate the department's official-use networks from the Internet using a variety of techniques, which include redesigning the addressing system for increased security and searching for and removing web browsing malicious software and spam from incoming email. We also have improved our defenses against blocking distributed denial-of-service attacks at perimeter routers, and that, coupled with quarantine of suspicious and known bad traffic and files, has resulted in increased security from Internet probes and attacks. Our internal efforts include configuring every computer securely and keeping them that way. We do this by using Defense Information Systems Agency and National Security Agency published security guides, which are now being automated for ease of implementation, and applying Unified Government Configuration Baseline operating system settings in accordance with OMB direction. Additionally, we are procuring advanced automated vulnerability scanning and remediation tools for our networks, and implementing a Department-wide enterprise Host-based Security System to extend protections to the user's desktop level.

The Department has taken many steps to improve its cyber security efforts. Implementation of the Host-based Security System is nearing global deployment on our unclassified and classified systems. Cyber Command has made progress in recruiting and hiring cyber specialists. Operations

plans and directives have also been issued to strengthen the U.S. Cyber Command role in defending, protecting, and operating the Department's vital classified and unclassified networks.	
4-2A. Information Technology (IT) Acquisition System	IG Summary of Challenge
Another challenge the Department faces is the development and implementation of a new acquisition process for IT systems. Section 804 of the National Defense Authorization Act (NDAA) for Fiscal Year 2006 requires the Secretary of Defense to develop and implement a new acquisition process for information systems. The process was to be based on recommendations from the March 2009 report of the Defense Science Board (DSB) Task Force on Department of Defense Policies and Procedures for the Acquisition of Information Technology. This report concluded that "the conventional DoD acquisition process is too long and too cumbersome to fit the needs of the many systems that require continuous changes and upgrades..." In fact, an analysis conducted by the Office of the Assistant Secretary of Defense for Networks and Information Integration (OASD/NII)) calculated that the average time to deliver an initial program capability is 91 months. The Department is challenged to respond more quickly to information technology's rapid turn-over and acquire new-age capabilities when available.	
4-2B. IT Acquisition System	IG Assessment of Progress
In November 2010, the Department issued its response to the requirements of Section 804 of the FY 2010 NDAA. This report, entitled "*A New Approach for Delivering Information Technology Capabilities in the DoD*," provides an update on the progress for developing a new acquisition process for information capabilities. The report identifies the establishment of an information technology (IT) Acquisition Task Force, made up of stakeholders from the Department and industry, to further refine the details of the new process, begin implementation, and provide transition oversight; however, no milestones for implementation activities were provided. The Department must continue to push forward on a new IT acquisition process in order to ensure success for its mission and the individual warfighters.	
4-2C. IT Acquisition System	**Department Response**
The Department is committed to the implementation of IT Acquisition Reform and has achieved key accomplishments, proposed short- and long-term milestones, and conducted risk assessments. On June 23, 2011, a Directive-Type Memorandum (DTM) on *Business Capability Lifecycle* (BCL) was signed by the USD(AT&L). The BCL provides a tailored acquisition process with alternative requirements development processes for Defense business systems, a major step forward in implementing more flexible and streamlined processes. Additionally, USD(AT&L) and the *Joint Requirements Oversight Council* (JROC) have launched efforts to update the DoD Acquisition Instruction and the Chairman of the Joint Chiefs of Staff Instruction to incorporate ongoing IT acquisition reform efforts. Finally, the Deputy Secretary of Defense soon will issue a memorandum that identifies existing flexibilities within current regulations that Components can leverage to better posture IT projects for upcoming acquisition reform policy changes. The implementation of the new IT acquisition reform process will be executed in the following phased approach: • Agreed upon IT acquisition reforms that do not require statutory change will be implemented as soon as possible. • Concurrently, the Department will maximize use of existing regulation flexibilities for streamlining its current IT acquisitions. • The IT reform initiatives that require further discussion but do not require statutory changes will	

be phased-in, beginning with business systems and IT infrastructure initiatives.

- Finally, reform initiatives that require statutory change will be piloted, with lessons learned incorporated into proposed regulation and statutory changes.

The Defense Business System Management Committee (DBSMC) will serve as the decision-making forum for IT reform initiatives.

5. IG-Identified Challenge: Health Care

5-1A. Medical Readiness	IG Summary of Challenge

Keeping members of the Active Duty and the Reserves and National Guard medically ready to deploy continues to challenge the DoD Military Health System (MHS). This challenge is compounded by the frequency and duration of deployments. Caring for Active Duty family members is part of the medical readiness challenge.

Increased numbers of returning service members with psychological health issues, along with a shortage of uniformed and civilian mental health workers, will require examination of automated screening tools and improved diagnostics to provide earlier detection and intervention. In addition, addressing the psychological effects of deployment on family members and non-Active Duty personnel will continue to be a challenge.

5-1B. Medical Readiness	IG Assessment of Progress

The MHS is moving forward on improving medical readiness while attempting to control costs. The MHS uses the Quadruple Aim Concept to shape its vision, identifying readiness, population health, experience of care, and per capita cost as the four aims that set the strategic direction to improve mission outcomes. The Quadruple Aim Concept is the military health care concept that focuses on the encouragement of healthy behaviors, beneficiary satisfaction, maximizing force readiness, and the successful management of per capita health costs. The MHS leadership adopted a dashboard to monitor implementation of strategic imperatives and serve as an indicator of mission success.

Individual medical readiness rates for the Active Duty, Reserves, and National Guard continued to improve from FY 2010 to FY 2011; however, while the Active Duty rate surpassed the overall MHS target rate of 80 percent, the Reserves and National Guard rate, while improved, has not attained the target rate. The MHS continues to meet all mission requirements despite very high operational tempo. Data from the Joint Theater Trauma Registry reveal unprecedented outcomes, including reduction in died-of-wounds rates and the lowest ever disease, non-battle injury rates.

The MHS management identified the family medical readiness strategic imperative, but the applicable performance measure is in the concept phase. The need to improve the planning for medical needs of family members was discussed in our report on the planning of Guam dental care for Active Duty family members. In addition, the DoD IG is currently assessing the medical staffing and specialty care requirements in Guam.

The MHS identified psychological health and resiliency as a strategic imperative, with performance measures and goals established for Post-Traumatic Stress Disorder (PTSD) and depression screening, referral, and engagement.

5-1C. Medical Readiness	**Department Response**

Readiness is at the core of the Department's Quadruple Aim concept, which focuses on encouraging healthy behaviors and beneficiary satisfaction, maximizing force readiness, and successfully managing per capita health costs. Every strategic initiative undertaken by the Department is selected and evaluated based on its ability to create positive change in one or more of these areas. Several initiatives are currently underway, including implementing the medical home concept and optimizing the delivery of psychological healthcare, that directly impact the readiness of the force and their families.

Through a wide variety of programs, including the Defense Centers of Excellence, the Department is committed to the psychological wellbeing of our wounded warriors, active duty service members and their families. As the conflicts wind down, the psychological effects of the deployments will continue to be felt for many years.

5-2A. Cost Containment	IG Summary of Challenge

The MHS must provide quality care for approximately 9.6 million eligible beneficiaries within fiscal constraints while facing increased user demands, legislative imperatives, and inflation, which makes cost control difficult in both the public and private sectors. During a hearing with the Senate Appropriations Subcommittee on Defense, the Secretary of Defense stated that the escalating cost of health care is a problem that must be addressed. The DoD budget for health care costs was approximately $52.6 billion in FY 2011, an increase of approximately 70 percent since FY 2005. Another part of the challenge in containing health care costs is combating fraud. Health care fraud is among the top five categories of criminal investigations of the DoD IG's Defense Criminal Investigative Service, representing 9.9 percent of the 1,856 open cases at the beginning of FY 2011. Increasing health care benefits also provides additional pressure to manage and contain costs.

5-2B. Cost Containment	IG Assessment of Progress

The MHS is focusing on many areas to manage per capita health care costs. Two new TRICARE contracts were awarded, and the request for proposal (RFP) for the remaining contract was issued during FY 2011. Award protests resulted in staggered implementation of the two new contracts. The contracts provide incentives for customer satisfaction and include the managed-care support contractors as partners in support of medical readiness. The MHS has organized an internal study group to examine the options for the next generation of TRICARE contracts for purchasing civilian health care, which are anticipated to begin 2015. No similar internal review process has been used to examine preceding generations of contracts. An unprecedented Federal budget environment, punctuated by regular reports of the poor quality of U.S. health care relative to its cost, compelled a fresh look at how the MHS purchases health care from the private sector. The guiding principle of the study group is that high-quality, patient-centered care is also cost-efficient care.

Officials within the Office of the Assistant Secretary of Defense (Health Affairs) identified areas that assist in managing costs, to include fraud management, and pharmaceuticals. Additionally, the Quadruple Aim Concept is intended to simultaneously improve quality and reduce costs by focusing on the elimination of unnecessary care, tests, and procedures, and by focusing on delivering health care in the most appropriate setting. Additionally, the MHS identified optimization of the pharmacy practices and implementation of the patient-centered medical home as strategic initiatives, both of which are aimed at increasing the quality of health care services while reducing the cost of providing high quality care.

Controls over Philippines medical claims continue to challenge MHS management. The DoD IG found that the MHS needs additional oversight of the Philippine medical payment process. Specifically, controls over procedures for certifying medical providers and for verifying beneficiaries' addresses before issuing payments need improvement.

5-2C. Cost Containment	Department Response

An unprecedented health care and Federal budget environment, punctuated by regular reports of the poor quality of U.S. healthcare relative to its cost, compelled a fresh look at how the military health system purchases healthcare from the private sector. This fresh look at the next generation of TRICARE contracts (known as "T4") for purchasing healthcare began in October 2010 with the organization of the T4 Study Group. The guiding principle of the group is: High-quality, patient-centered care is also cost efficient care, and those who serve and have served and their families should have both.

The T4 Study Group is composed of 18 representatives from the Army, Navy, Air Force, Army Reserves, Coast Guard, Uniformed Services University of the Health Sciences, Office of the Secretary of Defense (Health Affairs), and the TRICARE Management Activity. At this time, the group has narrowed the options to five potential courses of action based on the anticipated impact and ability to create incentives that influence patient and provider behavior and support the Quadruple Aim of readiness, population health, experience of care and per capita cost. The Group currently is performing a detailed market analysis and will present their recommendations in the fall of 2011. The group will then lead the effort to test the options within demonstration pilots and develop the acquisition strategy needed to meet the timeline for deploying these new contracts by 2015.

On the horizon, the Department has two strategic initiatives that demonstrate significant potential for transforming our healthcare delivery system and slowing, if not reversing, the cost trajectory: Healthy Behaviors and Evidence-Based Health Care. Both of these strategic imperatives are key to achieving the Quadruple Aim of Readiness, Population Health, Experience of Care, and Per Capita Cost.

To reduce the healthcare cost burden in the long term and improve readiness and productivity in the near term, the Department is focused on improving the general health of the force through development of healthy behaviors. By reducing obesity and tobacco usage, for example, the long term health implications of Diabetes and Chronic Obstructive Pulmonary Disease can be reduced significantly. Preventable conditions such as these are expensive and long-term in nature.

Similar to the Healthy Behaviors imperative, Evidence-Based Health Care is a key driver to reduce cost while improving the quality and outcomes. Using best practice care and technology to enhance the availability of information, intelligent standardization of health care practices can reduce variability in treatment, improve outcomes and reduce unnecessary utilization of medical services.

5-3A. Population Health	IG Summary of Challenge

Managing the overall health of this large population of approximately 9.6 million eligible beneficiaries is a continuing challenge for the MHS. Identifying unhealthy behaviors and providing appropriate interventions across the population is a challenge and one of the primary emphasis areas of the MHS Quadruple Aim. By reducing obesity and tobacco usage, for example, the long-term health implications of diabetes and chronic obstructive pulmonary disease can be reduced significantly. Preventable conditions such as these are expensive and long term in nature.

5-3B. Population Health	IG Assessment of Progress

The MHS is implementing the "medical home" concept throughout the direct care system. With the medical home, the patient will have more direct access to a medical team that is equipped to recognize potentially unhealthy behaviors and has the ability to intervene early. The MHS fully supports the National Prevention Strategy to support better health behaviors and overall fitness. Although the MHS goal was not attained, cigarette use among Active Duty forces decreased from FY 2010 to FY 2011. The MHS has actively committed to supporting the National Partnership for Patients initiative with the Department of Health and Human Services to improve care, transition, and prevention of harm during treatment. The two goals of this partnership are "keeping patients from getting injured or sicker" and "helping patients heal without complication."

5-3C. Population Health	**Department Response**

The Department's two strategic initiatives, "Support the National Prevention Strategy to promote healthy behaviors and total fitness" and "Partnership for Patients," combined with the implementation of the medical home throughout the system, are long-term programs designed to promote population health while avoiding unnecessary health care costs.

The vision of the National Prevention Strategy is to promote and improve the health and wellbeing of individuals, families, and communities by transitioning away from a focus on illness and disease to a focus on prevention and wellness activities that support healthy behaviors, lifestyles, and choices.

The Partnership for Patients initiative helps improve readiness and well-being through prevention, population health management and patient activation, while positively impacting cost by reducing uncoordinated care, repeated hospital readmissions and hospital-acquired conditions. As part of the Quadruple Aim, the MHS works to provide safe, effective care to the entire beneficiary population. The Partnership for Patients further supports this effort and will enable the MHS to demonstrate measurable improvements in each aspect of the Quadruple Aim. For example, reducing hospital-acquired conditions means that patients receive treatment only for the condition they arrive at the hospital with, and are not caused by any additional (avoidable) harm. This reduces per capita cost and improves population health as no extra treatments, procedures, or medications are required, and patients spend minimal time in the hospital. Military readiness is improved because patients in Military Treatment Facilities (MTFs) are part of the DoD workforce, and lower rates of injury and infection help maintain a fit and ready workforce.

5-4A. Experience of Care	IG Summary of Challenge

Strengthening comprehensive and integrated health care from accession through active service, to rehabilitation and transition to the Department of Veterans Affairs (VA) care is a major challenge for the MHS. The number of wounded warriors associated with Southwest Asia and other such conflicts, particularly those affected with Traumatic Brain Injury and PTSD and those in need of prosthetic services, requires diligent management of health care resources. In this respect, as a result of a congressional request for assistance, DoD IG initiated a "Wounded Warriors Matters" assessment program in the spring of 2010. This assessment determines whether DoD programs for the care, management, and transition of recovering service members wounded during deployment in Operation Iraqi Freedom (OIF)/Operation New Dawn (OND) or Operation Enduring Freedom (OEF) are managed effectively and efficiently. Field work has been completed, with visits to six Wounded Warrior Battalions. The first report, *"Assessment of DoD Wounded Warrior Matters – Fort Sam Houston"* was published in March 2011. The remaining reports pertaining to these visits are expected to be published in the 4th quarter, FY 2011, and 1st and 2nd quarters of FY 2012. This series of assessments will result in a report that reviews systemic problems identified in the DoD Wounded Warrior Programs.

Another challenge is oversight of post-deployment health needs, including identifying and managing those requiring care, to maximize the service members' experience of care. Although a number of objectives have been identified by the Department and the VA and programs have been initiated, the quality and oversight of these programs must be tightly managed. Transitioning wounded, ill, or injured service members to post-deployment care will grow as a challenge while Operation New Dawn (OND) and Operation Enduring Freedom (OEF), continue. The Department needs to improve the medical care and benefits transition program to achieve a streamlined, transparent, and timely process as wounded warriors move from the DoD system to the VA system.

5-4B. Experience of Care	IG Assessment of Progress
The MHS strategic plan recognizes continuum of care as a strategic priority concerning the experience of care. Disparities in the transition of health care and benefits have been identified, yet actionable solutions are difficult to implement and monitor. The MHS is redesigning primary care according to the Joint Principles of the Patient Centered Medical Home (PCMH) to improve the health of the population, improve care coordination, improve beneficiary satisfaction, and reduce growth in per capita cost. The MHS intends to build partnerships with beneficiaries in an integrated health delivery system that encompasses military treatment facilities, private sector care, and other federal health facilities, including the VA. Globally accessible health and business information enables patient-centered, evidence-based processes that are both effective and efficient.	

5-4C. Experience of Care	**Department Response**
The Department is redesigning primary care in MTFs according to the Joint Principles of the Patient Centered Medical Home to improve the health of the population, improve care coordination, improve beneficiary satisfaction, and reduce growth in per capita cost. The Department is also proposing demonstrations to encourage PCMH models of care in practices in the Private Sector Care (PSC) to which TRICARE beneficiaries are enrolled and also to encourage TRICARE patients in the network to seek primary care from PSC practices that are recognized as PCMHs by the National Center for Quality Assurance (NCQA or equivalent.) To address the transition issues for wounded warriors, beginning in November 2007, the Departments of Defense (DoD) and Veterans Affairs (VA) integrated their disability evaluation processes to create the Integrated Disability Evaluation System (IDES), enabling wounded, ill, and injured (WII) Service members to receive both their DoD and VA disability compensation as soon as possible after discharge from Military Service. While the IDES provides a significant improvement over the separate Department legacy processes, in early 2011 then-Secretary Gates and Secretary Shinseki recognized the need to continue to improve the IDES, particularly the timeliness of the process, for disabled Service members and their families. The Departments have been collaborating on the Remodeled IDES (rIDES) since March 2011, developing streamlined methods for determining fitness for duty and disability ratings for WII members. In June 2011, the Secretaries directed their Departments to begin testing the resulting efficiencies at three locations by December 31, 2011: Fort Carson, Colorado; Camp Lejeune, North Carolina; and Shaw Air Force Base, South Carolina. The rIDES proof of concept will run until August 2012, and the Departments will evaluate the results to determine the viability of deploying the lessons learned to improve the IDES.	

5-5A. Electronic Health Records	IG Summary of Challenge
Providing information to the right people so they can make informed decisions continues to be a challenge in the health care community. Along with the benefits of expanding automation efforts comes the increased risk to security and privacy of information. The transition from paper to electronic patient records increases the exposure of sensitive patient information to inadvertent or intentional compromise, highlighting the need for appropriate information assurance procedures. Developing and maintaining information operations that ensure the protection and privacy of data will continue to grow as a challenge.	

5-5B. Electronic Health Records	IG Assessment of Progress
The MHS Information Management/Information Technology Strategic Plan for 2010 to 2015 includes the electronic health record as a strategic goal. The goal over the next five years is to focus on improving the electronic health record family of applications to create a comprehensive and reliable system. Specific milestones were established to implement a personal health record prototype and to expand bidirectional sharing of health information between DoD and the	

Department of Veterans Affairs; however, DoD has encountered delays in establishing the electronic health record. The Department of Defense continues to progress in sharing electronic medical records with the Department of Veterans Affairs. The final report on the DoD and VA joint assessment project recommended that the Departments pursue a common-services approach to sharing inpatient records, which will allow them to build upon their existing information sharing capabilities. It also will set the stage for the appropriate level of interoperability with other government and private sector organizations.

5-5C. Electronic Health Records	**Department Response**

The Electronic Health Record (EHR) and related decision support capabilities underpin all of the Department's strategic goals, imperatives and initiatives. The foundation of information is critical to delivering the best care possible to our beneficiaries at the lowest cost. It will provide connected care across all care settings and venues - theater, en-route care, garrison, and VA/Civilian facilities and supports the Virtual Lifetime Electronic Record (VLER) – a seamless record for each service member from enlistment through retirement.

The strategic imperatives of "Enabling Better Decisions," "Fostering Innovation," "Managing Health Care Costs," and "Promoting Patient Centeredness" all rely on the accurate and timely flow of information across DoD and with external partners (e.g., Department of Veterans Affairs, private sector partners, etc.). The Department currently has two active strategic initiatives in support of the EHR: The Joint DoD-VA Integrated EHR and Evidence Based Healthcare.

5-6A. Implementing BRAC	IG Summary of Challenge

Implementing recommendations resulting from the 2005 Base Realignment and Closure (BRAC) process will continue to be a challenge. In addition to improving the readiness and cost efficiency associated with realigning base structure, a primary objective of the process was to examine and implement opportunities for greater joint activity among the Military Departments. Recapitalization of the physical infrastructure is a challenge. Military treatment facilities are aging and in need of replacement.

5-6B. Implementing BRAC	IG Assessment of Progress

The BRAC process addresses part of the aging infrastructure, but to fully address the challenge, better standardized data on the condition of facilities is needed. The MHS has begun the multiyear transition and acquisition process of improving capability and access to care in two major and several minor markets. For example, the new Walter Reed National Military Medical Center at Bethesda is expected to be completed in 2011.

By establishing more unity of purpose in each of the major markets, the market leaders should be able to distribute resources across hospitals and clinics within a market to meet the needs of the entire population of eligible beneficiaries. In addition, the increased span of control will enable improved continuity of care and coordination of safety and quality programs. In the National Capital Region, the Secretary of Defense established the Joint Task Force National Capital Region – Medical to clarify command and control and implemented a single-manning document categorizing civilian positions as Department of Defense rather than affiliated with any one Military Department. A different joint leadership initiative was established for the San Antonio major market. Evaluating the variety of governance models may provide innovative solutions that can be used across the MHS. The Tri-Service Medical Education and Training Campus should improve the quality and consistency of training for all enlisted personnel, contributing to a culture of jointness and interoperability.

Several infrastructure issues are addressed through implementation of the *American Recovery and Reinvestment Act (ARRA) of 2009*. We completed our review of planning for Phase I of the new hospital being built at Fort Hood. Planning for the facility was adequate and met the ARRA's goals of transparency and accountability. The DoD IG is currently reviewing the new hospital project at Camp Pendleton.

5-6C. Implementing BRAC	Department Response

The BRAC recommendations for the Military Health System (MHS) were approved in 2005 with the specific goals of promoting efficiency and joint-interoperability. These initiatives drove a historic and necessary transformation of DoD clinical care, medical education and training, and biomedical research and development (R&D) capabilities. The clinical portions of BRAC reorganized two of the largest military medical markets (National Capital Region and San Antonio) into jointly staffed and managed healthcare systems and downsized several small hospitals to clinics. Other medical BRAC actions consolidated DoD-wide basic medical enlisted training in San Antonio and consolidated the fragmented biomedical R&D technical base into centers of excellence.

BRAC Commission Recommendation 169 called for the realignment of Walter Reed Army Medical Center (WRAMC), Washington, DC. This entailed construction of a new community hospital and a dental clinic at Fort Belvoir and an expansion of the National Naval Medical Center (NNMC), Bethesda, MD, which is re-named the Walter Reed National Military Medical Center (WRNMMC). Implementation of this recommendation created a jointly staffed and managed healthcare system in the National Capital Region, including a more robust hospital at Fort Belvoir, VA, which brings a greater range of services closer to where most beneficiaries reside. Closure of WRAMC reduces funding required to operate and maintain a large and rapidly aging physical plant and allows for the elimination of both military and civilian positions.

BRAC Commission Recommendation 172 directed realignment of Lackland Air Force Base (AFB), Texas, by relocating the inpatient medical function of the 59th Medical Wing (Wilford Hall Medical Center) to the Brooke Army Medical Center (BAMC), Fort Sam Houston, Texas, establishing it as the San Antonio Regional Military Medical Center, and converting Wilford Hall Medical Center into an ambulatory care center. This required construction within the existing BAMC, alteration of portions of WHMC, and construction of a new free-standing outpatient clinic at Fort Sam Houston. Corollary actions within this recommendation included the Medical Enlisted Training Center (METC) and U.S. Army Institute of Surgical Research on Fort Sam Houston.

BRAC Commission Recommendation 198 directed the co-location of the Medical Command Headquarters. This action allowed for the lease of office space within the National Capital Region in order to co-locate the Services' Medical Headquarters with OSD Health Affairs and the TRICARE Management Activity. The on-going consolidation of governance within the various components of the MHS is a high priority task that has wide ranging implications on the operations of the Department. Between the 2006 call for consolidation and today, there have been examples of successful joint operations, including the Medical Education and Training Command and the Joint Task Force Capital Area Medical, both of which were facilitated by BRAC 2005. These entities' activities are consistent with our framework of incremental steps to support principles of unity of command and effort while creating a joint environment for the development of future MHS leaders. The concept includes co-location of medical headquarters, maintenance of OUSD(Personnel and Readiness) oversight of the Defense Health Program, and positions the MHS for further unification, if warranted. The concept is too new to fully understand the implications of applying the consolidation across all of the services.

6. IG-Identified Challenge: Equipping and Training Iraq and Afghan Security Forces

6-1A. Iraq National Security Forces	IG Summary of Challenge

A major national security goal is the establishment of a sovereign, stable, and self-reliant Iraq that contributes to the peace and security of the region and with whom the U.S. can forge a long-term security partnership. Iraq Security Forces (ISF), capable of providing for internal security as well as a foundational external defense capability, is essential to achieve these U.S. national objectives.

Over the next three months, U.S. policy and related DoD military strategy will encompass withdrawing the remaining U.S. combat forces from Iraq by the end of 2011 while continuing to train, equip, and mentor the ISF. To be able to continue supporting the development of the ISF, the Department will transition management of all remaining training, equipping, and mentoring activities from U.S. Forces-Iraq to the newly established Office of Security Cooperation - Iraq (OSC-I), under the Department of State and Chief of Mission authority. The OSC-I, with continued DoD assistance, will seek to establish the framework for a robust security assistance and Foreign Military Sales (FMS) program that will endure after the last U.S. military forces leave in December 2011.

The effective transition of DoD training, equipping, and mentoring assistance from U.S. Forces-Iraq to the OSC-I before December 2011 is critical to sustain progress made thus far in developing an independent ISF capability after the withdrawal of US combat forces. This objective is especially timely given that there still are Iraqi Army and Police minimum essential capabilities that have not been met, without which their security forces may not be prepared to counter internal or external threats to the country's stability. The OSC-I, functioning under Chief of Mission authority, will have a key role to play in this regard, further building the independent capability of the Government of Iraq's security forces while creating the foundation for a longer-term security cooperation and assistance relationship between our two countries.

It is imperative, therefore, that the political and legal framework and authorities necessary be established in a timely manner in the second half of 2011 so that the new OSC-I and its personnel can be in a strong position to operate effectively, safely, and with the necessary legal protections before the withdrawal of the remainder of US combat forces. In addition, the transition of DoD security cooperation and assistance functions to the Department of State authority must be completed before the end of 2011 and the enhanced capabilities vested in the OSC-I operating within the U.S. Mission fully organized and in place.

6-1B. Iraq National Security Forces	IG Assessment of Progress

The ISF must be able to effectively conduct counter-terrorism operations, protect critical national infrastructure, maintain civil order, and protect against external threats in order to minimize the strategic risk to Iraq and provide a stable partner in the region in support of achieving U.S. national security goals.

The ISF has made significant progress in developing these capabilities, and many of the security functions performed by U.S./NATO forces have already transferred to the ISF. Nonetheless, the ISF has not yet achieved certain minimum essential skills in the critical area of logistics sustainment and in the development of other enabling force functional capabilities. In addition, the capacity of the Government of Iraq and its Ministry of Defense to sufficiently plan, program, and budget the resources necessary to sustain the readiness of its military forces is still maturing.

U.S. Forces – Iraq is conducting an expedited, intensive push to address the most significant ISF sustainability deficiencies by December 31, 2011; however, to complete certain key aspects of this ISF force build-up will require the continuing efforts of a robust OSC-I capability beginning in 2012.

6-1C. Iraq National Security Forces	**Department Response**

The Department faces significant challenges in Iraq. The Department continues the training, equipping, and mentoring of the ISF, including development of the ISF's logistics sustainment base, while conducting a responsible drawdown of U.S. forces by December 31, 2011 in accordance with the United States-Iraq Security Agreement. In addition, the Department is faced with transitioning all remaining training, equipping, and mentoring activities to the OSC-I, as well as laying the groundwork for a security assistance and security cooperation program that will endure after U.S. forces leave in December 2011.

The Department has made considerable progress in achieving the goal of the establishment of a sovereign, stable, and self-reliant Iraq that contributes to the peace and security of the region and with whom the U.S. can forge a long-term security partnership. Additionally, DoD continues to support the ISF as they develop the capabilities to provide for internal security and foundational external defense. In addition, the Department continues to support the transition to a civilian-led Iraq mission and to stand up the OSC-I, which will be the foundation of the long-term security partnership.

6-2A. Afghan National Security Forces	IG Summary of Challenge

On June 28, 2011, the Government of the Islamic Republic of Afghanistan gained the support of the international community to significantly expand the size of the Afghan National Security Forces (ANSF) to 352,000 personnel to be able to conduct and sustain independent security operations and provide for the future stability of the country. In addition to expanding the force, a significant and sustained training, partnering and mentoring effort is required to professionalize the ANSF, ensuring "quality, not just quantity."

Between now and the end of 2014, U.S. policy and related DoD military strategy in the Afghanistan-Pakistan region will be implemented by high-intensity, complex operations that emphasize:

- Providing continued training, equipping, partnering and mentoring to enable the ANSF to assume a leading security operations role;
- Building the size of the ANSF to 352,000, as agreed by the International Joint Coordination and Monitoring Board's Security Standing Committee, June 28, 2011, and the Government of the Islamic Republic of Afghanistan;
- Withdrawing 10,000 U.S. combat forces from Afghanistan before December 2011;
- Withdrawing an additional 23,000 U.S. combat forces from Afghanistan in 2012;
- Conducting a phased drawdown of U.S. combat forces in 2013 and 2014, and
- Enabling the ANSF to assume lead responsibility for the security of the Afghan people and its government as ISAF forces withdraw.

The Department must continue its efforts to develop the capability of the Afghan Ministries of Defense and Interior to logistically sustain the ANSF. These efforts include the capacity to plan, program, budget, and execute the fiscal resources provided by the international community along with revenue generated by its own government. In addition, there are still certain combat support and service support functional capabilities of the ANSF that will need to be developed for them to be able to assume independent security responsibilities.

A strategic challenge to mission accomplishment has been to mobilize sufficient institutional trainers and mentors from NATO and coalition countries. The purpose of the mobilization is to keep pace with current and anticipated ANSF expansion and the priority of increasing the professional skills of the security forces.

The extremist force elements based in western Pakistan continue to pose a security threat to the stability of Afghanistan; therefore, the Department will need to continue developing the capacity of the Pakistan Security Forces to maintain internal security and eliminate extremist Taliban and al-Qaeda forces in the Northwest Frontier safe haven.

6-2B. Afghan National Security Forces	IG Assessment of Progress

The size of the ANA and ANP already has grown at a very significant rate over the past two years, and the International Security Assistance Force (ISAF) command is on track to meet or exceed its growth targets set for this year. Moreover, the partnering of US and Coalition units and training teams has enabled Afghan National Army (ANA) units to accelerate improvement in their operational capability.

Increasing command focus on the need to have visibility and oversight over the myriad of contractors supporting ISAF operations has led the NATO Training Mission – Afghanistan/Combined Security Transition Command – Afghanistan (NTM-A/CSTC-A) to request several hundred additional U.S. military personnel with specialized skills. A new training program support office within NTM-A/CSTC-A is intended to provide an integrated contract support program. In addition, ISAF Joint Command (IJC) has agreed to assume the additional responsibility of extending the contract oversight capability of NTM-A/CSTC-A by providing Contracting Officer Representatives when CSTC-A personnel are unable to do so. Finally, an initiative is underway which, if authorized by the Department, would provide the ability to use military personnel from non-U.S. coalition commands in a contract oversight role.

The success of the counterinsurgency campaign being conducted against Taliban and extremist anti-government elements depends on how well the ANSF provides protection for the Afghan people, establishes an environment of law and order, and gains the people's trust. The responsibility to protect the Afghan people falls most directly on the ANP, which operates at the direct interface with the population in provinces and districts around the country.

In light of this reality, the NTM-A/CSTC-A is conducting an accelerated build-up of the ANP forces and has achieved considerable progress in increasing its institutional training capacity to grow these forces, to improve training quality, reduce attrition, and improve recruitment.

In addition, U.S./Coalition forces have implemented an extensive literacy and numeracy program for army and police personnel. Along with pay reform, this has also improved morale as well as personnel effectiveness. This program will become even more essential as security forces now are entering into more specialized and technical training programs requiring a higher level of comprehension.

For the first time, with the concurrence of the ISAF command and the Government of the Islamic Republic of Afghanistan, several provinces and districts, along with the greater Kabul capitol area of operation, were selected to take the lead in governance and security operations starting in July 2011.

6-2C Afghan National Security Forces	**Department Response**

A key strategic focus remains on training, equipping, and partnering with the ANSF to enable the transition of lead security responsibility to the Government of Afghanistan. Redeployments of U.S. combat forces have already begun, with the ANSF to lead security responsibilities by 2015. The North Atlantic Treaty Organization (NATO) and the Government of the Islamic Republic of Afghanistan continue to grow both the quality and quantity of the ANSF. Both the ANA and the ANP still need support from the international community – particularly in pledging institutional trainers for the ANSF and Police Operational Mentoring and Liaison Teams – in order to train the ANSF and provide mentors and partners in the field.

As of July 2011, both ANA and ANP force levels were on track to achieve target goals, at approximately 170,000 and 131,000. The NATO Training Mission-Afghanistan has implemented several positive changes in the ANSF training regime since November 2009, including increasing the number of trainers, providing better marksmanship training, adding literacy training, and opening branch schools for higher end training.

7. IG-Identified Challenge: The Nuclear Enterprise	
7-1A. Prior Decline of Focus on the Nuclear Enterprise	IG Summary of the Challenge

Prior to FY 2011, various reports from government and non-government entities detailed an environment where the nuclear enterprise in the Department had experienced a marked but gradual decline in focus upon the nuclear enterprise. That decline was characterized by nuclear forces being subordinated to non-nuclear forces in military organizations and not receiving sufficient staffing and funding to perform the nuclear mission according to past standards. Since the last Management Challenge report, twelve reports were issued that commented on the current state of the nuclear enterprise.

During the past fiscal year, the DoD IG issued a classified report detailing the current environment of the nuclear enterprise. Although the specific findings and recommendations of that report are classified, the report identified continuing weaknesses in maintenance, logistics, and technical documentation for the employment of nuclear weapons. The organizations referenced in the report responded positively to the findings and recommendations, using the report results as justification for organizational and procedural changes.

7-1B. Prior Decline of Focus on the Nuclear Enterprise	IG Assessment of Progress

DoD Focus on Sustainment Assessment. In the wake of the Minot and Taiwan incidents numerous reports were issued by the Department and private consulting organizations concerning the current state of the Nuclear Enterprise, reasons for the decline of the nuclear enterprise, and recommendations to improve that enterprise. In September 2009, the DoD IG reported that the Department is making significant progress in addressing concerns raised and recommendations given by those reports.

The 2011 Defense Science Board Report from the Defense Science Board Permanent Task Force on Nuclear Weapons Surety stated that the actions taken since have been “effective in correcting many of the deficiencies in the operating forces.” At present, we are conducting a review to measure progress subsequent to the FY 2009 DoD IG report.

During FY 2011, the DoD IG reviewed progress to follow-up on the audit from the 2002 report, entitled “Physical Security of Nuclear Weapons Located in the Continental United States.” During that audit, we noted that uneven progress was being made, but overall completion was slower than the plan detailed in the roadmap. The U.S. Navy had made rapid progress on most areas identified for improvement. The DoD IG currently is reviewing U.S. Air Force progress as well as reviewing the status of the recommendations from several prior audits on the DoD nuclear enterprise.

The following reports were issued by either DoD, Nuclear Command and Control System Security Staff, Department of Energy, the Defense Science Board, or the Government Accountability Office since the last Management Challenge report:

- Government Accountability Office Report 11-387 “DoD and NNSA Need to Better Manage Scope of Future Refurbishments and Risks” (May 2011).
- Defense Science Board Permanent Task Force on Nuclear Weapons Surety, “Independent Assessment of the Air Force Nuclear Enterprise,” (April 2011).
- “Exercise Vigilant Shield/Global Thunder Nuclear Weapons Accident Incident Exercise After Action Report,” (April 2011).
- FY 2011-2017 Nuclear Weapon Stockpile Plan – (February 2011) DoD and Department of Energy.

- NSS Assessment Report on "DOE/NNSA and DoD Mechanisms to Achieve the NSPD-28 Access Denial Standard," (August 2010).
- 2010 Joint Defense Science Board/Threat Reduction Advisory Committee Task Force: "Nuclear Weapons Effects National Enterprise" (June 2010).
- "Nuclear Weapons Surety" (JSR-10-103) The JASONS, (May 2010).
- Nuclear Command and Control System Security Staff Assessment report on "Lifecycle Security and Integrity of Code and Authentication Materials," (May 2010).
- Nuclear Command and Control System Security Staff Assessment Report on "Critical Equipment," (March 2010).
- FY 2010 Joint Surety Report
- Joint Surety 2010 report on the "Nuclear Weapons Stockpile Assessment (ROSA)."
- "FY 2012 Annual Update to the Report Specified in Section 1251 of the National Defense Authorization Act for FY 2010."

Joint Chiefs of Staff**.** During FY 2010, the Chairman, Joint Chiefs of Staff, created the Command, Control, and Nuclear Operations (J36) within the Operations Directorate. This sub-directorate is headed by a Brigadier General who oversees all aspects of nuclear operations. Also during FY 2010, a Deputy Director for Strategic Stability was added to the Joint Staff Strategic Plans and Policy Directorate. This staff subsection oversees all aspects of nuclear weapons and other weapons of mass destruction from a prevention and preparation perspective.

Department of the Air Force**.** The Air Force accomplished the following goals since the last Management Challenge Report:

- The Air Force Global Strike Command activated August 7, 2009, has completed a year of operations since declaring Full Operational Capability in September 2010. Command staff has grown from an initial permanent staff of 47 to a staff of over 800 personnel. The command is responsible for three Intercontinental Ballistic Missile (ICBM) wings, two B-52 wings, one B-2 wing, and involves approximately 23,000 assigned personnel in locations around the world. Two of the three legs of the nuclear triad are now under one command. Global Strike Command is now the lead advocate for sustainment and recapitalization of nuclear related systems such as the development of a new manned/unmanned nuclear capable bomber, a follow-on cruise missile and replacement helicopter for missile field security.
- The Air Force Nuclear Oversight Board, chaired by the Secretary of the Air Force and the Chief of Staff of the Air Force, started meeting in 2008. The Board continues to meet on a regular basis several times annually, attended by senior Air Force officers, to discuss critical issues in all phases of the Air Force nuclear enterprise.
- The Air Force Assistant Chief of Staff for Strategic Deterrence and Nuclear Integration (HAF/A10) is a fully staffed and functional organization that provides oversight and guidance to all aspects of the Air Force Nuclear Enterprise, except for requirements, which have returned to Deputy Chief of Staff for Operations, Plans and Requirements (HAF/A3/5). Functional areas include Assessments, Capabilities, Executive Services, Force Development, Operations, and Planning Policy and Strategy.
- The Air Force Nuclear Weapons Center continues to enhance capabilities to perform its primary sustainment and maintenance missions. Its organization contains a missile sustainment group for ICBM issues, a nuclear systems group for engineering and logistics issues, and a munitions maintenance group for storage and surety issues. As the nuclear mission continues to approach its Cold War competency, the Nuclear Weapons Center continues to be tasked to provide technical assistance and increased logistics support.

- A decision to transfer CONUS Munitions Squadrons from the operational control of Air Force Materiel Command to Air Force Global Strike Command by April 2012. The Munitions Squadrons store, maintain, and prepare nuclear weapons for possible use during wartime. The units that deliver the weapons to missile and bomber wings are all under the command of Air Force Global Strike Command.
- The Nuclear Weapons Related Materiel Positive Inventory Control Fusion Center provides nuclear enterprise users with a single source for enterprise tracking of NWRM and is designed to prevent a repeat of the Taiwan incident.
- Inspection results now have an adjudication process to ensure there is one agreed-upon grade, which is approved by the Inspector General of the Air Force.

Department of the Navy**.** Prior reports on the U.S. Navy's nuclear enterprise, including the Schlesinger II report, recommended that the command of the Strategic Systems Program be elevated to Vice-Admiral. While Navy did concur with the intent of the recommendation to put more senior leader focus on the nuclear weapons enterprise issues, Navy did not concur with the notion that the Director, Strategic Systems programs (DIRSSP) needed to be a Vice Admiral. The Chief of Naval Operations corrected that deficiency by establishing the Navy's Nuclear Weapons Oversight Council and placing the Director of the Navy Staff in charge of all nuclear weapons management related issues.

Issues identified in those reports include the following:

(1) Strategic Systems Programs continues its leadership in the maintenance of survivability of fleet units, particularly regarding Electro-Magnetic Pulse vulnerability. Funding continues to be sufficient to conduct further survivability studies.

(2) The current Ohio class submarines will remain in service although preliminary plans are underway for a new class of nuclear armed submarines.

(3) The nuclear armed fleet is continuing to upgrade its in-port and at-sea security posture through acquisition of new systems and continuous training of security force personnel.

7-1C. Prior Decline of Focus on the Nuclear Enterprise	**Department Response**

The Department's summary-level response to the IG's challenge and its assessment of the Department's progress in the nuclear enterprise is reported in paragraph 7-2C of this section.

7-2A. Keys to Improvements in the DoD Nuclear Enterprise	IG Summary of Challenge

The Department needs to sustain its focus on the nuclear enterprise. The following elements are key to improvements within the DoD nuclear enterprise:

- Create an environment that emphasizes the nuclear mission and a reliable, safe, secure, and credible nuclear deterrent that is essential to national security and is a high DoD priority.
- Conduct detailed reviews and studies of all critical elements of the nuclear enterprise to identify key deficiencies and methods for improvement.
- Develop corrective action plans that address the deficiencies and provide adequate funding and leadership to ensure implementation.
- Ensure adequate funding and resources to effectively implement action plans.
- Implement the corrective actions and conduct follow-up reviews to ensure that the action plans are correcting the deficiencies.

7-2B. Keys to Improvements in the DoD Nuclear Enterprise	IG Assessment of Progress

Air Force. Since the Taiwan and Minot incidents, the Air Force has refocused their efforts on reinvigorating the management and everyday operations of their nuclear enterprise. The most significant events were the creation of the Air Force Global Strike Command and the Assistant Chief of Staff for Strategic Deterrence and Nuclear Integration (HAF/A10). Activated in 2009, the Air Force Global Strike Command assumed operational and administrative control of all Air Force ICBM and strategic bomber assets. With the full operation of that command, the various logistical, intelligence, and security organizations inherent in a military organization of that size are functioning properly. Within Headquarters Air Force, HAF/A10 is a fully staffed and functional organization, which performs oversight and provides advice in the area of assessments, operations, planning, policy, strategy, capabilities and force development. The Air Force maintains an application accessed through the Air Force Portal that tracks nuclear enterprise action items, along with due date and status. The DoD IG Intelligence and Special Programs Assessments staff was given access to that AF website, so continuous follow-up is now available.

The nuclear inspection process has become more standardized; as a result, systemic issues can be identified. The rate of failure on operational inspections has declined. According to the DSB 2011 report "the risk of an unauthorized transfer of a nuclear weapon is near zero."

Navy. The Navy continues its use of the Navy Nuclear Weapon Senior Leaders Council involving nuclear weapon systems. The lessons learned will be incorporated into the design of the new submarine follow-on. The OPNAV Nuclear Weapons Council and Navy Nuclear Weapons Senior Leader Oversight Council, established to coordinate all OPNAV staff responsibilities for nuclear weapons activities, were consolidated into a single Navy Nuclear Weapons Oversight Council.

National Nuclear Security Administration. The Administration proposed $11.8 billion in new budget authority for the National Nuclear Security Administration for FY 2012, a 5.1 percent increase over the FY 2011 request. The budget request includes $7.6 billion for Weapons Activities, including the B-61 Life Extension Program (LEP).

This action supports the recommendation made in the DoD IG report on B-61 Nuclear Weapon Use Control, issued September 18, 2009. The LEP will significantly extend the life of the B-61 and allow it to be mated with the F-35 Joint Strike Fighter. Also, with the approval of the New Strategic Arms Reduction Treaty (START), the reduction of total warheads will increase the importance of the B-61 Life Extension Program and place more emphasis on infrastructure capability and responsiveness.

Continuing Concerns**.** The increased emphasis in the re-vitalization of the nuclear enterprise has been joined by increased levels of spending for personnel, acquisitions, and maintenance (personnel and materiel). Improvements cannot be sustained without the appropriate financial commitment. If funding levels decline, the previous patterns will repeat: personnel paying less primary attention to the nuclear endeavor, acquisition of spare parts and new weapons systems either deferred or denied altogether, and shortages of skilled personnel in the critical technical areas.

In April 2010, the Department issued the Nuclear Posture Review report, which establishes the nuclear weapons policy, strategy, capabilities, and force protection for the next five to ten years; however, it lacks direction for some of the other areas of the nuclear enterprise, including threat and warning assessments as well as command and control direction. The Nuclear Posture Review report is crucial for the establishment of national level requirements and funding priorities for the entire nuclear enterprise, but limited itself to areas which were needed to successfully conclude the New START treaty.

Systemic problems still exist within the Air Force nuclear enterprise. Although not as prevalent as in the past, inspection failures continue to occur, resulting in the decertification of some systems and personnel. During an FY 2010 DoD IG classified audit of weapons storage facilities, problems were noted in funding levels for sustainment activities, and recommendations were made to the Air

Force Nuclear Weapons Center to obtain additional supplemental funding. Recommendations also were made to continue compatibility between storage systems and weapons upgrades, develop spare parts inventory management systems, and to review and update Technical Orders. To date, the Center has reported that additional funding was obtained, inventory management changes were made, and they are in the process of upgrading Technical Orders.	
7-2C. DoD Nuclear Enterprise	**Department Response**
The Department has made significant progress in continuously improving the nuclear enterprise. Specifically, new management structures, such as the Air Force Global Strike Command and the Air Force Assistant Chief of Staff for Strategic Deterrence and Nuclear Integration, are gaining momentum. Arguably, the clearest lines of accountability and responsibility have been established since the end of the Cold War. While much work remains, the nuclear community's interagency team has provided continuous surveillance and oversight, along with robust inspection regimens across the Services, thereby adding a layer of nuclear surety not seen in recent years. Additionally, while facing unprecedented challenges, in a fiscally-constrained environment, the Department remains committed to providing innovative solutions through sustainment and modernization programs.	

MANAGERS' INTERNAL CONTROL PROGRAM

The OUSD(Comptroller) leads DoD's *Federal Managers' Financial Integrity Act* (FMFIA) program, designated as the Managers' Internal Control Program (MICP). The MICP holds managers throughout the Department accountable for ensuring effective internal controls in their areas of responsibility. All Components are required to conduct a robust programmatic approach to establish and assess internal controls for all mission-essential operations. Components that produce stand-alone financial statements also are required to include assurances related to financial reporting and financial systems in their programs.

FINANCIAL STATEMENT MATERIAL WEAKNESSES

The following Table 1 lists the DoD IG's identified 13 areas of material weakness in the Department's financial statement reporting.

Table 1. Summary of Financial Statement Audit						
Audit Opinion: Disclaimer						
Restatement: Yes						
Areas of Material Weakness		**Beginning Balance**	**New**	**Resolved**	**Consolidated**	**Ending Balance**
1	Accounts Payable	1				1
2	Accounting Entries	1				1
3	Environmental Liabilities	1				1
4	Government Property in Possession of Contractors	1				1
5	Intragovernmental Eliminations	1				1
6	Operating Materials and Supplies	1				1
7	Reconciliation of Net Cost of Operations to Budget	1				1
8	Statement of Net Cost	1				1
9	Financial Management Systems	1				1
10	Fund Balance with Treasury	1				1
11	General Property, Plant & Equipment	1				1
12	Inventory	1				1
13	Accounts Receivable	1				1
	Total Material Weaknesses	**13**	**0**	**0**	**0**	**13**

TYPES OF MATERIAL WEAKNESSES

The Department's management-identified weaknesses are determined by assessments of internal controls, as required by the FMFIA, the *Federal Financial Management Improvement Act* (FFMIA), and *OMB Circular No. A-123*, and fall into three categories:

1. FMFIA Section 2, Financial Reporting Material Weaknesses (see Table 2a).
2. FMFIA Section 2, Operations Material Weaknesses (see Table 2b).
3. FMFIA Section 4, Financial System Nonconformance Weaknesses (see Table 2c).

Detail for each of the above three categories are explained below:

1. FMFIA Section 2, Financial Reporting Material Weaknesses. Under the oversight of the DoD Financial Improvement Audit Readiness (FIAR) Governance Board, DoD's assessment of its financial reporting identified the following areas of material weakness, listed in Table 2a. The column entitled "Ref Table 1" crosswalks the reported FMFIA manager-identified areas of material weakness to similar areas of weakness identified by the IG, which are listed in Table 1. The Department is reporting seven additional material weaknesses in FY 2011 due to its decision to merge the Internal Control Over Financial Reporting (ICOFR) and the Financial Improvement and Audit Readiness (FIAR) program reporting, as well as an increase in the number of assessable units for which Components are executing financial improvement and audit readiness efforts.

Table 2a. Effectiveness of Internal Control over Financial Reporting (FMFIA Section 2)							
Statement of Assurance: No assurance							
End-to-End Process	**Areas of Material Weakness**	**Ref Table 1**	**Beginning Balance**	**New**	**Resolved**	**Reassessed[1]**	**Ending Balance**
Budget-to-Report	Appropriations Received			1			1
	Fund Balance with Treasury (FBWT)	10	1				1
	Financial Reporting Compilation	2, 7, & 8	1				1
	Intragovernmental Eliminations	5	1				1
Hire-to-Retire	Health Care Liabilities		1				1
	Civilian Pay			1			1
	Military Pay			1			1
Order-to-Cash	Accounts Receivable	13	1				1
Procure-to-Pay	Contracts	1		1			1
	Accounts Payable	1	1			(1)	0
	MILSTRIP Orders	1		1			1
	Reimbursable Work Orders - Grantor	1		1			1
	Transportation of People	1		1			1
Acquire-to-Retire	Military Equipment Assets	11	1				1
	General Purpose Equipment	4 & 11	1				1
	Real Property Assets	11	1				1
	Environmental Liabilities	3	1				1
Plan-to-Stock	Inventory	12	1				1
	Operating Materials & Supplies	6	1				1
	Total Financial Reporting Material Weaknesses		**12**	**7**	**0**	**(1)**	**18**

[1] Reclassified to include Contracts, Reimbursable Work Orders – Guarantor, Military Standard Requisitioning and Issuance Procedure Orders, and Transportation of People

Table 2a-1 provides the description and corrective action plan for each material weakness related to internal control over financial reporting.

Table 2a-1. FY 2011 Internal Control over Financial Reporting Material Weaknesses

	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
1	Appropriations Received: The Department's processes and controls to account for transactions and balances of budgetary authority are not effective.	FY 2011	Department-wide	The Components are implementing regular controls over the apportionment and allotment of funds by identifying the entire transaction population and reconciling the financial statement amount to the general ledger, to the detailed transactions, and to supporting authorizing documents (e.g., public law, OMB apportionments, funding authorization documents). Components are also working with sub-allotees to document and reconcile funds distributed to them.	FY 2013
2	Fund Balance with Treasury: The Department does not have effective processes and controls to reconcile transactions posted to Fund Balance with Treasury (FBwT) general ledger accounts with transactions reported and posted to the Department of the Treasury's accounts to support FBwT transactions with supporting documents.	FY 2006	Army; Navy; DLA; DIA; NSA; SMA; USSOCOM	The Components are working toward integrating general ledger systems with feeder systems to maintain transaction-level supporting documentation for disbursements and collections. The Components also are developing the processes and controls to reconcile transaction-level differences between DoD and the Department of Treasury accounts in a timely, efficient manner.	FY 2016
3	Financial Reporting Compilation: Due to inadequate internal controls, the Department is unable to prepare accurate financial statements that are supported by general ledger balances and adequately documented and supported journal entries.	FY 2007	Department-wide	The Department continues to improve business processes and controls through the implementation of enterprise resource planning systems (ERPs) that produce accurate, timely, and auditable financial reports. Additional steps that will solidify correction of this weakness include actions to clean up legacy balances, eliminate record data types and routine general ledger tie point reconciliations, and other processes.	FY 2017

Table 2a-1. FY 2011 Internal Control over Financial Reporting Material Weaknesses

	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
4	Intragovernmental Eliminations: The Department is unable to collect, exchange, and reconcile buyer and seller intragovernmental transactions, resulting in unsupported adjustments.	FY 2008	Department-wide	The Department has developed standard business processes and data to capture trading partner information at the transaction level and to support eliminations. The Department is implementing replacement systems and a standard financial information structure, which will incorporate the necessary elements to enable the Department to correctly report, reconcile, and eliminate intragovernmental balances. The Department is collaborating with the Department of Treasury, OMB, the Treasury's Office of Financial Innovation and Transformation, and Federal partners to develop and implement a government-wide solution to capture the transaction level detail needed to reconcile intragovernmental transaction activity.	FY 2015
5	Health Care Liabilities: The current military health system financial processes cannot collect sufficient transaction-level cost and performance information for procedures performed in military treatment facilities to support financial reports.	FY 2003	MERHCF; SMA	Medical Components are implementing procedures to improve coding and financial reconciliation for military treatment facilities' operations as well as developing proposals to reimburse military treatment facilities on a per capita basis. Such proposals will be similar to arrangements with managed-care providers. Implementation of SMA ERPs will improve overall financial reporting.	FY 2017
6	Civilian Pay: The Department does not have effective processes and controls to account for transactions and balances in the civilian pay process.	FY 2011	Department-wide	The Components are addressing the reliability and existence of supporting documentation in the applicable ERPs. They are defining and prioritizing sub-processes into assessable units.	FY 2017
7	Military Pay: The Department's processes and controls to account for transactions and balances in the military pay process are not effective.	FY 2011	Department-wide	The Components are developing processes to reconcile supporting documents to the general ledger on a repeatable basis in order to audit around the numerous micro applications used to transfer data from the Defense Joint Military Pay System to the general ledgers.	FY 2017

Table 2a-1. FY 2011 Internal Control over Financial Reporting Material Weaknesses					
	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
8	Accounts Receivable: The Department is unable to accurately record, report, collect, and reconcile intragovernmental accounts receivable as well as accounts receivable due from the public.	FY 2003	Army; Air Force; DLA; MERHCF; SMA	The Components are continuing efforts to implement ERPs to improve collection of payments and minimize manual processes. Improving reconciliations between systems, to include identification of aging accounts, is another key aspect of the Department's efforts to resolve this weakness.	FY 2017
9	Contracts: The Department does not have effective processes and controls to account for transactions and balances supporting the Contracts procure-to-pay process.	FY 2011	Department-wide	The Components are continuing efforts to improve the ERPs' use of data currently distributed from contract writing systems to support timely and accurately recording of obligations/deobligations of funds. The Components are developing processes to ensure timely contract deobligation upon delivery or completion and regular review of obligation estimates.	FY 2017
10	MILSTRIP Orders: The Department has ineffective processes and controls to account for transactions and balances in the MILSTRIP Orders procure-to-pay process.	FY 2011	Department-wide	The Components are identifying and testing key controls in the requisition and issuance of material as well as testing the interfacing data between logistics receipt processing systems and the financial systems. The Components also are verifying timely recording of accounts payable to ensure that payment does not occur prior to physical receipt of material and returns are properly authorized and recorded to resolve this weakness.	FY 2017
11	Reimbursable Work Orders (Grantor): The Department does not have effective controls over the processes and controls to account for transactions and balances supporting the Reimbursable Work Orders – Grantor procure-to-pay process.	FY 2011	Department-wide	The Components are identifying and testing key controls related to the process, to include orders accepted; expenses; receivables and collections; recorded manually or automated; and those organizational roles or systems performing these transactions.	FY 2017

Table 2a-1. FY 2011 Internal Control over Financial Reporting Material Weaknesses

	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
12	Transportation of People: The Department does not have effective controls over the processes and controls to account for transactions and balances supporting the transportation of people.	FY 2011	Department-wide	The Components are developing plans to address 'segregation of duties' internal control issues within the transaction system due to overlapping permission-level assignments, as well as demonstrating effective information technology general and application controls.	FY 2017
13	Military Equipment Assets: The Department's financial systems do not support capturing and recording the quantity and historical cost of military equipment in compliance with Federal accounting standards.	FY 2003	Army; Navy; MDA ; USSOCOM	The Components are following a strategy to first validate the existence and completeness of mission-critical asset records in logistics and accounting systems. The OUSD(C) presented a Business Case Analysis on alternatives for valuing mission critical assets. The recommended alternative is to request the Federal Accounting Standards Advisory Board to change the Federal Accounting Standards to eliminate balance sheet reporting by expensing the cost of assets. Assuming a standards change, the Components will report Military Equipment quantities as "Required Supplementary Information" in the financial statements.	FY 2016
14	General Purpose Equipment: The Department does not meet Federal accounting standards for financial reporting of general personal property, specifically in the quantity and value of general equipment.	FY 2006	Army; Air Force; Navy; DLA; DIA; DSS; NGA; USSOCOM; NSA; MDA	The Components are validating the existence and completeness of general purpose equipment before moving forward to record the valuation of such equipment. A critical part of this effort is to identify property in the possession of contractors and ensure information in the property management systems is accurately reported.	FY 2015
15	Real Property Assets: The Department does not have adequate internal controls in place to provide assurance that real property asset quantities and values reported in the financial reports are accurate.	FY 2003	Army; Air Force; Navy; DLA; WHS	The Components have implemented real property inventory requirements (RPIR) data standards. The Components are in the process of implementing sustainable real property accountability and construction in progress (CIP) business processes and management controls. The Components will also complete reconciliation of real property records to ensure assets exist and	FY 2017

Table 2a-1. FY 2011 Internal Control over Financial Reporting Material Weaknesses					
	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
				records are complete and assess the effectiveness of management controls. Additionally, the Components will periodically evaluate the quality of real property data by comparing with physical assets and annual reconciliation. All stated steps will be validated by OSD (I&E) to ensure completeness of measures effectiveness.	
16	Environmental Liabilities: The Department's internal controls for reporting environmental liabilities do not provide assurance that clean-up costs for all of its ongoing, closed, and disposal operations are identified, consistently estimated, and appropriately reported.	FY 2001	Army; Air Force; USACE	The Components are implementing systems, processes, and controls to ensure the accuracy of site-level liability data to report environmental liabilities. The Components are updating guidance and training base level environmental personnel on processes and cost to complete (CTC) estimating practices, standardizing cost estimating supporting documentation practices.	FY 2015
17	Inventory: The Department is unable to accurately account for the quantity and value of inventory reported in its financial statements.	FY 2005	Army; Navy; Air Force; DLA	The Components are developing physical inventory processes, including the reconciliation of quantities of inventory with data recorded in the accounting systems. The ability to track historical costs with the implementation of ERPs is also an important element. In addition, the processes and controls related to in-transit inventory is a key focus area.	FY 2016
18	Operating Material & Supplies (OM&S): The Department cannot accurately account for the quantity and value of operating material and supplies.	FY 2005	Army; Navy; Air Force; USSOCOM	The Components are implementing ERPs that will track OM&S purchases and issuances at a transaction level to address this weakness. In addition, Components are enhancing physical inventory processes to ensure accurate reporting.	FY 2017

2. FMFIA Section 2, Operational Material Weaknesses. The Department's Components utilize an entity-wide, risk-based, self-assessment approach to establish and assess internal controls for mission-essential operations. Table 2b shows the weaknesses resulting from this assessment.

In the 2010 Agency Financial Report (AFR), the Department classified material weaknesses into the following six categories:

(1) Personnel Resourcing, Qualifications and Training;

(2) Information Technology Management and Assurance;

(3) Personnel Security Investigations;

(4) Internal Controls over Contingency Contracting;

(5) Contracting for Services, and

(6) Certain Audits do not Meet Professional Standards.

In FY 2011, the Department realigned its reported material weaknesses into 15 categories, as outlined in the Department of Defense Instruction (DoDI) Number 5010.40, "Managers Internal Control Program Procedures", dated July 29, 2010.

Additional evaluation and analysis of the material weaknesses determined that prior year reportable conditions were significant and should be reported as material weaknesses; these material weaknesses are included in the "new" column in Table 2b, below, and described in Table 2b-1. Material weaknesses reported in previous years that have been corrected are not listed in Table 2b-1, and are listed only in Table 2b. In addition, we reclassified material weaknesses as "reportable conditions," because the actual deficiency in test and evaluations did not meet the criteria for a material weakness as described in the MICP Assessment Section in the Management Discussion and Analysis section of this report.

Table 2b. Effectiveness of Internal Control over Operations (FMFIA Section 2)						
Statement of Assurance: Qualified						
	Area of Material Weakness	**Beginning Balance**	**New**	**Resolved**	**Reassessed**	**Ending Balance**
1	Major Systems Acquisition	1	1	(1)		1
2	Communications, Intelligence and/or Security	3	3	(2)		4
3	Comptroller and/or Resource Management		2			2
4	Contract Administration	1				1
5	Force Readiness	1	2		(1)	2
6	Personnel and/or Organizational Management	2	1			3
7	Property Management	1				1
8	Supply Operations		1			1
9	Information Technology	1			(1)	
	Total Operational Material Weaknesses	10	10	(3)	(2)	15

Table 2b-1 provides the description and corrective action plan for each material weakness related to internal control over operations in Table 2b.

Table 2b-1. FY 2011 Internal Control over Operations Material Weaknesses

	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
1	Major Systems Acquisition:				
a	The Department lacks efficient processes that ensure they maximize the return on weapon system investments. In addition, the Department must find ways to deliver more capability to the warfighter for less than it has cost in the past.	FY 2011	Department-wide	The Department is developing an analytical approach to prioritize capability needs. Empowering portfolio managers to prioritize needs, make decisions, and allocate resources facilitates holding programs and individuals accountable for policy implementation via milestone and funding decisions to include the use of reporting metrics.	Reassessed annually based on incremental improve-ments
2	Communications, Intelligence and/or Security:				
a	Controls related to safeguarding Personally Identifiable Information (PII) are ineffective. Department PII breaches are unacceptably high. Metrics demonstrate a need to strengthen the existing or develop new safeguarding policies. Information is not properly maintained in order to develop and execute comprehensive trend analyses.	FY 2011	OSD; Navy	The Department is developing a PII training module to update/remind employees of the need to safeguard PII. An automated tool is being developed to capture PII breaches for further analysis.	FY 2013
b	Processes are not in place to ensure that military, civilian, and contractor personnel with Information Assurance (IA) duties have the proper certification in their computer network area of responsibility.	FY 2011	Air Force	The Air Force is in the process of developing and installing a training and certification system to track IA personnel certifications.	FY 2012
c	Weaknesses exist in the Department's management and assurance of the reliability and security of	FY 2006	Navy[2]; USAFRICOM[3]	The Navy is establishing a Communications Security Account Manager position. In addition, USAFRICOM plans to assess its consolidated enterprise and to	FY 2012

[2] Previously classified as Information Technology Management and Assurance.
[3] Ibid.

Table 2b-1. FY 2011 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
	the information technology infrastructures.			develop additional requirements; engineer, implement, operate, and maintain a joint enterprise network; and provide additional capabilities for the tactical local area network.	
d	Internal assessments have identified weaknesses in the Department's Cyber Security controls, exposing systems to potential information warfare attacks.	FY 2011	OSD; DSS; USAFRICOM	The Department is implementing a risk management program to evaluate the security state of information systems and identify risks. Systems Security Engineering programs are being developed to resist the forces to which they are subjected.	FY 2012
3	Comptroller and/or Resource Management:				
a	The Department's current processes, systems, and controls do not provide reliable and accurate financial statements.	FY 2011	Department-wide	The Department is in the process of implementing ERPs and improving standard operating procedures and controls related to producing financial statements.	FY 2017
b	Weaknesses within the funds control processes result in the inability to adequately track funds consistent with regulations, policies, existing laws, and use fund execution information to support budget requests. The lack of adequate funds control has led to several Anti Deficiency Act violations.	FY 2011	OSD; Air Force; USSOCOM	The Department is enhancing systems for tracking funds in addition to publishing guidance and scheduling training for personnel related to funding activities. The Department requires Components to review and evaluate training records to ensure personnel certifying and handling funds have financial management and fiscal law training.	FY 2014
4	Contract Administration:				
a	The Department's lack of well-defined requirements, the use of ill-suited business arrangements, and the lack of an adequate number of trained acquisition and contract oversight personnel contribute to unmet expectations and place the department at risk of potentially paying more than necessary.	FY 2006	Department-wide	The Department is revising guidance on contracting operations, which includes oversight, responsibilities, policy, and defining roles, as well as assessing the effectiveness of efforts to improve competition, contracting arrangements, and incentives. The Department intends to fully integrate operational contract support through education and pre-deployment training in addition to establishing improved processes and procedures.	Reassessed annually based on incremental improve-ments
5	Force Readiness:				

Table 2b-1. FY 2011 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
a	The Air Force has failed to effectively implement a weapons-of-mass-destruction emergency response program, which includes plans, policy, and reporting requirements, in addition to the management of equipment funds and inventory levels.	FY 2011	Air Force	The Air Force is developing a weapons-of-mass-destruction emergency response program, which includes training personnel and ordering necessary equipment to ensure appropriate inventory levels and standardized policies for reporting emergencies exist.	FY 2012
b	The Air Force did not properly report Unit Type Codes in the personnel system leading to inaccurate readiness assessments.	FY 2011	Air Force	The Air Force has developed a checklist for ensuring accurate transaction coding, as well as evaluating and expanding procedures for requesting, processing and obtaining Deployment Requirements Manning Documents.	FY 2012
6	<u>Personnel and/or Organizational Management</u>:				
a	Audits have found that DCAA personnel lacked sufficient professional judgment and quality to properly plan, execute and report findings due to improper personnel qualifications and organizational mismanagement.	FY 2009	DCAA[4]	DCAA is developing policies and procedures to ensure auditors receive sufficient training, work force surveys and instituting peer reviews, in order to strengthen the quality of the workforce conducting audits of contracts.	FY 2012
b	The lack of quality assurance training for the acquisition workforce, along with the increasing complexity of products purchased, inhibits the agency's ability to conduct necessary and critical reviews of contract documentation. From 2003 to 2009, there has been a 60% workforce reduction resulting in a requirement to absorb risk in cost monitoring activities.	FY 2010	DCMA[5]	DCMA is developing a formalized education, training, and certification program for all levels of employees. The DCMA will review and evaluate the results of a hiring initiative upon completion of a 24-month training and certification program. The DCMA is developing a robust data analysis and information management tool to assist the contract review process.	FY 2014

[4] Previously classified as Certain Audits do not Meet Professional Standards.
[5] Previously classified as Personnel Resourcing, Qualifications, and Training.

Table 2b-1. FY 2011 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
c	Domestic abuse has increased throughout the Department due to limited or reduced effectiveness of the Family Advocacy Program.	FY 2011	Department-wide	The Department continues to comply with Section 543(b) of the FY 2011 National Defense Authorization Act. This section requires the implementation and oversight of the Family Advocacy Program in addition to providing a formal report to both House and Senate Armed Services Committees. A robust campaign to ensure personnel are aware of the program is underway. An assessment tool will assist in further monitoring the risk of domestic abuse.	FY 2012
7	<u>Property Management:</u>				
a	The Department has not properly trained staff or enabled sufficient tools to address the accountability requirements in place to adequately oversee and execute personal property transactions.	FY 2011	Department-wide	The Department is establishing procedures and training personnel on property management policies. The Components are to establish accountable records that will identify property as Government Furnished Property. OUSD(AT&L) will validate accountable property records and supporting documentation through existence and completeness testing.	Reassessed annually based on incremental improve-ments
8	<u>Supply Operations</u>				
a	The Department lacks management of supply inventories and responsiveness to warfighters' requirements, such as shortages of critical items during the early years of operations in Iraq.	FY 2011	Department-wide	Improving Supply Change Management (SCM) operations through better demand forecasting, asset visibility, and distribution processes including: publishing a DoD Logistics Strategic Plan, developing and implementing a comprehensive inventory management plan, expanding automated process to worldwide inventory and linkages to distribution, and executing materiel distribution through stock positioning.	Reassessed annually based on incremental improve-ments

3. FMFIA Section 4, Financial System Nonconformance Weaknesses: The Department requires financial system conformance with federal requirements and reports. The Department reported one weakness that includes a wide range of pervasive problems related to financial systems. Table 2c shows the resulting weakness.

Table 2c. Conformance with Financial Management System Requirements (FMFIA Section 4)						
Statement of Assurance: Systems do not conform to financial management system requirements						
Non-Conformances	**Ref Table 1**	**Beginning Balance**	**New**	**Resolved**	**Reassessed**	**Ending Balance**
1. Financial Management Systems	9	1				1
Total System Conformance Material Weaknesses	**9**	**1**				**1**

Table 2c-1, below, provides the description and corrective action plan for the material weakness related to internal control over financial systems.

TABLE 2c-1. FY 2011 Internal Control over Financial Systems Material Weakness					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
1	<u>Financial Management Systems</u>: The Department's financial systems were originally developed to meet the requirements of budgetary accounting and do not provide the capability to record costs and assets in compliance with current accounting standards. Improvements to the current systems environment are complicated by the use of and reliance upon many mixed systems that are not well integrated.	FY 2001	Department-wide	Most DoD Components have embarked on an effort to implement a compliant, end-to-end financial management system, anchored by ERPs that provide the core financial system as well as replacing many of the mixed (feeder) systems.	FY 2017

Statement of Assurance over Financial Reporting, Operations and Financial Systems Process:

The revised *OMB Circular A-123* requires an annual Statement of Assurance that provides management's assurances on the effectiveness of internal controls of overall operations, financial reporting, and financial systems. The Department's 33 Component Heads are required to report their respective Component Statement of Assurance to the Secretary of Defense. The Components include the 3 Military Departments, 9 Combatant Commands, the Joint Staff, the Office of Secretary of Defense, the DoD

Office of Inspector General, and 18 Department Agencies. Following the submission of the Components' Statements of Assurance, the Secretary of Defense produces an overall Department Statement of Assurance that reports the Department's pervasive material weaknesses. Prior to creating an annual Statement of Assurance, each Component flowcharts its key business processes that impact financial reporting and operations, identify and assess risk within the processes, identify and test internal controls, establish controls found to be deficient, and report on the results of these assessments and tests. The Department asserts that all Components, as prescribed by DoD's regulatory guidelines, have reported their individual statements of assurance over internal controls to the Secretary of Defense. More information concerning DoD's process for developing the Statement of Assurance is available at *Office of the Under Secretary of Defense (Comptroller)*.

FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT

The DoD IG and the audit agencies within the Military Services have reported on DoD's noncompliance with FFMIA. The DoD's noncompliance is due to its reliance upon legacy financial management systems by the various Components. These legacy financial systems, for the most part, do not comply with the wide range of requirements for systems compliance, in accordance with FFMIA and therefore do not provide the necessary level of assurance that the core financial system data or the mixed systems information can be traced to source transactional documentation. Table 3 reflects DoD's compliance with FFMIA.

Table 3. Compliance with Federal Financial Management Improvement Act

	Agency	Auditor
Overall Substantial Compliance	No	No
1. System Requirements	No	No
2. Accounting Standards	No	No
3. U.S. Standard General Ledger at Transaction Level	No	No

IMPROPER PAYMENT AND PAYMENT RECAPTURE PROGRAMS

The *Improper Payments Information Act of 2002* (IPIA), as implemented by OMB Circular No. A-123, Appendix C, "Requirements for Effective Measurement and Remediation of Improper Payments," requires federal agencies to review all programs and activities annually and identify those that may be susceptible to significant erroneous payments. On November 20, 2009, the President issued *Executive Order 13520*, "Reducing Improper Payments and Eliminating Waste in Federal Programs," adding several new reporting requirements for Federal agencies, such as quarterly reporting of high-dollar improper payments to individuals and entities.

The Improper Payments Elimination and Recovery Act of 2010 (IPERA), which was passed unanimously by both houses of Congress and signed into law on July 22, 2010, is targeted at reducing wasteful spending by identifying and requiring corrective action plans for government programs that are susceptible to significant improper payments. The IPERA, which amends the IPIA, established new reporting thresholds based on either the percentage of program outlays or the dollar amounts of annual improper payments.

Based on the large volume of transactions and high dollar amounts, the Department reports on the following programs:

(1) Military Health Benefits

(2) Military Pay

(3) Civilian Pay

(4) Military Retirement

(5) Travel Pay

(6) Commercial Pay

The Improper Payment Reduction Outlook table (Table 4), included at the end of this section, presents improper payment estimates for these programs as well as future year improper payment reduction targets.

DEFENSE FINANCE AND ACCOUNTING SERVICE (DFAS)

Risk Assessment

The Department also monitors changes in programs associated with the OMB-mandated criteria (e.g., a large increase in annual outlays, regulatory changes, new programs) to track troubling trends and implement corrective measures, as necessary. The DoD's improper payment percentages are extremely low, though the total improper payment dollars are high. Numerous pre- and post-payment controls minimize and reduce improper payments as well as improve DoD's estimates of future improper payments and the need for corrective actions.

Statistical Sampling Process

The Department uses statistically valid, random sampling methods designed to meet or exceed OMB's requirements (90 percent confidence interval, plus or minus 2.5 percent) for estimating and projecting the Department's annual improper payments for five of the six programs previously listed. The Department will begin statistical sampling of the Commercial Pay program in FY 2012. For smaller reporting programs, such as the Army-Korea travel payments or U.S. Army Corps of Engineers (USACE) Travel Pay, the Department normally performs 100 percent post-payment reviews, or a full review of payments above a certain dollar threshold with random sampling for lower-dollar payments.

Military Health Benefits. TRICARE is a triple-option health benefit plan available for Active Duty family members, retirees and their family members, and family members of deceased service members. To estimate the annual amount of improper payments, the Department uses a statistically valid method of sampling for the managed care support services contracts and the Medicare dual eligibility contractor (TRICARE Dual Eligibility Fiscal Intermediary Contract). The payment errors disclosed in the review of sampled payments are projected to the universe of program payments.

The Department samples data records for claims processed by the managed care support contractors and the Medicare dual eligible contractor. There are two kinds of payment samples: one for "non-denied" claims, and one for "denied" claims. For the managed-care support services contracts:

- The "non-denied" payment sample is drawn from all records with government payments of $100 to $100,000. In addition, all records with a government payment over $100,000 are audited.
- The "denied" payment sample is drawn from all records with a billed amount of $100 to $100,000. In addition, all records with billed amounts over $100,000 are audited.

Both the "non-denied" and "denied" payment samples are stratified at multiple levels within the $100 to $100,000 range. For the Medicare dual eligible contract:

- The "non-denied" payment sample is drawn from all records with government payments of $1 to $25,000. All records with a government payment over $25,000 are audited.
- The "denied" payment sample is drawn from all records with a billed amount of $1 to $500,000. In addition, all records with billed amounts over $500,000 are audited.

The "non-denied" payment sample is stratified at multiple levels within the $1 to $25,000 range; the "denied" payment sample is stratified at multiple levels within the $1 to $500,000 range.

Military Pay. The Department samples Military Pay accounts for the Active Duty (Army, Navy, Air Force, and Marine Corps) and Reserve Components (Army Reserve, Army National Guard, Navy Reserve, Air Force Reserve, Air National Guard, and Marine

Corps Reserve) on a monthly basis. The DFAS selects the accounts for each Component to review and produce annual estimates of improper payments.

Civilian Pay. The DFAS randomly reviews Civilian Pay accounts from each of the Components (Army, Air Force, Navy/Marine Corps, and Defense Agencies) on a monthly basis. The DFAS processes the largest portion of DoD's civilian payments; however, both the Navy and Army independently process civilian payments for civilian mariners and local national payrolls in foreign countries. These amounts are reported by Components and included in total DoD-wide figures.

Military Retirement. The monthly random sampling universe of Military Retirement payments includes both the retired and annuitant pay accounts. In FY 2011, the Department expanded reporting to include complete population extracts of deceased retirees and annuitants. The scope of the retired and annuitant pay reviews also include periodic special reviews of Combat Related Special Compensation, Concurrent Receipt of Disability Payment, Daily Payroll accounts, and other targeted reviews.

Travel Pay. The DFAS reports the largest portion of DoD's travel payments made by both the Defense Travel System (DTS) and Windows Integrated Automated Travel System (WinIATS) for the Department of the Army and select Defense Agencies. The Department's total travel payments include travel payments computed, paid, and reported independently by the Military Services and other Defense Agencies. Table 4, included at the end of this section, represents the combined results of the review of DFAS-disbursed travel payments as well as non-DFAS-disbursed travel payments (Army-Europe, Army-Korea, Air Force, Navy, and USACE. Both Temporary Duty Travel (TDY) and Permanent Change of Station travel (PCS) vouchers are included in the post-payment reviews.

Root Causes of Error and Corrective Actions

Military Health Benefits. This program reports total improper payments of $30.2 million (.24 percent), comprised of $21.2 million in overpayments and $9 million in underpayments. The amounts reported are actual – not estimated – improper payments identified in FY 2010. Military Health Benefits reports improper payments one year in arrears to accommodate its 100% post-payment review.

The Department's contracts have had payment performance standards for Military Health Benefit claims processing in place for many years. Overpayments found in the annual audit process are projected to the audit universe, and the managed care support contractor is liable for the total amount. The 2 percent improper payment threshold is based on the contract performance standard. This contractual design, combined with numerous pre-payment and post-payment controls, effectively reduces improper payments and ensures that the Government's risk for improper payments in military health benefits is minimized.

Root Causes. The primary reasons for payment errors in the Military Health Benefits program include:

- Incorrect pricing of medical procedures and equipment;

- Cost-share/deductible miscalculations; and
- Other Health Insurance/government pay miscalculations.

Corrective Actions. TRICARE's third-party contractors are monetarily incentivized through contractual performance standards to reduce and eliminate improper payments. The fewer improper payments the contractors make, the less money is deducted from their contractual reimbursements.

Military Pay. As reflected in Table 4, the Department projects a total of $474.3 million (0.49 percent of total gross pay) in Military Pay improper payments based on reviews and estimates for the period October 2010 through September 2011. Approximately $281.7 million (59 percent) of the total improper payments occurred within the Reserve/Guard Components.

Underpayments account for $265.2 million (56 percent) of the $474.3 million in improper payments. Most of these underpayments occurred within the Army Reserve and Army National Guard ($176.2 million) and represent unpaid leave the member did not use before discharge or de-activation from Active Duty to Reserve status.

Root Causes for Underpayments. The primary reasons for $265.2 million in underpayments, identified through random reviews as administrative and documentation errors, include:

- Leave Accountability/Lump Sum Leave (80 percent) resulting from un-reconciled/unpaid leave balances for Reservists/Guardsmen;
- Basic Allowance for Housing (4 percent) resulting from incorrect reporting of the entitlement;
- Family Separation Allowance (5 percent) resulting from incorrect reporting of the entitlement; and
- Other miscellaneous causes (11 percent) account for the remainder of underpayments.

Overpayments account for $209.1 million (44 percent) of the $474.3 million in improper payments. Nearly 100 percent of the $209.1 million in overpayments either were recovered or have an action in place to recover the overpayment. Collections for overpayments from current service members amounted to $143.4 million (30.2 percent) of the $474.3 million total improper payments.

Most of the overpayments to the Service member involved payroll adjustments, when the member's duty or personal status changed and the pay system was not updated in a timely or accurate manner. Most improper payments identified from random reviews as well as from debt collection are attributable to untimely or inaccurate data entry into the pay systems.

Corrective Actions. The Department, primarily through DFAS, continues to work with the Military Services to advise them of the results of payment reviews and the associated reasons for the errors. Of specific interest, the DFAS provides the Military Service financial managers with monthly reports on the results of random reviews, reasons for and dollar value of errors, and year-to-date trends.

Civilian Pay. The Department projects $90.9 million (0.16 percent of total gross pay) in total Civilian Pay improper payments for FY 2011, $90.8 million in overpayments and $0.1 million in underpayments. Nearly 100 percent of the overpayments were identified through review of the Accounts Receivable due from current civilian employees. Because the employees remain employed with the Department, there is an action in place to recover the overpayment, generally through payroll offset. Civilian Pay overpayment errors of $90.8 million are attributed to time and attendance ($41.3 million); overseas and other allowances ($31.0 million); and late personnel actions ($18.5 million).

Root Causes. The primary causes of Civilian Pay improper payments are untimely or inaccurate entry of information into the pay systems. Because most government payroll systems base their time and attendance submissions on anticipated versus actual hours worked, the Department must correct overpayments and underpayments in a subsequent pay period.

Collections of overpayments in the overseas Civilian Pay accounts often are attributed to repayment of overseas pay allowances that continued after the individual returned to the United States. These improper payments often result from inaccurate personnel actions generated by human resources offices. Corrections subsequently are generated by human resource offices and transmitted to the civilian payroll system. These corrections result in re-computing pay and allowances and create a collection (Accounts Receivable) action to offset the overpayment and correct the improper payment. The initial improper payments are discovered through various sources, such as agency reviews, bi-weekly exception reports, and employee or supervisor notification.

Corrective Actions. The Department, primarily through DFAS, continues to advise Components on the results of payment reviews and the associated reasons for errors that result in improper payments to civilian employees. The DFAS advises Components on best business practices to prevent improper payments in the future. DFAS also participates at various conferences to instruct personnel on how to correctly submit information, such as changes to entitlements and travel vouchers.

Military Retirement. Prior to FY 2011, improper payments for deceased accounts reflected the total amount of monies paid after the date of death of a Retiree. This practice caused the Agency to overstate the amount of the improper payment, as payments to the Retiree stop on the date of death and credits for partial months were not considered to reduce the reported overpayment. Beginning in FY 2011, the Agency calculated offsets to overpayments based on the estimated amounts, considering partial month's entitlement, due to the Retirees next of kin or estate.

Based on FY 2011 reviews, the Department projected approximately $18.9 million (0.04 percent) in improper payments for the Military Retirement program, with almost the entire amount caused by payments to deceased retirees and annuitants. Eligibility for military retired pay ends on the date of death of the retiree. Prompt reporting of a deceased retiree's death can help avoid delay and possible financial hardship to surviving beneficiaries, family members or executors, who are required to return any unearned payments of the decedent's military retired pay.

<u>Root Causes</u> The delay in notifying the Payroll Activity of the death of a Military Retiree results in unavoidable overpayments to deceased retirees. Our review of confirmed overpayments to deceased retirees in FY 2011 disclosed that the Department recovered approximately 96 percent of the overpayments within 60 days, demonstrating the effectiveness of controls within the retired pay system once the Department is notified of a retiree's death (refer to Table 9).

<u>Corrective Actions</u>. The Department's control processes to prevent, identify, and reduce overpayments to deceased retiree) and annuitants include:

- Validating existence of retiree and/or annuitant, if living outside the United States;
- Annual certification of existence for all annuitants;
- Periodic random certifications for retirees over a certain age; and
- Validating Military Retiree existence if payments are returned and/or if account was suspended for several months due to bad check/correspondence address.

Acceptable proof of death for suspending a Military Retiree's account includes:

- Funeral Director's Report;
- VA Cemetery Files;
- Notification from the Defense Enrollment Eligibility Reporting System; and
- Social Security reports or other forms of notification that can be confirmed as coming from an authoritative source.

The notification of death is considered official when DFAS receives a certified death certificate or a message from a Military Service-connected hospital; Naval Military Personnel Command (NMPC); Air Force Personnel Center (AFPC); Marine Corps Casualty Branch (MRC); Casualty Operations Division (Army); a phone call from an immediate family member (i.e., spouse, son, daughter).

Early detection and data mining efforts, along with partnerships with other Federal and State entities, also are used. The Department takes a proactive approach to ensure the accuracy of Military Retiree payments, routinely comparing retired and annuitant payroll master file databases with the Social Security Administration's deceased records and periodically comparing records with the Office of Personnel Management's deceased files, Department of Veterans Affairs' database, and with individual States with sizable retiree and annuitant populations (e.g., Texas, California, and Florida). Payments for Military Retirees identified as deceased are suspended pending validation of death or validation of continued eligibility. The DoD's expanded definition of "acceptable source documents for notice of death" has allowed DFAS to initiate reclamation actions earlier, thereby increasing recovery of funds paid after date of death.

<u>Travel Pay</u>. Total improper payments for travel include the two DFAS payment systems (Defense Travel System (DTS) and Interagency Travel System for windows (WinIATS), as well as additional travel payments made outside of DFAS for the Army, Navy, Air Force, and certain Defense components. The Department projects FY 2011 cumulative improper travel payments of $286.6 million, $238.2 million in overpayments and

$48.4 million in underpayments. The overall error for this area is 3.28 percent. (The Army Corps of Engineers travel payments are reported separately in Table 4.) The FY 2011 improper payment estimates include random reviews of DTS trip records for the Military Services, random monthly reviews of WinIATS TDY, and military and civilian PCS vouchers computed and disbursed by DFAS.

Errors in the traveler's request for reimbursement and Approving Official (AO) lack of proper review and approval of such requests resulted in nearly all of the errors detected during the random reviews of travel payments.

<u>DTS Root Causes</u>. The primary reasons for DTS improper payments include:

- Reimbursable Expense (36 percent): The Department incorrectly paid airfare, paid non-travel related expenses, and/or failed to reimburse registration/conference fees correctly.
- Per Diem (33 percent): The Department paid lodging incorrectly, reimbursed the traveler for lodging expenses not validated by receipts, and/or paid meals at an incorrect rate.
- Missing Documentation (31 percent): The Department reimbursed lodging, airfare or rental car expenses without a receipt

<u>DTS Corrective Actions</u>. On a quarterly basis, DFAS provides the Defense Travel Management Office and DoD Components with error trend reports. The DFAS post-payment review personnel give presentations at various DTS training sessions and conferences and also brief Senior Service Executives on these post-payment review statistics, trends, and input errors. In addition, any improper payments identified are forwarded to the appropriate Debt Management Monitor for establishment and recovery of overpayments.

<u>WinIATS Root Causes</u>. The primary reasons for WinIATS improper payments:

- Per Diem (68 percent): Per Diem/Meals & Incidental Expenses (M&IE) and lodging paid at the incorrect rate or not paid at all.
- Administrative (22 percent): Required signatures or dates were missing or the travel order was missing or invalid.
- Reimbursable Expenses (8 percent): Rental car expenses and mileage reimbursed incorrectly or not reimbursed at all.
- Miscellaneous (2 percent).

In FY 2011, civilian PCS claims were included in the random review process. The Department attributes the majority of improper payments to processing errors, either by the traveler or technician input errors. Initial results reflect the following primary causes of errors:

- PCS and TDY lodging or quarters subsistence expenses paid incorrectly (48 percent);
- Reimbursable Expenses paid incorrectly (31 percent);
- Per diem paid incorrectly (14 percent); and

- Miscellaneous causes account for the remaining 7 percent.

WinIATS Corrective Actions. The DFAS has established an extensive set of preventative and monitoring actions to prevent improper payments, including:

- Post-payment reviewers meet monthly with travel pay operations personnel to discuss findings and preventative measures;
- Pre-payment accuracy rates are reported to the DFAS post-payment review team by travel pay operations and monitored daily;
- Travel Pay examiner training programs, based on post-payment review findings and recommendations, have been implemented;
- Pre- and post-payment checklists are linked to identify and prevent improper payments.
- Pre-payment validations and cross checks have been implemented to ensure the traveler was not previously reimbursed for the same trip, therefore avoiding a duplicate payment.

DFAS Commercial Pay. The amount of DFAS commercial pay improper payments is $224.6 million (0.06 percent) of the total commercial pay outlays for the period August 1, 2010 through July 31, 2011. Of the $224.6 million, approximately $91.1 million (41.1 percent) in overpayments and $133.5 million (59.4 percent) in underpayments.

Root Causes. The majority of improper payment errors in Commercial Pay are caused by input errors into the payment entitlement systems.

Corrective Actions. The ongoing corrective actions include:

- Business Activity Monitoring (BAM) refinements that reduce payments to the wrong vendor, which is the cause for approximately 30 percent of overall commercial pay improper payments;
- Continued analysis of DoD's legacy systems Wide Area Work Flow (WAWF) rejections that identify corrective actions to increase electronic commerce and minimize manual intervention;
- Movement to a central processing hub, Global Exchange to gain efficiencies in posting contractual documents into the legacy entitlement systems and provide additional training to technicians; and
- Continue to work with Contracting Officers to simplify contract terms and eliminate the need for manual calculations.

Other initiatives to reduce improper payments include outreach to reduce vendor billing errors caused by duplicate manual and electronic submission of invoices. In addition, the Department conducts manual reviews to ensure it meets all Certifying Officer Legislation requirements prior to certifying payment, such as ensuring proper documentation, correct payment amounts, and payment type before disbursement.

The DFAS uses the pre-payment BAM tool, initially deployed in August 2008, to identify and prevent improper payments in DoD's four largest commercial payment systems: Mechanization of Contract Administrative Services (MOCAS); Computerized Accounts Payable System-Windows (CAPS-Windows); Integrated Accounts Payable System (IAPS); and One Pay. These systems account for 86 percent of all DoD commercial payments. These types of preventative program activities consistently prove to be the most cost effective.

To further ensure proper identification and recovery of improper commercial payments, the Department uses various post-payment initiatives, including periodic duplicate payment reviews performed by the DFAS Internal Review (IR) Directorate for the four major commercial payment systems. The DFAS IR auditors analyze monthly extracts of invoice and disbursing data for payments made through these systems and perform quality control checks to ensure the data is consistent and reasonable. The DFAS IR auditors identify what they believe to be duplicate payments and refer these to DFAS Accounts Payable staff for final determination. Further, DFAS captures these improper payments in either the Contract Debt System (CDS) or Improper Payment On-Line Database (IPOD) to identify, track, recover, and analyze to determine the root cause(s) of the improper payment.

U. S. ARMY CORPS OF ENGINEERS (USACE)

Risk Assessment

The USACE assessments for travel and contract payments risk address the effectiveness of internal controls in place to prevent improper payments (such as pre-payment reviews), as well as system weaknesses identified internally or by outside audit activities. While USACE improper payment percentages are extremely low, numerous pre- and post-payment controls further minimize and eliminate improper payments.

Statistical Sampling Process

Travel Pay. The USACE processes travel payments using the Corps of Engineers Financial Management System (CEFMS) and WinIATS. The total travel payment population includes TDY and PCS payments made by the USACE Finance Center. Random sampling is used to review all TDY travel payments less than $2,500. All PCS and TDY vouchers payments over $2,500 are reviewed.

Commercial (Contract) Payments. The USACE utilizes pre-payment internal controls, post-payment contract audits and data mining to prevent and identify improper payments. The audits are conducted using a random sample of payments taken over the entire contract payment population.

Root Causes of Errors and Corrective Actions

Travel Pay. The total projected improper payments for Travel Pay for FY 2011 is $2.1 million, comprised of $2.0 million in overpayments and $100 thousand in underpayments.

Root causes of errors in Travel Pay normally result from travelers inadvertently omitting information or items overlooked by approving officials. The primary corrective action was to require training for all new travelers and Approving Officials as well as refresher training for seasoned travelers and approving officials. This corrective action was completed during FY 2011.

Commercial (Contract) Payments. Total improper commercial payments for USACE Commercial (Contract) payments total $11.9 million (0.04 percent error rate), all of which are comprised of overpayments. The main cause of the overpayments is due to the real estate community not documenting transfers in ownership. In these instances, staff has been counseled to immediately notify the appropriate individuals once it is known that ownership has changed. In addition, due to changes in prices or rates during a contract, some overpayments and underpayments are identified during contract close-out. If an overpayment is identified, the amount either is offset against a current invoice or an accounts receivable is established with a demand letter sent to recover the amount.

Payment Reviews and Recoveries Reporting

The USACE utilizes data mining as part of the post-payment/recovery audit program. The USACE data-mining tool utilizes the power of Oracle programming to search CEFMS and identify potential errors, such as duplicate, missing, or suspicious invoices as well as specific types of reoccurring payments. The use of a data-mining tool complements the pre-payment safeguards already built into CEFMS. These safeguards include edits that require a matching of the receiving report with an invoice and which prevent use of duplicate invoice numbers for the same obligation (see Table 9).

Program Improper Payment Reporting

Table 4 summarizes DoD's improper payment reduction outlook and total program outlays (payments) from FY 2010 through FY 2014.

Table 4. Improper Payment Reduction Outlook

	FY 2010					FY 2011					FY 2012 Estimate			FY 2013 Estimate			FY 2014 Estimate		
Program	Outlays ($B)	IP (%)	IP Over ($M)	IP Under ($M)	IP Total ($M)	Outlays ($B)	IP (%)	IP Over ($M)	IP Under ($M)	IP Total ($M)	Outlays ($B)	IP (%)	IP ($M)	Outlays ($B)	IP (%)	IP ($M)	Outlays ($B)	IP (%)	IP ($M)
Military Health Benefits[1]	$11.7	0.42	$35.1	$14.0	$49.1	$12.6	0.24	$21.2	$9.0	$30.2	$16.4	2.00	$321.0	$17.5	2.00	$328.0	$19.0	2.00	$380.0
Military Pay[6]	$82.5	0.61	$167.1	$338.8	$505.9	$96.0	0.49	$209.1	$265.2	$474.3	$96.0	0.48	$460.8	$95.0	0.47	$446.5	$94.0	0.46	$432.4
Civilian Pay[2,6]	$34.0	0.27	$79.4	$1.6	$81.0	$58.7	0.16	$90.8	$0.1	$90.9	$58.0	0.16	$92.8	$57.5	0.16	$92.0	$57.0	0.16	$91.2
Military Retirement	$43.2	0.14	$58.2	$0.3	$58.5	$42.2	0.04	$18.8	$0.1	$18.9	$42.5	0.04	$17.0	$42.9	0.04	$17.2	$43.5	0.04	$17.4
Travel Pay[3,4,6]	$9.3	1.91	$145.7	$28.9	$174.6	$8.7	3.28	$238.2	$48.4	$286.6	$8.5	3.27	$278.0	$8.5	3.26	$277.1	$8.5	3.25	$276.3
DFAS Commercial Pay[5]	$384.1	0.18	$358.2	$329.9	$688.1	$368.5	0.06	$91.1	$133.5	$224.6	$364.5	0.06	$200.5	$360.9	0.05	$180.5	$357.3	0.05	$160.8
USACE Travel Pay[6,7,8]	NA	NA	NA	NA	NA	$0.212	1.00	$2.0	$0.1	$2.1	$0.212	1.00	$2.1	$0.212	1.00	$2.1	$0.212	1.00	$2.1
USACE Commercial Pay	$26.7	0.02	$4.1	$-0-	$4.1	$30.5	0.04	$11.9	$-0-	$11.9	$31.0	0.04	$12.4	$31.0	0.04	$12.4	$31.0	0.04	$12.4

Note 1: Out-year error rates are shown at 2% which is the contract performance standard. However, this program has reported less than a 1% error rate since FY 2007.
Note 2: Civilian Pay represents data from DFAS, Army, and Navy
Note 3: Travel Pay: DFAS Travel Pay represents travel vouchers settled from July 2010 through March 2011. The review of civilian permanent change of station (PCS) vouchers did not begin until October 2010, and therefore, only includes results for October 2010 through June 2011.
Note 4: Travel Pay also includes travel data from Army, Navy, and Air Force for vouchers paid outside of DTS.
Note 5: DFAS commercial improper payments are now identified by date paid rather than date identified; in addition, underpayments are now included in the total improper payments figure. This data line also includes Overseas Army Vendor Pay.
Note 6: Out-year projections for Travel, Civilian Pay, and Military Pay represent input from DFAS only. However, USACE computed its own out-year projections.
Note 7: Prior to FY 2011 reporting, USACE travel and commercial pay were included in the DFAS figures.
Note 8: All travel vouchers > $2500 are reviewed; travel vouchers < $2500 are subjected to statistical sampling (95 percent +/- 2 percentage points).

The Department currently does not utilize external payment recapture auditors to identify and recover outstanding overpayments; therefore, the table entitled "Payment Recapture Audit Reporting," identified in OMB Circular A-136, is not included in this report. The Department's recoveries are shown in Table 8.

Table 5 reflects the dollar amount and percentages of overpayments the Department recovered during FY 2011. As reflected in Table 5, the Department has exceeded the OMB-established FY 2013 threshold to recover 85 percent of overpayments.

Table 5. Payment Recapture Audit Targets

Type of Payment	CY Amount Identify	CY Amount Recovered	CY Recovery Rate (Amount Recovered/ Amount Indentified)	CY +1 Recovery Rate Target	CY +2 Recovery Rate Target	CY +3 Recovery Rate Target
DoD-Wide	$408.3M	$377.2M	92.4%	93.0%	93.0%	93.0%
DFAS[2,3]	$395.2M	$364.3M	92.2%	92.5%	92.5%	92.5%
USACE[4]	$13.1M	$12.9M	98.5%	99.0%	99.0%	99.0%

"M" represents millions.

Note 1: The figures shown in this table are not strictly speaking payment recapture targets, as DoD does not currently employ payment recapture auditors. A more appropriate term would be collection targets, but they are listed here to ensure inclusion for government-wide reporting.

Note 2: The DFAS commercial improper payments are now captured by date paid rather than date discovered.

Note 3: The DFAS figures include Military Pay, Civilian Pay, Military Retirement and Annuitant Pay, Travel Pay, and Commercial Pay amounts.

Note 4: The USACE figures includes Travel Pay and Commercial Pay amounts.

Note 5: See Table 8 for Tricare Management Agency (TMA) health benefit recoveries. The TMA third party payer contracts require reimbursement to the Government of an extrapolated sampling amount, and therefore, are not deemed collections against a debt.

Table 6 depicts the dollar amount of overpayments outstanding as of September 20, 2011.

Table 6. Aging of Outstanding Overpayments

Type of Payment	CY Amount Outstanding (0 – 6 months)	CY Amount Outstanding (6 months to 1 year)	CY Amount Outstanding (Over 1 year)
Amount	$11.4M	$11.6M	$0

"M" represents millions.

Note 1: Dollars represent DFAS commercial collections only.

Note 2: The aging schedule is based on overpayments identified and paid from August 1, 2010 through July 31, 2011.

Table 7 illustrates that virtually all recovered FY 2011 funds were returned to the original appropriation and/or used for the original purpose.

Table 7. Disposition of Recaptured Funds

Type of Payment	Agency Expenses to Administer the Program	Payment Recapture Auditor Fees	Financial Management Improvement Activities	Original Purpose	Office of Inspector General	Returned to Treasury
Amount	$0	$0	$0	$386.6M[1]	$0	$0

"M" represents millions.

Note 1: This dollar amount represents the sum of Column 3 from Table 8 (Amount Recovered (CY)).

The Department does not currently utilize external payment recapture auditors to identify and recovery outstanding overpayments. The Department's collections are show in Table 8.

Table 8. Overpayments Recaptured Outside of Payment Recapture Audits

Agency Source	Amount Identified (CY)	Amount Recovered (CY)	Amount Identified (PY)	Amount Recovered (PY)	Cumulative Amount Identified (CY+PYs)	Cumulative Amount Recovered (CY+PYs)
DFAS Commercial Pay[4]	$91.1M	$68.0M	$1.3B	$1.2B	$1.4B	$1.3B
Military Pay[1]	$143.4M	$143.4M	$181.7M	$159.3M	$325.1M	$302.7M
Civilian Pay[1]	$90.8M	$90.8M	$159.5M	$159.5M	$250.3M	$250.3.M
Military R&A[2]	$67.6M	$62.0M	$107.7M	$101.5M	$175.3M	$163.5M
Travel Pay[3,5]	$1.6M	$0.1M	NA[6]	NA[6]	$1.6M	$0.1M
USACE Travel Pay[7]	$1.1M	$1.1M	NA[6]	NA[6]	$1.1M	$1.09M
USACE Commercial Pay	$11.9M	$11.8M	$38.9M	$38.4M	$53.0M	$52.3M
TRICARE Management Activity (TMA) Health Benefits Contracts[8]	$9.5M	$9.4M	$47.5M	$31.8M	$57.0M	$41.2M

"K" represents thousands. "M" represents millions. "B" represents billions.

Note 1: "In-Service" collection dollars are considered as recovery amounts. Actual results from random sample overpayments are negligible.
Note 2: FY 2011 amounts identified and recovered are based on 100 percent review of deceased retiree and annuitant accounts. FY 2011 recoveries will not be completed until December 31, 2011, as they are tracked for 120 days.
Note 3: Amounts for Current Year (CY) only include overpayments identified in the sampling of travel vouchers settled July 2010 through March 2011, as DFAS allows 120 days for the Service and Defense Components to resolve improper travel payments. In addition, the amount includes $670K in duplicate payments from FY 2009 and 2010 in addition to the statistical sampling amount identified; however, the total excludes $298K in improper payments to foreign military students and amounts of $10 or less, both of which are non-recoverable pursuant to Regulation.
Note 4: Methodology for identification of Commercial Pay improper payments is now based on date of payment rather than discovery date. The Prior Year (PY) data shown remains unchanged as these figures were reported to the OMB MAX database and previously published. Going forward, prior year amounts may require revision based on this change in methodology..
Note 5: Travel Pay also includes travel data from Army, Navy, and Air Force for vouchers paid outside of DTS. The period of review for DFAS travel pay is July 1, 2010 through June 30, 2011.
Note 6: FY 2011 is the first year that Travel Pay recoveries are being tracked and reported in the Agency Financial Report.
Note 7: FY 2011 is the first time USACE Travel is being reported separately from DFAS and other DoD travel.
Note 8: TMA contract improper payments and recoveries are reported 12 months in arrears to accommodate its 100 percent post-payment review.

The Department does not have a Payment Recapture Audit plan that utilizes private companies to identify and recover overpayments; however, the Department performs internal collection activities that account for the cumulative recovery rate of 92.4 percent for FY 2004 – 2011.

When the Recovery Auditing Act was passed in 2002, the Department awarded several contracts to identify and recover improper payments. Recovery auditors would be paid only on a contingency basis and only after funds were actually recovered. Unfortunately, in nearly every instance, the private sector firms were not able to establish an adequate profit margin; consequently, these firms asked that the contracts be terminated. Based on our historical experience with the use of contingency contracts to recover outstanding overpayments, the Department determined this type of effort was not cost-effective.

The Department is working diligently toward auditability of its financial statements, an essential part of which is ensuring that recorded transactions can be traced to source documents. Because our transactions and processes are neither standard nor sound in all cases, it would still be very difficult for private sector firms to run any type of post-payment review to identify potential overpayments. Once our financial statements reach auditability, the Department will be in a position to consider the use of outside contractors to perform this type of payment review.

Accountability

Certifying Officer legislation holds Certifying and Disbursing Officers accountable for government funds. In accordance with *10 U.S.C. 2773a*, pecuniary liability attaches automatically when there is a fiscal irregularity, i.e., (1) a physical loss of cash, vouchers, negotiable instruments, or supporting documents, or (2) an improper payment. These requirements are further codified in *DoD FMR, Volume 5, Chapter 33*, "Certifying Officers, Accountable Officials, and Review Officials." Efforts to recover overpayments from a recipient must be undertaken in accordance with the debt collection procedures outlined in the *DoD FMR, Volume 5, Chapter 28*, "Management and Collection of Individual Debt," and *DoD FMR, Volume 10, Chapter 18*, "Contractor Debt".

Agency Information Systems and Other Infrastructure

The Department has much of the information and infrastructure needed to reduce improper payments in each of its six improper payment programs. The DoD uses the BAM tool to identify potential improper commercial payments prior to disbursement. With the additional requirements for tracking and reporting payment errors that were issued during FY 2010, such as Executive Order 13520, "Reducing Improper Payments and Eliminating Waste in Federal Programs," the enactment of the IPERA, the Payment Recapture Audit memorandum, and the "Do Not Pay" List, the Department will need to continuously reevaluate and prioritize its resource allocations to ensure maximum compliance.

The Department's ongoing migration from the legacy systems to ERPs systems presents a number of challenges for prevention and detection of improper payments, as well as debt collection for recapturing overpayments. These issues are being addressed by stakeholders, but initially these modern systems will add some additional complexity to processes.

Barriers

There are no current legislative barriers that hinder the Department from complying with legislative or regulatory requirements for improper payment identification, recovery, and reporting, other than the due process statutes.

Additional Comments

Because the Department currently does not have an auditable Statement of Budgetary Resources (SBR), it is not possible for the Department to reconcile outlays to the quarterly or annual gross outlays reported in the SBR to ensure all required payments for reporting purposes are captured. The Department is aggressively working to improve its business and financial processes, controls, and systems to achieve financial statement audit readiness by September 30, 2017, as required by Congress. In October 2011, the Secretary of Defense directed the USD(C)/CFO to provide a revised plan to achieve audit readiness for the Statement of Budgetary Resources by the end of 2014. The Department is committed to meeting this goal by 2014.

UNITED STATES DEPARTMENT OF DEFENSE

Agency Financial Report

November 2011

Addendum B

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER) / CFO

The following Defense Security Cooperation Agency financial statements include these programs executed on behalf of Executive Office of the President (EOP). The Department continues to report activity resulting from EOP allocation transfers within the DoD financial statements.

Consolidated Balance Sheet Security Assistance *Dollars in Thousands*	**2011 Consolidated**	**2010 Consolidated**
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$ 21,093,874	$ 20,121,055
Other Assets (Note 6)	0	670
Total Intragovernmental Assets	**$ 21,093,874**	**$ 20,121,725**
Cash and Other Monetary Assets (Note 7)	18,160,143	18,647,997
Accounts Receivable, Net (Note 5)	51,430	42,609
Loans Receivable (Note 8)	983,831	1,075,587
Other Assets (Note 6)	25,231,799	20,504,441
TOTAL ASSETS	**$ 65,521,077**	**$ 60,392,359**
LIABILITIES (Note 11)		
Intragovernmental:		
Accounts Payable (Note 12)	334,081	189,675
Debt (Note 13)	340,909	462,989
Other Liabilities (Note 15 and 16)	661,264	630,948
Total Intragovernmental Liabilities	**$ 1,336,254**	**$ 1,283,612**
Accounts Payable (Note 12)	285,823	330,940
Employment Benefits (Note 17)	487	486
Other Liabilities (Note 15 and 16)	58,607,803	53,914,931
TOTAL LIABILITIES	**$ 60,230,367**	**$ 55,529,969**
NET POSITION		
Unexpended Appropriations - Other Funds	2,615,107	2,524,190
Cumulative Results of Operations - Other Funds	2,675,603	2,338,200
TOTAL NET POSITION	**$ 5,290,710**	**$ 4,862,390**
TOTAL LIABILITIES AND NET POSITION	**$65,521,077**	**$60,392,359**

Consolidated Statement of Net Cost Security Assistance		*Dollars in Thousands*
	2011 Consolidated	**2010 Consolidated**
Program Costs		
Gross Costs	$24,687,441	$23,517,323
(Less: Earned Revenue)	(34,341)	(134,858)
Net Cost before Losses (Gains) from Actuarial Assumption Changes for Military Retirement Benefits	**$24,653,100**	**$23,382,465**
Net Cost of Operations	**$24,653,100**	**$23,382,465**

Consolidated Statement of Changes in Net Position
Security Assistance

Dollars in Thousands

	2011 Earmarked Funds	2011 All Other Funds	2011 Eliminations	2011 Consolidated	2010 Earmarked Funds	2010 All Other Funds	2010 Eliminations	2010 Consolidated
CUMULATIVE RESULTS OF OPERATIONS								
Beginning Balances	$ 0	$ 2,338,200	$ 0	$ 2,338,200	$ 0	$ 1,501,113	$ 0	$ 1,501,113
Beginning balances, as adjusted	**$ 0**	**$ 2,338,200**	**$ 0**	**$ 2,338,200**	**$ 0**	**$ 1,501,113**	**$ 0**	**$ 1,501,113**
Budgetary Financing Sources:								
Appropriations used	0	5,391,067	0	5,391,067	0	5,423,865	0	5,423,865
Nonexchange revenue	0	19,599,436	0	19,599,436	0	18,795,687	0	18,795,687
Total Financing Sources	**$ 0**	**$ 24,990,503**	**$ 0**	**$ 24,990,503**	**$ 0**	**$ 24,219,552**	**$ 0**	**$ 24,219,552**
Net Cost of Operations (+/-)	0	24,653,100	0	24,653,100	0	23,382,465	0	23,382,465
Net Change	**$ 0**	**$ 337,403**	**$ 0**	**$ 337,403**	**$ 0**	**$ 837,087**	**$ 0**	**$ 837,087**
Cumulative Results of Operations	**$ 0**	**$ 2,675,603**	**$ 0**	**$ 2,675,603**	**$ 0**	**$ 2,338,200**	**$ 0**	**$ 2,338,200**
UNEXPENDED APPROPRIATIONS								
Beginning Balances	0	2,524,190	0	2,524,190	0	3,530,529	0	3,530,529
Beginning balances, as adjusted	**$ 0**	**$ 2,524,190**	**$ 0**	**$ 2,524,190**	**$ 0**	**$ 3,530,529**	**$ 0**	**$ 3,530,529**
Budgetary Financing Sources:								
Appropriations received	0	5,485,905	0	5,485,905	0	4,411,706	0	4,411,706
Appropriations transferred (in/out)	0	0	0	0	0	9,500	0	9,500
Other adjustments (rescissions, etc)	0	(3,921)	0	(3,921)	0	(3,680)	0	(3,680)
Appropriations used	0	(5,391,067)	0	(5,391,067)	0	(5,423,865)	0	(5,423,865)
Total Budgetary Financing Sources	**$ 0**	**$ 90,917**	**$ 0**	**$ 90,917**	**$ 0**	**$ (1,006,339)**	**$ 0**	**$ (1,006,339)**
Unexpended Appropriations	**$ 0**	**$ 2,615,107**	**$ 0**	**$ 2,615,107**	**$ 0**	**$ 2,524,190**	**$ 0**	**$ 2,524,190**
Net Position	**$ 0**	**$ 5,290,710**	**$ 0**	**$ 5,290,710**	**$ 0**	**$ 4,862,390**	**$ 0**	**$ 4,862,390**

Combined Statement Of Budgetary Resources Security Assistance *Dollars in Thousands*	Budgetary Financing Accounts 2011 Combined	Budgetary Financing Accounts 2010 Combined	Nonbudgetary Financing Accounts 2011 Combined	Nonbudgetary Financing Accounts 2010 Combined
Budgetary Resources				
Unobligated balance, brought forward, October 1	$ 128,339	$ 1,316,139	$ 7,110	$ 11,433
Recoveries of prior year unpaid obligations	21,967	23,609	0	0
Budget authority				
Appropriation	29,432,784	28,422,462	0	0
Borrowing authority	0	0	6,144	4,650
Contract authority	28,163,552	27,267,781	0	0
Spending authority from offsetting collections				
Earned				
Collected	96	50	158,739	290,551
Subtotal	**$ 57,596,432**	**$ 55,690,293**	**$ 164,883**	**$ 295,201**
Nonexpenditure transfers, net, anticipated and actual	0	9,500	0	0
Permanently not available	(23,950,800)	(24,014,438)	$ (169,679)	$ (294,069)
Total Budgetary Resources	**$ 33,795,938**	**$ 33,025,103**	**$ 2,314**	**$ 12,565**
Obligations incurred:				
Direct	33,769,145	32,896,764	2,287	5,455
Subtotal	**$ 33,769,145**	**$ 32,896,764**	**$ 2,287**	**$ 5,455**
Unobligated balance:				
Apportioned	4,829	106,845	0	(3,556)
Subtotal	**$ 4,829**	**$ 106,845**	**$ 0**	**$ (3,556)**
Unobligated balance not available	21,964	21,494	27	10,666
Total status of budgetary resources	**$ 33,795,938**	**$ 33,025,103**	**$ 2,314**	**$ 12,565**

Combined Statement Of Budgetary Resources Security Assistance *Dollars in Thousands*	Budgetary Financing Accounts 2011 Combined	Budgetary Financing Accounts 2010 Combined	Nonbudgetary Financing Accounts 2011 Combined	Nonbudgetary Financing Accounts 2010 Combined
Change in Obligated Balance:				
Obligated balance, net				
Unpaid obligations, brought forward, October 1	91,701,933	87,898,916	2,462,224	2,587,278
Total unpaid obligated balance	91,701,933	87,898,916	2,462,224	2,587,278
Obligations incurred net (+/-)	33,769,145	32,896,764	2,287	5,455
Less: Gross outlays	(28,456,093)	(29,070,137)	(2,287)	(130,509)
Less: Recoveries of prior year unpaid obligations, actual	(21,967)	(23,609)	0	0
Obligated balance, net, end of period				
Total, Unpaid obligations balance, net, end of period	96,993,018	91,701,934	2,462,224	2,462,224
Total, unpaid obligated balance, net, end of period	**$ 96,993,018**	**$ 91,701,934**	**$ 2,462,224**	**$ 2,462,224**
Net Outlays				
Net Outlays:				
Gross outlays	28,456,093	29,070,137	2,287	130,509
Less: Offsetting collections	(96)	(50)	(158,739)	(290,551)
Less: Distributed Offsetting receipts	(23,946,831)	(24,010,756)	0	0
Net Outlays	**$ 4,509,166**	**$ 5,059,331**	**$ (156,452)**	**$ (160,042)**

Note 1. Significant Accounting Policies

1.A. Basis of Presentation

These financial statements have been prepared, in accordance with Chief Financial Officers Act of 1990 (CFO), to report the financial position and results of operations of the Foreign Military Sales (FMS) Trust Fund and its accounts, as identified in the President's Budget Request, the Foreign Operations (International Affairs) appropriated accounts. The FMS Trust Fund accounts for U.S. government funds appropriated for security assistance and for funds deposited by foreign countries and international organizations, or by others for their use. The FMS Trust Fund and other accounts for funds appropriated for security assistance are managed by the Defense Security Cooperation Agency (DSCA) on behalf of the Department of Defense (DoD), in accordance with the authority of the Executive Office of the President (EOP) and the requirements of the CFO Act of 1990, as expanded by the Government Management Reform Act of 1994, and other applicable laws and regulations.

The financial statements were prepared from accounting records that are maintained by the Military Departments, Other Defense Organizations (ODO), and the Defense Finance and Accounting Service (DFAS) in accordance with, and to the extent possible, U.S. generally accepted accounting principles (USGAAP) promulgated by the Federal Accounting Standards Advisory Board (FASAB); the Office of Management and Budget (OMB) Circular No. A-136, Financial Reporting Requirements; and the DoD Financial Management Regulation (FMR).

The accompanying financial statement information accounts for all FMS Trust Fund resources and the accounts for funds appropriated for security assistance, unless otherwise noted. Information relative to classified assets, programs, and operations is excluded from the statements or otherwise aggregated and reported in such a manner that it is not discernable.

The FMS Trust Fund accounting systems, including its subaccounts and the accounts for funds appropriated for security assistance, are unable to fully implement all elements of USGAAP and OMB Circular No. A-136 due to limitations of financial management processes, financial systems, and nonfinancial systems and processes that support the financial statements. Many of the accounts derive their reported values and other information for major asset and liability categories largely from nonfinancial systems, such as the Military Departments' inventory and logistic systems. Such legacy systems were designed to support reporting requirements for maintaining asset accountability and reporting the status of federal appropriations rather than preparing financial statements consistent with USGAAP. There are ongoing efforts to implement process and system improvements addressing these limitations.

The Department currently has 13 auditor identified material weaknesses. Of these, the FMS Trust Fund and the accounts for funds appropriated for security assistance may include: (1) Financial Management Systems, (2) Intergovernmental Eliminations, (3) Fund Balance with Treasury, (4) Statement of Net Cost, (5) Other Accounting Entries, (6) Reconciliation of Net Cost of Operations to Budget, (7) Accounts Payable, and (8) Accounts Receivable.

1.B. Mission of the Reporting Entity

The DSCA mission is to lead, direct, and manage security cooperation programs and resources to support the U.S. national security objectives. Such programs build relationships with foreign countries and international organizations that promote the U.S. interests, develop allied and partner capacities for self-defense and coalition participation in overseas contingency operations, and promote peacetime and contingency access for U.S. forces. The DSCA accomplishes its responsibilities for security cooperation in concert with the Department of State (DOS), Military Departments, other U.S. Government organizations, U.S. industry, and non-governmental organizations. Together we provide financial and technical assistance, Foreign Military Financing (FMF) for defense articles and services, including training, provided through the FMS program, as well as training provided and funded under International Military Education and Training (IMET) authorities.

1.C. Appropriations and Funds

The FMS Trust Fund is a U.S. Treasury account (Treasury Account Symbol (TAS) 8242) which contains deposits from FMS foreign country and international organization customers, as well as funds transferred into the account from U.S. Government appropriations, for use in carrying out specific purposes or programs in accordance with the Arms Export and Control Act (AECA), as amended (22 U.S.C. § 2751 et seq.), the Foreign Assistance Act of 1961 (FAA), as amended, (22 U.S.C. § 2151 et seq.), and other legal authorities. The monies in the FMS Trust Fund are subject to U.S. Treasury account system controls from the date of receipt to the date of expenditure or refund. At the country or customer level, there are separate subaccounts used by the Department through DSCA and DFAS to separately and individually account for each FMS customer's deposits, other collections or deposits, payments of bills, refunds, and adjustments. At the U.S. Treasury level, the corpus of the FMS Trust Fund represents the total aggregations of balances (receipts minus disbursements) for all activities and programs.

The Department utilizes separate U.S. Treasury Accounts for the general fund Foreign Operations (International Affairs) appropriations. These accounts are:

- International Military Education and Training (TAS 1081)
- Foreign Military Financing Program Account (TAS 1082)
- Foreign Military Loan Liquidating Account (TAS 4121)
- Foreign Military Financing Direct Loan Financing Account (TAS 4122)
- Military Debt Reduction Financing Account (TAS 4174)

The DSCA receives funds for the FMS Trust Fund and the accounts for funds appropriated for security assistance as general, special, and trust funds. The DSCA uses these appropriations and funds to execute its missions and subsequently reports on resource usage.

General and special appropriations transferred into the FMS Trust Fund are used for financial transactions, including personnel, operations and maintenance of security assistance functions, and financing of FMS, which may include sales of defense articles and services from stock or through procurement, and the sale of foreign military construction.

The FMS Trust Fund accounts for receipts and expenditures of funds held in trust by the U.S. government for use in carrying out specific purposes or programs in accordance with applicable laws, regulations, and agreements.

The DSCA receives allocation transfers from certain fund(s) that meet the OMB exception, and all related activity is included in DSCA financial statements, which are reported separately from the DoD financial statements, for: International Military Education and Training, Foreign Military Financing Program Account, Foreign Military Loan Liquidating Account, Foreign Military Financing Direct Loan Financing Account, Military Debt Reduction Financing Account, and the FMS Trust Fund. An allocation transfer is an entity's legal delegation of authority to obligate budget authority and outlay funds on its behalf. Generally, all financial activity related to allocation transfers are reported in the financial statements of the parent entity. Exceptions to this general rule will apply to specific funds for which OMB has directed that all activity will be reported in the financial statements of the child to the transfer. Exceptions include all U.S. Treasury-Managed Trust Funds, EOP, and all other funds specifically designated by OMB.

1.D. Basis of Accounting

The legacy financial management systems utilized for the FMS Trust Fund and the accounts for funds appropriated for security assistance are unable to meet full accrual accounting. Many of the DSCA, Military Departments, and ODO financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of USGAAP guidance. These legacy systems were not designed to collect and record financial information on a full accrual accounting basis as required by USGAAP. Most of DSCA, Military Departments, and

ODO financial and nonfinancial legacy systems were designed to record information on a budgetary basis.

The FMS Trust Fund and the accounts for funds appropriated for security assistance financial statements and supporting trial balances are compiled from the underlying financial data and trial balances of the Military Departments, ODOs, and their sub-entities. The underlying data is largely derived from budgetary transactions (obligations, disbursements, and collections), from nonfinancial feeder systems, and accruals made for major items such as payroll expenses and accounts payable. Some of the lower level trial balances may reflect known abnormal balances resulting largely from business and system processes. At the consolidated Military Service and Defense Agency level, these abnormal balances may not be evident. Disclosures of abnormal balances are made in the applicable footnotes, but only to the extent that the abnormal balances are evident at the consolidated level.

The DSCA, with Military Departments and ODOs, is determining the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with USGAAP. One such action is the current revision of accounting systems to record transactions based on the U.S. Standard General Ledger (USSGL). Until all DSCA, Military Departments, and ODO systems and related processes have been updated to collect and report financial information as required by USGAAP, reported financial data is based on budgetary transactions data from nonfinancial feeder systems, and accruals.

1.E. Revenues and Other Financing Sources

As authorized by legislation, payments for the sales of defense articles and services are deposited into the FMS Trust Fund. Appropriations provided on an annual or multiyear basis for security assistance are a financing source and are transferred into the FMS Trust Fund, or deposited into the accounts for funds appropriated for security assistance. Pricing for defense articles and services, including training, is established to recover costs as required by the AECA, the FAA, and OMB Circular A-25, User Charges. The FMS Trust Fund and the accounts for funds appropriated for security assistance recognize revenue when earned within the constraints of current system capabilities.

The DSCA does not include nonmonetary support provided by friendly foreign countries and international organizations in amounts reported in the Statement of Net Cost and the Note 21, Reconciliation of Net Cost of Operations to Budget.

The DSCA participates in assistance in kind agreements in its overseas presence. The assistance in kind provided in support of security cooperation programs includes the use of facilities and personnel (guards and drivers) at a small number of Security Cooperation Offices worldwide.

1.F. Recognition of Expenses

DoD policy requires the recognition of operating expenses in the period incurred. Current financial and nonfinancial feeder systems for the FMS Trust Fund and the accounts for funds appropriated for security assistance were not designed to collect and record transactions on an accrual accounting basis. Estimates are made for major items such as payroll expenses, accounts payable, and unbilled revenue.

1.G. Accounting for Intragovernmental Activities

Accounting standards require that an entity eliminates intraentity activity and balances from consolidated financial statements in order to prevent overstatement for business with itself. However, DSCA cannot accurately identify most of its intragovernmental transactions because Military Department's systems do not track buyer and seller data needed to match related transactions. In most cases, the buyer-side records are adjusted to agree with DoD seller-side balances and are then eliminated. The Department is implementing replacement systems and a standard financial information structure that will incorporate the necessary elements that will enable DoD to correctly report, reconcile, and eliminate intragovernmental balances.

The U.S. Treasury's Federal Intragovernmental Transactions Accounting Policy Guide and U.S. Treasury Financial Manual, Part 2 Chapter 4700, Agency Reporting Requirements for the Financial Report of the United States Government provide guidance for reporting and reconciling intragovernmental balances. The FMS Trust Fund and the accounts for funds appropriated for security assistance are unable to fully reconcile intragovernmental transactions with all federal agencies; however, the FMS Trust Fund is able to reconcile balances pertaining to borrowing from the U.S. Treasury and the Federal Financing Bank, Federal Employees' Compensation Act (FECA) transactions with the Department of Labor, and benefit program transactions with the Office of Personnel Management.

The DoD's proportionate share of public debt and related expenses to the Federal Government is not included. The Federal Government does not apportion debt and its related costs to federal agencies. The DoD's financial statements do not report any public debt, interest, or source of public financing whether from issuance of debt or tax revenues.

1.H. Transactions with Foreign Governments and International Organizations

Each year, the FMS Trust Fund and the accounts for funds appropriated for security assistance sells defense articles and services to foreign governments and international organizations under the provisions of the AECA. Under the provisions of the Act, the Department has authority to sell defense articles and services to foreign countries and international organizations generally at no profit or loss to the Federal Government. Payment in U.S. dollars is required in advance.

1.I. Funds with the U.S. Treasury

The FMS Trust Fund monies are held in U.S. Treasury accounts and the Federal Reserve Bank in individual accounts established by the U.S. for foreign countries. Funds held in the Federal Reserve Bank are transferred to the FMS Trust Fund account to be disbursed for FMS purposes.

For monetary financial resources maintained in U.S. Treasury accounts, the disbursing offices of DFAS, the Military Departments, the U.S. Army Corps of Engineers (USACE), and the DOS's financial service centers process the majority of the FMS Trust Fund and the accounts for funds appropriated for security assistance cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on checks issued, electronic fund transfers, interagency transfers, and deposits.

In addition, DFAS sites and USACE Finance Center submit reports to the U.S. Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records this information to the applicable Fund Balance with Treasury (FBWT) account. On a monthly basis, FMS Trust Fund and the accounts for funds appropriated for security assistance FBWT is adjusted to agree with the U.S. Treasury accounts.

1.J. Cash and Other Monetary Assets

The FMS Trust Fund only accepts U.S. dollars for payment of defense articles and services per DoD 5015.38M Security Assistance Management Manual; Chapter 5; Foreign Military Sales Case Development. All payments and collections are in U.S. dollars.

1.K. Accounts Receivable

The FMS Trust Fund and the accounts for funds appropriated for security assistance accounts receivable from other federal entities or the public include accounts receivable, claims receivable, and refunds receivable. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. The Department does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intragovernmental Business Rules published in the Treasury Financial Manual.

1.L. Direct Loans and Loan Guarantees

The DSCA administers the Foreign Military Financing program on behalf of the EOP. Direct loans and loan guarantees are authorized by sections 23 and 24 of the AECA (P.L. 90-269, as amended) and other specific legislation. These loans and guarantees assist friendly foreign countries and international organizations in purchasing U.S. defense articles and services.

1.M. Inventories and Related Property

The FMS Trust Fund and the accounts for funds appropriated for security assistance do not maintain inventory. The defense articles are provided to the FMS customer from the U.S. Government or the contractor pursuant to a contract with the U.S. Government. Defense articles sold from the Department or the U.S. Coast Guard are assets of the providing component until title is transferred to foreign customer.

1.N. Investments in U.S. Treasury Securities

Not applicable.

1.O. General Property, Plant and Equipment

Not applicable.

1.P. Advances and Prepayments

When advances are permitted by law, legislative action, or presidential authorization, DoD's policy is to record advances and prepayments in accordance with USGAAP. As such, payments made in advance of the receipt of goods and services are reported as an asset on the Balance Sheet. The DoD's policy is to expense and/or properly classify assets when the related goods and services are received. Not all military services who execute on behalf DSCA have implemented this policy primarily due to system limitations.

1.Q. Leases

Lease payments for the rental of DSCA operating facilities are contracted for and classified as operating leases. The DSCA, as the lessee, receives the use and possession of leased property, for example real estate, from a lessor in exchange for payment of funds. An operating lease does not substantially transfer all the benefits and risk of ownership. Payments for operating leases are charged to expenses over the lease terms as it becomes payable.

Office space and leases are funded by the FMS Trust Fund. These costs were gathered from existing operating leases and General Services Administration bills, and interservice support agreements. Future year projections use the Consumer Price Index. The FMS Trust Fund and the accounts for funds appropriated for security assistance do not have capital leases.

1.R. Other Assets

Other assets includes civil service employee pay advances, travel advances, and certain contract financing payments that are not reported elsewhere on the FMS Trust Fund and the accounts for funds appropriated for security assistance Balance Sheet.

The FMS Trust Fund and the accounts for funds appropriated for security assistance conduct business with commercial contractors using two primary types of contracts: fixed price and cost reimbursable. Contract financing payments are defined in the Federal Acquisition Regulations, Part 32, as authorized disbursements to a contractor prior to acceptance of supplies or services by the Government. These payments are designed to alleviate the potential financial burden on contractors performing on certain long-term contracts and facilitate competition for defense contracts. Contract financing payments clauses are incorporated in the contract terms and conditions and may include advance payments, performance-based payments, commercial advance and interim payments, progress payments based on cost, and interim payments under certain cost-reimbursement contracts. It is DoD policy to record certain contract financing payments as other assets.

Contract financing payments do not include invoice payments, payments for partial deliveries, lease and rental payments, or progress payments based on a percentage or stage of completion. The Defense Federal Acquisitions Regulation Supplement authorizes progress payments based on a percentage or stage of completion only for construction of real property, shipbuilding, and ship conversion, alteration, or repair. Progress payments based on percentage or stage of completion are reported as Construction in Progress.

1.S. Contingencies and Other Liabilities

The Statement of Federal Financial Accounting Standards (SFFAS) No. 5, Accounting for Liabilities of the Federal Government, as amended by SFFAS No. 12, Recognition of Contingent Liabilities Arising from Litigation, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. The FMS Trust Fund and the accounts for funds appropriated for security assistance recognize contingent liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. The FMS Trust Fund and the accounts for funds appropriated for security assistance risk of loss due to contingencies arise as a result of pending or threatened litigation or claims and assessments due to events such as aircraft, ship, and vehicle accidents; medical malpractice; property or environmental damages; and contract disputes.

1.T. Accrued Leave

The FMS Trust Fund reports liabilities for military leave and accrued compensatory and annual leave for civilians. Sick leave for civilians is expensed as taken. The liabilities are based on current pay rates.

1.U. Net Position

Net Position consists of unexpended appropriations and cumulative results of operations. Unexpended Appropriations represent the amounts of budget authority that are unobligated and have not been rescinded or withdrawn. Unexpended Appropriations also represent amounts obligated for which legal liabilities for payments have not been incurred. Cumulative Results of Operations represent the net difference between expenses and losses and financing sources (including appropriations, revenue, and gains) since inception. The Cumulative results of operations also include donations and transfer in and out of assets that were not reimbursed.

1.V. Treaties for Use of Foreign Bases

Not applicable.

1.W. Undistributed Disbursements and Collections

The FMS Trust Fund and accounts for funds appropriated for security assistance follow DoD policy, which is to allocate supported undistributed disbursements and collections between federal and nonfederal categories based on the percentage of federal and nonfederal accounts payable and accounts receivable. Supported undistributed disbursements and collections are then applied to reduce accounts payable and receivable accordingly.

Unsupported undistributed disbursements are recorded as disbursements in transit and reduce nonfederal accounts payable. Unsupported undistributed collections are recorded in nonfederal other liabilities.

Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to a specific obligation, payable, or receivable in the source systems and those reported by the U.S. Treasury. Supported disbursements and collections are evidenced by collaborating documentation. Unsupported disbursements and collections do not have supporting documentation for the transaction and most likely would not meet audit scrutiny.

1.X. Fiduciary Activities

Not applicable.

1.Y. Military Retirement and Other Federal Employment Benefits

Not applicable.

1.Z. Significant Events

Not applicable.

Note 2. Nonentity Assets

Nonentity Assets		*Dollars in Thousands*
As of September 30	**2011**	**2010**
Intragovernmental Assets		
Fund Balance with Treasury	$ 15,121,753	$ 14,688,827
Other Assets	0	671
Total Intragovernmental Assets	**$ 15,121,753**	**$ 14,689,498**
Nonfederal Assets		
Cash and Other Monetary Assets	$ 18,160,143	$ 18,647,997
Accounts Receivable	712,582	673,437
Other Assets	25,223,804	20,500,847
Total Nonfederal Assets	**$ 44,096,529**	**$ 39,822,281**
Total Nonentity Assets	**$ 59,218,282**	**$ 54,511,779**
Total Entity Assets	**6,302,795**	**5,880,580**
Total Assets	**$ 65,521,077**	**$ 60,392,359**

Nonentity Assets are assets for which the Foreign Military Sales (FMS) Trust Fund and the accounts for funds appropriated for security assistance maintains stewardship accountability and reporting responsibility, but are not available for the agency’s operations.

Fund Balance with Treasury and Cash and Other Monetary Assets consist of advance deposits from friendly countries and international organizations to facilitate the purchase of U.S. defense articles and services based on future requirement forecasts.

Accounts Receivable consist of amounts for interest, fines, and penalties due on debt from loans and nonfederal funds owed to the FMS Trust Fund country accounts that are in litigation at Department of Justice or collection status at Defense Finance Accounting Service. Some portion of these uncollected funds may be payable to the FMS Administrative Surcharge account, but are not discernable prior to collection.

Intragovernmental and Nonfederal Other Assets consist primarily of advances paid for undelivered defense articles and services intended for future delivery to the FMS customer.

NOTE 3. FUND BALANCE WITH TREASURY

Fund Balance with Treasury		Dollars in Thousands
As of September 30	**2011**	**2010**
Fund Balance		
Appropriated Funds	$ 2,632,921	$ 2,568,679
Trust Funds	15,121,753	14,688,827
Other Fund Types	3,339,200	2,863,549
Total Fund Balance	**$ 21,093,874**	**$ 20,121,055**
Fund Balance Per Treasury Versus Agency		
Fund Balance per Treasury	$ 21,093,874	$ 20,121,055
Fund Balance per Agency	21,093,874	20,121,055
Reconciling Amount	**$ 0**	**$ 0**

The $3.3 billion reported as Fund Balances, Other Fund Types consists of funds on deposit for the management of Foreign Military Sales (FMS) Administration, Contract Administrative Services, Transportation, Attrition and General Services Administration Packing, Crating and Handling.

Status of Fund Balance with Treasury		Dollars in Thousands
As of September 30	**2011**	**2010**
Unobligated Balances		
Available	$ 4,829	$ 103,289
Unavailable	21,992	32,159
Obligated Balance not yet Disbursed	99,455,241	94,164,157
Nonbudgetary FBWT	23,946,837	24,010,761
NonFBWT Budgetary Accounts	(102,335,025)	(98,189,311)
Total Fund Balance	**$ 21,093,874**	**$ 20,121,055**

The Status of Fund Balance with Treasury (FBWT) reflects the budgetary resources to support FBWT and is a reconciliation between budgetary and proprietary accounts. It primarily consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current or future obligations.

Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations.

The unavailable balance consists primarily of funds invested in U.S. Treasury securities that are temporarily precluded from obligation by law. Certain unobligated balances are restricted for future use and are not apportioned for current use. Unobligated balances for trust fund accounts are restricted for use by the public law that established the funds.

Obligated Balance not yet Disbursed represents funds that have been obligated for goods and services not received and those received but not paid.

Nonbudgetary FBWT includes accounts that do not have budgetary authority, such as deposit funds, unavailable receipt account, clearing accounts and nonentity FBWT. The Nonbudgetary FBWT consists of Contingency Operations provided to Department of Defense in supplemental appropriations, and Contingency Operations funding transferred from Department of State (DOS), which DOS received in supplemental appropriations. Obligations are incurred using contract authority and liquidated with these appropriations.

NonFBWT Budgetary Accounts reduces the Status of FBWT. The NonFBWT Budgetary Accounts primarily consists of nonentity cash deposited in the Federal Reserve Bank and contract authority.

Unobligated balances are segregated to show available and unavailable amounts in the note schedule. Certain unobligated balances are restricted to future use and are not apportioned for current use. The unobligated balance is restricted for use for specific purposes and time.

NOTE 5. ACCOUNTS RECEIVABLE

Accounts Receivable			*Dollars in Thousands*
	2011		
As of September 30	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	$ 0	N/A	$ 0
Nonfederal Receivables (From the Public)	51,436	(6)	51,436
Total Accounts Receivable	**$ 51,436**	**$ (6)**	**$ 51,430**

Accounts Receivable			*Dollars in Thousands*
	2010		
As of September 30	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	$ 0	N/A	$ 0
Nonfederal Receivables (From the Public)	42,609	0	42,609
Total Accounts Receivable	**$ 42,609**	**$ 0**	**$ 42,609**

The accounts receivable represents the Foreign Military Sales (FMS) Trust Fund claim for payment from other entities. The FMS Trust Fund only recognizes an allowance for uncollectible amounts from the public. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules.

NOTE 6. OTHER ASSETS

Other Assets		Dollars in Thousands
As of September 30	**2011**	**2010**
Intragovernmental Other Assets		
Advances and Prepayments	$ 0	$ 670
Other Assets	0	0
Total Intragovernmental Other Assets	**$ 0**	**$ 670**
Nonfederal Other Assets		
Outstanding Contract Financing Payments	$ 2,657,874	$ 1,833,123
Advances and Prepayments	22,573,925	18,671,318
Total Nonfederal Other Assets	**$ 25,231,799**	**$ 20,504,441**
Total Other Assets	**$ 25,231,799**	**$ 20,505,111**

Contract terms and conditions for certain types of contract financing payments convey certain rights to the Foreign Military Sales (FMS) Trust Fund that protect the contract work from state or local taxation, liens or attachment by the contractor's creditors, transfer of property, or disposition in bankruptcy. However, these rights should not be misconstrued to mean that ownership of the contractor's work has transferred to the Government. The Government does not have the right to take the work, except as provided in contract clauses related to termination or acceptance, and the FMS Trust Fund is not obligated to make payment to the contractor until delivery and acceptance of a satisfactory product.

The balance of Outstanding Contract Financing Payments includes $2.2 billion in contract financing payments and an additional $500 million in estimated future payments to contractors upon delivery and government acceptance of a satisfactory product. (See additional discussion in Note 15, Other Liabilities).

NOTE 7. CASH AND OTHER MONETARY ASSETS

Cash and Other Monetary Assets		Dollars in Thousands
As of September 30	**2011**	**2010**
Cash	$ 18,160,143	$ 18,647,997
Total Cash, Foreign Currency, and Other Monetary Assets	**$ 18,160,143**	**$ 18,647,997**

Restricted cash of $18.2 billion includes advance deposits from foreign nations in the Federal Reserve Bank which have not been transferred to the Foreign Military Sales Trust Fund and are not available for agency use (nonentity cash).

NOTE 8. DIRECT LOAN AND LOAN GUARANTEES

Direct Loan and Loan Guarantee Programs

The Defense Security Cooperation Agency (DSCA) operates the following direct loans and/or loan guarantee programs:

The Arms Export Control Act, as amended, authorizes funds to be appropriated to the President for financing the sales of defense articles and defense services to eligible foreign countries. Each loan is reviewed in the light of the purchasing country's financial condition, its need for credit, U.S. economic or military assistance programs in the country and region, and other proposed arms purchases by the country. The President delegates the Secretary of Defense the authority to issue and guaranty loans through the designated administering agency, DSCA. The loans are issued to friendly and less economically developed countries. Pursuant to the authority contained in the Act, DSCA operates the four funds, known as: For pre-1992 loans (1) Foreign Military Loan Liquidating Account (FMLLA). For post-1991 loans (2&3) the Foreign Military Direct Loan Program and Financing Accounts for post-1991 loans, and (4) the Military Debt Reduction Financing Account (MDRFA) for reducing loan receivables for eligible countries.

The FMLLA is a liquidating account that includes all assets, liabilities, and equities for loan balances recorded prior to FY 1992. No new loan disbursements are made from this account. Certain collections made into this account are made available for default claim payments. The Federal Credit Reform Act (FCRA) provides permanent indefinite authority to cover obligations for default payments in the event the funds in the liquidating account are otherwise insufficient.

Foreign Military Financing Direct Loan Program Account (FMFDLPA) is a program account that was established pursuant to FCRA to provide the funds necessary for the subsidy element of loans. Expenditures from this account finance the subsidy element of direct loan disbursements and are transferred into the Foreign Military Financing Direct Loan Financing Account (FMFDLFA) to make required loan disbursements for approved Foreign Military Sales or commercial sales.

The FMFDLFA account is a financing account that is used to make disbursements of Foreign Military Loan funds for approved procurements and for subsequent collections for the loans after September 30, 1991. The account uses permanent borrowing authority from the U.S. Treasury combined with transfers of appropriated funds from FMFDLPA account to make the required disbursements to loan recipient country borrowers for approved procurements. Receipts of debt service collections from borrowers are used to repay borrowings from U.S. Treasury.

MDRFA is a financing account that was established for the debt relief of certain countries as established by Public Law 103-87. The MDRFA buys the portfolio of loans from the FMLLA, thus transferring the loans from the FMLLA to the MDRFA. The Paris Club negotiates the debt forgiveness with Highly Indebted Poor Countries (HIPC).

The Paris Club has nineteen member countries that negotiate rescheduling or refinancing of debt for HIPC. The Paris Club provides debt reduction initially on payments coming due over a specific period corresponding to the length of an International Monetary Fund (IMF) supported economic reform program. Reduction then is staged, with each successive stage contingent upon debtor country compliance with its IMF-support program. Under Naples Terms, stock of debt reduction is provided after three years of good performance with respect to IMF reform programs and payments to Paris Club creditors. The United States incurs the budget cost of the eventual stock of debt reduction when it agrees to the initial "maturities" reduction of payments coming due, since bilateral agreements commit us to stock reduction once the Paris Club agrees to provide them.

The FCRA governs all amended direct loan obligations and loan guarantee commitments made after FY 1991 resulting in direct loans or loan guarantees.

Direct loans are reported at the net present value of the following projected cash flows: (1) loan disbursements, (2) repayments of principal, and (3) payments of interest and other payments over the life of the loan after adjusting for estimated defaults, prepayments, fees, penalties, and other recoveries.

Summary of Direct Loans and Loan Guarantees		*Dollars in Thousands*
As of September 30	**2011**	**2010**
Loans Receivable		
Direct Loans:		
Foreign Military Loan Liquidating Account	$ 958,462	$ 1,052,375
Foreign Military Financing Account	11,259	10,651
Military Debt Reduction Financing Account	14,110	12,561
Total Loans Receivable	**$ 983,831**	**$ 1,075,587**

Direct Loans Obligated		Dollars in Thousands
As of September 30	**2011**	**2010**
Direct Loans Obligated After FY 1992 (Allowance for Loss Method):		
Foreign Military Loan Liquidating Account:		
Loans Receivable Gross	$ 735,510	$ 873,975
Interest Receivable	1,573,671	1,455,012
Allowance for Loan Losses	(1,350,719)	(1,276,612)
Value of Assets Related to Direct Loans	**$ 958,462**	**$ 1,052,375**
Direct Loans Obligated After FY 1991 (Present Value Method):		
Foreign Military Financing Account:		
Allowance for Subsidy Cost (Present Value)	$ 11,259	$ 10,651
Value of Assets Related to Direct Loans	**$ 11,259**	**$ 10,651**
Military Debt Reduction Financing Account:		
Loans Receivable Gross	$ 190,745	$ 190,745
Interest Receivable	70,182	56,738
Allowance for Subsidy Cost (Present Value)	(246,817)	(234,922)
Value of Assets Related to Direct Loans, Net	**14,110**	**12,561**
Total Direct Loans Receivable	**$ 983,831**	**$ 1,075,587**

OTHER DISCLOSURES:

The DSCA bills the countries every six months for loan repayments. Applying terms of the loans with the countries, accrued interest receivable is calculated using the simple interest method. Interest accrued on unpaid balances use the same interest rate plus 4 percent for loans owed to the Federal Financing Bank.

The allowance for credit subsidy account for the FMFDLFA account is calculated taking into consideration three transactions: (1) transfers of subsidy from the program account to the financing account; (the subsidy is the difference between the expected cash outlays from the U.S. Government and the present value of the expected collections); (2) interest payments from the U.S. Treasury to the financing fund; and (3) upward adjustments due to reestimates as U.S. Treasury borrowing rates change over time from the loan repayment rate and an increase in estimated defaults on the loan.

The abnormal debit balance for the allowance of $11.3 million in the FMFDLF is the unamortized portion of the subsidy that results from a credit balance reflecting the cost of the loan to the U.S. Government. A debit balance results from: (1) interest expense paid on U.S. Treasury borrowings and (2) downward adjustments due to reestimates when the loan repayment rate exceeds the U.S. Treasury borrowing rate, and a decrease in estimated defaults. The loans in the FMFDLF account are categorized as moderate to medium risk and were expected to have an increasing amount of defaults over the years. This was built into the subsidy amount. As the loan matured, none of the loans defaulted and the U.S.

Treasury borrowing rates fell below some of the loan interest rates. This resulted in downward reestimates and a negative subsidy rate for the loans, which resulted in a debit balance in the allowance for subsidy. This unexpected debit balance has occurred for several years due to the downward reestimates due to zero defaults.

Total Amount of Direct Loans Disbursed		*Dollars in Thousands*
As of September 30	**2011**	**2010**
Direct Loan Programs		
Foreign Military Financing Account	$ 0	$ 125,054
Total	**$ 0**	**$ 125,054**

Schedule for Reconciling Subsidy Cost Allowance Balances for Post FY1991 Direct Loans		*Dollars in Thousands*
As of September 30	**2011**	**2010**
Beginning Balance, Changes, and Ending Balance:		
Beginning Balance of the Subsidy Cost Allowance	**$ 224,271**	**$ 216,696**
Adjustments		
Loans Written Off	0	(160)
Subsidy Allowance Amortization	11,287	7,735
Total of the above Adjustment Components	**$ 11,287**	**$ 7,575**
Ending Balance of the Subsidy Cost Allowance before Reestimate	**$ 235,558**	**$ 224,271**
Add or Subtract Subsidy Reestimate by Component		
Interest Rate Reestimate	0	0
Total of the above Reestimate Components	**0**	0
Ending Balance of the Subsidy Cost Allowance	**$ 235,558**	**$ 224,271**

Administrative Expenses

Administrative expenses for loans are not funded in the loan program account. The Office of Management and Budget made the decision to fund administration of loans in the Foreign Military Financing Grant account (11*1082) since the dollar amount was so low.

Note 11. Liabilities Not Covered by Budgetary Resources

Liabilities Not Covered by Budgetary Resources *As of September 30*	2011		2010	
				Dollars in Thousands
Intragovernmental Liabilities				
Accounts Payable	$	1	$	0
Debt	$	0	$	0
Other		111		120
Total Intragovernmental Liabilities	**$**	**112**	**$**	**120**
Nonfederal Liabilities				
Military Retirement and Other Federal Employment Benefits		487		486
Total Nonfederal Liabilities	**$**	**487**	**$**	**486**
Total Liabilities Not Covered by Budgetary Resources	**$**	**599**	**$**	**606**
Total Liabilities Covered by Budgetary Resources	**$**	**60,229,768**	**$**	**55,529,363**
Total Liabilities	**$**	**60,230,367**	**$**	**55,529,969**

The Liabilities Not Covered by Budgetary Resources includes liabilities for which congressional action is needed before budgetary resources can be provided. These liabilities are categorized as not covered because there is no current or immediate appropriation available for liquidation.

Military Retirement and Other Federal Employment Benefits consists of Federal Employee Compensation Act (FECA) actuarial liabilities of $487.4 thousand that is not due and payable during the current fiscal year. Refer to Note 17, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

Intragovernmental Liabilities Other, represents the amount payable to Department of Labor for FECA liabilities.

Note 12. Accounts Payable

Accounts Payable *As of September 30*	2011				*Dollars in Thousands*
	Accounts Payable		Interest, Penalties, and Administrative Fees	Total	
Intragovernmental Payables	$	334,081	N/A	$	334,081
Nonfederal Payables (To the Public)		285,823	0		285,823
Total Accounts Payable	**$**	**619,904**	**$ 0**	**$**	**619,904**

Accounts Payable			Dollars in Thousands
	2010		
As of September 30	Accounts Payable	Interest, Penalties, and Administrative Fees	Total
Intragovernmental Payables	$ 189,675	N/A	$ 189,675
Nonfederal Payables (To the Public)	330,940	0	330,940
Total Accounts Payable	**$ 520,615**	**$ 0**	**$ 520,615**

Accounts Payable includes amounts owed to federal and nonfederal entities for goods and services received by Foreign Military Sales (FMS) Trust Fund and the accounts for funds appropriated for security assistance.

The systems utilized by the FMS Trust Fund and the accounts for funds appropriated for security assistance do not track intragovernmental transactions by customer at the transaction level. The FMS therefore cannot reconcile accounts payable with other federal entities. Buyer-side accounts payable are adjusted to agree with interagency seller-side accounts receivable.

NOTE 13. DEBT

Debt			Dollars in Thousands
	2011		
As of September 30	Beginning Balance	Net Borrowing	Ending Balance
Agency Debt (Intragovernmental)			
Debt to the Treasury	$ 41,442	$ 2,158	$ 43,600
Debt to the Federal Financing Bank	421,547	(124,238)	297,309
Total Debt	**$ 462,989**	**$ (122,080)**	**$ 340,909**

Debt			Dollars in Thousands
	2010		
As of September 30	Beginning Balance	Net Borrowing	Ending Balance
Agency Debt (Intragovernmental)			
Debt to the Treasury	$ 37,819	$ 3,623	$ 41,442
Debt to the Federal Financing Bank	581,743	(160,196)	421,547
Total Debt	**$ 619,562**	**$ (156,573)**	**$ 462,989**

The Federal Credit Reform Act (FCRA) of 1990 provides financing accounts with indefinite authority to borrow from the U.S. Treasury to fund disbursements of loans made to sovereign nations for security assistance. This debt to the U.S. Treasury is reflected in the Foreign Military Financing Direct Loan Financing account and the Military Debt Reduction account.

Beginning in January 1975, the Defense Security Cooperation Act (DSCA) and the Federal Financing Bank (FFB), acting under section 24 of the Arms Export Control Act, as amended, entered into an agreement whereby the FFB would make loan agreements with friendly nations and acquire promissory notes guaranteed by DSCA. The promissory notes are considered DSCA borrowings from the FFB. The promissory notes still owed to the FFB are reflected in the Foreign Military Loan Liquidating account.

The majority of the debt represents direct and guaranteed loans to foreign countries for pre-1992 and post-1991 loans. The FCRA governs all direct loan obligations and loan guarantee commitments made after FY 1991. Before 1992, funds were borrowed from the FFB to either directly loan the funds to foreign countries or to reimburse guaranteed loans defaulted. Beginning in 1992, based on the FCRA, the security assistance program began borrowing the funds from the U.S. Treasury.

The DSCA must pay the debt if the foreign country borrower defaults on the loan. For loan defaults, DSCA must pay the outstanding principal amounts guaranteed.

NOTE 15. OTHER LIABILITIES

Other Liabilities			*Dollars in Thousands*
	2011		
As of September 30	**Current Liability**	**Noncurrent Liability**	**Total**
Intragovernmental			
FECA Reimbursement to the Department of Labor	$ 52	$ 59	$ 111
Custodial Liabilities	0	661,153	661,153
Total Intragovernmental Other Liabilities	**$ 52**	**$ 661,212**	**$ 661,264**
Nonfederal			
Accrued Funded Payroll and Benefits	$ 157	$ 0	$ 157
Advances from Others	55,899,255	2,657,874	58,557,129
Contract Holdbacks	50,517	0	50,517
Contingent Liabilities	0	0	0
Total Nonfederal Other Liabilities	**$ 55,949,929**	**$ 2,657,874**	**$ 58,607,803**
Total Other Liabilities	**$ 55,949,981**	**$ 3,319,086**	**$ 59,269,067**

Other Liabilities *As of September 30*	*Dollars in Thousands* **2010** **Current Liability**	**Noncurrent Liability**	**Total**
Intragovernmental			
FECA Reimbursement to the Department of Labor	$ 54	$ 66	$ 120
Custodial Liabilities	0	630,828	630,828
Total Intragovernmental Other Liabilities	**$ 54**	**$ 630,894**	**$ 630,948**
Nonfederal			
Accrued Funded Payroll and Benefits	$ 416	$ 0	$ 416
Advances from Others	52,047,828	1,833,123	53,880,951
Contract Holdbacks	33,564	0	33,564
Contingent Liabilities	0	0	0
Total Nonfederal Other Liabilities	**$ 52,081,808**	**$ 1,833,123**	**$ 53,914,931**
Total Other Liabilities	**$ 52,081,862**	**$ 2,464,017**	**$ 54,545,879**

Other Liabilities

Advances from Others includes $2.7 billion related to contracts authorizing progress payments based on cost as defined in the Federal Acquisition Regulation (FAR). In accordance with contract terms, specific rights to the contractors' work vest with the Federal Government when a specific type of contract financing payment is made. This action protects taxpayer funds in the event of contract nonperformance. These rights should not be misconstrued as rights of ownership. The Department is under no obligation to pay contractors for amounts greater than the amounts authorized in contracts until delivery and government acceptance. Due to the probability the contractors will complete their efforts and deliver satisfactory products, and because the amount of potential future payments are estimable, the Department has recognized a contingent liability for estimated future payments which are conditional pending delivery and government acceptance.

Total Advances from Others for progress payments based on cost represent the difference between the estimated costs incurred to date by contractors and amounts authorized to be paid under progress payments based on cost provisions within the FAR. Estimated contractor-incurred costs are calculated by dividing the cumulative unliquidated progress payments based on cost by the contract-authorized progress payment rate. The balance of unliquidated Progress Payments Based on Cost is deducted from the estimated total contractor-incurred costs to determine the contingency amount.

Note 16. Commitments and Contingencies

Claims may be presented and/or the U.S. Government may be a party in various administrative proceedings or court litigations, but it is highly unlikely that any can implicate the Foreign Military Sales Trust Fund. The U.S. funds appropriated for security assistance generally are not legally available for paying claims.

NOTE 17. MILITARY RETIREMENT AND OTHER FEDERAL EMPLOYMENT BENEFITS

Military Retirement and Other Federal Employment Benefits				*Dollars in Thousands*
	2011			
As of September 30	Liabilities	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Pension and Health Actuarial Benefits				
FECA	$ 487	0.0	$ 0.0	$ 487
Total Military Retirement and Other Federal Employment Benefits	**$ 487**	**0.0**	**$ 0.0**	**$ 487**

Military Retirement and Other Federal Employment Benefits				*Dollars in Thousands*
	2010			
As of September 30	Liabilities	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Pension and Health Actuarial Benefits				
FECA	$ 486	0.0	$ 0.0	$ 486
Total Military Retirement and Other Federal Employment Benefits	**$ 486**	**0.0**	**$ 0.0**	**$ 486**

FEDERAL EMPLOYEES' COMPENSATION ACT

Actuarial Cost Method Used and Assumptions:

The Defense Security Cooperation Agency Foreign Military Sales (FMS) Trust Fund actuarial liability for workers' compensation benefits is developed by the Department of Labor and provided to the FMS Trust Fund at the end of each fiscal year. The liability for future workers' compensation benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The liability is determined using a method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Consistent with past practice, these projected annual benefit payments have been discounted to present value using OMB'S economic assumptions for 10-year Treasury notes and bonds. Interest rate assumptions utilized for discounting were as follows:

<u>Discount Rates</u>

3.54 percent in Year 1

4.03 percent 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 (cost of living adjustments or COLAs) and medical inflation factors (consumer price index medical or CPIMs) were applied to the calculation of projected future benefits. The actual rates for these factors for the charge back year (CBY) 2011 were also used to adjust the methodology's historical payments to current year constant dollars.

The compensation COLAs and CPIMs used in the projections for various CBYs were as follows:

Federal Employees — Compensation Act (FECA)		
CBY	COLA	CPIM
2012	2.10%	3.07%
2013	2.53%	3.62%
2014	1.83%	3.66%
2015	1.93%	3.73%
2016+	2.00%	3.73%

The model's resulting projections were analyzed to ensure that the estimates were reliable. The analysis was based on four tests: (1) a sensitive analysis of the model to economic assumptions; (2) a comparison of the percentage change in the liability amount to the percentage change in the actual incremental payments; (3) a comparison of the incremental paid losses per case (a measure of case-severity) in CBY 2011 to the average pattern observed during the most current three CBYs; (4) a comparison of the estimated liability per case in the CBY 2011 projection to the average pattern for the projections of the most recent three years.

Note 18. General Disclosures Related to the Statement of Net Cost

Costs and Exchange Revenue		*Dollars in Thousands*
As of September 30	2011	2010
Operations, Readiness & Support		
1. Gross Cost		
A. Intragovernmental Cost	$ 3,416,436	$ 1,814,121
B. Nonfederal Cost	$ 21,271,005	$ 21,703,202
C. Total Cost	$ 24,687,441	$ 23,517,323
2. Earned Revenue		
A. Intragovernmental Revenue	$ (738)	$ (3,940)
B. Nonfederal Revenue	$ (33,603)	$ (130,918)
C. Total Revenue	$ (34,341)	$ (134,858)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$	$
Total Net Cost	**$** 24,653,100	**$** 23,382,465

Costs and Exchange Revenue		*Dollars in Thousands*
As of September 30	**2011**	**2010**
Consolidated		
1. Gross Cost		
A. Intragovernmental Cost	$ 3,416,436	$ 1,814,121
B. Nonfederal Cost	$ 21,271,005	$ 21,703,202
C. Total Cost	$ 24,687,441	$ 23,517,323
2. Earned Revenue		
A. Intragovernmental Revenue	$ (738)	$ (3,940)
B. Nonfederal Revenue	$ (33,603)	$ (130,918)
C. Total Revenue	$ (34,341)	$ (134,858)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$	$ 0
4. Costs Not Assigned to Programs		
5. (Less: Earned Revenues) Not Attributed to Programs	$	$
Total Net Cost	**$** 24,653,100	**$** 23,382,465

Intragovernmental costs and revenue are related to transactions made between two reporting entities within the Federal Government.

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the Federal Government supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity. The Department's current processes and systems do not capture and report accumulated costs for major programs based upon the performance measures as required by the Government Performance and Results Act. The Department is in the process of reviewing available data and developing a cost reporting methodology as required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government", as amended by SFFAS No. 30, "Inter-entity Cost Implementation."

Intragovernmental costs and revenue represent transactions made between two reporting entities within the Federal Government.

Public costs and revenues are exchange transactions made between the reporting entity and a nonfederal entity.

The systems utilized by Defense Security Cooperation Agency for the Foreign Military Sales (FMS) Trust Fund and the accounts for funds appropriated for security assistance do not track intragovernmental transactions by customer at the transaction level. In 3rd quarter 2010, the FMS Trust Fund incorporated the DoD trading partner process. The FMS Trust Fund adjusted expenses by reclassifying amounts between federal and nonfederal expenses and accruing additional payables and expenses. Intradepartment revenues and expenses are then eliminated.

The DSCA does not meet accounting standards. Information presented is based on budgetary obligations, disbursements, and collections transactions, as well as nonfinancial feeder systems adjusted to record known accruals for major items such as payroll expenses and accounts payable.

NOTE 19. DISCLOSURES RELATED TO THE STATEMENT OF CHANGES IN NET POSITION

The Appropriations Received on the Statement of Budgetary Resources do not agree with Appropriations on the Statement of Changes in Net Position. The difference of $24 billion is due to the Foreign Military Sales Trust Fund receipts from foreign governments that liquidate contract authority, but are not recorded as appropriations on the Statement of Changes in Net Position. These receipts are transferred from the receipt account to cover disbursements as they occur, similar to the receipt of appropriations.

NOTE 20. DISCLOSURES RELATED TO THE STATEMENT OF BUDGETARY RESOURCES

Disclosures Related to the Statement of Budgetary Resources	Dollars in Thousands	
As of September 30	2011	2010
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period.	$ 121,409,053	$ 112,315,078

On the Statement of Budgetary Resources (SBR), obligations incurred of $33.8 billion are direct and exempt from apportionment.

The SBR includes intraentity transactions because the statements are presented combined.

Borrowings from the U.S. Treasury are required to be repaid once a year at the end of the fiscal year. The financing sources for the repayments on borrowings are loan repayments from the countries or permanent indefinite appropriations through subsidy reestimates.

The portions of the Foreign Military Sales (FMS) Trust Fund receipts collected in the current fiscal year that exceed current outlays are temporarily precluded from obligation by law. These receipts, however, are available for obligation as needed in the future.

The Federal Credit Reform Act of 1990 (FCRA) provides permanent indefinite appropriations to fund upward subsidy reestimates that fund repayments of principal and interest of U.S. Treasury borrowings with the Foreign Military Financing Direct Loan Program and the Military Debt Reduction Financing Account. The FCRA also provides permanent indefinite appropriations to fund loan defaults with the Federal Financing Bank in the Foreign Military Loan Liquidating Account.

The Appropriations on the SBR do not agree with Appropriations Received on the Statement of Changes in Net Position. The difference of $24 billion is due to the FMS Trust Fund contract authority not being reported as appropriation received on the Statement of Changes in Net Position.

Legal limitations and time restriction on the use of unobligated appropriation balances are provided under Public Law.

Unobligated Balances Apportioned includes an abnormal balance of $22.9 million in USSGL account 4510 (Apportionments). This was systematically created to reverse funding in order to keep the trial balance and reconciliation in balance.

NOTE 21. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

Reconciliation of Net Cost of Operations to Budget		*Dollars in Thousands*
As of September 30	**2011**	**2010**
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations incurred	$ 33,771,432	$ 32,902,219
Less: Spending authority from offsetting collections and recoveries (-)	(180,802)	(314,210)
Obligations net of offsetting collections and recoveries	**$ 33,590,630**	**$ 32,588,009**
Less: Offsetting receipts (-)	(23,946,831)	(24,010,756)
Net Budgetary Resources Obligated	**$ 9,643,799**	**$ 8,577,253**
Total resources used to finance activities	**$ 9,643,799**	**$ 8,577,253**
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided:		
Undelivered Orders (-)	**$** 9,093,975)	**$** 9,279,409)
Resources that fund expenses recognized in prior Periods	(8)	0
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	24,105,570	24,301,304
Resources that finance the acquisition of assets (-)	(2,287)	(130,507)
Total resources used to finance items not part of the Net Cost of Operations	**$ 15,009,300**	**$ 14,891,388**
Total resources used to finance the Net Cost of Operations	**$ 24,653,099**	**$ 23,468,641**
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in Future Period:		
Other (+/-)	$ 1	$ 71
Total components of Net Cost of Operations that will Require or Generate Resources in future periods	**$ 1**	**$ 71**
Components not Requiring or Generating Resources:		
Revaluation of assets or liabilities	$ 0	$ (86,247)
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	**$ 1**	**$ (86,176)**
Net Cost of Operations	**$ 24,653,100**	**$ 23,382,465**

The following Reconciliation of Net Cost of Operations to Budget lines are presented as combined instead of consolidated due to intraagency budgetary transactions not being eliminated:

- Obligations Incurred
- Less: Spending Authority from Offsetting Collections and Recoveries

- Obligations Net of Offsetting Collections and Recoveries
- Less: Offsetting Receipts
- Net Obligations
- Undelivered Orders
- Unfilled Customer Orders

Components Requiring or Generating Resources in Future Period, Other represents the FECA liabilities and the related actuarial liabilities not requiring current year budget authority.

Due to the Foreign Military Sales Trust Fund system limitations, budgetary data is not in agreement with proprietary expenses and assets capitalized. The difference between budgetary and proprietary data is a previously identified deficiency.

Contributors to the Fiscal Year 2011 Agency Financial Report

In addition to the significant contributions of the individuals listed below, many other individuals in the Office of the Secretary of Defense and the Military Services contributed to the development of this Agency Financial Report.

Crystal D. Allen
Colonel Mark E. Allen
Lyndi Balven
William Beasley
Sally C. Beecroft
Debora Brand
Steven Bringle
Javier Castro
Nina Chun
Victoria A. Crouse
Gerald Davenport
Thomas P. Dee
M. Scott Deutsch
Monique Dilworth
Dr. Michael Dinneen
Mark E. Easton
Colonel John S. Fant
Daniel Folliard
Linda J. Gileau
Sandra A. Gregory
David R. Gross
Robert F. Hale
Bonnie M. Hammersley
John T. Hastings
Galen M. Heflin
John J. Hunter
Patty Issler
Robert T. Jennings
Joseph M. Jones
Bryan Kitchens
Robert J. Koss
Gregory P. Kuechler
Joseph Leonard
Lt. Col. Vincent R. Littrell
Mark S. Loepker
Joseph W. Lontos, Jr.
Jerome S. Macken
Faafiti Malufau
Michael J. Metzger
CAPT Reece D. Morgan
Marianne Petty
Carol S. Phillips
Joseph O. Quinn
Robert G. Ravas
Paula J. Rebar
Ginger Bressler Rice
Jean M. Rice
Sandra V. Richardson
Terry L. Roberts
Angela M. Rogers
John P. Roth
John F. Ruoff
Kathy Sherrill
Thomas F. Simoes
Dr. Robert Francis Smith
Justin Sweetman
Stephen Tabone
Steve Tkac
Steve Weidenkopf
Keith Welk
Brent White
Anthony A. Wisdom
Peter Wright
James R. Wroten
Dwight Young
Jennifer N. Zakriski

WELCOME TO THE DEPARTMENT OF DEFENSE

We are interested in your feedback
regarding the content of this report.

Please feel free to send your comments to

DoDAFR@osd.mil

or

United States Department of Defense
Office of the Under Secretary of Defense (Comptroller)
1100 Defense Pentagon
Washington, DC 20301-1100

You may also view this document at:
http://comptroller.defense.gov/afr/fy2011.html

KNOW YOUR BUSINESS
CONTROL YOUR FUTURE