DEPARTMENT OF DEFENSE AGENCY FINANCIAL REPORT FISCAL YEAR 2012

OFFICE OF THE UNDER SECRETARY OF DEFENSE
(COMPTROLLER) / CHIEF FINANCIAL OFFICER

FOREWORD

The Department of Defense Agency Financial Report (AFR) for Fiscal Year (FY) 2012 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 2012, 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 2012 reporting consists of three components:

- Agency Financial Report – Published November 15, 2012
- Annual Performance Report – Published February 6, 2013
- Summary of Performance and Financial Information – Published February 15, 2013

All three reports will be available at the Under Secretary of Defense (Comptroller) public website: *http://comptroller.defense.gov/*

Agency Financial Report (AFR)

The AFR consists of the Management's Discussion and Analysis section 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 measure.

Summary of Performance and Financial Information (SPFI)

The SPFI 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.

DoD photo by Helene C. Stikkel

TABLE OF CONTENTS

Preparation of this study/report cost the Department of Defense a total of approximately $228,000 in Fiscal Year 2012.

Generated on 11/09/2012
RefID: 3-A8D5B25

A MESSAGE FROM THE DEPUTY SECRETARY OF DEFENSE

I appreciate the opportunity to introduce the Department of Defense (DoD) Agency Financial Report (AFR) for Fiscal Year (FY) 2012. This report contains the most complete financial picture of how the Department managed taxpayer resources last year.

The AFR accounts for nearly $650 billion in funds Congress appropriated to the Department. It explains how that money was used to provide America's military with the resources necessary to provide for our nation's security as we deal with a complex set of national security challenges in the Middle East, the Asia-Pacific region, and elsewhere.

During Fiscal Year 2012 we established a new national security strategy that guided efforts to reduce defense spending. The Budget Control Act of 2011 led to reductions of $487 billion in defense budgets in the ten years beginning in FY 2012. To accommodate these reductions, the new strategy accepts smaller and leaner forces but requires that they be highly ready. We will no longer maintain forces needed for large, prolonged stability operations, but we will rebalance our forces to the Mideast and the Asia-Pacific region. Overall, this new strategy will permit us to reduce defense funding while meeting key national security objectives in an effective manner.

This AFR also describes efforts within DoD to improve business practices and reduce overhead costs. The initiative aims at achieving more than $150 billion in efficiencies over the five-year period from Fiscal Years 2012 to 2017.

Lastly, this report summarizes our efforts to improve the Department's financial management. We aggressively sought the financial flexibility we need to meet the emerging needs of our warfighters, especially those in combat. We also sought to improve our systems and business process to achieve audit readiness. At the direction of Secretary Panetta, the DoD management team has accelerated the pace for key elements of this audit initiative. For example, we now expect to achieve audit readiness for the Statement of Budgetary Resources for general funds by the end of 2014.

In presenting this report, I salute the Department's 58,000 financial managers, both military and civilian. Their hard work and dedication were vital to the Defense organization and its mission in Fiscal Year 2012. They did everything asked of them and more. This report is their story.

Ashton B. Carter
Deputy Secretary of Defense

This Page Left Blank Intentionally

A MESSAGE FROM THE CHIEF FINANCIAL OFFICER

I take pride in presenting the Department of Defense (DoD) Agency Financial Report for Fiscal Year (FY) 2012. This document highlights the Department's management of the billions of dollars that the Congress appropriated last year for the Nation's defense.

As the report explains, the dedication and professionalism of the Department's financial management workforce ensured that the men and women of America's military were supplied with the resources they needed to do their jobs. In particular, we met the changing financial requirements of our warfighters and commanders while working within the confines of our budget and our fiscal laws. Because of the time required for assembly and review, the Department puts together budgets two to three years before they are executed. Especially during war, there are inevitably changes in budgetary requirements during this two- to three-year period. Working with the Congress, the Department has used techniques, such as reprogramming, to meet the emerging needs of our warfighters and commanders. I appreciate the support of the Department's managers, and the support of the Congress, in this important endeavor.

Fiscal Year 2012 also marked the beginning of a major initiative to improve the efficiency of the Department's business operations. The Department seeks to find ways to meet warfighter needs at less cost by changing process so they can be accomplished with fewer civilian employees, eliminating lower-priority organizations, and reducing overhead through approaches such as strategic sourcing and information technology consolidation. I am teaming with our Deputy Chief Management Officer to monitor the implementation of these important changes.

During Fiscal Year 2012, we made substantial progress toward improving financial management in the Department and achieving audit readiness. Despite significant obstacles, we are steadily moving toward our goal of audit readiness by 2014 for our highest-priority financial information - the Statement of Budgetary Resources for general funds and counts and locations of key assets – as well as auditability for all financial statements by 2017. We also made continued progress in creating a course-based certification program for defense financial managers that will allow us to improve training in many areas, including audit readiness.

I am very proud of the efforts of all of the Department's employees and particularly its financial managers. Their commitment to the Department's mission and to financial stewardship is second to none.

Robert F. Hale

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

This Page Left Blank Intentionally

MANAGEMENT'S DISCUSSION AND ANALYSIS

FISCAL YEAR 2012 OVERVIEW

The Department of Defense fields, sustains, and employs the military capabilities necessary to protect the United States and its allies and to advance our national interests. Key among America's interests is security, prosperity, broad respect for universal values, and an international order that promotes cooperative action.

Leon E. Panetta
Secretary of Defense

For FY 2012, the Department continued to shape its program based on the defense strategy expressed in the *2010 Quadrennial Defense Review* (QDR) report, a legislative-mandated review of DoD strategies and priorities. The 2010 QDR identified 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
- Preserve and enhance the All-Volunteer Force

To enhance the ability of U.S. forces to protect and advance U.S. interests in both the near- and long-term, the Department has focused on prevailing in today's wars and rebalancing military capabilities to prepare for an uncertain future. The Department also has sought to further reform our institutions and processes to better support the urgent needs of the warfighter; buy weapons that are effective, affordable, and truly needed, and ensure taxpayer dollars are spent wisely and responsibly. The 2010 QDR and the FY 2012 budget also address the Department's imperative to take care of its people. Much has been asked of the All-Volunteer Force and the civilians who have supported that force over the past decade, and, as a nation, we are obligated to take care of our people to the best of our ability.

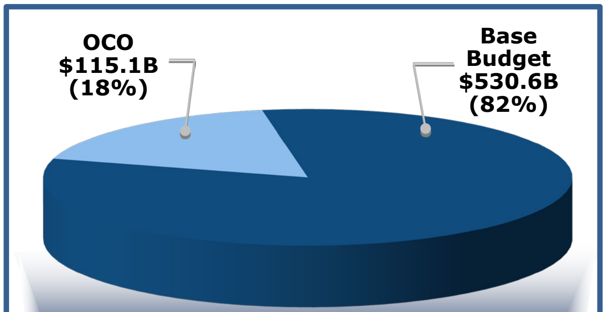
During FY 2012, the Department's enacted appropriations amounted to $645.7 billion (Figure 2 depicts the composition of DoD's budget authority). The DoD FY 2012 budget was crafted to rebalance the priorities of America's defense establishment, institutionalizing successful wartime innovations to better enable success in today's wars while ensuring that our forces are prepared for a complex future. The 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.

The Overseas Contingency Operations (OCO) resources enabled the Department to support and fund efforts primarily in Afghanistan and Iraq. The Department continued activities under Operation New Dawn (OND)/post-OND Iraq activities, as it worked to complete the military mission and the responsible drawdown of forces in accordance with the U.S.-Iraq Security Agreement and transition of authority, building on Iraq's improving security gains. In December 2011, the U.S. made good on its pledge to end the "advise and assist" mission in Iraq.

Figure 1. Mission

In Afghanistan, our goal remains to disrupt, dismantle, and eventually defeat al-Qa'ida and to prevent their return to either Afghanistan or Pakistan. U.S. coalition and Afghan forces have arrested the Taliban's momentum in much of the country and reversed it in several key areas. The last of the 33,000 surge troops sent to Afghanistan nearly two years ago to contain the Taliban insurgency have left the country. 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. We also continue to apply relentless pressure to al-Qa'ida and other terrorist networks around the globe that threaten the U.S., its allies and partners, and our interests abroad.

Figure 2. Department of Defense FY 2012 Enacted Budget ($645.7B)



Budget by Appropriation	$ in Billions
Military Personnel	153.1
Operation and Maintenance	284.0
Procurement	120.6
RDT&E	71.9
Military Construction	11.3
Family Housing	1.7
Revolving Funds	3.1
Total	**$645.7**

B10-17

In addition, during FY 2012, the Department concluded its portion of the U.S. Government's support to the North Atlantic Treaty Organization (NATO)-led mission in Libya, Operation Unified Protector, to respond to Muammar Gaddafi's brutal behavior against the people of Libya. The U.S. Government and its international partners acted to mobilize a broad coalition, secure an international mandate to protect civilians, stop an advancing army, prevent a massacre, and establish a no-fly zone.

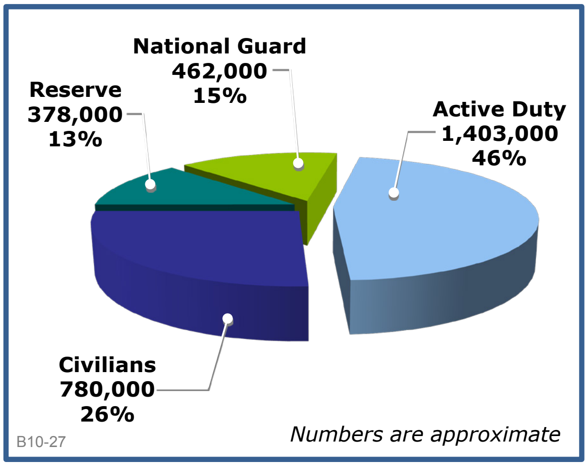
Also during FY 2012, the Department deployed approximately 100 U.S. military personnel to the areas of Central Africa affected by the Lord's Resistance Army (LRA). These military personnel advised and assisted the regional forces pursuing the LRA and its leadership, who have been indicted by the International Criminal Court. The Department also utilized its new authority, section 1206 of the FY 2012 National Defense Authorization Act (NDAA), to train and equip foreign forces participating in the effort to counter the LRA.

The Department's FY 2012 budget also looked ahead, continuing the process of rebalancing the capabilities of the Armed Forces to confront future threats. For example, the Department made investments to ensure that we can operate effectively in cyberspace and maintain resilient and reliable networks that can operate in contested environments. The defense program strengthened capabilities for projecting power, such as the long-range strike family of weapons systems. The FY 2012 budget also included funding to ensure that the U.S. nuclear posture continues to provide a safe, secure, and effective deterrent as we implement the *New START Treaty*.

The Department sought to further reform our institutions and processes--buying weapons that are effective, affordable, and truly needed, and ensuring taxpayer dollars are spent wisely and responsibly. We continue to invest in weapon systems and capabilities to counter 21st Century threats, support the workforce, and accomplish mission requirements and objectives. Development, modernization and recapitalization of equipment, focused on current and emerging threats, greatly improved combat capability. These new capabilities include the fifth generation Joint Strike Fighter, the Littoral Combat Ship, a new generation of ground vehicles, and many more weapons.

The FY 2012 budget also addressed the Department's imperative to take care of its 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 is staffed by approximately 1,403,000 men and women on Active Duty, 840,000 Reservists and National Guard members, and 780,000 civilians (Figure 3).

Figure 3. Staffing as of August 31, 2012



During FY 2012, the Department mobilized approximately 75,500 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 Active Components and five of the six Reserve Components met or exceeded their numerical accession goals for FY 2012. The Army Reserve finished 834 short for the year. This shortfall was the result of precision recruiting, which was implemented to balance the right mix of skilled personnel with the right set of requirements. All Active and Reserve Components exceeded recruit quality benchmarks in FY 2012 – 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.

A soldier uses his hand held radio to give a situation report to members of his company while other soldiers provide security during a dismounted foot patrol. The soldiers are assigned to the Michigan Army National Guard.

U.S. Army photo by Staff Sgt. Helen Miller

Throughout FY 2012, the civilian workforce continued to play a critical role in supporting the accomplishment of the Department's mission. In FY 2012, we witnessed their continued voluntary and enthusiastic participation in new and challenging roles, especially in support of the Department's wartime efforts. The *Civilian Expeditionary Workforce Program* has deployed volunteers to war zones to serve in career fields as diverse as intelligence, public affairs, policy development, financial management, 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 at Muscatatuck Urban Training Center and at the Indiana National Guard Camp Atterbury Joint Maneuver Training Center, 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 force.

To protect the security of the U.S., the Department operates almost 16,000 aircraft, almost 600 ships, and many ground units. The Department's worldwide infrastructure includes more than 555,000 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 2.2 million acres, or the Navy's large complex of installations in Norfolk, Virginia.

The Department's FY 2012 resources also funded the construction and maintenance of additional modernized housing, both government-owned and privatized. In addition, the Department built schools for DoD dependents and medical facilities. The Department funded the operation of 254 commissaries and education for over 87,000 students in 194 schools.

The *Base Realignment and Closure* (BRAC) initiatives continued with $582.3 million in funding, which allowed the Department to provide environmental remediation and caretaker operations at properties not disposed of or handed over to local reuse authorities.

Even as we continued our strategic emphasis on prevailing in today's conflicts and rebalancing capabilities to prepare for future threats, in FY 2012 we continued an aggressive pursuit of efficiencies throughout the Department. The FY 2012 budget proposed more than $150 billion in savings from efficiencies, continuing initiatives begun in FYs 2010 and 2011. Recognizing the fiscal pressures the country is facing, in FY 2012 the Department launched a comprehensive effort – within the Military Services and in the Department as a whole – to generate efficiency savings by reducing overhead costs, improving business practices, and terminating lower priority or troubled programs. We redirected resources away from those programs and activities so that more pressing needs can be addressed.

The Department remains dedicated to obtaining, investing, and effectively using its financial resources to ensure the security of the U.S. and to meet the needs of both the warfighter and the ever-changing battlefield. The strategic placement of the Department's personnel, installations, and facilities is essential 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. Taking care of our people, reshaping and modernizing the force, and supporting our troops in the field remain the highest priorities for the Department.

U.S. Army paratroopers and Afghan soldiers and policemen conduct a presence patrol in Afghanistan's Ghazni province.

U.S. Army photo by Sgt. Michael J. MacLeod

PERFORMANCE GOALS, OBJECTIVES, AND RESULTS

This section presents some of the key goal and measures that we use to assess our success in the Department of Defense.

DEPARTMENT OF DEFENSE STRATEGIC PLAN

The Quadrennial Defense Review (QDR) examines national defense strategy, force structure, infrastructure, budget plans, and other elements of the defense program, consistent with *National Security Strategy*, *National Defense Strategy*, and *National Military Strategy*. Consequently, the QDR Report constitutes DoD's Strategic Plan and forms the basis for development of the Department's Annual Performance Plan.

Figure 4. DoD Strategic Goals

In addition to the four QDR priorities--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 it does business. Consequently, these five reflect the Department's Strategic Goals. Strategic goals 1 through 3 reflect DoD's core warfighting missions, and Strategic goals 4 and 5 focus on DoD infrastructure support (Figure 4).

- Strategic Goal 1, "Prevail in Today's Wars," refers to 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," indicates 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, "Reform the Business and Support Functions of the Defense Enterprise," focuses on improving and integrating DoD business operations to better support the warfighter.

DEPARTMENT OF DEFENSE (DOD) PERFORMANCE HIERARCHY

The FY 2012 Performance Plan, as updated in the FY 2013 President's Budget, reflects 5 overarching Department strategic goals, as well as 20 strategic objectives and 72 enterprise-level or DoD-wide performance goal priorities. The following section describes a representative sample of key strategic objectives and performance goals from the Department's FY 2012 Annual Performance Plan.

Primary responsibility for performance improvement rests with the Deputy Secretary of Defense in his role as the Chief Management Officer (CMO). 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 and of highest priority for DoD-wide management. The Department's strategic objectives and performance goals are subject to annual refinement based on changes in missions and strategic direction. Figure 5 shows that every level within the Defense Department is accountable for performance and results.

Figure 5. Department of Defense Performance Budget Hierarchy

FY 2012 DEPARTMENT OF DEFENSE KEY PERFORMANCE RESULTS

The following tables, organized by DoD strategic goal and objective, depict 17 key performance measures for FY 2012. Unless otherwise stated, the results reflect progress through the third quarter and show that the Department is on track to meet 71 percent of these key performance goals for FY 2012 and will come close to meeting most other goals.

Strategic Goal 1: Prevail in Today's Wars

The Afghan National Security Force (ANSF) is the backbone of long-term security and stability plans for Afghanistan (Strategic Objective 1.1-OCO). The ANSF is on schedule to achieve its October 2012 surge end strength recruitment goal of 352,000, including the subordinate goals of 195,000 soldiers and 157,000 police. The ANSF has grown to a force of over 337,000, including 185,000 soldiers, 147,000 police and 5,500 airmen. As the Afghan National Army and the Afghan National Police have achieved growth goals, the ANSF and the North Atlantic Treaty Organization (NATO) Training Mission – Afghanistan (NTM-A) have shifted focus from force generation to training and development. The ANSF continues to develop into a force capable of assuming the lead for security responsibility throughout Afghanistan by the end of 2014.

STRATEGIC GOAL 1: PREVAIL IN TODAY'S WARS.				
Key Performance Measures	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2011 Results	**FY 2012 Goals**	**FY 2012 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.				
1.1.4-OCO: Cumulative number of Afghan National Security Force (ANSF) end strength	1.1.4-OCO: By FY 2012, the DoD will improve combat effectiveness by increasing the Afghan National Security Forces to 352,000.	306,903	352,000	■ 337,351

Goal 2: Prevent and Deter Conflict

Four 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 (Strategic Objective 2.1-1F1). The ability to successfully execute military operational plans is a core competency of the Department. By the end of the third quarter, the DoD Combatant Commanders were meeting all of their readiness goals and actually exceeding the DoD goal for being ready to execute contingency plans. In FY 2012, the Army completed the modular conversion of 228 of its 229 planned Multi-Functional and Functional (MFF) brigades, with the final MFF brigade activation scheduled for the fourth quarter of FY 2013. In addition, Defense Nuclear Surety Inspection results have consistently improved over the last four years

The USS Carl Vinson leads the USS Bunker Hill and the USS Halsey during a passing exercise with Indian navy ships during Exercise Malabar 2012 in the Indian Ocean.

U.S. Navy photo by Seaman George M. Bell and are currently achieving the desired goal of 100 percent first-time pass rate (Strategic Objective 2.2-1F2A). This is a positive indication of sustained Military Services' excellence and senior leader focus on the nuclear enterprise.

While the Department has fielded one more Aegis Ballistic Missile Defense (BMD)-capable ship today than it had in FY 2011 (Strategic Objective 2.3-1F3), the FY 2012 third quarter result (24 ships) falls significantly below the year-end projection (29 ships). By the end of calendar year 2012, 28 ships are scheduled for completion. Due to an austere budget environment, the Department reduced the number of funded Aegis BMD-capable ships to 31 through FY 2013. In the President's 2013 budget, the Department maintains funding for 36 BMC ship conversions through FY 2018.

STRATEGIC GOAL 2: PREVENT AND DETER CONFLICT.				
Key Performance Measures	Strategic Plan Long-Term Performance Goals	Annual Performance Goals/Results		
		FY 2011 Results	FY 2012 Goals	FY 2012 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.				
2.1.2-1F1: Percent of the DoD Combatant Commanders' (CoComs) Contingency Plans which they report ready to execute	2.1.2-1F1: For each fiscal year, DoD Combatant Commanders (CoComs) will be ready to execute at least 80 percent of their Contingency Plans.	85%	80%	91%
2.1.4-1F1: Cumulative number of Army Multi-functional and functional Support (MFF) brigades converted to a modular design and available to meet military operational demands	2.1.4-1F1: By FY 2013, the DoD will convert 229 Army Multi-functional and functional Support (MFF) brigades to a modular design.	225	227	228
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.	85.7%	100%	100%
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.	23	29	24

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

A Navy Lieutenant carries a young girl to safety on Naval Air Station Joint Reserve Base New Orleans, Louisiana.

U.S. Air Force photo by Master Sgt. Dan Farrell

One key performance goal, carried over from FY 2011, is focused on establishing and certifying Homeland Response Forces (HRFs) at a response time of 6 – 12 hours (Strategic Objective 3.1-1F2B). The HRFs are operationally focused and aligned to the ten Federal Emergency Management Agency regions, and sourced by either a single state or a collection of states in that region. The HRFs, under control of the state governors, deploy in 6 – 12 hours with life-saving capabilities (emergency medical, search and extraction, decontamination, security, and command and control) supporting the needs of civilian agencies in response to chemical, biological, radiological, or nuclear incidents. By the end of FY 2012, the DoD had certified all ten HRFs located in the states of California, Missouri, Georgia, Pennsylvania, Ohio, Washington, Texas, New York, Utah, and Massachusetts.

STRATEGIC GOAL 3: PREPARE TO DEFEAT ADVERSARIES AND SUCCEED IN A WIDE RANGE OF CONTINGENCIES				
Key Performance Measure	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2011 Results	**FY 2012 Goals**	**FY 2012 3 Qtr Results**
Strategic Objective 3.1-1F2B: Improve the responsiveness and flexibility of consequence management response forces.				
3.1.1-1F2B: Cumulative number of Homeland Response Forces (HRFs) trained, equipped, evaluated, and validated at a reduced response time of 6-12 hours	3.2.1-1F2: By FY 2012, the DoD will have and maintain 10 Homeland Response Forces (HRFs) trained, equipped, evaluated, and validated at a reduced response time of 6-12 hours to a very significant or catastrophic event.	2	10	■ 8

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

The Department is on track to achieve three of four key performance goals that affect its ability to maintain an All Volunteer military. In the area of military health care costs (Strategic Objective 4.1-2M), outpatient prospective payment systems have yielded pricing reductions for private sector care as these are phased into full implementation. Pharmacy rebates provide reductions in retail pharmacy which is the highest cost pharmacy venue.

Less progress has been made in conversion to the Integrated Disability Evaluation System (IDES), which was completed in FY 2011 and is now used for all Service member disability evaluation processing. In this area, all Military Services report staffing shortages and information technology challenges. Mitigation measures include additional staff and actions to streamline medical and physical evaluation boards.

While the Services continue to meet their end strength goals for both Active and Reserve components, managing the deployment tempo remains a challenge (Strategic Objective 4.2-2P). In FY 2012, the Army made significant progress from 86 percent at the end of FY 2011 to 90 percent at the end of third quarter of FY 2012 for time deployed and time at home. In addition, the Department met its quarterly goal for civilian hiring for the first three quarters of FY 2012 and is on track to meet the annual, Federal-wide timeliness goal of 80 days for external hires. The use of USA Staffing has improved the Department's hiring timeliness and enabled human resource professionals to manage the end-to-end process more effectively.

Defense Secretary Leon E. Panetta, center, and Army Chief of Staff General Raymond T. Odierno, far left, pose for a photograph with the athletes of the 2012 Warrior Games in the Pentagon courtyard. The Warrior Games is an annual sporting event for wounded, ill and injured service members.

U.S. Army photo by Staff Sgt. Teddy Wade

STRATEGIC GOAL 4: PRESERVE AND ENHANCE THE ALL-VOLUNTEER FORCE.				
Key Performance Measures	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2011 Results	**FY 2012 Goals**	**FY 2012 3 Qtr Results**
Strategic Objective 4.1-2M: Provide top-quality physical and psychological care to wounded warriors, while reducing growth in overall healthcare costs.				
4.1.1-2M: Average percent variance in Defense Health Program annual cost per equivalent life increase compared to average civilian sector increase	4.1.1-2M: Beginning in FY 2007, the DoD will maintain an average Defense Health Program medical cost per equivalent life increase at or below the average healthcare premium increase in the civilian sector.	1.4%	</=0%	-8.3%
4.1.3-2M: Percent of Service members who are processed through the Single Disability Evaluation System (IDES) within 295 days (Active) and 305 days (Reserve) Components.	4.1.3-2M: By FY 2014, 80 percent of Service members will be processed through the IDES within 295 days (Active) and 305 days (Reserve) Components.	Non-applicable	60%	20%
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.				
4.2.3-2P: 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	4.2.3-2P: By FY 2015, 95 percent of active duty Army personnel will meet the deployment to dwell objective of 1:2.	85.7%	80%	90%
4.2.8-2P: Number of days for external civilian hiring (end-to-end timeframe)	4.2.8-2P: By FY 2012, the Department will improve and maintain its timeline for all external (direct hire authority, expedited hire authority, and delegated examining) civilian hiring actions to 80 days or less.	104	80	82

Strategic Goal 5: Reform the Business and Support Functions of the Defense Enterprise

The Department is on track to achieve five of seven key performance goals to improve business-related support across the Defense enterprise. However, the Department is under-executing its share of the Federal-wide initiative to reduce the number of data centers (Strategic Objective 5.2-2C).

An F-16 Fighting Falcon launches at dawn during a Peninsula Operational Readiness Exercise on Kunsan Air Base, South Korea. The exercise ensures service members are capable of performing their duties in wartime conditions.

U.S. Air Force photo by Staff Sgt Rasheen A. Douglas

Perhaps the most noteworthy result shows the average rate of Major Defense Acquisition Program (MDAP) cost growth (at 0.13 percent) – significantly below the annual FY 2012 goal of three percent (Strategic Objective 5.3-2E). However, the Department is not meeting its FY 2012 cycle time goal. Most of the programs in the portfolio of MDAPs starting in FY 2002 and after have experienced little or even, in some cases, negative cycle time growth. However, there are a total of 10 programs out of 28 in the measured population with cycle time growth exceeding five percent. Collectively, they result in the 6.26 average percent cycle time growth for the third quarter of FY 2012.

In the area of Major Automated Information System (MAIS) acquisition, the Department is meeting its goal to restrain the number of "critical" MAIS breaches to no more than two per year.

In the area of logistics (Strategic Objective 5.4-2L), all Military Services are meeting FY 2012 customer wait goals. The Army has made the most substantive improvement by reducing its average customer wait time by 13 percent (from 14.1 days in FY 2011 to 12.3 days at the end of the third quarter of FY 2012). This improvement was achieved by receiving materiel at selected sites through the nearest supply activity which allowed closing orders faster.

The Department relies on four key performance indicators or measures to assess its progress with regard to becoming audit ready. All of the measures are focused on the accuracy and reliability of the Department's ledgers, accounting systems, and associated financial reports. As of the third quarter (Strategic Objective 5.5-2U/V), the Department had exceeded its FY 2012 annual goals pertaining to the audit readiness of DoD mission-critical assets and for achieving audit readiness of DoD's Statement of Budgetary Resources (SBR) for Appropriations Received. An independent public accountant examination of the Defense Agencies' appropriations received will be completed in FY 2013.

STRATEGIC GOAL 5: REFORM THE BUSINESS AND SUPPORT FUNCTIONS OF THE DEFENSE ENTERPRISE.				
Key Performance Measures	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2011 Results	**FY 2012 Goals**	**FY 2012 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.				
5.2.2-2C: Cumulative percent reduction in the number of DoD data centers	5.2.2-2C: By FY 2015, the DoD will reduce its number of data centers by 45 percent (from 772 in FY 2010 to 428 in FY 2015) in order to increase data center storage utilization/capacity.	7%	19%	11.3%
Strategic Objective 5.3-2E: Improve acquisition processes, from requirements definition to the execution phase, to acquire military-unique and commercial items.				
5.3.2-2E: Average percent increase from the Acquisition Program Baseline (APB) cycle time for Major Defense Acquisition Programs (MDAPs) starting in FY 2002 and after	5.3.2-2E: Beginning in FY 2011, the DoD will not increase by more than five percent from the Acquisition Program Baseline (APB) cycle time for Major Defense Acquisition Programs (MDAPs) starting in FY 2002 and after.	4.5%	</=5%	6.3%
5.3.5-2E: Number of Major Automated Information System (MAIS) "critical" breaches (equal to or greater than 25 percent of Acquisition Program Baseline (APB) total cost or with schedule slippages of one year or more))	5.3.5-2E: By FY 2012, the DoD will ensure that the number of MAIS "critical" breaches (equal to or greater than 25 percent of Acquisition Program Baseline (APB) total cost or with schedule slippages of one year or more)) will not exceed two.	1	2	2
5.3.6-2E: Average rate of acquisition cost growth from the previous year for Major Defense Acquisition Programs (MDAPs) starting in FY 2002	5.3.6-2E: Beginning in FY 2012, the DoD will ensure that average rate of acquisition cost growth from the previous year for Major Defense Acquisition Programs (MDAPs) starting in FY 2002 does not exceed three percent.	-0.2%	3%	0.13%
Strategic Objective 5.4-2L: Provide more effective and efficient logistical support to forces abroad.				
5.4.2-2L: Army customer wait time	5.4.2-2L: By FY 2013, the DoD will maintain the Army's average customer wait time at or below 15 days.	14.1	15.5	12.3
Strategic Objective 5.5-2U/V: Improve financial management and increase efficiencies in headquarters and administrative functions, support activities, and other overhead accounts.				
5.5.3-2U: Percentage of DoD mission critical assets (real property, military equipment, general equipment, operating materials and supplies, and inventory balances) validated for existence and completeness	5.5.3-2U: By FY 2017, 100 percent of DoD mission critical assets (real property, military equipment, general equipment, operating materials and supplies, and inventory balances) validated for existence and completeness	4%	40%	41%

STRATEGIC GOAL 5: REFORM THE BUSINESS AND SUPPORT FUNCTIONS OF THE DEFENSE ENTERPRISE.				
Key Performance Measures	Strategic Plan Long-Term Performance Goals	Annual Performance Goals/Results		
		FY 2011 Results	FY 2012 Goals	FY 2012 3 Qtr Results
5.5.4-2U: Percentage of DoD Statement of Budgetary Resources (SBR) for Appropriations Received validated as audit-ready	5.5.4-2U: By FY 2013, the DoD will improve its audit readiness on the Statement of Budgetary Resources (SBR) for Appropriations Received to 100 percent.	80%	83%	■ 88%*
*Reflects August 31, 2012 (versus FY 2012 third quarter) status.				

All performance results for FY 2012 and associated trend analysis will be addressed in the Department's FY 2012 Annual Performance Report with the FY 2014 Congressional Budget Justification and will be posted at http://comptroller.defense.gov/ in February 2013.

Rigid-hull inflatable boats carry guests and sailors assigned to Special Boat Team 12 through San Diego Bay to an at-sea change of command in San Diego, California.

U.S. Navy photo by Seaman Geneva G. Brier

FINANCIAL OVERVIEW

FINANCIAL HIGHLIGHTS AND ANALYSIS

Ms. Teresa McKay, Director, Defense Finance and Accounting Service

The preceding sections provided an overview of DoD operations in FY 2012 and compared performance with goals. Meeting our defense goals requires resources. Our use of these resources in FY 2012 is summarized in the Department's financial statements, which appear later in this report.

The Department cannot yet produce financial statements that are auditable, and management cannot yet provide sufficient assurance of effective internal controls over financial reporting to pass an audit. This situation occurs because the Department currently cannot supply auditable documentation in a timely fashion and cannot demonstrate that its business processes are sufficiently reliable and well-controlled to pass an audit. The Financial Improvement and Audit Readiness initiative, discussed later in this report, is guiding the Department's effort to improve financial management and achieve audit readiness for key financial statements by 2014 and for all statements by 2017.

While the Department's financial statements are not auditable because of documentation and control problems, the underlying data are used regularly and successfully to pay people and vendors and to keep track of those payments. The data summarized in this section are providing the Department with the financial information necessary to manage its operations, including its wartime operations.

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 have been prepared from the 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) for Federal entities, and the DoD Financial Management Regulation. 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 Defense Finance and Accounting Service (DFAS) prepared the consolidated financial statements and explanatory notes, located in the Financial Information section of this report. The financial statements include:

- Statement of Budgetary Resources
- Balance Sheet

- Statement of Net Cost
- Statement of Changes in Net Position

Statement of Budgetary Resources.

One of the most critical financial improvement and audit readiness priorities in the Department involves the processes, controls, and systems that support information most often used to manage the Department, namely, budgetary resources. The Statement of Budgetary Resources (SBR) presents the Department'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. 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.

As discussed in the Overview section and depicted in Figure 2 of this report, the Department's FY 2012 enacted appropriations total $645.7 billion. The $42.3 billion decrease from FY 2011 enacted amounts is mostly attributable to a decrease in appropriations for overseas contingency operations (OCO). The amounts needed for OCO in FY 2012 were significantly lower due to completing the military and "advise and assist" missions in Iraq at the end of 2011, and the redeployment of approximately 33,000 troops from Afghanistan by the end of FY 2012.

The Department reported $1.2 trillion in FY 2012 total budgetary resources as summarized in Figure 7.

Figure 6. Trend in DoD Enacted Appropriations

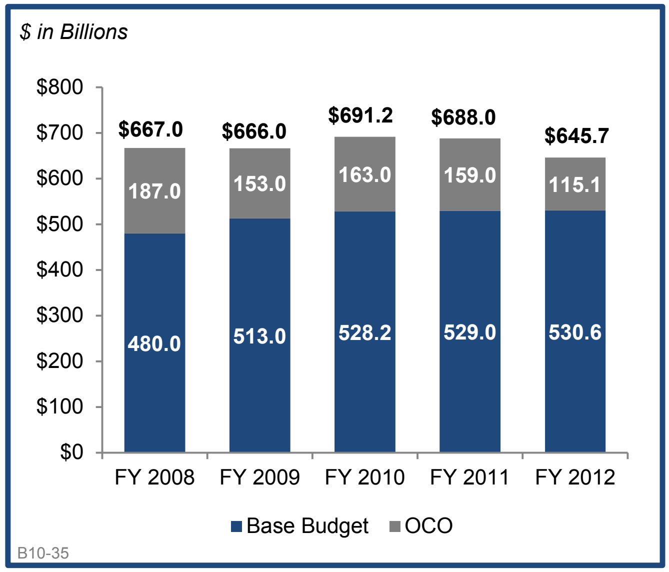


Figure 7. Composition of DoD Total Budgetary Resources

Description	FY 2012 *($ in billions)*
DoD Enacted Appropriations	$645.7
U.S. Treasury Contribution for Military Retirement and Health Benefits	76.8
Civil Works Projects Executed by the USACE	5.7
Trust Fund Receipts	125.3
Trust Fund Resources Temporarily Not Available	(61.3)
Total Appropriations Reported on SBR	**$792.2**
Brought Forward Unobligated Budget Authority	214.9
Spending Authority from Offsetting Collections	117.2
Contract Authority	80.5
Total Budgetary Resources	**$1,204.8**

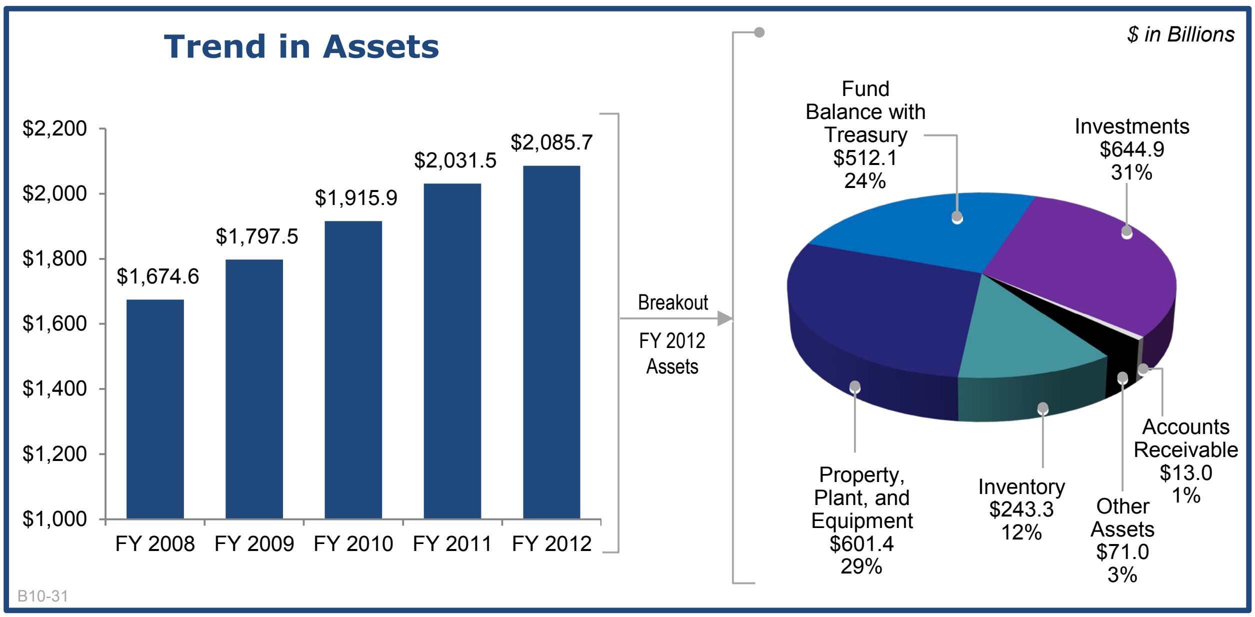
Total appropriations of $792.2 billion reported on the Statement of Budgetary Resources consist of enacted appropriations and appropriations that were provided by the U.S. Treasury for DoD retirement and health benefits. DoD also receives appropriations to finance the civil work projects managed by the U.S. Army Corps of Engineers. Current year trust fund receipts, to include the Military Retirement Fund and the Medicare Eligible Retiree Health Care Fund, are also included in the SBR "Total Appropriations" line. Trust fund receipts, labeled as "Temporarily not available," represent budget authority the Department will execute in future years to pay the current unfunded liabilities carried in these large funds.

Additional budgetary resources include $214.9 billion of unobligated balances brought forward from past years, $117.2 billion in spending authority from offsetting collections related to reimbursable work performed for public entities or other Federal agencies, and $80.5 billion of contract authority.

Of the $1.2 trillion in total budgetary resources, $1.059 trillion were obligated and $980.1 billion of obligations were disbursed. The remaining balance of unobligated budgetary resources relates to appropriations that are available to cover multi-year investment projects, which require additional time to procure. Additionally, appropriations that are expired for purposes of new obligations remain available for valid upward adjustments to prior year obligations.

Balance Sheet. The Balance Sheet, which reflects the Department's financial position as of September 30, 2012, reports amounts available to provide future economic benefits (Assets) owned or managed by the Department, the amounts owed (Liabilities) requiring use of available assets, and the difference between them (Net Position).

Figure 8. Summary of Total Assets



The $2.1 trillion in assets shown in Figure 8 represent 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.

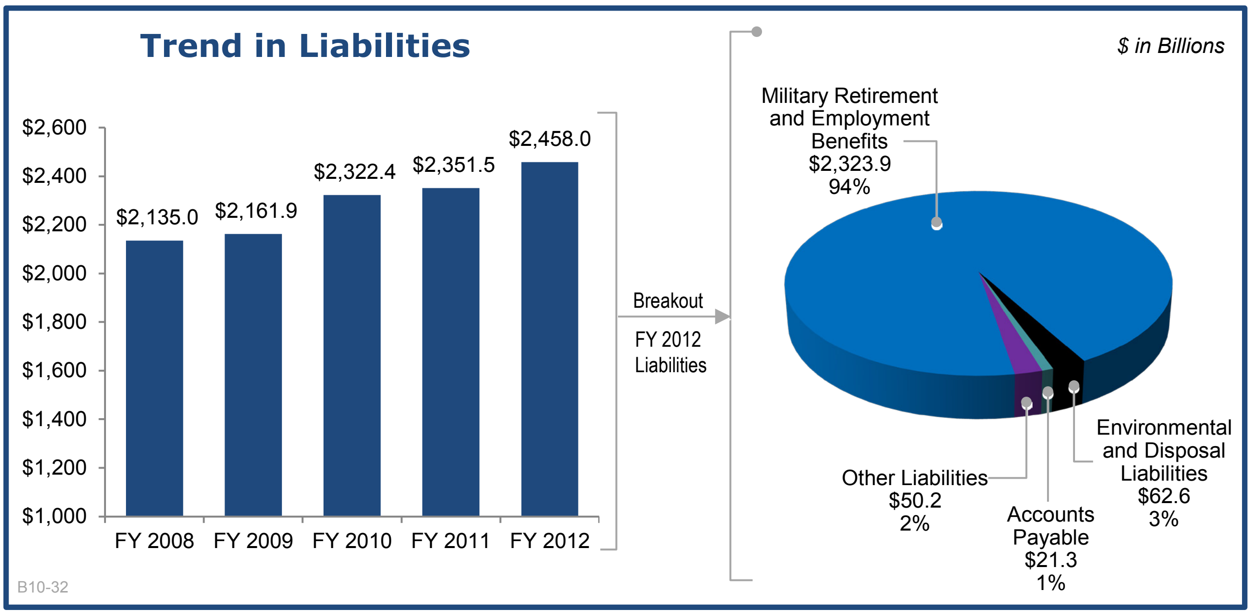
Assets increased $54.2 billion (3 percent) from FY 2011, largely due to increases in Investments in U.S. Treasury securities which were offset by decreases in the Department's General Property Plant and Equipment and Fund Balance with Treasury.

The $72.4 billion net increase in investments relates 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 $11.3 billion reduction in the Department's Fund Balance with Treasury is largely related to the overall reduction in the FY 2012 defense budget.

The $7.9 billion decrease 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.

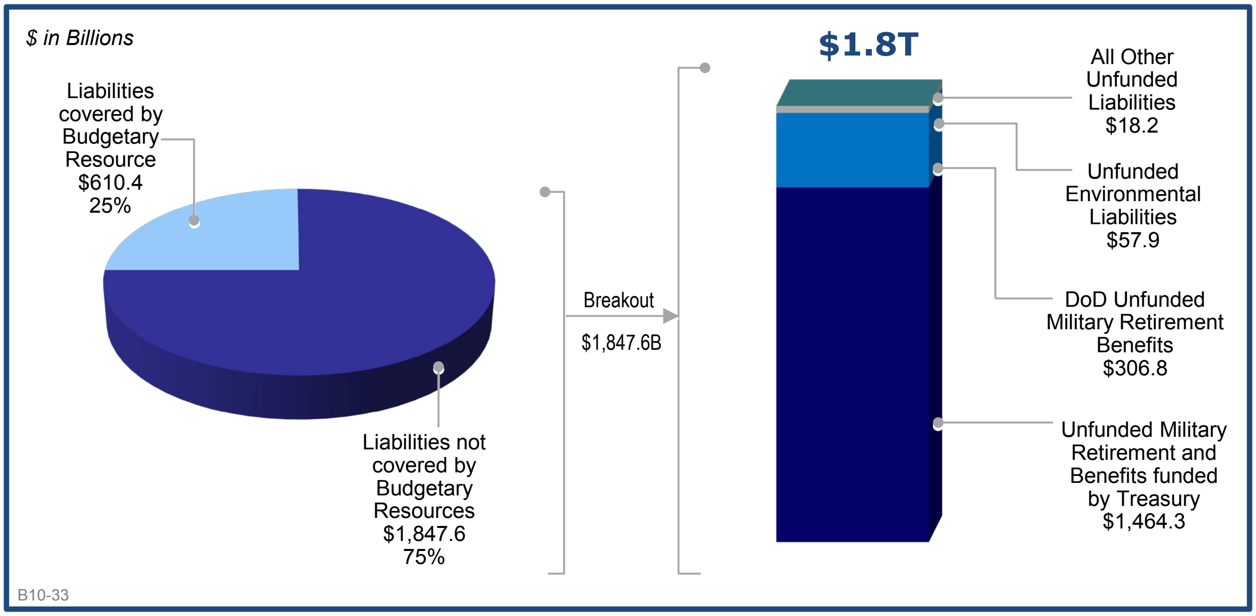
Figure 9. Summary of Total Liabilities



As seen in Figure 9, the Department's liabilities increased $106.5 billion during FY 2012, almost exclusively from normal growth in actuarial liabilities related to military retirement pension and health care benefits. The Department is confident in its ability to meet its financial obligations for the $2.5 trillion of liabilities reported in FY 2012.

Figure 10 identifies the unfunded liabilities that will require future resources. The U.S. Treasury is responsible for funding the actuarial liability that existed at the inception of the military retirement and health care programs. This actuarial liability accounts for approximately $1.5 trillion (79 percent) of the total $1.8 trillion in liabilities that are not currently covered by budgetary resources. Additionally, the Department has resources available to cover approximately $610.4 billion of the remaining liabilities, including funds primarily invested in U.S. Treasury securities.

Figure 10. Unfunded Liabilities

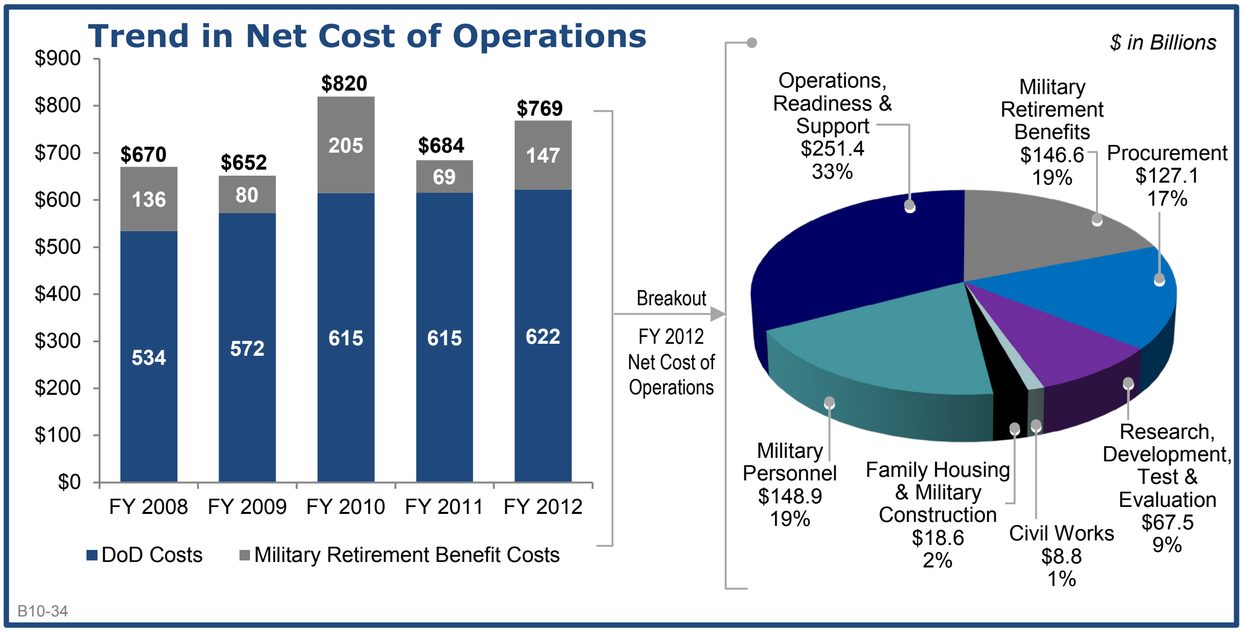


Net Cost of Operations. The Statement of Net Cost presents the net cost of all the Department's programs, including military retirement benefits. The statement reports total expenses incurred less the revenues earned from external sources to finance those expenses. Generally, the resulting balance of net cost is equivalent to the outlays reported on the SBR, 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.

The Department's costs incurred relate primarily to operations, readiness, and support activities, military personnel cost, and military retirement benefits. 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 $768.9 billion in net costs of operations during the fiscal year.

As depicted in Figure 11, the $768.9 billion represents an $84.7 billion increase (12 percent) since FY 2011. The military retirement benefits accounted for $77.7 billion (92 percent) of the increase, which is largely due to changes in trend and other key assumptions used to calculate the liability for military retirement benefits.

Figure 11. Summary of Net Cost of Operations



The Department's financial performance is summarized in Figure 12. This table represents the Department's condensed financial position, results of operations, and budgetary resources, and includes comparisons of financial balances from the current year to the prior year. As previously noted, the lack of auditable financial data is a limiting factor in the ability of the Department to explain all material variances presented in the comparative statements. Nevertheless, the data underlying the amounts can be and is effectively used to manage the Department's operations in support of successful mission accomplishment.

Figure 12. Financial Performance Summary

Dollars in Billions

	FY 2012	Restated FY 2011	Change	% Change
ASSETS				
Fund Balance with Treasury	$ 512.1	$ 523.4	**$ (11.3)**	-2.2%
Investments	644.9	572.5	**72.4**	12.6%
Accounts Receivable	13.0	11.7	**1.3**	11.1%
Other Assets	71.0	72.0	**(1.0)**	-1.3%
Inventory and Related Property, Net	243.3	242.6	**0.7**	0.3%
General Property, Plant and Equipment, Net	601.4	609.3	**(7.9)**	-1.3%
TOTAL ASSETS	**$ 2,085.7**	**$ 2,031.5**	**$ 54.2**	**2.7%**
LIABILITIES				
Accounts Payable	$ 21.3	$ 28.0	$ (6.7)	-23.9%
Other Liabilities	50.2	46.3	3.9	8.4%
Military Retirement and Other Federal Employment Benefits	2,323.9	2,212.4	111.5	5.0%
Environmental and Disposal Liabilities	62.6	64.8	(2.2)	-3.4%
TOTAL LIABILITIES	**$ 2,458.0**	**$ 2,351.5**	**$ 106.5**	**4.5%**
TOTAL NET POSITION (ASSETS MINUS LIABILITIES)	**$ (372.3)**	**$ (320.0)**	**$ (52.3)**	**16.3%**
Total Financing Sources	$ 728.0	$ 758.2	$ (30.2)	-4%
Less: Net Cost	768.9	684.2	84.7	12.4%
NET CHANGE OF CUMULATIVE RESULTS OF OPERATIONS	**$ (40.9)**	**$ 74.0**	**$ (114.9)**	**-155.3%**
TOTAL BUDGETARY RESOURCES	**$ 1,204.8**	**$ 1,231.3**	**$ (26.5)**	**-2.2%**

Financial Management Improvement Initiatives

In FY 2012, the Department carried out its mission even as it dealt with budgetary pressures. With further Defense cuts on the horizon, it is more important than ever for the Department to maintain the public's trust in our stewardship of taxpayer resources for the national defense. We are committed to improving defense financial management and providing the financial resources and business operations necessary to meet our national security objectives. The following initiatives highlight the Department's progress toward better financial management.

Financial Flexibility for Warfighters

The concept of financial flexibility means the ability to adjust priorities, identify financial resources, and make investment decisions quickly. In this context, "quickly" means realizing investment results within two years, which is much faster than the usual, deliberate budgeting process. The Department works closely with the Congress to address unanticipated capability shortfalls and balance the traditional acquisition risk areas of cost, schedule, and system performance through financial flexibility. In wartime, schedule slippage can cost lives. During active conflicts, the speed at which an urgent need is satisfied becomes the most relevant factor for reducing a commander's operational risk and for saving lives and maintaining tactical advantage.

Deputy Secretary of Defense Ashton B. Carter talks with soldiers assigned to 101st Airborne Division during a counter Improvised Explosive Device training exercise, at Fort Campbell, Kentucky.

DoD photo by Petty Officer 1st Class Chad J. McNeely, U.S. Navy

Since June 2011, the Department's Warfighter Senior Integration Group (SIG) has facilitated a flexible, agile approach for quickly identifying emerging urgent operational needs (UONS), and for rapidly adjusting program and budgetary priorities to fulfill UONS within an operationally relevant timeframe. The Deputy Secretary of Defense chairs the Warfighter SIG, which prioritizes actions and resources to resolve UONS. The SIG facilitates financial flexibility to better provide our forces with the best capabilities possible in the areas of force protection, command and control, counter Improvised Explosive Devices, and Intelligence, Surveillance and Reconnaissance.

The most flexible financing available to the Department are the accounts appropriated by the Congress 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 beyond the scope of these appropriations, the Department uses other tools provided by Congress, such as the Rapid Acquisition Authority provided by Public Law 107-314, as amended, which results from the "Ronald W. Reagan

National Defense Authorization Act for Fiscal Year 2005." In addition, the Congress has 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.

Also, the Department remains heavily dependent upon the transfer authorities granted by the Congress within the annual appropriations, which allow the Department to be more financially agile in a rapidly changing world. Within prescribed limits, the Department uses its authority to transfer funds within accounts to meet changing priorities. When those limits must be exceeded, the Department requests specific, above-threshold approval for each transfer from the congressional oversight committees.

Defense Secretary Leon E. Panetta gives the thumbs up during his launch sequence of an AV-8B Harrier Jet on board the USS Peleliu in the Pacific Ocean.

DoD photo by Erin Kirk-Cuomo

In FY 2012, transfer authority allowed the Department to accelerate selected programs and projects in response to the new Defense Strategic Guidance, positioning the Department to meet defense needs in the coming era. For example, the Department gained congressional approval to expedite the preparation of Bahrain-based patrol craft to defend U.S. Navy vessels against hostile fast attack craft.

The Congress provided additional financial tools for the Department when the Global Security Contingency Fund (GSCF) was created as a four-year pilot project by the FY 2012 National Defense Authorization Act (P.L. 112-81), Section 1207. The GSCF is jointly administered and funded by the Department of State (DoS), and the Department of Defense. The Department recently reprogrammed $21.8 million in support of security activities with partner nations across the globe. This newly created financial tool enables better cooperation among DoS and DoD activities for national security.

Finally, as part of its Strategic Management Plan, the Department's Chief Financial Officer tracks the time to process above threshold reprogramming requests. This metric provides a view of how well the Department supports its requests with the congressional oversight committees and responds to the needs of the warfighter for adjusting resources to meet evolving requirements. This year, the Department averaged 24 days – a 50 percent reduction from FY 2009 – to process and receive Congressional approval for UONS reprogramming.

In summary, financial flexibility gives the Department critical management tools to balance between available resources and urgent security needs to ensure that our Armed Forces can meet the demands of the U.S. National Security Strategy.

Financial Improvement and Audit Readiness (FIAR) Initiative

Although the Department's FY 2012 financial statements are not auditable, the Department is effectively managing and spending the dollars appropriated to it by Congress for the purposes intended. With only limited exceptions, the Department's dedicated financial management workforce pays DoD personnel, contractors, and other commitments accurately and on time, and also accurately records obligations and expenditures in the general ledgers of DoD financial systems. Failure in either of these responsibilities would result in unavoidable problems that would impact the warfighter and the Department's ability to accomplish its challenging, worldwide mission. The evidence shows that this is not happening.

U.S. Army World Class Athlete Program rifle shooter Sgt. Vincent Hancock won the Olympic gold medal in men's skeet after competing at the Royal Artillery Barracks in London during the 2012 Summer Olympics. The 23-year-old Hancock is assigned to the U.S. Army Marksmanship Unit.

U.S. Army photo by Tim Hipps

While we are confident that we effectively manage taxpayer funds, the Department currently lacks the ability to demonstrate reliable and well-controlled business processes, and to consistently provide supporting documentation in a timely manner to the auditors. These capabilities are required to successfully pass a financial statement audit. Part of the challenge lies with DoD's unique size and mission. Figure 13 shows the magnitude of financial activities processed by DFAS in FY 2012, excluding processing by other DoD entities, such as the U.S. Army Corps of Engineers (USACE) or TRICARE Management Agency (TMA).

Figure 13. FY 2012 Transactions Processed and Managed by DFAS

Description	FY 2012
Number of Active DoD Appropriations Managed	1,215
Number of Pay Transactions	164,900,000
Number of People/Accounts	6,600,000
Disbursements to Pay Recipients	$556,500,000,000
Number of Travel payments	7,100,000
Number of Commercial Invoices Paid	11,300,000
Military Retirement and Health Benefit Funds Managed	$631,200,000,000

Financial statement auditability is important to the Department for many reasons. It is required by law, but it also will validate that the Department is properly and effectively managing and executing the resources entrusted to it by Congress and the taxpayers. To better enable the Department to move toward auditable financial statements, the Department refocused its FIAR initiative in 2009 on the information most often used to manage the Department. With the change in focus, two financial improvement priorities were established: budgetary information (i.e., auditable SBR) and accountability of mission critical assets, validated by existence and completeness audits.

These priorities were codified by Congress in the NDAA of 2010, and in October 2011, Secretary Panetta directed that these priorities be an "all hands" effort and that SBR audit readiness be achieved in 2014. Secretary Panetta's message may be viewed at *http://comptroller.defense.gov/video_ts/secdefaccountabilitymsg.wmv*.

The Department's plan (the FIAR Plan) for achieving the goals of the FIAR initiative are presented in the *FIAR Plan Status Report*, issued on a semi-annual basis. The FIAR Plan addresses the issues affecting the reliability of DoD financial statements. Specific DoD Component near-term and long-term milestones, representing incremental steps toward audit readiness, are included in the *FIAR Plan Status Report*, as well as Component progress and accomplishments, metrics used to monitor progress, and deployment plans of Enterprise Resource Planning systems that are modernizing DoD-wide information systems. The report serves as the Department's annual Financial Management Improvement Plan, required by Section 1008(a) of the NDAA for FY 2002.

USMC aerial refueling operation.

U.S. Marine Corps photo by Cpl. Reece Lodder

Significant progress is being made to achieve audit readiness. We anticipate that in FY 2012, six Defense organizations will continue to receive unqualified audit opinions on their financial statements, and three additional organizations will receive qualified audit opinions (see Figure 14). In addition, the U.S. Marine Corps, the first Military Service to undergo an SBR audit, may receive positive results by the end of 2012. Also in FY 2012, the Department exceeded its audit readiness interim goal by achieving 88 percent (goal 83 percent) of auditability of its Appropriations Received, or funds distribution process. Also, 41 percent (40 percent goal) of existence and completeness assertions for the Department's mission critical assets will be either under audit or validated as audit ready.

Figure 14. FY 2012 Financial Statement Opinions

FY 2012 Unqualified Audit Opinions
U.S. Army Corps of Engineers – Civil Works
Defense Contract Audit Agency
Defense Commissary Agency
Defense Finance and Accounting Service
Military Retirement Fund
TRICARE Management Activity – Contract Resource Management
FY 2012 Qualified Audit Opinions
Defense Information Systems Agency – Working Capital Fund
Medicare-Eligible Retiree Health Care Fund
Office of Inspector General

Other important, incremental progress has been made on other key elements of the SBR and accountability of mission critical assets. As of the date of this report, 15 percent of the Department's budgetary resources are under audit. This percentage will significantly increase as the Navy plans to assert SBR audit readiness by the end of FY 2013, followed by the Army, Air Force, and other Defense organizations in FY 2014.

The Department manages the Managers' Internal Control Program (MICP), with the goal of providing instructions, guidance, and training on how to effectively execute an internal control program, enhance knowledge and understanding of audit readiness goals and priorities, and disseminate best practices and lessons learned. Additional information regarding the Department's MICP program is contained in the Systems, Controls, and Legal Compliance section and in Addendum A to this report.

Secretary of Defense Leon E. Panetta addresses soldiers deployed to Forward Operating Base Shukvani, Afghanistan.

DoD photo by Petty Officer 1st Class Chad J. McNeeley, U.S. Navy

Financial Management Workforce Improvement Initiative

The Department has initiated a Strategic Human Capital Plan process to ensure it meets DoD-wide civilian financial management workforce and lifecycle management needs. This multi-year effort, which is being applied across the Department's financial management civilian community, involves analysis of both manpower and position requirements.

In FY 2012, the Department established enterprise-wide, financial management competencies applicable to each financial management occupation. Based on these competencies, the Department has started action to implement a DoD Financial Management (FM) Certification Program to assist the FM workforce in meeting future needs and requirements. Goals of the Certification Program are to:

- Advance the professionalism of DoD's FM workforce
- Strengthen public confidence in the Department's financial management
- Improve skills and knowledge in audit readiness and decision support
- Leverage the benefits derived from implementing the Department's Enterprise Resource Planning systems
- Encourage career broadening and leadership training
- Establish a standard DoD FM body of knowledge

A U.S. pararescue crew hovers in an HH-60G Pave Hawk helicopter as part of a maritime personnel recovery exercise annual competition in Key West, Florida.

U.S. Air Force photo by Tech. Sgt. Michael Fuller

The new certification program will identify a required certification level (1, 2 or 3) for each civilian and military financial management position and within each certification level, a minimum number of training course hours will be required. The training is targeted to financial management technical competencies, DoD leadership competencies, and specific topics, such as audit readiness, fiscal law, and ethics. In addition to the training, a minimum number of years of financial management experience will be required for each certification level. Upon obtaining certification, a minimum level of continuing education credits will be required every two years.

The Department introduced pilot versions of this program for several Components this year, with large-scale implementation planned to begin in 2013.

Disciplined Use of Resources

In the FY 2012 budget submission, the Department proposed more than $150 billion in streamlining and efficiency goals for FYs 2012 – 2016, and we continue to monitor progress in implementing these changes. On May 15, 2012, Secretary Panetta recommitted the Department and its leadership to an effort initiated by his predecessor to look unsparingly at the DoD organization and its operations to establish more efficient, effective, and cost-conscious ways of doing business. Secretary Panetta emphasized that maintaining this focus is more important than ever, given the current fiscal environment, and he directed the Department to eliminate lower-priority programs, streamline support activities, and instill a culture of savings and accountability.

U.S. Marines conduct a battlefield zero on Camp Leatherneck in Afghanistan's Helmand province.

U.S. Marine Corps photo by Sgt. Keonaona Paulo

The Department continues to find further savings associated with streamlining overhead and headquarters, business practices and support activities. The Department is committed to aggressively seek ways to be more efficient, reduce costs, and be excellent stewards of taxpayer dollars while maintaining the ability to perform its mission. In FY 2012, the Department projected an estimated savings of $19.8 billion. Examples of a few of the FY 2012 efficiencies follow:

- Navy Cuts Costs by Consolidating Wireless Contracts. The Navy saved an estimated $10 million by consolidating numerous contracts with major carriers of wireless services, which enabled better pricing and "minute pooling."
- Air Force Aircraft Uses Less Fuel. The Air Force implemented and is implementing sixteen fuel saving initiatives that saved an estimated $45 million. For example, the Air Force is using commercial flight planning software to make real-time flight adjustments (airspeed, altitude) to save fuel. The Air Force also is reducing fuel reserves, consistent with safety and mission performance, in order to cut weight and save fuel.
- Army Recruiting. The Army saved an estimated $764 million by restructuring its recruiting and retention efforts in order to capitalize on the current and projected economic environments.

- Disestablishment of Joint Forces Command. The Department eliminated the Four Star Headquarters operation, along with redundant or non-essential functions and reassigned essential functions to other organization while scaling each remaining function to an efficient and appropriate capacity. This action resulted in estimated savings of $292 million in FY 2012.
- Business Transformation Agency (BTA) Disestablishment. The Department also eliminated the BTA, with critical functions reassigned to the Defense Logistics Agency, Washington Headquarters Services, and the Office of the Deputy Chief Management Officer, with savings estimated at $98 million in FY 2012.
- Health Care Costs Reduced by Responsibly Paying Hospitals for Outpatient Costs. The Department requested and won authority to use Medicare's Outpatient Prospective Payment Systems for reimbursing private sector institutions for outpatient care delivered to TRICARE beneficiaries, resulting in an estimated savings of $840 million in FY 2012.

A U.S. Air Force C-17 Globemaster III aircraft taxis to its parking spot on Bagram Airfield, Afghanistan. The Globemaster III is a regular visitor to Bagram Airfield, transporting troops, equipment and supplies in and out of the country.

U.S. Air Force photo by Capt. Raymond Geoffroy

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

MANAGERS' INTERNAL CONTROL PROGRAM

The Department has a fundamental responsibility to be an effective steward of government money. Effective internal controls are the foundation of an organizational framework predicated on accuracy and accountability. Internal controls represent an organization's plans, methods, and procedures used to meet its mission, goals, and objectives, and serve as the first line of defense in safeguarding assets and preventing and detecting errors, fraud, waste, abuse, and mismanagement. The purpose of internal control is to provide reasonable assurance that an organization's objectives are achieved through (1) effective and efficient operations, (2) reliable financial reporting, and (3) compliance with laws and regulations.

The Department is responsible for establishing, maintaining, and assessing internal controls in order to provide reasonable assurance that it meets the objectives of the *Federal Managers' Financial Integrity Act*, Public Law (PL) 97-255, sections 2 and 4; the *Federal Financial Management Improvement Act*, PL 104-208; and the *Office of Management and Budget's Circular (OMB) No. A-127*, entitled "Financial Management Systems."

OMB Circular No. A-123, entitled "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.
- Report annually on internal controls through management assurance statements.

A U.S. Army Sgt. shares a high five with an Afghan boy during a presence patrol in Kabul, Afghanistan.

U.S. Army photo by Sgt. Catherine Threat

Based on the Department's assessment of internal controls, the Deputy Secretary of Defense has signed the following Statement of Assurance.

STATEMENT OF ASSURANCE

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

NOV 06 2012

The leadership of the Department of Defense (the Department) recognizes the importance of 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 Office of Management and Budget (OMB) Circular A-127, "Financial Management Systems." The Department continues to focus on strengthening the Managers' Internal Control Program, despite this resource-constrained environment, to exceed the objectives.

During this past fiscal year, the Department performed validations of select internal control programs. The purpose of the validations was to determine if the organization: (1) protected its resources against waste, fraud, and inefficiency; (2) ensured accuracy and reliability in accounting and operating data; and (3) complied with the policies of the organization. An independent assessment team provided the Components with written feedback for improvements.

The Department conducted its assessment of the effectiveness of internal controls over operations in accordance with OMB Circular A-123, "Management's Responsibility for Internal Control." Based on 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, 2012. Details of the material weaknesses identified are available in Addendum A, "Other Accompanying Information."

The Department conducted its assessment of the effectiveness of internal controls over financial reporting in accordance with OMB Circular A-123, Appendix A, "Internal Control over Financial Reporting." 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, 2012. Related to this financial reporting assessment, as of September 30, 2012, 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. The Department remains fully committed to a culture centered on an effective control environment.

Ashton B. Carter

The Department maintains and provides oversight of a Managers' Internal Control Program (MICP), led by the Office of the Under Secretary of Defense, Comptroller, to fulfill the responsibilities and requirements described above. Under the MICP, the Comptroller organization provides instructions, guidance, and training to:

- Share knowledge and insight with 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.
- Disseminate best practices and lessons learned, and assess the 32 DoD Components' internal control programs during on-site validations, designed to measure the progress of organizations as well as their strengths and challenges.

The aircraft carrier USS George Washington sails through calm seas near Guam at sunset while under way in the Pacific Ocean.

U.S. Navy photo by Petty Officer 3rd Class Paul Kelly

ACCOMPLISHMENTS

An internal control could be defined as a business practice, policy, or procedure that is established within an organization to create value or minimize risk. In most cases our focus is on reducing risk and addressing weaknesses, but organizational submissions by management also include accomplishments which, in the judgment of their Commanders, have created value by improving or strengthening the way we do business.

The following are highlights that reflect a few of the many improvements brought about through efforts to improve internal controls.

- Efficiency and Savings. The DFAS reorganized and implemented changes, beginning in October 2011, that will result in approximately $196 million in savings through FY 2017, to include the reduction of 395 full-time equivalents.
- Transportation and Cost Savings. The Defense Contract Management Agency (DCMA) Combat Support Center (CSC), during an internal control self-assessment of transportation costs related to deploying DCMA personnel, determined considerable cost savings could be achieved by maximizing the use of government versus commercial

U.S. Army paratroopers and Afghan soldiers patrol a village in the Tani district in Afghanistan's Khost province.

U.S. Army photo by Sgt. William Begley carriers. After considerable research and input from the DCMA Contingency Contract Administration Services (CCAS) Operations Team, deployed personnel, and DCMA Kuwait Operations personnel, the CSC developed, coordinated and posted the "Freedom Flight Policy" which directs all DCMA CCAS personnel to use Military Air transport for CCAS missions entering deployment and redeployment. Travel vouchers are certified and verified by CSC personnel ensuring Freedom Flights are utilized as required. In the first year since the inception of the Freedom Flight Policy, the Agency had an estimated $1 million in savings. The CSC continues to leverage the use of these non-commercial flights to achieve fiscal stewardship and cost savings within the Agency.

- Mobile Aircraft Fire Trainers (Force Readiness). Air Force firefighters are required to complete two live aircraft training exercises and a crew-based, issue-focused training event each year. The Air Force entered into a contract to obtain a five-year operational lease that provides two Mobile Aircraft Fire Trainers (MAFT) to serve four installations. The MAFT allows each installation to conduct crew-based proficiency training on an as-needed basis, ensuring firefighters maintain mandatory certification training and that the installation airfield meets annual Federal Aviation Administration certification criteria.

Air Force firefighters train with civilian firefighters from five locations to remove simulated victims from a burning aircraft on Francis S. Gabreski Air National Guard Base in Westhampton, New York. The airmen are assigned to the 106th Civil Engineering Squadron. Kellogg University provided the mock aircraft, which burned with propane at an estimated 1,200 degrees.

U.S. Air Force photo by Senior Airman Christopher S. Muncy

Additionally, sharing the MAFT between multiple installations is more cost effective than retaining permanent trainers at each location.

The Manager's Internal Control Program also plays a role in ensuring that these kinds of improvements are sustained and remain relevant to mission needs.

ASSESSMENT

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

- 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
- Represents nonconformance with government-wide, financial management system requirements.

Individual DoD Components issue assurance statements that assess and certify the effectiveness of internal controls. The Components' assurance statements serve as the primary basis for the Deputy Secretary's assurance statement on the effectiveness of the Department's entity wide internal controls. Information gathered from various sources serves as the basis for the assurance statements. This information includes management-initiated internal controls testing, program reviews, and evaluations. In addition, the IG DoD and the Government Accountability Office conduct reviews, audits, inspections, and investigations, and the findings are considered in the individual Component's assurance statements and provide the foundation for their individual assessments.

Members of coalition special operations forces wait for an air drop of supplies in the Shah joy district in Afghanistan's Zabul province. Such drops help resupply forces in remote areas of Afghanistan.

U.S. Navy Petty Officer 2nd Class Jon Rasmussen

The Department has effective processes in many key areas. As a result, there has been significant progress toward improving both financial and operational internal controls; however, it remains clear that the most daunting of challenges remain ahead, and more emphasis on effective and efficient operations is 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.

Material Weaknesses

The Department's outstanding material weaknesses for FY 2012 are listed in Figure 15. 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," of this report.

Figure 15. Department of Defense Outstanding Material Weaknesses

	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	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	2	FY 2006	Department-wide	Reassessed annually based on incremental improvements
7	Force Readiness	2	FY 2011	Air Force	FY 2013
8	Personnel and/or Organizational Management	3	FY 2006	Department-wide	FY 2015
9	Property Management	1	FY 2011	Department-wide	FY 2016
10	Supply Operations	1	FY 2011	Department-wide	Reassessed annually based on incremental improvements
	Total Material Weaknesses	**35**			

Financial Management Systems

The Department recognizes that to successfully meet our goal of achieving and sustaining improvements in financial management and auditable financial statements, we must improve our business systems. Our goal is to deliver a streamlined, 21st-century systems environment with information technology (IT) capabilities that work together seamlessly to support effective and efficient business processes and operations. Regrettably, 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 strong financial management and audit standards and/or were focused more on budgetary rather than proprietary accounting standards. These IT systems tend to be non-standard, and sometimes do not include strong financial controls. Many of these legacy systems also do not record data at the transaction level, a capability that is essential to audit success.

To address these issues, the Department is pursuing improvements in its business systems environment by implementing modern, compliant systems and modernizing legacy systems when necessary and supported by a business case. The Department also is aggressively retiring legacy systems that are obsolete, redundant, or not aligned with our business objectives. Implementing modern technology solutions, a central part of our business systems modernization strategy, will directly enable key elements of auditability, such as: the ability to trace all transactions from source to statement and to recreate a transaction; documented, repeatable processes and procedures; demonstrable compliance with laws, regulations and standards; and a control environment that is sufficient to reduce risk to an acceptable level.

These improvements to our business systems are enabled by the advancements we are making in Business Enterprise Architecture, Business Process Reengineering (BPR), acquisition oversight, and investment management. Most recently, Section 901 of the FY 2012 NDAA introduced important changes to our investment management process, consolidating its execution and broadening its scope. To comply with this new law, the Department created a single Investment Review Board (IRB), chaired by the Deputy Chief Management Officer, that reviews the planning, design, acquisition, development, deployment, operation, maintenance, modernization, and project cost versus benefits of all defense business systems with total costs greater than $1 million across the current Future-Year Defense Program. This single, cross-functional IRB provides greater visibility of the IT investments planned for

An MH-60S Knight Hawk helicopter passes the USS Chafee while delivering supplies to the USS Vinson during a vertical replenishment mission with the USNS Bridge in the Pacific Ocean.

U.S. Navy photo by Petty Officer 2nd Class James R. Evans the business area and will better integrate business strategies with investment decisions. This greater understanding of our business systems environment will significantly aid our audit efforts. This IRB forum will help the Department to make better investment decisions, to ask the right questions when it comes to duplicative systems and the number of interfaces, and to reinforce the relationship of the business environment to the audit.

In accordance with Section 901 and in support of the single IRB, the Department also modified its existing business process re-engineering requirements. Over many years, the Department has taken a holistic approach to BPR to assess process weaknesses, identify gaps, and streamline and improve processes to ensure success in changes to the full spectrum of its business operations. The Department is fully integrating its BPR assessment process with its expanded investment management and oversight framework to make certain that BPR is conducted at the portfolio, end-to-end process, and system level. Conducting appropriate BPR will help the Department make wise investment decisions, improve its use of performance management, control scope changes, and reduce the cost of fielding business capability. The Department's updated BPR process provides a standard method for assessing and documenting efforts to support consistent compliance with BPR requirements. Financially auditable processes that use standard data will increase transparency and reduce the vulnerability of improper payments and potential fraud.

Improved systems alone, however, will not eliminate weaknesses or guarantee auditable statements. Achieving auditability requires consistent application of process controls across organizations and functional areas. Business and financial information that is passed from system to system must be controlled to ensure that only authorized personnel are using the system, that the systems protect data quality and integrity, and that a compliant audit trail is maintained. These processes must be controlled at the transaction level, from the source document to general ledger postings, accurate trial balances, and reliable period closeouts. Only by completing these steps can we prepare financial statements that can be cost-effectively reviewed and verified.

A U.S. Marine and an improvised explosive device detection dog search the perimeter of the Safar School compound.

Photo by Cpl Reece Lodder

Additional information about the Department's defense business systems, including the plans for acquiring new systems and modernizing or retiring legacy systems, can be found in the statutorily mandated *Enterprise Transition Plan*. Further information about the link between these systems and the Department's auditability efforts can be found in the *Financial Improvement and Audit Readiness (FIAR) Plan*.

MANAGEMENT CHALLENGES

U.S. Navy SEALs exit a C-130 Hercules aircraft during a training exercise.

U.S. Navy photo by Mass Communication Specialist Seaman Apprentice Anthony Harding

While we have made progress in FY 2012 in managing DoD financial resources, challenges remain. The Office of Inspector General works to promote efficiency, effectiveness, and integrity in the programs and operations of the Department.

Under the *Reports Consolidation Act of 2000,* the Agency Financial Report must include a statement, prepared by the Department's Inspector General (IG), that summarizes what the IG 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. Detailed information regarding these challenges, along with the Department's management response, is included in the Other Accompanying Information (Addendum A) to this report.

The following lists the IG-cited management and performance challenges facing the Department:

- 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
- The Nuclear Enterprise

Detailed information regarding these challenges and the IG's assessment of the Department's progress, along with the Department's management response, is included in Other Accompanying Information (Addendum A) of this report.

PATH FORWARD

Over the last decade, the Department has undertaken extended operations in Iraq and Afghanistan to bring stability to those countries and secure our nation's interests. Even as these large-scale military campaigns recede, the U.S. still faces a complex and growing array of security challenges across the globe. Unlike past drawdowns, when often the threats that the U.S. faced were subsiding, the U.S. faces a strategic turning point due to the challenging and rapidly changing geopolitical environment amid difficult domestic fiscal circumstances. These challenges include the need to confront violent extremism around the globe; the proliferation of lethal weapons and materials; the destabilizing behavior of nations such as Iran and North Korea; the rise of new powers in Asia; and the new geopolitical landscape in the wake of the "Arab Awakening."

President Barack Obama briefs the press on a new defense strategy as Defense Secretary Leon E. Panetta and Army Gen. Martin E. Dempsey, Chairman of the Joint Chiefs of Staff, prepare to offer remarks at the Pentagon.

DoD photo by Erin Kirk-Cuomo

These challenges prompted the Department to begin a strategy-driven review in early 2011 to reshape our defense priorities and spending over the coming decade. This strategic review, an inclusive process throughout the Department, was guided by four overarching principles: maintain the world's finest military; avoid hollowing out the force; take the reductions in a balanced, strategy-driven manner; and preserve the quality of the All-Volunteer Force by ensuring that we do not break faith with our men and women in uniform or their families. The Department released a new Defense strategy in January 2012, "*Sustaining U.S. Global Leadership: Priorities for 21st Century Defense,*" that describes the tough choices the Department made to ensure that our Armed Forces have the capabilities and readiness they need while contributing to the nation's economic vitality.

The U.S. Armed Forces will remain capable across the spectrum of potential conflicts. We will continue to conduct a complex set of missions, ranging from counterterrorism and countering weapons of mass destruction to maintaining a safe, secure and effective nuclear deterrent and projecting power abroad. We will be fully prepared to protect our interests, defend our homeland, and support civil authorities. Going forward, the U.S. joint force will be smaller and leaner, but it will be agile, more flexible, ready to deploy quickly, innovative and technologically advanced. We will rebalance our global posture and presence, emphasizing the Asia-Pacific and the Middle East regions. We will continue to strengthen our key alliances, build partnerships, and develop innovative ways to sustain U.S. presence elsewhere in the world. We must be capable of successfully confronting and defeating any aggressor and have the ability to defeat more than one adversary at a time. And, even as we reduce the growth in the `overall defense budget, we will protect, and in some cases increase, our investments in technology and new capabilities as well as our capacity to adapt, mobilize, and grow the force if necessary.

Marines conduct immediate action drills during Exercise Lava Viper on Pohakuloa Training Area, Hawaii. The Marines are assigned to Gulf Company, 2nd Battalion, 3rd Marine Regiment. Lava Viper is a battalion-level, combined-arms training exercise to better prepare Marines for upcoming deployments.

U.S. Marine Corps photo by Sgt. Pete Thibodeau

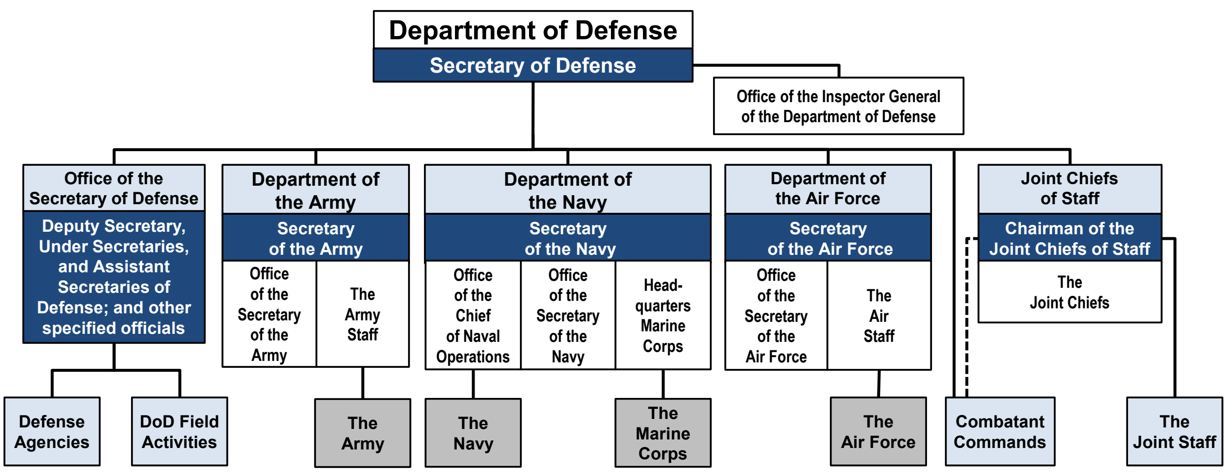
ORGANIZATION

Management of a large, complex enterprise like the U.S. Department of Defense requires an equally sophisticated organization. In keeping with the information typically presented in the Agency Financial Report, the following section briefly describes DoD's 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.

The Secretary of Defense is the principal assistant to the President in all matters relating to the Department of Defense and exercises authority, direction, and control over the Department. The *Department of Defense* is composed of the Office of the Secretary of Defense (OSD), the Joint Chiefs of Staff, the Joint Staff, the Office of the Inspector General of the Department of Defense (IG DoD), the Military Departments, the Defense Agencies, the DoD Field Activities, the Combatant Commands, and such other offices, agencies, activities, organizations, and commands established or designated by law, the President, or the Secretary of Defense.

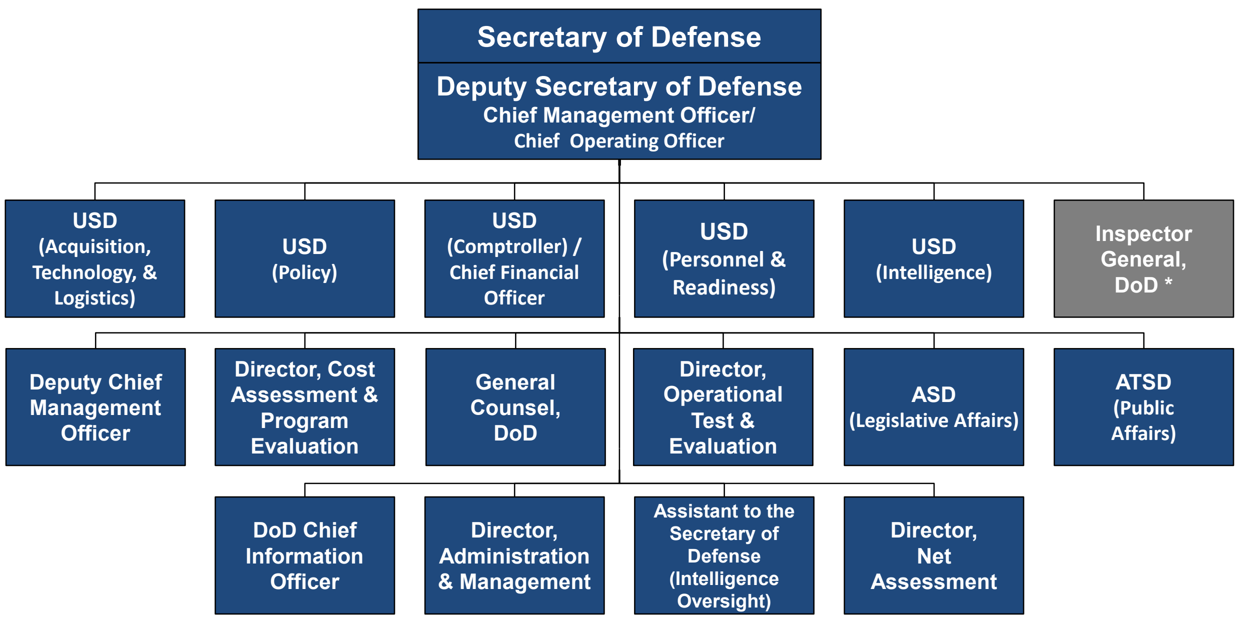
Figure 17. Department of Defense Organizational Structure



THE OFFICE OF THE SECRETARY OF DEFENSE

The function of OSD is to assist the Secretary of Defense in carrying out the Secretary's duties and responsibilities and to carry out such other duties as prescribed by law. The OSD Principal Staff Assistants (PSAs) are responsible for the formulation and oversight of defense strategy and policy. The OSD is comprised of the Deputy Secretary of Defense, who also serves as the Chief Management Officer; the Under Secretaries (USDs); the Deputy Chief Management Officer (DCMO); the General Counsel; the Assistant Secretaries (ASDs); the Assistants to the Secretary of Defense; the OSD Directors, and equivalents, who report directly to the Secretary or the Deputy Secretary; their staffs; the IG DoD; and such other staff offices within OSD established by law or the Secretary to assist in carrying out assigned responsibilities.

Figure 18. Office of the Secretary of Defense Organizational Structure



* *Although the IG DoD is statutorily part of OSD and is under the general supervision of the Secretary of Defense, the Office of the IG DoD (OIG) functions as an independent and objective unit of the Department of Defense*

THE JOINT CHIEFS OF STAFF AND THE JOINT STAFF

The Joint Chiefs of Staff, supported through the Chairman by the Joint Staff, constitute the immediate military staff of the Secretary of Defense. The Joint Chiefs of Staff consist of the Chairman, the Vice Chairman, the Chief of Staff of the U.S. Army, the Chief of Naval Operations, the Chief of Staff of the U.S. Air Force, the Commandant of the Marine Corps, and the Chief of the National Guard Bureau. The Joint Chiefs of Staff function as the military advisors to the President, the National Security Council, the Homeland Security Council, and the Secretary of Defense.

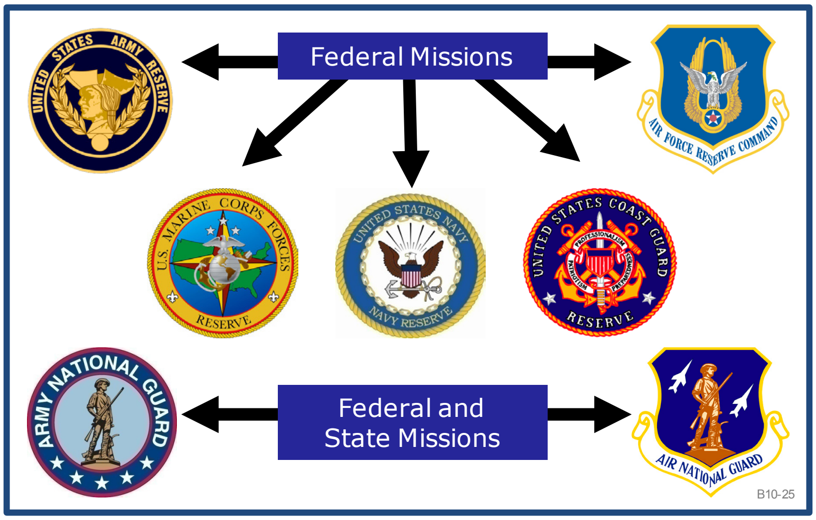
Office of the Inspector General

The Office of the IG DoD is an independent and objective unit within DoD that conducts and supervises audits and investigations relating to the programs and operations of the Department.

Military Departments

The Military Departments consist of the Departments of the *Army*, the *Navy* (of which the *Marine Corps* is a component), and the *Air Force*. Upon the declaration of war, if Congress so directs in the declaration or when the President directs, the U.S. Coast Guard becomes a special component of the Navy; otherwise, it is part of the Department of Homeland Security. The three Military Departments organize, staff, train, equip, and sustain America's military forces and are composed of the four Military Services (or five when including the U.S. Coast Guard when directed). 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.

Figure 19. Reserve Forces and National Guard

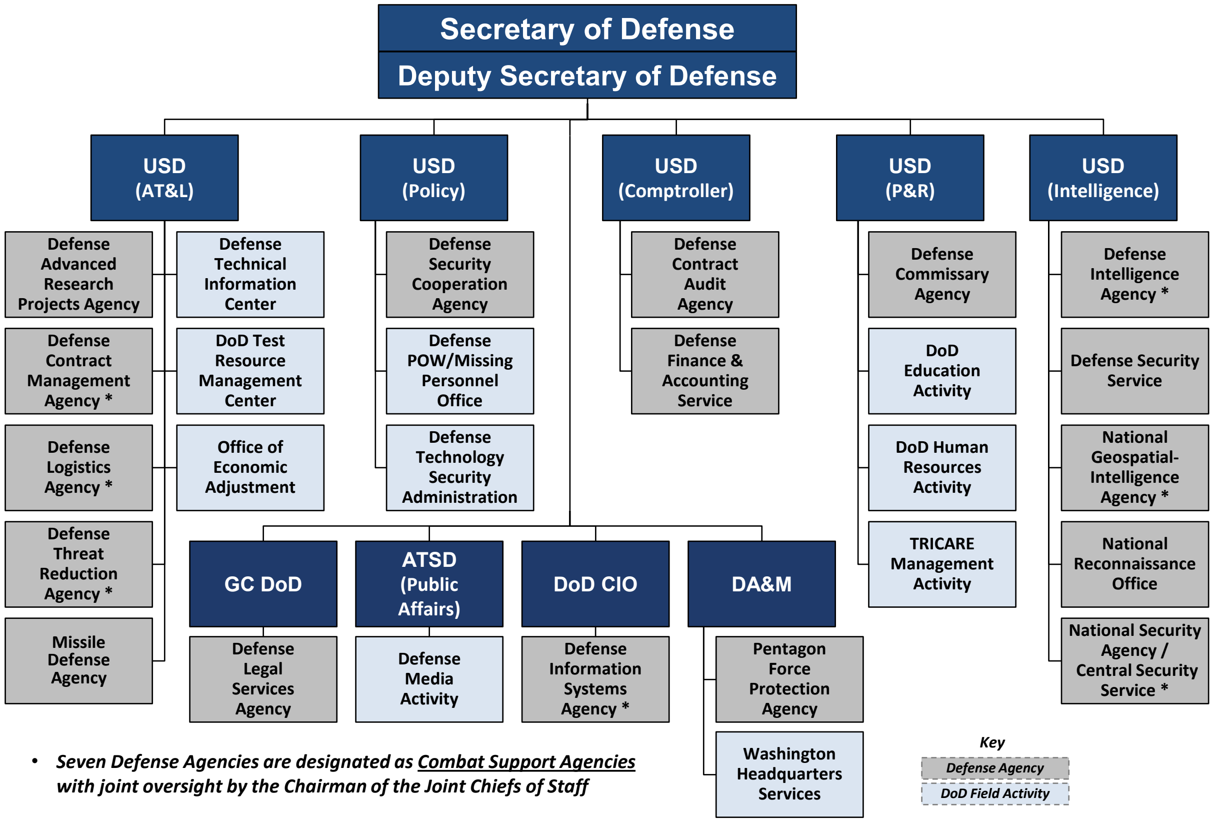


Military Departments include Active and Reserve Components. The Active Component is composed of units under the authority of the Secretary of Defense manned by active duty Military Service members, Reservists on active duty orders, or a combination of the two. The National Guard has a unique dual mission with both Reserve Component and State responsibilities (see Figure 19). The National Guard, when commanded by the Governor of each state or territory, can be called into action during local, statewide, or other emergencies, such as storms, drought, or civil disturbances (non-Federalized service). 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 Commander. The Guard and Reserve forces are recognized as indispensable and integral parts of the Nation's defense and fully part of the applicable Military Department.

Defense Agencies and DoD Field Activities

Defense Agencies and DoD Field Activities are established as DoD Components by law, the President, or the Secretary of Defense to provide for the performance, on a DoD-wide basis, of a supply or service activity that is common to more than one Military Department when it is determined to be more effective, economical, or efficient to do so. Each of the 17 Defense Agencies and 10 DoD Field Activities operate under the authority, direction, and control of the Secretary of Defense, through an OSD PSA or the Chairman of the Joint Chiefs of Staff.

Figure 20. Defense Agencies and DoD Field Activities



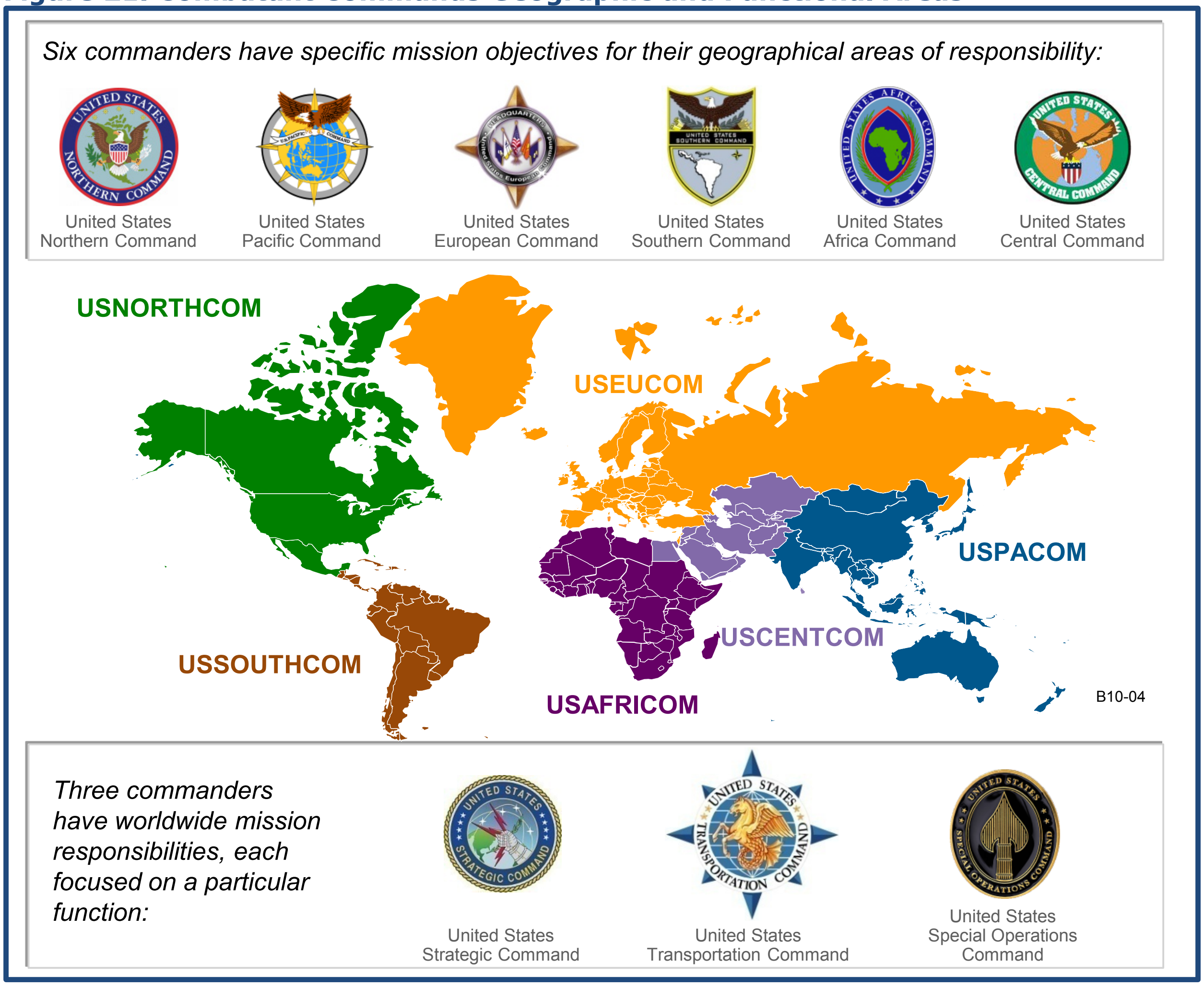
COMBATANT COMMANDS

The Commanders of the Combatant Commands are responsible to the President and the Secretary of Defense for accomplishing the military missions assigned to them and shall exercise command authority over assigned forces as directed by the Secretary of Defense. The operational chain of command runs from the President to the Secretary of Defense to the Commanders of the Combatant Commands. The Chairman of the Joint Chiefs of Staff functions within the chain of command by transmitting the orders of the President or the Secretary of Defense to the Commanders of the Combatant Commands.

The U.S. Special Operations Command (USSOCOM) is a Combatant Command with unique functions, responsibilities, and authorities. These unique functions, responsibilities, and authorities are similar to a number of authorities exercised by the Military Departments and Defense Agencies and include programming, budgeting, acquisition, training, organizing, equipping, and providing special operations forces (SOF), and developing SOF strategy, doctrine, tactics, and procedures. The USSOCOM is reliant upon the Services for common support and base operating support.

In addition to supplying assigned forces and capabilities to the Combatant Commands, the Military Departments provide administrative and logistics support by managing the operational costs and execution of these commands. The USSOCOM is the only Combatant Command that has budget authority provided directly to the Command through Congressional appropriations.

Figure 21. Combatant Commands Geographic and Functional Areas



This Page Left Blank Intentionally

Department of Defense Agency Financial Report Fiscal Year 2012

FINANCIAL SECTION

This Page Left Blank Intentionally

FINANCIAL INFORMATION

INDEPENDENT AUDITOR'S REPORT

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

November 15, 2012

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

SUBJECT: Independent Auditor's Report on the Department of Defense FY 2012 and FY 2011 Financial Statements (Report No. DODIG-2013-021)

We are providing the subject report to be published in the Department of Defense FY 2012 Agency Financial Report in conjunction with the Department of Defense FY 2012 and FY 2011 Annual Financial Statements provided to us in draft on November 1, 2012. 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 Department of Defense FY 2012 and FY 2011 Annual 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) 604-8938 (DSN 664-8938).

Richard B. Vasquez, CPA
Acting Assistant Inspector General
Financial Management and Reporting

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

November 15, 2012

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

SUBJECT: Independent Auditor's Report on the Department of Defense FY 2012 and FY 2011 Financial Statements (Report No. DODIG-2013-021)

The Chief Financial Officers Act of 1990, as amended, requires the DoD Inspector General to audit the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2012 and 2011, 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 management is also responsible for implementing effective internal control and for complying with laws and regulations. In addition, management is responsible for implementing and maintaining financial management systems that comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA). Our responsibility is to express an opinion on the financial statements based on our audit.

We are unable to express an opinion on the Department of Defense FY 2012 and FY 2011 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. The report is an integral part of our opinion report 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, represented to us that the Department of Defense FY 2012 and FY 2011 Annual 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, 2012. Section 1008(d) of the FY 2002 National Defense Authorization Act limits the DoD 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 all the auditing procedures required by generally accepted 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 material internal control weaknesses may affect the reliability of certain information contained in the principal financial statements—much of which was taken from the same data sources.[2] Therefore, we are unable to express, and we do not express, an opinion on the principal 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 to the Principal Financial Statements, DoD restated its financial statements as of September 30, 2011, to correct errors in assets, gross costs, and net position. We did not withdraw our auditor's report on the FY 2011 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 continue 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

[2] The annual financial statements include the Principal Financial Statements, Management Discussion and Analysis, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

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 control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, adversely affecting the entity's ability to initiate, authorize, record, or report financial data reliability in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. The following significant deficiency continued to exist.

- Contingent Legal Liabilities

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 2012 Agency Financial Report.

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 represented that instances of noncompliance identified in prior audits continued to exist. The Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, represented 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.

Other Information in the Annual Financial Statements

We performed our audit for the purpose of forming an opinion on the principal financial statements taken as a whole. DoD Management Discussion and Analysis, Required Supplementary Information, and Other Accompanying Information are presented for additional analysis and are not a required part of the principal basic financial statements. We did not audit and do not express an opinion on the information. We compared the information with DoD financial statements for consistency. Based on our limited work, we did not find any material inconsistencies between the information and the financial statements and applicable sections of OMB Circular No. A-136 (Revised), "Financial Reporting Requirements," August 3, 2012.

Scope and Methodology

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 are responsible for planning and performing the audit to obtain reasonable assurance and to provide an opinion on whether the DoD financial statements are presented fairly, in all material respects, in conformity with U.S. GAAP. We are also responsible for (1) testing whether DoD financial management systems substantially comply with the FFMIA requirements, (2) testing compliance with selected provisions of laws and regulations that have direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the Annual Financial Statements.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing over financial reporting and compliance to previously identified significant deficiencies, all of which are material and continue to exist. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected.

Because of the significance of the limitations on the scope of our work, we were unable to and did not perform our audit of internal control in accordance with U.S. GAAP and OMB audit guidance. We considered the limitation on the scope of our work in forming conclusions and in testing the financial statements.

We performed our audit in accordance with U.S. generally accepted government auditing standards. We believe our audit provides a reasonable basis for our opinions and other conclusions.

Agency Comments and Our Evaluation

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.

This report is intended solely for the information and use of DoD's management, DoD Office of Inspector General, Office of Management and Budget, Government Accountability Office, and Congress and is not intended to be used by anyone other than these specified parties.

Richard B. Vasquez, CPA
Acting 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 to include providing reasonable assurance that DoD personnel accumulated, recorded, and reported accounting data properly; met that the requirements of applicable laws and regulations; and safeguarded assets against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting. However, the following 13 material weaknesses and 1 significant deficiency exist that could adversely affect DoD financial 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 continued to exist related to in-transit disbursements, unmatched disbursements, negative unliquidated obligations, and unreconciled differences between U.S. Treasury records and DoD accounting records.

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

Attachment
Page 1 of 6

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. 6 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 101 pending cases, with a total claim amount of $5.3 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 34 of the 48 pending legal actions, totaling $12 trillion.[3]

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.

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

[3] 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 four additional pending legal actions totaling about $10.5 billion. The $10.5 billion was not included in the $12 trillion. The four legal actions were also not included in the final management schedule of information that was provided to us for our review.

Attachment
Page 4 of 6

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

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 2012, 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, 2012.

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 2012, DoD reported 12 cases of ADA violation. Therefore, DoD did not comply with 31 U.S.C. § 1341 (1990) and 31 U.S.C § 1517 (2004).

DoD 7000.14-R, "Financial Management Regulation," volume 14, chapter 7, "Antideficiency Act Report," November 2010, 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 6, 2012, 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).

Recommendations

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.

Attachment
Page 6 of 6

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 *Office of Management And Budget (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 $2.1 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, 2012). 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 its 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
	2012 Consolidated	Restated 2011 Consolidated
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$ 512,121.6	$ 523,441.6
Investments (Note 4)	641,666.5	569,342.2
Accounts Receivable (Note 5)	1,439.6	1,726.9
Other Assets (Note 6)	1,583.2	1,760.3
Total Intragovernmental Assets	**$ 1,156,810.9**	**$ 1,096,271.0**
Cash and Other Monetary Assets (Note 7)	1,822.0	1,720.3
Accounts Receivable, Net (Note 5)	11,522.4	9,961.4
Loans Receivable (Note 8)	957.5	814.4
Inventory and Related Property, Net (Note 9)	243,299.7	242,582.0
General Property, Plant and Equipment, Net (Note 10)	601,458.0	609,298.5
Investments (Note 4)	3,255.0	3,185.0
Other Assets (Note 6)	66,601.2	67,714.4
TOTAL ASSETS	**$ 2,085,726.7**	**$ 2,031,547.0**
Stewardship Property, Plant & Equipment (Note 10)		
LIABILITIES (Note 11)		
Intragovernmental:		
Accounts Payable (Note 12)	$ 1,762.9	$ 1,893.2
Debt (Note 13)	952.6	783.4
Other Liabilities (Note 15)	12,941.6	14,231.7
Total Intragovernmental Liabilities	**$ 15,657.1**	**$ 16,908.3**
Accounts Payable (Note 12)	19,492.0	26,103.9
Military Retirement and Other Federal Employment Benefits (Note 17)	2,323,924.3	2,212,359.6
Environmental and Disposal Liabilities (Note 14)	62,602.6	64,823.1
Loan Guarantee Liability (Note 8)	12.7	13.9
Other Liabilities (Note 15)	36,308.1	31,308.1
TOTAL LIABILITIES	**$ 2,457,996.8**	**$ 2,351,516.9**
Commitments & Contingencies (Note 16)		
NET POSITION		
Unexpended Appropriations – Earmarked Funds (Note 23)	$ 295.6	$ 134.6
Unexpended Appropriations – Other Funds	528,660.0	540,239.4
Cumulative Results of Operations – Earmarked Funds	(1,477,793.5)	(1,430,273.8)
Cumulative Results of Operations – Other Funds	576,567.8	569,929.9
TOTAL NET POSITION	**$ (372,270.1)**	**$ (319,969.9)**
TOTAL LIABILITIES AND NET POSITION	**$ 2,085,726.7**	**$ 2,031,547.0**

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

Department of Defense Consolidated Statement of Net Cost Agency Wide	2012 Consolidated	Restated 2011 Consolidated
	Dollars in Millions	
Program Costs		
Gross Costs	**$ 781,731.1**	**$ 811,635.0**
Military Retirement Benefits	85,570.4	107,519.6
Civil Works	10,967.2	13,530.1
Military Personnel	150,330.5	153,881.4
Operations, Readiness & Support	295,704.1	314,560.0
Procurement	130,578.8	128,572.8
Research, Development, Test & Evaluation	76,772.6	79,230.9
Family Housing & Military Construction	31,807.5	14,340.2
(Less: Earned Revenue)	(83,304.8)	(115,039.9)
Net Cost before Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	**$ 698,426.3**	**$ 696,595.1**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	70,427.3	(12,369.6)
Net Cost of Operations	**$ 768,853.6**	**$ 684,225.5**

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*
	2012 Earmarked Funds	2012 All Other Funds	2012 Eliminations	2012 Consolidated	2011 Earmarked Funds	Restated 2011 All Other Funds	2011 Eliminations	Restated 2011 Consolidated
Cumulative Results Of Operations								
Beginning Balances	$ (1,325,647.1)	$ 464,297.5	$ 0.0	$ (861,349.6)	$ (1,338,741.2)	$ 417,826.0	$ 0.0	$ (920,915.2)
Prior Period Adjustments:								
Changes in accounting principles								
Corrections of errors	0.0	1,005.7	0.0	1,005.7	0.0	(13,322.9)	0.0	(13,322.9)
Beginning balances, as adjusted	$ (1,325,647.1)	$ 465,303.2	$ 0.0	$ (860,343.9)	$ (1,338,741.2)	$ 404,503.1	$ 0.0	$ (934,238.1)
Budgetary Financing Sources:								
Appropriations used	347.3	730,232.2	0.0	730,579.5	206.9	747,758.5	0.0	747,965.4
Nonexchange revenue	2,785.7	(96.3)	0.0	2,689.4	2,764.4	(24.3)	0.0	2,740.1
Donations and forfeitures of cash and cash equivalents	29.5	0.2	0.0	29.7	30.3	0.1	0.0	30.4
Transfers(in/out without reimbursement)	(948.1)	1,081.7	0.0	133.6	(874.8)	964.0	0.0	89.2
Other	(132.2)	(14.2)	0.0	(146.4)	(1.8)	0.0	0.0	(1.8)
Other Financing Sources (Non-Exchange)								
Donations and forfeitures of property	0.0	37.5	0.0	37.5	0.3	7.3	0.0	7.6
Transfers(in/out without reimbursement)	(97.2)	163.3	0.0	66.1	(71.7)	(75.7)	0.0	(147.4)
Imputed financing	3.4	19,731.9	14,687.2	5,048.1	2.2	19,698.3	14,076.6	5,623.9
Other	(45.3)	(10,420.4)	0.0	(10,465.7)	12.7	1,799.6	0.0	1,812.3
Total Financing Sources	**$ 1,943.1**	**$ 740,715.9**	**$ 14,687.2**	**$ 727,971.8**	**$ 2,068.5**	**$ 770,127.8**	**$ 14,076.6**	**$ 758,119.7**
Net Cost of Operations (+/-)	48,368.0	735,172.8	14,687.2	768,853.6	(11.025.6)	709,327.7	14,076.6	684,225.5
Net Change	**$ (46,424.9)**	**$ 5,543.1**	**$ 0.0**	**$ (40,881.8)**	**$ 13,094.1**	**$ 60,800.1**	**$ 0.0**	**$ 73,894.2**
Cumulative Results of Operations	**$ (1,372,072.0)**	**$ 470,846.3**	**$ 0.0**	**$ (901,225.7)**	**$ (1,325,647.1)**	**$ 465,303.2**	**$ 0.0**	**$ (860,343.9)**
Unexpended Appropriations								
Beginning Balances	134.6	541,194.5	0.0	541,329.1	325.2	528,479.4	0.0	528,804.6
Prior Period Adjustments:								
Correction of Error	0.0	(955.1)	0.0	(955.1)	0.0	(955.1)	0.0	(955.1)
Beginning balances, as adjusted	$ 134.6	$ 540,239.4	$ **0.0**	$ 540,374.0	$ **325.2**	$ **527,524.3**	$ **0.0**	$ **527,849.5**
Budgetary Financing Sources:								
Appropriations received	1.3	736,780.9	0.0	736,782.2	16.5	775,450.0	0.0	775,466.5
Appropriations transferred (in/out)	507.0	(898.3)	0.0	(391.3)	0.0	(781.2)	0.0	(781.2)
Other adjustments	0.0	(17,229.8)	0.0	(17,229.8)	(0.2)	(14,195.2)	0.0	(14,195.4)
Appropriations used	(347.3)	(730,232.2)	0.0	(730,579.5)	(206.9)	(747,758.5)	0.0	(747,965.4
Total Budgetary Financing Sources	**$ 161.0**	**$ (11,579.4)**	**$ 0.0**	**$ (11,418.4)**	**$ (190.6)**	**$ 12,715.1**	**$ 0.0**	**$ 12,524.5**
Unexpended Appropriations	**$ 295.6**	**$ 528,660.0**	**$ 0.0**	**$ 528,955.6**	**$ 134.6**	**$ 540,239.4**	**$ 0.0**	**$ 540,374.0**
Net Position	**$ (1,371,776.4)**	**$ 999,506.3**	**$ 0.0**	**$ (372,270.1)**	**$ (1,325,512.5)**	**$ 1,005,542.6**	**$ 0.0**	**$ (319,969.9)**

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**		**Non-Budgetary Financing Accounts**	
	2012 Combined	**2011 Combined**	**2012 Combined**	**2011 Combined**
Budgetary Resources				
Unobligated balance, brought forward, October 1	$ 162,271.1	$ 160,032.1	$ 17.5	$ 24.9
Unobligated balance brought forward, October 1, as adjusted	162,271.1	160,032.1	17.5	24.9
Recoveries of prior year unpaid obligations	65,533.9	56,015.4	0.0	0.0
Other changes in unobligated balance	(12,952.1)	(11,205.6)	0.0	0.0
Unobligated balance from prior year budget authority, net	214,852.9	204,841.9	17.5	24.9
Appropriation (discretionary and mandatory)	792,178.8	829,461.3	0.0	0.0
Borrowing Authority (discretionary and mandatory)	0.0	0.0	172.6	229.8
Contract authority (discretionary and mandatory)	80,486.2	75,760.9	0.0	0.0
Spending authority from offsetting collections (discretionary and mandatory)	117,242.4	121,426.6	62.6	88.3
Total Budgetary Resources	**$ 1,204,760.3**	**$ 1,231,490.7**	**$ 252.7**	**$ 343.0**
Status of Budgetary Resources				
Obligations incurred	$ 1,059,067.8	$ 1,069,218.2	$ 237.2	$ 326.8
Unobligated balance, end of year:				
Apportioned	115,696.1	137,148.4	1.6	0.1
Exempt from Apportionment	3,976.1	4,180.3	0.0	0.0
Unapportioned	26,020.3	20,943.8	13.9	16.1
Unobligated balance brought forward, end of year	**$ 145,692.5**	**$ 162,272.5**	**$ 15.5**	**$ 16.2**
Total Budgetary Resources	**$ 1,204,760.3**	**$ 1,231,490.7**	**$ 252.7**	**$ 343.0**
Change in Obligated Balance				
Unpaid obligations, brought forward, October 1 (gross)	$ 454,926.2	$ 458,620.6	$ 569.1	$ 619.4
Uncollected customer payments from Federal Sources, brought forward, October 1	(75,184.3)	(69,766.8)	(99.9)	(97.3)
Obligated balance start of year (net), before adjustments	379,741.9	388,853.8	469.2	522.1
Obligated balance, start of year (net), as adjusted	379,741.9	388,853.8	469.2	522.1
Obligations incurred	1,059,067.8	1,069,218.2	237.2	326.8
Outlays (Gross)	(979,889.9)	(1,016,898.9)	(264.5)	(375.3)
Change in uncollected customer payments from Federal Sources	(2,769.1)	(5,417.5)	16.4	(2.6)
Recoveries of prior year unpaid obligations	(65,533.9)	(56,015.1)	0.0	0.0
Obligated balances, end of year				
Unpaid Obligations, end of year (gross)	468,570.2	454,924.8	541.8	570.9
Uncollected customer payments from	(77,953.4)	(75,184.3)	(83.5)	(99.9)
Obligated balance, end of year (net)	**$ 390,616.8**	**$ 379,740.5**	**$ 458.3**	**$ 471.0**

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**		**Non-Budgetary Financing Accounts**	
	2012 Combined	**2011 Combined**	**2012 Combined**	**2011 Combined**
Budgetary Authority and Outlays, Net:				
Budget Authority, gross (discretionary and mandatory)	$ 989,907.4	$ 1,026,648.8	$ 235.2	$ 318.1
Actual offsetting collections (discretionary and mandatory)	(190,586.0)	(190,906.0)	(92.6)	(102.6)
Change in uncollected customer payments from Federal sources (discretionary and mandatory)	(2,769.1)	(5,417.5)	16.4	(2.6)
Budget Authority, net (discretionary and mandatory)	**$ 796,552.3**	**$ 830,325.3**	**$ 159.0**	**$ 212.9**
Outlays, gross (discretionary and mandatory)	$ 979,889.9	$ 1,016,898.9	$ 264.5	$ 375.3
Actual offsetting collections (discretionary and mandatory)	(190,586.0)	(190,906.0)	(92.6)	(102.6)
Outlays, net (discretionary and mandatory)	789,303.9	825,992.9	171.9	272.7
Distributed offsetting receipts	(79,238.4)	(83,198.6)	0.0	0.0
Agency Outlays, net (discretionary and mandatory)	**$ 710,065.5**	**$ 742,794.3**	**$ 171.9**	**$ 272.7**

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*. 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 discernible.

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 and Supplies; (6) General Property, Plant, and Equipment; (7) Government Property in Possession of Contractors; (8) Accounts Payable; (9) Environmental Liabilities; (10) Statement of Net Cost; (11) Intragovernmental Eliminations; (12) 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 its 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 *http://www.defense.gov/recovery/*.

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 the 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.

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. The Department receives allocation transfers for the Security Assistance programs that meet the OMB exceptions for EOP funds. These funds are reported separately from the DoD financial statements based on an agreement with OMB.

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 the 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 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.

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 84 percent of resale inventory using the moving average cost method. An additional 12 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 2012 and FY 2011, 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 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 WCF 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, 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 may be evidenced by corroborating documentation that would generally support the summary level adjustments made to accounts payable and receivable. Unsupported disbursements and collections do not have supporting documentation for the transaction and most likely would not meet audit scrutiny. However, both supported and unsupported adjustments may have been made to the Department's Accounts Payable and Receivable trial balances prior to validating underlying transactions required to establish the Accounts Payable/Receivable were previously made. As a result, misstatements of reported Accounts Payable and Receivable are likely present in the Department's financial statements.

Due to noted material weaknesses in current accounting and financial feeder systems, the Department is generally unable to determine whether undistributed disbursements and collections should be applied to Federal or non-Federal accounts payable/receivable at the time accounting reports are prepared. Accordingly, the Department's policy is to allocate supported undistributed disbursements and collections between Federal and non-Federal categories based on the percentage of distributed Federal and non-Federal accounts payable and accounts receivable. Both supported and unsupported undistributed disbursements and collections are then applied to reduce accounts payable and receivable accordingly.

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 on 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*		2012		Restated 2011
				Dollars in Millions
Intragovernmental Assets				
Fund Balance with Treasury	$	788.8	$	988.6
Total Intragovernmental Assets	**$**	**788.8**	**$**	**988.6**
Non-Federal Assets				
Cash and Other Monetary Assets	$	1,709.1	$	1,643.2
Accounts Receivable		7,172.8		6,490.7
Other Assets		179.1		184.8
Total Non-Federal Assets	$	9,061.0	$	8,318.7
Total Nonentity Assets	$	8,849.8	$	9,307.3
Total Entity Assets	$	2,075,876.9	$	2,022,239.7
Total Assets	**$**	**2,085,726.7**	**$**	**2,031,547.0**

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 $1.0 billion understatement of General Property, Plant and Equipment, and a $0.9 billion overstatement of Other Assets to align the accounting records to the property accountability system. These corrections result in a $0.1 billion increase in Total Entity Assets. Refer to Note 26, Restatements, for further information.

Other Disclosures

Intra-governmental Fund Balance with Treasury (FBWT) primarily consists of deposit funds and receipt accounts. Deposit funds are used to record amounts held temporarily until paid to the appropriate party. Receipt accounts are used for amounts collected on behalf of the U.S. Treasury General Fund.

Intra-governmental Accounts Receivable consist of amounts associated with canceled year 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 consist of cash held by Disbursing Officers to carry out payment, collection, and foreign currency accommodation exchange missions.

Non-Federal Accounts Receivable consist of amounts associated with canceled year appropriations, and interest, fines and penalties due on debt. Generally, the Department cannot use collections and must distribute them to the U.S. Treasury.

Non-Federal Other Assets consist of Advance Payment Pool Agreements (APPAs) for research and development projects. AAPAs are utilized when multiple contracts with a nonprofit educational institution require advance payments.

NOTE 3. FUND BALANCE WITH TREASURY

Fund Balance with Treasury *As of September 30*	*Dollars in Millions* 2012	 2011
Fund Balance		
Appropriated Funds	$ 500,572.1	$ 509,337.0
Revolving Funds	8,037.2	9,887.2
Trust Funds	2,132.9	2,494.4
Special Funds	548.2	697.7
Other Fund Types	831.2	1,025.3
Total Fund Balance	**$ 512,121.6**	**$ 523,441.6**
Fund Balance Per Treasury Versus Agency		
Fund Balance per Treasury	$ 521,342.1	$ 530,849.7
Fund Balance per Agency	512,121.6	523,441.6
Reconciling Amount	**$ 9,220.5**	**$ 7,408.1**

Other Fund Types primarily consists of deposit funds and receipt accounts.

The Department shows a reconciling net difference of $9.2 billion with U.S. Treasury. This includes canceling year authority of $8.5 billion, unavailable receipts of $586.6 million, allocation transfers of $103.3 million, and fiduciary activities of $36.9 million.

Status of Fund Balance with Treasury *As of September 30*	*Dollars in Millions* 2012	 2011
Unobligated Balances		
Available	$ 119,674.0	$ 141,171.4
Unavailable	582,311.3	583,913.4
Obligated Balance not yet Disbursed	469,112.0	455,495.4
Non-Budgetary FBWT	723.3	1,966.0
Non-FBWT Budgetary Accounts	(659,699.0)	(659,104.6)
Total Fund Balance	**$ 512,121.6**	**$ 523,441.6**

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 disbursements 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 laws 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.

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

Non-FBWT Budgetary Accounts reduce the Status of FBWT and consist of investments in U.S. Treasury securities, unfilled customer orders without advance, contract and borrowing authority accounts, and receivables.

NOTE 4. INVESTMENTS AND RELATED INTEREST

Investments and Related Interest					*Dollars in Millions*
	2012				
As of September 30	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities					
Nonmarketable, Market-Based					
Military Retirement Fund	$ 435,206.4	See Below	$ (11,012.4)	$ 424,194.0	$ 536,544.6
Medicare-Eligible Retiree Health Care Fund	207,793.6	See Below	(6,433.4)	201,360.2	262,831.3
US Army Corps of Engineers	7,264.6	See Below	(57.7)	7,206.9	7,416.2
Other Funds	3,278.3	See Below	(79.8)	3,198.5	3,461.3
Total Nonmarketable, Market-Based	653,542.9		(17,583.3)	635,959.6	810,253.4
Accrued Interest	5,706.9			5,706.9	5,706.9
Total Intragovernmental Securities	$ 659,249.8		$ (17,583.3)	$ 641,666.5	$ 815,960.3
Other Investments					
Total Other Investments	$ 3,255.0	See Below	$ 0.0	$ 3,255.0	N/A
Amortization Method Used: Effective 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	6,495.4	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					

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 and used 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. Government wide 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 primarily consists of $2.0 billion in investments of the DoD Education Benefits Trust Fund, $817.9 million in investments of the Host Nation Support for U.S. Relocation Activities Trust Fund, and $316.7 million in investments of the Voluntary Separation Incentive Trust Fund.

Other Investments consist of Military Housing Privatization Initiative limited partnerships. The limited partnerships support military housing at Army, Air Force, Navy and Marine Corps installations. This investment relates to limited partnerships that do not require Market Value Disclosure.

Note 5. Accounts Receivable

Accounts Receivable			*Dollars in Millions*
	2012		
As of September 30	**Gross Amount Due**	**Allowance for Estimated Uncollectibles**	**Accounts Receivable, Net**
Intragovernmental Receivables	$ 1,439.6	N/A	$ 1,439.6
Non-Federal Receivables (From the Public)	12,420.5	(898.1)	11,522.4
Total Accounts Receivable	$ 13,860.1	$ (898.1)	$ 12,962.0

Accounts Receivable As of September 30	2011 Gross Amount Due		2011 Allowance for Estimated Uncollectibles		2011 Accounts Receivable, Net	*Dollars in Millions*
Intragovernmental Receivables	$	1,726.9		N/A	$	1,726.9
Non-Federal 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 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 As of September 30	2012		Restated 2011	*Dollars in Millions*
Intragovernmental Other Assets				
Advances and Prepayments	$	1,447.3	$	1,634.2
Other Assets		135.9		126.1
Total Intragovernmental Other Assets	**$**	**1,583.2**	**$**	**1,760.3**
Non-Federal Other Assets				
Outstanding Contract Financing Payments	$	65,342.9	$	66,713.5
Advances and Prepayments		1,063.6		801.3
Other Assets (With the Public)		194.7		199.6
Total Non-Federal Other Assets	**$**	**66,601.2**	**$**	**67,714.4**
Total Other Assets	**$**	**68,184.4**	**$**	**69,474.7**

Restatements

The Department corrected a $955.1 million prior-year overstatement of Other Assets (With the Public). Refer to Note 26, Restatements, for further information.

Other Disclosures

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

Other Assets (With the Public) consist of Advance Payment Pool Agreements (APPAs) for research and development projects. AAPAs are utilized when multiple contracts with a nonprofit educational institution require advance payments.

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. The Department is not obligated to make payment to contractors until delivery and acceptance.

Outstanding Contract Financing Payments includes $61.9 billion in contract financing payments and an additional $3.4 billion in estimated future payments to contractors upon delivery and government acceptance of satisfactory product. Refer to Note 15, Other Liabilities, for further information.

NOTE 7. CASH AND OTHER MONETARY ASSETS

Cash and Other Monetary Assets *As of September 30*	*Dollars in Millions* 2012	2011
Cash	$ 443.9	$ 472.9
Foreign Currency	1,378.1	1,247.4
Total Cash, Foreign Currency, and Other Monetary Assets	**$ 1,822.0**	**$ 1,720.3**

Cash (except for $112.9 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)
- 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
- Payments of interest and other payments over the life of the loan after adjusting for estimated defaults, prepayments, fees, penalties, and 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*	
	2012	**2011**
Loans Receivable		
Direct Loans:		
Military Housing Privatization Initiative	957.5	814.4
Total Direct Loans	**$ 957.5**	**$ 814.4**
Defaulted Loan Guarantees:		
Military Housing Privatization Initiative	0.0	0.0
Armament Retooling & Manufacturing Support Initiative	0.0	0.0
Total Default Loan Guarantees		
Total Loans Receivable	**$ 957.5**	**$ 814.4**
Loan Guarantee Liability		
Military Housing Privatization Initiative	11.7	13.7
Armament Retooling & Manufacturing Support Initiative	1.0	0.2
Total Loan Guarantee Liability	**$ 12.7**	**$ 13.9**

Direct Loans Obligated	*Dollars in Millions*	
	2012	**2011**
Direct Loans Obligated After FY 1991 (Present Value Method):		
Military Housing Privatization Initiative		
Loans Receivable Gross	$ 1,119.6	$ 953.8
Interest Receivable	0.0	0.0
Foreclosed Property	0.0	0.0
Allowance for Subsidy Cost (Present Value)	(162.1)	(139.4)
Value of Assets Related to Direct Loans	957.5	814.4
Total Direct Loans Receivable	**$ 957.5**	**$ 814.4**

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*
	2012		2011	
Direct Loan Programs				
Military Housing Privatization Initiative	$	261.1	$	304.8
Total	**$**	**261.1**	**$**	**304.8**

Subsidy Expense for Direct Loan by Program									*Dollars in Millions*
2012	Interest Differential		Defaults		Fees		Other		Total
New Direct Loans Disbursed									
Military Housing Privatization Initiative	$	21.3	$	22.2	$	0.0	$	0.0	$ 43.5
Total	**$**	**21.3**	**$**	**22.2**	**$**	**0.0**	**$**	**0.0**	**$ 43.5**
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**
2012	Modifications		Interest Rate Reestimates		Technical Reestimates		Total Reestimates		Total
Direct Loan Modifications and Reestimates									
Military Housing Privatization Initiative	$	0.0	$	(9.6)	$	(4.1)	$	(13.7)	$ (13.7)
Total	**$**	**0.0**	**$**	**(9.6)**	**$**	**(4.1)**	**$**	**(13.7)**	**$ (13.7)**
2011	Modifications		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)**
	2012		2011						
Total Direct Loan Subsidy Expense:									
Military Housing Privatization Initiative	$	29.8	$	21.3					
Total	**$**	**29.8**	**$**	**21.3**					

Subsidy Expense for Direct Loan by Program *As of September 30*	Interest Differential	Defaults	Fees	Other	Total *Dollars in Millions*
Budget Subsidy Rates for Direct Loans					
Military Housing Privatization Initiative	-7.26%	10.35%	0.00%	0.00%	3.09%

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*	2012	2011
Beginning Balance, Changes, and Ending Balance:		
Beginning Balance of the Subsidy Cost Allowance	**$ 139.4**	**$ 129.2**
Add: Subsidy Expense for Direct Loans Disbursed during the Reporting Years by Component		
Interest Rate Differential Costs	21.3	30.3
Default Costs (Net of Recoveries)	22.2	27.3
Fees and Other Collections	0.0	0.0
Other Subsidy Costs	0.0	0.0
Total of the above Subsidy Expense Components	**43.5**	**$ 57.6**
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	(7.1)	(11.1)
Other	0.0	0.0
Total of the above Adjustment Components	**$ (7.1)**	**$ (11.1)**
Ending Balance of the Subsidy Cost Allowance before Reestimates	**$ 175.8**	**$ 175.7**
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimates	$ (9.6)	$ (5.5)
Technical/Default Reestimate	(4.1)	(30.8)
Total of the above Reestimate Components	**(13.7)**	**(36.3)**
Ending Balance of the Subsidy Cost Allowance	**$ 162.1**	**$ 139.4**

Defaulted Guaranteed Loans *As of September 30* *Dollars in Millions*	2012	2011
Defaulted Guaranteed Loans from Post-FY 1991 Guarantees (Present Value Method):		
Military Housing Privatization Initiative		
Defaulted Guaranteed Loans Receivable, Gross	$ 0.0	$ 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	**$ 0.0**	**$ 0.0**

Guaranteed Loans Outstanding *As of September 30*	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
	Dollars in Millions	
2012		
Guaranteed Loans Outstanding		
Military Housing Privatization Initiative	$ 448.4	$ 448.4
Armament Retooling & Manufacturing Support Initiative	0.0	0.0
Total	**$ 448.4**	**$ 448.4**
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**
2012		
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**
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**

Liabilities for Loan Guarantees *As of September 30*	2012	2011
	Dollars in Millions	
Liabilities for Loan Guarantee from Post 1991 (Present Value)		
Military Housing Privatization Initiative	$ 11.7	$ 13.7
Armament Retooling & Manufacturing Support Initiative	1.0	0.2
Total Loan Guarantee Liability (Post FY 1991)	**$ 12.7**	**$ 13.9**
Total Loan Guarantee Liability	**$ 12.7**	**$ 13.9**

Subsidy Expense for Direct Loan by Program

As of September 30 — *Dollars in Millions*

2012	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	**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**
2012	**Modifica-tions**	**Interest Rate Reestimates**	**Technical Reestimates**	**Total Reestimates**	**Total**
Modifications and Reestimates					
Military Housing Privatization Initiative	$ 0.0	$ (0.9)	$ (1.7)	$ (2.6)	$ (2.6)
Armament Retooling & Manufacturing Support Initiative	0.0	0.8	(0.0)	0.8	0.8
Total	**$ 0.0**	**$ (0.1)**	**$ (1.7)**	**$ (1.8)**	**$ (1.8)**
2011	**Modifica-tions**	**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)**

	2012	2011
Total Loan Guarantee		
Military Housing Privatization Initiative	$ (2.6)	$ (3.3)
Armament Retooling & Manufacturing Support Initiative	0.8	(3.6)
Total	**$ (1.8)**	**$ (6.9)**

There are no new loan guarantees in FY2012.

Subsidy Expense for Direct Loan 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	0.0%	0.0%	0.0%	0.0%	0.0%
Armament Retooling & Manufacturing Support Initiative	0.0%	0.0%	0.0%	0.0%	0.0%

There are no new loan guarantees in FY 2012.

Schedule for Reconciling Loan Guarantee Liability Balances for Post-FY 1991 Loan Guarantees *As of September 30*	Dollars in Millions 2012	 2011
Beginning Balance, Changes, and Ending Balance		
Beginning Balance of the Loan Guarantee Liability	**$ 13.9**	**$ 19.8**
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	0.6	1.0
Other	0.0	0.0
Total of the above Adjustments	**$ 0.6**	**$ 1.0**
Ending Balance of the Loan Guarantee Liability before Reestimates	**$ 14.5**	**$ 20.8**
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimate	$ (0.1)	$ (1.1)
Technical/Default Reestimate	(1.7)	(5.8)
Total of the above Reestimate Components	**$ (1.8)**	**(6.9)**
Ending Balance of the Loan Guarantee Liability	**$ 12.7**	**$ 13.9**

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 *As of September 30*	Dollars in Millions 2012	 2011
Inventory, Net	$ 90,156.8	$ 94,280.2
Operating Materiel & Supplies, Net	152,591.5	147,731.5
Stockpile Materiel, Net	551.4	570.3
Total Inventory and Related Property	**$ 243,299.7**	**$ 242,582.0**

Inventory, Net				Dollars in Millions
	2012			Valuation Method
As of September 30	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	
Inventory Categories				
Available and Purchased for Resale	$ 61,608.0	$ (2,602.5)	$ 59,005.5	FIFO,LAC, MAC
Held for Repair	33,864.2	(4,143.9)	29,720.3	LAC,MAC
Excess, Obsolete, and Unserviceable	6,833.8	(6,833.8)	0.0	NRV
Raw Materiel	1,352.6	0.0	1,352.6	MAC,SP,LAC
Work in Process	78.4	0.0	78.4	AC
Total Inventory, Net	**$ 103,737.0**	**$ (13,580.2)**	**$ 90,156.8**	

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
	2011			Valuation Method
As of September 30	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	
Inventory Categories				
Available and Purchased for Resale	$ 65,084.4	$ 590.1	$ 65,674.5	FIFO,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

Restrictions

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

- War reserve materiel valued at $1.8 billion;
- Commissary items valued at $398.8 million held for purchase by authorized patrons; and
- Dispositions pending litigation or negotiation valued at $64.0 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.

As a result of audit readiness efforts, adjustments had to be made to mission critical asset balances that resulted from events that could not be identified to specific accounting periods, and those adjustments were made against current year gain/loss accounts. Significant accounting adjustments have been made to the Department's mission critical assets as a result of the Department's ongoing audit readiness efforts. These accounting adjustments were recognized in current year gain/loss accounts when auditable data was not available to support restatement of prior period financial statements.

Operating Materiel and Supplies, Net							*Dollars in Millions*
	2012						**Valuation Method**
As of September 30	**OM&S, Gross Value**		**Revaluation Allowance**		**OM&S, Net**		
Inventory Categories							
Held for Use	$	134,535.9	$	(28.0)	$	134,507.9	SP, LAC, MAC
Held for Repair		18,882.2		(798.6)		18,083.6	SP, LAC, MAC
Excess, Obsolete, and Unserviceable		1,925.0		(1,925.0)		0.0	NRV
Total OM&S	**$**	**155,343.1**	**$**	**(2,751.6)**	**$**	**152,591.5**	

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*
	2011						**Valuation Method**
As of September 30	**OM&S, Gross Value**		**Revaluation Allowance**		**OM&S, Net**		
Inventory 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

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 include 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*
	2012			
As of September 30	Stockpile, Materiel Amount	Allowance for Gains (Losses)	Stockpile, Materiel, Net	Valuation Method
Stockpile Materiel Categories				
Held for Sale	$ 522.1	$ 0.0	$ 522.1	AC, LCM
Held for Reserve for Future Sale	29.3	0.0	29.3	AC, LCM
Total Stockpile Materiel	**$ 551.4**	**$ 0.0**	**$ 551.4**	
Legend for Valuation Methods:				
AC = Actual Cost			LCM = Lower of Cost or Market	

Stockpile Materiel, Net				*Dollars in Millions*
	2011			
As of September 30	Stockpile, Materiel Amount	Allowance for Gains (Losses)	Stockpile, Materiel, Net	Valuation Method
Stockpile Materiel Categories				
Held for Sale	$ 541.0	$ 0.0	$ 541.0	AC, LCM
Held for Reserve for Future Sale	29.3	0.0	29.3	AC, LCM
Total Stockpile Materiel	**$ 570.3**	**$ 0.0**	**$ 570.3**	
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 3rd Quarter, FY 2012, 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 As of September 30	2012 Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value Dollars in Millions
Major Asset Classes					
Land	N/A	N/A	$ 10,706.2	N/A	$ 10,706.2
Buildings, Structures, and Facilities	S/L	20 or 40	248,871.1	(120,845.8)	128,025.3
Leasehold Improvements	S/L	Lease term	880.5	(302.2)	578.3
Software	S/L	2 – 5 or 10	11,324.7	(7,640.2)	3,684.5
General Equipment	S/L	5 or 10	105,745.4	(69,931.6)	35,813.8
Military Equipment	S/L	Various	878,687.7	(500,413.0)	378,274.7
Assets Under Capital Lease[1]	S/L	Lease term	901.4	(520.4)	381.0
Construction-in-Progress	N/A	N/A	42,825.7	N/A	42,825.7
Other			1,171.4	(2.9)	1,168.5
Total General PP&E			**$ 1,301,114.1**	**$ (699,656.1)**	**$ 601,458.0**

[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 As of September 30	Restated 2011 Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value Dollars in Millions
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	854,180.3	(446,334.0)	407,846.3
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			**$ 1,247,237.4**	**$ (637,938.9)**	**$ 609,298.5**

[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 $1.0 billion understatement 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. The discovery and validation phases are identifying adjustments to values resulting in current year gains/losses.

Other consists of assets awaiting disposition.

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 2011 ending to the FY 2012 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 2012 due to limitations of the Department's financial and nonfinancial management processes and systems that feed the financial statements.

Categories	Measure Quantity	As of 9/30/11	Additions	Deletions	As of 9/30/12
Buildings and Structures	Each	58,603	859	3,287	56,175
Archeological Sites	Each	30,637	633	1,357	29,913
Museum Collection Items (Objects, not including fine art)	Each	1,367,534	28,272	163,580	1,232,226
Museum Collection Items (Objects, fine art)	Each	51,296	2,222	125	53,393

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.

Facility Code	Predominant Land Use Categories	As of 9/30/11 *(Acres in Thousands)*	Additions	Deletions	As of 9/30/12
9110	Government Owned Land	6,505	93	47	6,551
9111	State Owned Land	7	0	2	5
9120	Withdrawn Public Land	16,135	0	1,421	14,714
9130	Licensed and Permitted Land	2,362	461	1,906	917
9140	Public Land	202	0	0	202
9210	Land Easement	376	3	1	378
9220	In-leased Land	226	10	112	124
9230	Foreign Land	454	0	157	297
	Grand Total				**23,188**
	Total – All Other Lands				**8,267**
	Total – Stewardship Lands				**14,921**

Assets Under Capital Lease *As of September 30*	*Dollars in Millions* 2012	2011
Entity as Lessee, Assets Under Capital Lease		
Land and Buildings	$ 273.0	$ 538.8
Equipment	628.4	643.5
Accumulated Amortization	(520.4)	(748.6)
Total Capital Leases	**$ 381.0**	**$ 433.7**

NOTE 11. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

Liabilities Not Covered by Budgetary Resources *As of September 30*		*Dollars in Millions* 2012		2011
Intragovernmental Liabilities				
Accounts Payable	$	12.9	$	9.2
Debt		4.3		5.1
Other		2,141.0		2,142.1
Total Intragovernmental Liabilities	**$**	**2,158.2**	**$**	**2,156.4**
Non-Federal Liabilities				
Accounts Payable	$	53.0	$	692.2
Military Retirement and Other Federal Employment Benefits		1,771,202.7		1,656,021.3
Environmental Liabilities		57,911.8		60,567.0
Other Liabilities		16,323.7		17,186.6
Total Non-Federal Liabilities	**$**	**1,845,491.2**	**$**	**1,734,467.1**
Total Liabilities Not Covered by Budgetary Resources	**$**	**1,847,649.4**	**$**	**1,736,623.5**
Total Liabilities Covered by Budgetary Resources	**$**	**610,347.4**	**$**	**614,893.4**
Total Liabilities	**$**	**2,457,996.8**	**$**	**2,351,516.9**

Liabilities Not Covered by Budgetary Resources includes liabilities requiring congressional action before budgetary resources can be provided.

Abnormal Balance

Total Liabilities Covered by Budgetary Resources includes an abnormal balance of $6.2 million in USSGL account 2140, Accrued Interest Payable. This is primarily due to improper posting of accounting transactions.

Other Disclosures

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.

Non-Federal 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 liabilities for Federal Employees Compensation Act, Unemployment Insurance, and Judgment Fund.

Non-Federal 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 $1.1 trillion in pension liabilities and $656.3 billion in 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						*Dollars in Millions*
	2012					
As of September 30	Accounts Payable		Interest, Penalties, and Administrative Fees		Total	
Intragovernmental Payables	$	1,762.9		N/A	$	1,762.9
Non-Federal Payables (To the Public)		19,498.2		(6.2)		19,492.0
Total Accounts Payable	**$**	**21,261.1**	**$**	**(6.2)**	**$**	**21,254.9**

Accounts Payable						*Dollars in Millions*
	2011					
As of September 30	Accounts Payable		Interest, Penalties, and Administrative Fees		Total	
Intragovernmental Payables	$	1,893.2		N/A	$	1,893.2
Non-Federal Payables (To the Public)		26,102.4		1.5		26,103.9
Total Accounts Payable	**$**	**27,995.6**	**$**	**1.5**	**$**	**27,997.1**

Accounts Payable include amounts owed to Federal and non-Federal 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 reclassifying amounts between Federal and non-Federal accounts payable, accruing additional accounts payable and expenses, and applying both supported and unsupported undistributed disbursements at the reporting entity level.

Abnormal Balance

Non-Federal Payables, interest, penalties, and administrative fees, includes an abnormal balance of $6.2 million in USSGL account 2140 (Accrued Interest Payable). This is primarily due to an improper posting of accounting transactions.

NOTE 13. DEBT

Debt						Dollars in Millions
	2012					
As of September 30	Beginning Balance		Net Borrowing		Ending Balance	
Agency Debt (Intragovernmental)						
Debt to the Treasury	$	783.4	$	169.2	$	952.6
Total Agency Debt	**$**	**783.4**	**$**	**169.2**	**$**	**952.6**

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
Total Agency Debt	**$**	**518.3**	**$**	**265.1**	**$**	**783.4**

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 Capital Improvements 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				Dollars in Millions
As of September 30	2012		2011	
Environmental Liabilities–Non-Federal				
Accrued Environmental Restoration Liabilities				
Active Installations – Installation Restoration Program (IRP) and Building Demolition and Debris Removal (BD/DR)	$	10,571.0	$	11,043.3
Active Installations – Military Munitions Response Program (MMRP)		3,953.9		4,120.0
Formerly Used Defense Sites – IRP & BD/DR		3,063.4		3,295.4
Formerly Used Defense Sites – MMRP		10,842.6		10,990.0
Other Accrued Environmental Liabilities – Non-BRAC				
Environmental Corrective Action	$	786.4	$	500.2
Environmental Closure Requirements		1,838.8		1,968.6
Environmental Response at Operational – Ranges		93.7		95.2
Asbestos		1,057.4		1,485.0
Non-Military Equipment		554.1		548.2
Other		1,121.7		1,079.9
Base Realignment and Closure Installations (BRAC)				
Installation Restoration Program	$	3,388.2	$	3,743.0
Military Munitions Response Program		703.1		707.3
Environmental Corrective Action/Closure Requirements		159.5		309.9
Asbestos		0.3		0.0

Environmental Liabilities and Disposal Liabilities *As of September 30*	*Dollars in Millions* 2012	2011
Environmental Disposal for Military Equipment/Weapons Programs		
Nuclear Powered Military Equipment/Spent Nuclear Fuel	$ 14,055.9	$ 13,637.3
Non-Nuclear Powered Military Equipment	36.4	36.4
Other Weapons Systems	146.0	161.0
Chemical Weapons Disposal Program		
Chemical Demilitarization – Chemical Materials Agency (CMA)	$ 3,691.1	$ 4,592.0
CAMD Demilitarization – Assembled Chemical Weapons Alternatives (ACWA)	6,539.1	6,510.4
Total Environmental Liabilities	**$ 62,602.6**	**$ 64,823.1**

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 clean-up costs associated with General Property, Plant, and Equipment (PP&E) is $3.2 billion for FY 2012. 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 clean up requirements for the Defense Environmental Restoration Program (DERP) sites at active installations, Base Realignment and Closure installations, Formerly Used Defense Sites, sites at active installations that are not covered by DERP, weapon systems programs, and chemical weapons disposal programs. The weapons systems program consists of chemical weapons disposal, nuclear powered aircraft carriers, nuclear powered submarines, and other nuclear ships. All cleanup efforts are 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 weapon 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 (Public Law 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 prior to October 1, 1997, unless the costs are intended to be recovered through user charges. If the costs are 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 life of the assets.

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, re-estimation 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
	2012		
As of September 30	Current Liability	Noncurrent Liability	Total
Intragovernmental			
Advances from Others	$ 1,185.8	$ 0.0	$ 1,185.8
Deposit Funds and Suspense Account Liabilities	153.3	0.0	153.3
Disbursing Officer Cash	1,889.4	0.0	1,889.4
Judgment Fund Liabilities	328.1	0.0	328.1
FECA Reimbursement to the Department of Labor	616.9	756.1	1,373.0
Custodial Liabilities	4,647.9	2,508.0	7,155.9
Employer Contribution and Payroll Taxes Payable	365.6	0.0	365.6
Other Liabilities	490.5	0.0	490.5
Total Intragovernmental Other	**$ 9,677.5**	**$ 3,264.1**	**$ 12,941.6**
Non-Federal			
Accrued Funded Payroll and Benefits	$ 9,387.2	$ 0.0	$ 9,387.2
Advances from Others	4,225.2	0.0	4,225.2
Deferred Credits	0.0	0.0	0.0
Deposit Funds and Suspense Accounts	473.1	0.0	473.1
Nonenvironmental Disposal Liabilities			
Military Equipment (Nonnuclear)	151.3	26.5	177.8
Excess/Obsolete Structures	66.1	525.6	591.7
Conventional Munitions Disposal	0.0	2,136.6	2,136.6
Accrued Unfunded Annual Leave	10,638.2	0.0	10,638.2
Capital Lease Liability	184.0	22.3	206.3
Contract Holdbacks	964.2	0.2	964.4
Employer Contribution and Payroll Taxes Payable	371.4	0.0	371.4
Contingent Liabilities	531.9	6,421.2	6,953.1
Other Liabilities	182.6	0.5	183.1
Total Non-Federal Other Liabilities	**$ 27,175.2**	**$ 9,132.9**	**$ 36,308.1**
Total Other Liabilities	**$ 36,852.7**	**$ 12,397.0**	**$ 49,249.7**

Other Liabilities As of September 30	2011					Dollars in Millions
	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	**$**	**10,921.5**	**$**	**3,310.2**	**$**	**14,231.7**
Non-Federal						
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		0.0		0.0		0.0
Deposit Funds and Suspense Accounts		164.8		0.0		164.8
Nonenvironmental Disposal Liabilities						
Military Equipment (Nonnuclear)		12.8		207.6		220.4
Excess/Obsolete Structures		3.2		535.4		538.6
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		0.0		373.9
Contingent Liabilities		1,581.1		4,288.3		5,869.4
Other Liabilities		150.1		0.5		150.6
Total Non-Federal Other Liabilities	**$**	**23,494.0**	**$**	**7,814.1**	**$**	**31,308.1**
Total Other Liabilities	**$**	**34,415.5**	**$**	**11,124.3**	**$**	**45,539.8**

Capital Lease Liability				Dollars in Millions
	2012 – Asset Category			
As of September 30	Land and Buildings	Equipment	Other	Total
Future Payments Due				
2013	$ 17.5	$ 0.1	$ 2.8	$ 20.4
2014	19.6	0.0	1.1	20.7
2015	19.1	0.0	0.0	19.1
2016	10.4	0.0	0.0	10.4
2017	11.7	0.0	0.0	11.7
After 5 Years	126.9	0.0	0.0	126.9
Total Future Lease Payments Due	**$ 205.2**	**$ 0.1**	**$ 3.9**	**$ 209.2**
Less: Imputed Interest Executory Costs	2.9	0.0	0.0	2.9
Net Capital Lease Liability	**$ 202.3**	**$ 0.1**	**$ 3.9**	**$ 206.3**
Capital Lease Liabilities Covered by Budgetary Resources				**206.3**
Capital Lease Liabilities Not Covered by Budgetary Resources				**0.0**

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**

Intragovernmental Other Liabilities primarily consists of unemployment compensation liabilities.

Non-Federal Other Liabilities primarily consist of estimated costs for services provided; accrued liabilities for inventory owned and managed on behalf of foreign governments; and undistributed international tariff receipts.

Contingent Liabilities includes $3.4 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 contractor costs incurred but yet unpaid are estimable, the Department has recognized a contingent liability for the estimated unpaid costs that are considered conditional for payment 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 records contingent liabilities in Note 15, Other Liabilities.

The Department reports 48 legal actions with individual claims greater than the Department's FY 2012 materiality threshold of $140.3 million. The total of the 48 actions is approximately $13.0 trillion. Of this amount, the OGC determined that claims totaling approximately $8.6 billion are classified "reasonably possible," $956.7 billion are classified "remote," and $12.0 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*
	2012		
As of September 30	Liabilities	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Pension and Health Benefits			
Military Retirement Pensions	$ 1,477,918.0	$ (371,657.5)	$ 1,106,260.5
Military Retirement Health Benefits	298,216.9	0.0	298,216.9
Military Medicare-Eligible Retiree Benefits	532,781.3	(174,703.7)	358,077.6
Total Pension and Health Actuarial Benefits	**$ 2,308,916.2**	**$ (546,361.2)**	**$ 1,762,555.0**
Other Benefits			
FECA	$ 6,540.8	$ 0.0	$ 6,540.8
Voluntary Separation Incentive Programs	678.2	(308.5)	369.7
DoD Education Benefits Fund	1,385.4	(1,385.4)	0.0
Other	6,403.7	(4,666.3)	1,737.4
Total Other Benefits	**$ 15,008.1**	**$ (6,360.2)**	**$ 8,647.9**
Total Military Retirement and Other Federal Employment Benefits	**$ 2,323,924.3**	**$ (552,721.4)**	**$ 1,771,202.9**
Actuarial Cost Method Used: Aggregate Entry-Age Method *Assumptions: Effective Interest* *Market Value of Investments in Market-based and Marketable Securities: $807.7 billion*			

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**
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	**$ 2,212,359.6**	**$ (556,338.3)**	**$ 1,656,021.3**

Other Federal Employment Benefits			
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*
	2012				
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	**$ 1,360,922.5**	**$ 305,985.0**	**$ 533,667.7**	**$ 770.1**	**$ 1,773.6**
Normal Cost Liability	30,563.7	10,700.7	10,958.3	0.0	299.0
Interest Cost	64,807.2	15,237.2	26,457.4	27.1	78.2
Plan Amendments	0.0	1,384.1	(33,269.9)	0.0	0.0
Experience Losses (Gains)	(3,202.1)	(5,611.4)	(6,682.4)	(14.2)	(93.4)
Other factors	0.2	(0.0)	0.1	(0.1)	(259.7)
Subtotal: Expenses before Losses (Gains) from Actuarial Assumption Changes	**92,169.0**	**21,710.6**	**(2,536.5)**	**12.8**	**24.1**
Actuarial (Gain)/Loss due to :					
Changes in trend assumptions	0.0	(23,958.5)	(14,673.9)	0.0	0.0
Changes in assumptions other than trend	77,190.2	6,063.8	25,794.6	11.0	0.0
Subtotal: Losses (Gains) from Actuarial Assumption Changes	**77,190.2**	**(17,894.7)**	**11,120.7**	**11.0**	**0.0**
Total Expenses	**$ 169,359.2**	**$ 3,815.9**	**$ 8,584.2**	**$ 23.8**	**$ 24.1**
Less Benefit Outlays	52,363.7	11,584,0	9,470.6	115.7	412.3
Total Changes in Actuarial Liability	**$ 116,995.5**	**$ (7,768.1)**	**$ (886.4)**	**$ (91.9)**	**$ (388.2)**
Ending Actuarial Liability	**$ 1,477,918.0**	**$ 298,216.9**	**$ 532,781.3**	**$ 678.2**	**$ 1,385.4**

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 2012 roll-forward amount:

Military Retirement Pensions	Inflation	Salary	Interest
Fiscal Year 2012	3.6% (actual)	1.6% (actual)	4.8%
Fiscal Year 2013	1.6% (estimated)	1.7% (estimated)	4.6%
Long Term	2.6%	3.0%	4.6%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Market Value of Investments in Market-Based and Marketable Securities: $540.2 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 October 1, 2025. All subsequent gains and losses experienced are amortized over a 30-year period.

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 2012 actuarial liability calculation, the actuaries used the following assumptions:

MHRB Medical Trend	FY 2011 – FY 2012	Ultimate Rate FY 2036
Medicare Inpatient (Direct Care)	1.60%	5.35%
Medicare Outpatient (Direct Care)	2.26%	5.35%
Medicare Prescriptions (Direct Care)	0.00%	5.35%
Non-Medicare Inpatient (Direct Care)	2.00%	5.35%
Non-Medicare Outpatient (Direct Care)	5.00%	5.35%
Non-Medicare Prescriptions (Direct Care)	1.70%	5.35%
Non-Medicare Inpatient (Purchased Care)	4.57%	5.35%
Non-Medicare Outpatient (Purchased Care)	5.34%	5.35%
Non-Medicare Prescriptions (Purchased Care)	5.25%	5.35%
U.S. Family Health Plan (USFHP) (Purchased Care)	4.75%	5.35%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Assumed Interest Rate: 4.6 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 2012 roll-forward amount:

MERHCF Benefits – Medical Trend	FY 2011 – FY 2012	Ultimate Rate FY 2036
Medicare Inpatient (Direct Care)	1.60%	5.35%
Medicare Inpatient (Purchased Care)	3.60%	5.35%
Medicare Outpatient (Direct Care)	2.26%	5.35%
Medicare Outpatient (Purchased Care)	3.26%	5.35%
Medicare Prescriptions (Direct Care)	0.00%	5.35%
Medicare Prescriptions (Purchased Care)	4.44%	5.35%
Medicare USFHP (Purchased Care)	3.83%	5.35%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Market Value of Investments in Market-Based and Marketable Securities: $264.8 billion* *Assumed Interest Rate: 4.6 percent*		

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The $532.8 billion liability includes $520.7 billion for the Department, $10.8 billion for the Coast Guard, $1.2 billion for the Public Health Service and $78.5 million for National Oceanic and Atmospheric Administration (NOAA). The FY 2012 contributions from each of the Uniformed Services were $10.8 billion from the Department, $261.9 million from the Coast Guard, $36.0 million from the Public Health Service, and $1.8 million from NOAA.

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 2.3 percent interest rate was assumed for year one and 3.1 percent 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) 2012 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**
2013	2.83%	3.65%
2014	2.03%	3.66%
2015	1.93%	3.72%
2016	2.00%	3.73%
2017+	2.03%	3.80%

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 2012 to the average pattern observed during the prior three charge back years, and (4) a comparison of the estimated liability per case in the 2012 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 3.4 percent used to calculate the actuarial liability. Since VSI 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: $364.4 million

DoD Education Benefits Fund (EBF)

The EBF 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 4.0 percent that was approved by the DoD Board of Actuaries.

Market Value of Investments in Market-based and Marketable Securities: $2.3 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 *As of September 30*	*Dollars in Millions* 2012	Restated 2011
Military Retirement Benefits		
1. Gross Cost		
A. Intragovernmental Cost	$ 6.1	$ 0.0
B. Non-Federal Cost	$ 85,564.3	$ 107,519.8
C. Total Cost	$ 85,570.4	$ 107,519.8
2. Earned Revenue		
A. Intragovernmental Revenue	$ (19,073.3)	$ (27,456.7)
B. Non-Federal Revenue	$ 0.0	$ 0.0
C. Total Revenue	$ (19,073.3)	$ (27,456.7)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 88,311.0	$ 12,646.1
Total Net Cost	**$ 154,808.1**	**$ 92,709.2**
Civil Works		
1. Gross Cost		
A. Intragovernmental Cost	$ 1,435.6	$ 1,466.4
B. Non-Federal Cost	$ 9,531.6	$ 12,063.7
C. Total Cost	$ 10,967.2	$ 13,530.1
2. Earned Revenue		
A. Intragovernmental Revenue	$ (1,393.5)	$ (1,623.6)
B. Non-Federal Revenue	$ (774.1)	$ (694.6)
C. Total Revenue	$ (2,167.6)	$ (2,318.2)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 8.799.6**	**$ 11,211.9**
Military Personnel		
1. Gross Cost		
A. Intragovernmental Cost	$ 38,673.2	$ 35,115.5
B. Non-Federal Cost	$ 111,657.3	$ 118,765.9
C. Total Cost	$ 150,330.5	$ 153,881.4
2. Earned Revenue		
A. Intragovernmental Revenue	$ (1,119.5)	$ (804.3)
B. Non-Federal Revenue	$ (339.1)	$ (77.3)
C. Total Revenue	$ (1,458.6)	$ (881.6)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 148,871.9**	**$ 152,999.8**
Operations, Readiness & Support		
1. Gross Cost		
A. Intragovernmental Cost	$ (56,303.5)	$ (55,748.9)
B. Non-Federal Cost	$ 352,007.6	$ 370.308.9
C. Total Cost	$ 295,704.1	$ 314,560.0
2. Earned Revenue		
A. Intragovernmental Revenue	$ 13,726.5	$ 11,470.3

Costs and Exchange Revenue As of September 30	2012		Restated 2011	
B. Non-Federal Revenue	$	(48,357.2)	$	(73,595.3)
C. Total Revenue	$	(34,630.7)	$	(62,125.0)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$	(17,883.7)	$	(25,015.9)
Total Net Cost	**$**	**243,189.7**	**$**	**227,419.1**
Procurement				
1. Gross Cost				
A. Intragovernmental Cost	$	30,773.4	$	29,956.9
B. Non-Federal Cost	$	99,805.4	$	98,615.9
C. Total Cost	$	130,578.8	$	128,572.8
2. Earned Revenue				
A. Intragovernmental Revenue	$	(3,192.3)	$	(3,150.6)
B. Non-Federal Revenue	$	(305.7)	$	(3,015.0)
C. Total Revenue	$	(3,498.0)	$	(6,165.6)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$	0.0	$	0.0
Total Net Cost	**$**	**127,080.8**	**$**	**122,407.2**
Research, Development, Test & Evaluation				
1. Gross Cost				
A. Intragovernmental Cost	$	22,256.0	$	22,993.7
B. Non-Federal Cost	$	54,516.6	$	56,237.2
C. Total Cost	$	76,772.6	$	79,230.9
2. Earned Revenue				
A. Intragovernmental Revenue	$	(7,676.9)	$	(7,916.6)
B. Non-Federal Revenue	$	(1,590.3)	$	(251.7)
C. Total Revenue	$	(9,267.2)	$	(8,168.3)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$	0.0	$	0.0
Total Net Cost	**$**	**67,505.4**	**$**	**71,062.6**
Family Housing & Military Construction				
1. Gross Cost				
A. Intragovernmental Cost	$	2,019.9	$	1,734.3
B. Non-Federal Cost	$	29,787.6	$	12,605.9
C. Total Cost	$	31,807.5	$	14,340.2
2. Earned Revenue				
A. Intragovernmental Revenue	$	(8,579.0)	$	(7,547.4)
B. Non-Federal Revenue	$	(4,630.4)	$	(377.1)
C. Total Revenue	$	(13,209.4)	$	(7,924.5)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$	0.0	$	0.0
Total Net Cost	**$**	**18,598.1**	**$**	**6,415.7**
Consolidated				
1. Gross Cost				
A. Intragovernmental Cost	$	38,860.7	$	35,517.9
B. Non-Federal Cost	$	742,870.4	$	776,117.3
C. Total Cost	$	781,731.1	$	811,635.2

Dollars in Millions

Costs and Exchange Revenue As of September 30	2012	Restated 2011
	Dollars in Millions	
2. Earned Revenue		
A. Intragovernmental Revenue	$ (27,308.0)	$ (37,028.9)
B. Non-Federal Revenue	$ (55,996.8)	$ (78,011.0)
C. Total Revenue	$ (83,304.8)	$ (115,039.9)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 70,427.3	$ (12,369.8)
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	**$ 768,853.6**	**$ 684,225.5**

Abnormal Balances

Operations, Readiness & Support Intragovernmental Gross Cost on the SNC has an abnormal balance of $56.3 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 $13.7 billion. The current business practice is to include elimination reporting in this program group.

Earned Revenue includes an abnormal balance of $93.7 million in USSGL account 5909 (Contra Revenue for Other Revenue). During FY 2012, the prior year deferred revenue balance was reversed and the current year recorded. The prior year deferred revenue was greater than the current year causing the abnormal balance.

Restatements

The Department identified an understatement of General Property, Plant and Equipment. This correction increased the FY 2011 net cost by $72.2 million. This prior period adjustment is reflected in the schedule above as non-Federal Gross Cost in Procurement; Research, Development, Test and Evaluation. 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 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 non-Federal 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 non-Federal 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.

During FY 2011, based on SFFAS No. 33, the Department included all costs associated with the change in the actuarial liabilities for military retirement in "Losses/(Gains) from Actuarial Assumption Changes". During FY 2012, the Department of Treasury and the Government Accountability Office provided additional guidance which specified only trend and other assumption changes should be recorded as "Losses/(Gains) from Actuarial Assumption Changes". To ensure comparability, the FY 2011 column on the Statement of Net Cost has been updated to reflect the additional guidance. As a result, there may be inconsistencies between the FY 2011 column and the FY 2011 published statements.

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

Abnormal Balances

Net Cost of Operations includes an abnormal balance of $93.7 million in USSGL account 5909 (Contra Revenue for Other Revenue). During FY 2012, the prior year deferred revenue balance was reversed in the current year and the current year deferred revenue was recorded. The prior year deferred revenue was more than the current year deferred revenue causing this account balance to be abnormal.

Nonexchange Revenue includes an abnormal balance of $26.4 million in USSGL account 5320 (Penalties and Fines Revenue). During 4th Quarter, FY 2012, penalties previously recorded for the Cerrillos Dam long term water storage contract at the Jacksonville District were reversed as the cost share agreement did not allow for penalties.

Other Financing Sources, Other – Earmarked Funds on the Statement of Changes in Net Position include an abnormal balance of $21.8 million in USSGL account 5791 (Adjustment to Financing Sources - Downward Reestimate or Negative Subsidy). This account is offset by a corresponding entry in the non-earmarked direct loan program account.

Restatements

The Department corrected a $1.0 billion understatement of General Property, Plant and Equipment to align the accounting records with the property accountability system and a $955.1 million overstatement of Other Assets (With the Public). 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, revenues 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) by $55.4 billion. This difference represents $125.3 billion in trust and special fund receipts reported as exchange revenue on the Statement of Net Cost and included in appropriations on the SBR, offset by $60.5 billion in receipts and appropriations temporarily precluded from obligation, $8.5 billion in permanent reductions, and $0.9 billion in receipts and appropriations temporarily precluded from obligations and current year authority transfers. 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 *As of September 30*	2012	Restated 2011
		Dollars in Millions
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period.	$ 486,886.1	$ 477,099.3

Restatements

The Department corrected a $955.1 million overstatement impacting the Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period. Refer to Note 26, Restatements, for further information.

Reconciliation Differences

Appropriations on the SBR exceed Appropriations Received on the Statement of Changes in Net Position by $55.4 billion. This difference represents $125.3 billion in trust and special fund receipts reported as exchange revenue on the Statement of Net Cost and included in appropriations on the SBR, offset by $60.5 billion in receipts and appropriations temporarily precluded from obligation, $8.5 billion in permanent reductions, and $0.9 billion in receipts unavailable for obligation upon collection and current year authority transfers. In accordance with OMB guidance, $109.9 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 2011 column includes $108.5 billion more in budget authority than reported in the 2011 actual column of the President's FY 2013 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 2011 column includes $66.3 million less in obligations than reported in the 2011 actual column of the President's FY 2013 Budget. The difference is primarily due to the timing of the recognition of obligations.

The SBR FY 2011 column includes $83.2 billion less in net outlays than reported in the 2011 actual column of the President's FY 2013 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) $503.4 billion in category A; (2) $222.3 billion in category B; and (3) $130.7 billion in exempt from apportionment. The Department reported reimbursable obligations of: (1) $27.1 billion in category A and (2) $175.5 billion in category B. 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 A-129*, "Managing Federal Credit Programs."

The Department received additional funding of $115.1 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 *As of September 30*		*Dollars in Millions* **2012**		**Restated 2011**
Resources Used to Finance Activities				
Budgetary Resources Obligated:				
Obligations incurred	$	1,059,305.0	$	1,069,545.0
Less: Spending authority from offsetting collections and recoveries (-)		(258,964.9)		(252,444.2)
Obligations net of offsetting collections and recoveries	**$**	**800,340.1**	**$**	**817,100.8**
Less: Offsetting receipts (-)		(79,238.4)		(83,198.6)
Net obligations	**$**	**721,101.7**	**$**	**733,902.2**
Other Resources:				
Donations and forfeitures of property	$	37.5	$	7.6
Transfers in/out without reimbursement (+/-)		66.1		(147.4)
Imputed financing from costs absorbed by others		5,048.1		5,623.9
Other (+/-)		(10,465.7)		1,812.3
Net other resources used to finance activities	**$**	**(5,314.0)**	**$**	**7,296.4**
Total resources used to finance activities	**$**	**715,787.7**	**$**	**741,198.6**
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 (-)	$	(16,379.3)	$	(9,125.9)
Unfilled Customer Orders		3,715.0		3,691.4
Resources that fund expenses recognized in prior Periods (-)		(19,822.5)		(74,469.2)
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations		966,1		2,507.9
Resources that finance the acquisition of assets (-)	$	(105,865.0)	$	(128,667.3)
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 (+/-)		10,323.4		(1,672.7)
Total resources used to finance items not part of the Net Cost of Operations	**$**	**(127,062.3)**	**$**	**(207,735.8)**
Total resources used to finance the Net Cost of Operations	**$**	**588,725.4**	**$**	**533,462.8**
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:				

Reconciliation of Net Cost of Operations to Budget *As of September 30*		*Dollars in Millions*
	2012	**Restated 2011**
Increase in annual leave liability	$ 253.6	$ 363.7
Increase in environmental and disposal liability	657.2	3,667.8
Upward/Downward reestimates of credit subsidy expense (+/-)	(12.0)	8.3
Increase in exchange revenue receivable from the public (-)	84.6	(552.3)
Other (+/-)	124,388.8	112,105.1
Total components of Net Cost of Operations that will Require or Generate Resources in future periods	**$ 125,372.2**	**$ 115,592.6**
Components not Requiring or Generating Resources:		
Depreciation and amortization	$ 47,978.8	$ 55,937.5
Revaluation of assets or liabilities (+/-)	2,693.3	(8,286.9)
Other (+/-)		
Trust Fund Exchange Revenue	(50,977.7)	(55,336.7)
Cost of Goods Sold	78,140.6	72,938.9
Operating Materiel and Supplies Used	27,873.0	33,442.2
Other	(50,952.0)	(63,524.9)
Total Components of Net Cost of Operations that will not Require or Generate Resources	**$ 54,756.0**	**$ 35,170.1**
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	**$ 180,128.2**	**$ 150,762.7**
Net Cost of Operations	**$ 768,853.6**	**$ 684,225.5**

Abnormal Balance

Budgetary Resources Obligated, Other and Other Resources or Adjustments to Net Obligated Resources that do not Affect Net Cost of Operations, Other include an abnormal balance of $21.8 million in USSGL account 5791 (Adjustment to Financing Sources - Downward Reestimate or Negative Subsidy). This account is offset by a corresponding entry in the non-earmarked direct loan program account.

Restatements

The Department corrected a $955.1 million understatement of undelivered orders and Resources that finance the acquisition of assets, and a $72.2 million understatement of Depreciation and amortization to align the accounting records to the property accountability system. These corrections resulted in a $72.2 million increase in Net Cost of Operations. Refer to 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:

		Dollars in Millions
Resources that Finance the Acquisition of Assets	$	9,385.7
Other Components not Requiring or Generating Resources	$	2.8
Total Amount	**$**	**9,388.5**

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.

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 $6.3 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 are rendered to the U.S. Treasury.

NOTE 23. EARMARKED FUNDS

Earmarked Funds As of September 30	Military Retirement Fund	Medicare Eligible Retiree Health Care Fund	Other Earmarked Funds	Eliminations	Total
Dollars in Millions	2012				
Balance Sheet					
Assets					
Fund balance with Treasury	$ 23.0	$ 162.3	$ 2,973.7	$ 0.0	$ 3,159.0
Investments	427,867.4	203,341.5	10,329.9	0.0	641,538.8
Accounts and Interest Receivable	67.0	1,004.3	1,619.0	(8.7)	2,681.6
Other Assets	0.0	2.3	1,346.3	0.0	1,348.6
Total Assets	**$ 427,957.4**	**$ 204,510.4**	**$ 16,268.9**	**$ (8.7)**	**$ 648,728.0**
Liabilities and Net Position					
Military Retirement Benefits and Other Federal Employment Benefits	$ 1,481,969.9	$ 533,392.4	$ 2,063.7	$ 0.0	$ 2,017,426.0
Other Liabilities	2.0	555.1	2,530.0	(150.6)	2,936.5
Total Liabilities	**$ 1,481,971.9**	**$ 533,947.5**	**$ 4,593.7**	**$ (150.6)**	**$ 2,020,362.5**
Unexpended Appropriations	$ 0.0	$ 0.0	$ 295.6	$ 0.0	$ 295.6
Cumulative Results of Operations	(1,054,014.5)	$ (329,437.1)	$ 11,379.6	$ (105,721.5)	$ (1,477,793.5)
Total Liabilities and Net Position	**$ 427,957.4**	**$ 204,510.4**	**$ 16,268.9**	**$ (105,872.1)**	**$ 542,864.6**

Statement of Net Cost					
Program Costs	$ 169,471.1	$ 7,304.5	$ 1,572.8	$ (3,004.9)	$ 175,343.5
Less Earned Revenue	(104,506.2)	(24,118.7)	(1,355.5)	109,791.0	(20,189.4)
Net Program Costs	64,964.9	(16,814.2)	217.3	106,786.1	155,154.1
Net Cost of Operations	**$ 64,964.9**	**$ (16,814.2)**	**$ 217.3**	**$ 106,786.1**	**$ 155,154.1**

Statement of Changes in Net Position					
Net Position Beginning of the Period	$ (989,049.6)	$ (346,251.3)	$ 9,788.5	$ 0.0	$ (1,325,512.4)
Net Cost of Operations	64,964.9	(16,814.2)	217.3	106,786.1	155,154.1
Budgetary Financing Sources	0.0	0.0	2,243.0	991.9	3,234.9
Other Financing Sources	0.0	0.0	(139.0)	72.7	(66.3)
Change in Net Position	**$ (64,964.9)**	**$ 16,814.2**	**$ 1,886.7**	**$ (105,721.5)**	**$ (151,985.5)**
Net Position End of Period	**$ (1,054,014.5)**	**$ (329,437.1)**	**$ 11,675.2**	**$ (105,721.5)**	**$ (1,477,497.9)**

Earmarked Funds As of September 30	2011 Military Retirement Fund	Medicare Eligible Retiree Health Care Fund	Other Earmarked Funds	Eliminations	Total *Dollars in Millions*
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)**

Abnormal Balances

Other Financing Sources on the Statement of Changes in Net Position include an abnormal balance of $21.8 million in USSGL account 5791 (Adjustment to Financing Sources – Downward Reestimate or Negative Subsidy). This account is offset by a corresponding entry in the non-earmarked direct loan program account.

Cumulative Results of Operations/Net Cost of Operations include an abnormal balance of $93.7 million in USSGL account 5909, Contra Revenue for Other Revenue. During FY 2012, the prior year deferred revenue balance was reversed and the current year deferred revenue recorded. The prior year deferred revenue was greater than the current year causing the abnormal balance.

Other Disclosures

The *SFFAS No. 27*, "Identifying and Reporting Earmarked Funds," requires the disclosure of Earmarked Funds separate from All Other Funds on the 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 Non-Federal 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 non-Federal 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.

Coastal 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 Bureau of Public Debt.

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 Military Housing Privatization Initiative (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 Fiduciary Activity *As of September 30*	*Dollars in Millions* 2012	2011
Fiduciary net assets, beginning of year	$ 199.5	$ 178.9
Contributions	222.5	282.5
Investment earnings	15.2	18.0
Distributions to and on behalf of beneficiaries	(278.5)	(279.9)
Increase/(Decrease) in fiduciary net assets	(40.8)	20.6
Fiduciary net assets, end of period	**$ 158.7**	**$ 199.5**

Schedule of Fiduciary Net Assets *As of September 30*	2012	2011
Fiduciary Assets		
Cash and cash equivalents	$ 158.7	$ 199.5
Total Fiduciary Net Assets	**$ 158.7**	**$ 199.5**

Dollars in Millions

Fiduciary activities exist when the Department has collected, received, held, or made disposition of assets on behalf of an individual or non-Federal 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 in designated areas. These contributions and earned interest are deposited in the U.S. Treasury on behalf of the members.

Note 25. Other Disclosures

Dollars in Millions

Other Disclosures *As of September 30*	2012 – Asset Category			
	Land and Buildings	Equipment	Other	Total
Entity as Lessee – Operating Leases				
Future Payments Due				
Fiscal Year 2013	$ 551.3	$ 67.0	$ 16.3	$ 634.6
Fiscal Year 2014	551.6	67.9	16.3	635.8
Fiscal Year 2015	567.7	68.2	16.3	652.2
Fiscal Year 2016	570.2	68.3	16.5	655.0
Fiscal Year 2017	537.0	67.9	16.6	621.5
After 5 Years	956.1	2.4	16.9	975.4
Total Future Lease Payments Due	**$ 3,733.9**	**$ 341.7**	**$ 98.9**	**$ 4,174.5**

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 primarily made up of commercial leases. Commercial leases are leases made by the Department with the general public. These would include leases with dealerships, car rental companies, or any other such entity that provides care leasing services. Future year cost projections use the Consumer Price Index.

Note 26. Restatements

The Department restated its financial statements as of September 30, 2011, to correct errors in assets, gross costs, and net position identified during ongoing audit readiness efforts.

The Department corrected a $1.0 billion understatement of General Property, Plant and Equipment to align the accounting records to the property accountability system and a $955.1 million overstatement of Other Assets (With the Public). This correction increased General Property, Plant and Equipment, Net and Cumulative Results of Operations on the

Balance Sheet; Gross Costs on the Statement of Net Cost; and Net Cost of Operations and Cumulative Results of Operations on the Statement of Changes in Net Position. The correction also decreased Other Assets (With the Public) and Unexpended Appropriations on the Balance Sheet; and Unexpended Appropriations on the Statement of Changes in Net Position. The following notes were restated: Note 2, Nonentity Assets; Note 6, Other Assets; Note 10, General Property, Plant and Equipment, Net; Note 18, General Disclosures Related to the Statement of Net Cost; Note 19, Disclosures Related to the Statement of Changes in Net Position; Note 20, Disclosures Related to the Statement of Budgetary Resources; and Note 21, Reconciliation of Net Cost of Operations to Budget.

Effect on FY 2012 Beginning Cumulative Results of Operations and Unexpended Appropriations:

FY 2012 Statement of Changes in Net Position	*Dollars in Billions*
CUMULATIVE RESULTS OF OPERATIONS	
Correction of Errors (+/-)	$ 1.0
Beginning balance adjustments	**$ 1.0**
UNEXPENDED APPROPRIATIONS	
Correction of Errors	$ (0.9)
Beginning balance adjustments	**$ (0.9)**

Effect on Comparative Balances

FY 2011 Balance Sheet	*Dollars in Billions*
General Property, Plant and Equipment, Net	$ 1.0
Intragovernmental Other Assets	$ (0.9)
Total Assets	**$ 0.1**
Unexpended Appropriations – Other	$ (0.9)
Cumulative Results of Operations – Other	$ 1.0
Net Position	**$ 0.1**
Total Liabilities and Net Position	**$ 0.1**
FY 2011 Statement of Net Cost	*Dollars in Billions*
Gross Costs	$ 0.1
Net Cost of Operations	**$ 0.1**

FY 2011 Statement of Changes in Net Position	*Dollars in Billions*
CUMULATIVE RESULTS OF OPERATIONS	
Corrections of Errors (+/-)	$ 1.1
Beginning balance adjustments	**$ 1.1**
Other Financing Sources:	
Net Cost of Operations	$ 0.1
Net Change	**$ (0.1)**
Cumulative Results of Operations	**$ 1.0**
UNEXPENDED APPROPRIATIONS	
Correction of Errors	$ (0.9)
Beginning balance adjustments	**$ (0.9)**
Unexpended Appropriations	**$ (0.9)**
Net Position	**$ 0.1**

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) Non-Federal Physical Property (federally-financed, but not federally owned), and (2) federally-financed Research and Development (R&D). Information on additional reporting requirements for non-Federal Physical Property and R&D follows.

NON-FEDERAL PHYSICAL PROPERTY

The Non-Federal Physical Property investments support the purchase, construction, or major renovation of physical property owned by state and local governments. In addition, Non-Federal Physical Property investments include federally-owned physical property transferred to state and local governments. The Department participates in cost-sharing agreements with non-Federal 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.

Non-Federal Physical Property
Department of Defense Consolidated – Non-Federal Physical Property

Yearly Investments in State and Local Governments
For Fiscal Years 2012 through 2008 — *Dollars in Millions*

Categories	2012	2011	2010	2009	2008
Transferred Assets:					
National Defense Mission Related	$ 1,445.4	$ 2,304.5	$ 2,126.2	$ 1,224.7	$ 1,169.2
Funded Assets:					
National Defense Mission Related	$ 7.7	$ 12.0	$ 0.0	$ 26.7	$ 1 9.6
Total	**$ 1,453.1**	**$ 2,316.5**	**$ 2,126.2**	**$ 1,251.4**	**$ 1,188.8**

INVESTMENTS IN RESEARCH AND DEVELOPMENT

Investment values included in this report are based on R&D expenditures. 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 2008 – FY 2012 for all DoD Components. Through efforts to improve the quality of reported data, the FY 2008 through FY2012 values have been updated to include investments reported by the Defense Health Program and the DoD Inspector General (the entity). These investment values were not reported in FY 2011. 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 State and Local Governments
For the Current and Four Preceding Fiscal Years

Dollars in Millions

Categories	2012	2011	2010	2009	2008
Basic Research	**$ 1,645.3**	**$ 1,816.6**	**$ 1,805.5**	**$ 821.0**	**$ 1,346.4**
Applied Research	5,819.3	6,848.3	5,758.4	2,604.6	4,260.9
Development					
Advanced Technology Development	5,868.0	6,024.3	6,353.4	2,263.2	6,032.7
Advanced Component Development and Prototypes	13,005.0	13,964.2	14,304.6	12,148.3	15,410.6
System Development and Demonstration	11,926.3	13,882.0	15,156.7	21,501.9	18,052.9
Research, Development, Test and Evaluation Management Support	5,640.5	5,659.2	5,503.6	5,141.3	5,471.0
Operational Systems Development	23,274.6	23,861.3	23,986.2	42,450.6	20,246.7
Totals:	**$ 67,179.0**	**$ 72,055.9**	**$ 72,868.4**	**$ 86,930.9**	**$ 70,821.2**

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, 2012 — *Dollars in Millions*

Property Type	Current Fiscal Year		
	1. Plant Replacement Value	2. Required Work (Deferred Maintenance & Repair)	3. Percentage
1. Category 1	**$ 939,394**	**$ 103,708**	**11%**
2. Category 2	**$ 28,864**	**$ 5,870**	**20%**
3. Category 3	**$ 21,493**	**$ 1,567**	**7%**

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, 2012

Major Categories	*Dollars in Millions*
1. Aircraft	$ 456.8
2. Automotive Equipment	$ 84.2
3. Combat Vehicles	$ 37.9
4. Construction Equipment	$ 32.9
5. Electronics and Communications Systems	$ 80.3
6. Missiles	$ 257.7
7. Ships	$ 131.0
8. Ordnance Weapons and Munitions	$ 63.1
9. General Purpose Equipment	$ 11.4
10. All Other Items Not Identified to above Categories	$ 42.5
Total	**$ 1,197.8**

Statement of Disaggregated Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	**2012**								
	Military Personnel	**Procurement**	**Research, Development, Test and Evaluation**	**Family Housing/ Military Construction**	**Military Retirement Benefits**	**Civil Works**	**Operations, Readiness & Support**	**2012 Combined**	**2011 Combined**
Budgetary Resources									
Unobligated balance, brought forward, October 1	$ 1,641.5	$ 75.579.6	$ 18,012.9	$ 15,817.3	$ 0.0	$ 8,528.5	$ 42,691.3	$ 162,271.1	$ 160,032.1
Unobligated balance brought forward, October 1, as adjusted	1,641.5	75.579.6	18,012.9	15,817.3	0.0	8,528.5	42,691.3	162,271.1	160,032.1
Recoveries of prior year unpaid obligations	14,009.1	14,351.9	3,461.6	3,120.5	0.0	93.5	30,497.3	65,533.9	56,015.4
Other changes in unobligated balance	(907.9)	(581.7)	(907.0)	(83.9)	0.0	(1.7)	(10,469.9)	(12,952.1)	(11,205.6)
Unobligated balance from prior year budget authority, net	14,742.7	89,349.8	20,567.5	18,853.9	0.0	8,620.3	62,718.7	214,852.9	204,841.9
Appropriations (discretionary and mandatory)	152,975.9	114,505.5	68,523.5	10,627.7	61,231.6	7,641.8	376,672.8	792,178.8	829,461.3
Borrowing Authority (discretionary and mandatory)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contract Authority (discretionary and mandatory)	0.0	0.0	0.0	0.0	0.0	0.0	80,486.2	80,486.2	75,760.9
Spending Authority from offsetting collections (discretionary and mandatory)	1,182.6	3,275.5	9,629.4	9,567.4	0.0,	10,699.0	82,888.5	117,242.4	121,426.6
Total Budgetary Resources	**$ 168,901.2**	**$ 207,130.8**	**$ 98,720.4**	**$ 39,049.0**	**$ 61,231.6**	**$ 26,961.1**	**$ 602,766.2**	**$ 1,204,760.3**	**$ 1,231,490.7**
Status of Budgetary Resources:									
Obligations Incurred	166,437.4	143,783.1	83,516.5	22,991.1	61,231.6	18,351.0	562,757.1	1,059,067.8	1,069,218.2
Unobligated balance, end of year:									
Apportioned	616.5	59,276.9	13,570.7	15,230.8	0.0	7,412.0	19,589.2	115,696.1	137,148.4
Exempt from Apportionment	0.0	0.0	0.0	0.0	0.0	1,184.2	2,791.9	3,976.1	4,180.3
Unapportioned	1,847.3	4,070.8	1,633.2	827.1	0.0	13.9	17,628.0	26,020.3	20,943.8
Unobligated balance brought forward, end of year	**$ 2,463.8**	**$ 63,347.7**	**$ 15,203.9**	**$ 16,057.9**	**$ 0.0**	**$ 8,610.1**	**$ 40,009.1**	**$ 145,692.5**	**$ 162,272.5**
Total Budgetary Resources	**$ 168,901.2**	**$ 207,130.8**	**$ 98,720.4**	**$ 39,049.0**	**$ 61,231.6**	**$ 26,961.1**	**$ 602,766.2**	**$ 1,204,760.3**	**$ 1,231,490.7**

Statement of Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	2012								
	Military Personnel	Procurement	Research, Development, Test and Evaluation	Family Housing/ Military Construction	Military Retirement Benefits	Civil Works	Operations, Readiness & Support	2012 Combined	2011 Combined
Change in Obligated Balance									
Unpaid obligations, brought forward, October 1 (Gross)	$ 7,648.2	$ 147,138.7	$ 43,453.6	$ 29,244.6	$ 868.2	$ 10,405.5	$ 216,167.4	$ 454,926.2	$ 458,620.6
Uncollected customer payments for Federal Sources, brought forward, October 1	(155.0)	(4,264.6)	(5,126.6)	(11.811.6)	0.0	(3,097.7)	(50,728.8)	(75,184.3)	(69,766.8)
Obligated balance start of year (net), before adjustments	7,493.2	142,874.1	38,327.0	17,433.0	868.2	7,307.8	165,438.6	379,741.9	388,853.8
Obligated balance, start of year (net), as adjusted	7,493.2	142,874.1	38,327.0	17,433.0	868.2	7,307.8	165,438.6	379,741.9	388,853.8
Obligations incurred	166,437.4	143,783.1	83,516.5	22,991.1	61,231.6	18,351.0	562,757.1	1,059,067.8	1,069,218.2
Outlays (gross)	(148,100.8)	(125,100.4)	(75,796.2)	(20,584.4)	(57,456.6)	(20,288.3)	(532,563.2)	(979,889.9)	(1,016,898.9)
Change in uncollected customer payments from Federal Sources)	28.2	25.1	(593.8)	(466.3)	0.0	921.0	(2,683.3)	(2,769.1)	(5,417.5)
Actual Transfers, unpaid obligations (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recoveries of prior year unpaid obligations	(14,009.1)	(14,351.9)	(3,461.5)	(3,120.5)	0.0	(93.5)	(30,497.4)	(65,533.9)	(56,015.1)
Obligated balance, end of year									
Unpaid Obligations, end of year (gross)	11,975.7	151,469.5	47,712.4	28,530.8	4,643.2	8,374.7	215,863.9	468,570.2	454,924.8
Uncollected customer payments from Federal Sources, end of year	(126.8)	(4,239.5)	(5,720.4)	(12,277.9)	0.0	(2,176.7)	(53,412.1)	(77,953.4)	(75,184.3)
Obligated balance, end or year (net)	**$ 11,848.9**	**$ 147,230.0**	**$ 41,992.0**	**$ 16,252.9**	**$ 4,643.2**	**$ 6,198.0**	**$ 162,451.8**	**$ 390,616.8**	**$ 379,740.5**
Budget Authority and Outlays, Net:									
Budget Authority, gross (discretionary and mandatory)	$ 154,158.5	$ 117,781.0	$ 78,152.9	$ 20,195.1	$ 61,231.6	$ 18,340.8	$ 540,047.5	$ 989,907.4	$ 1,026,648.8
Actual offsetting collections (discretionary and mandatory)	(1,210.8)	(3,300.6)	(9,035.5)	(9,101.1)	0.0	(11,953.7)	(155,984.3)	(190,586.0)	(190,906.0)
Change in uncollected customer payments from Federal Sources (discretionary and mandatory)	28.2	25.1	(593.8)	(466.3)	0.0	921.0	(2,683.3)	(2,769.1)	(5,417.5)
Anticipated offsetting collections (discretionary and mandatory)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Budget authority, net (discretionary and mandatory)	**$ 152,975.9**	**$ 114,505.5**	**$ 68,523.6**	**$ 10,627.7**	**$ 61,231.6**	**$ 7,308.1**	**$ 381,379.9**	**$ 796,552.3**	**$ 830,325.3**

Statement of Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	2012								
	Military Personnel	Procurement	Research, Development, Test and Evaluation	Family Housing/ Military Construction	Military Retirement Benefits	Civil Works	Operations, Readiness & Support	2012 Combined	2011 Combined
Outlays, gross (discretionary and mandatory)	$ 148,100.8	$ 125,100.4	$ 75,796.2	$ 20,584.4	$ 57,456.6	$ 20,288.3	$ 532,563.2	$ 979,889.9	$ 1,016,898.9
Actual offsetting collections (discretionary and mandatory)	(1,210.8)	(3,300.6)	(9,035.5)	(9,101.1)	0.0	(11,953.7)	(155,984.3)	(190,586.0)	(190,906.0)
Outlays, net (discretionary and mandatory)	146,890.0	121,799.8	66,760.7	11,483.3	57,456.6	8,334.6	376,578.9	789,303.9	825,992.9
Distributed offsetting receipts	0.0	0.0	0.0	0.0	(77,647.4)	(552.6)	(1,038.4)	(79,238.4)	(83,198.6)
Agency outlays, net (discretionary and mandatory)	**$ 146,890.0**	**$ 121,799.8**	**$ 66,760.7**	**$ 11,483.3**	**$ (20,190.8)**	**$ (7,782.0**	**$ 375,540.5**	**$ 710,065.5**	**$ 742.794.3**

Combined Statement of Budgetary Resources	Non Budgetary		
For the Years ended September 30 *Dollars in Millions*	**Other**	**2012 Combined**	**2011 Combined**
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 17.5	$ 17.5	$ 24.9
Unobligated balance brought forward, October 1, as adjusted	$ 17.5	$ 17.5	$ 24.9
Recoveries of prior year unpaid obligations	0.0	0.0	0.0
Other changes in unobligated balance	0.0	0.0	0.0
Unobligated balance from prior year budget authority, net	17.5	17.5	24.9
Appropriations (discretionary and mandatory)	0.0	0.0	0.0
Borrowing Authority (discretionary and mandatory)	172.6	172.6	229.8
Contract Authority (discretionary and mandatory)	0.0	0.0	0.0
Spending Authority from offsetting collections (discretionary and mandatory)	62.6	62.6	88.3
Total Budgetary Resources	**$ 252.7**	**$ 252.7**	**$ 343.0**
Status of Budgetary Resources:			
Obligations Incurred	$ 237.2	$ 237.2	$ 326.8
Unobligated balance, end of year:			
Apportioned	1.6	1.6	0.1
Exempt from Apportionment	0.0	0.0	0.0
Unapportioned	13.9	13.9	16.1
Unobligated balance brought forward, end of year	**$ 15.5**	**$ 15.5**	**$ 16.2**
Total Budgetary Resources	**$ 252.7**	**$ 252.7**	**$ 343.0**

Statement of Disaggregated Budgetary Resources	Non Budgetary		
For the Years ended September 30 *Dollars in Millions*	Other	2012 Combined	2011 Combined
Change in Obligated Balance			
Unpaid obligations, brought forward, October 1 (Gross)	$ 569.1	$ 569.1	$ 619.4
Uncollected customer payments for Federal Sources, brought forward, October 1	(99.9)	(99.9)	(97.3)
Obligated balance start of year (net), before adjustments	469.2	469.2	522.1
Obligated balance, start of year (net), as adjusted	469.2	469.2	522.1
Obligations incurred	237.2	237.2	326.8
Outlays (gross)	(264.5)	(264.5)	(375.3)
Change in uncollected customer payments from Federal Sources	16.4	16.4	(2.6)
Actual Transfers, unpaid obligations (net)	0.0	0.0	0.0
Recoveries of prior year unpaid obligations	0.0	0.0	0.0
Obligated balance, end of year			
Unpaid Obligations, end of year (gross)	541.8	541.8	570.9
Uncollected customer payments from Federal Sources, end of year	(83.5)	(83.5)	(99.9)
Obligated balance, end or year (net)	**$ 458.3**	**$ 458.3**	**$ 471.0**
Budget Authority and Outlays, Net:			
Budget Authority, gross (discretionary and mandatory)	235.2	235.2	318.1
Actual offsetting collections (discretionary and Mandatory)	(92.6)	(92.6)	(102.6)
Change in uncollected customer payments from Federal Sources (discretionary and mandatory)	16.4	16.4	(2.6)
Anticipated offsetting collections (discretionary and mandatory)	0.0	0.0	0.0
Budget authority, net (discretionary and mandatory)	**$ 159.0**	**$ 159.0**	**$ 212.9**
Outlays, gross (discretionary and mandatory)	264.5	264.5	375.3
Actual offsetting collections (discretionary and mandatory)	(92.6)	(92.6)	(102.6)
Outlays, net (discretionary and mandatory)	171.9	171.9	272.7
Distributed offsetting receipts	0.0	0.0	0.0
Agency outlays, net (discretionary and mandatory)	**$ 171.9**	**$ 171.9**	**$ 272.7**

This Page Left Blank Intentionally

APPENDIX A: GLOSSARY OF ACRONYMS AND ABBREVIATIONS

Acronym	Definition
AFR	Agency Financial Report
ALP	Afghan Local Police
ANA	Afghan National Army
ANP	Afghan National Police
ANSF	Afghan National Security Forces
APB	Acquisition Program Baseline
APR	Annual Performance Report
ARMS	Armament Retooling and Manufacturing Support Initiative
ARRA	American Recovery and Reinvestment Act of 2009 (Recovery Act)
ASD	Assistant Secretary of Defense
BAM	Business Activity Monitoring
BCL	Business Capability Lifecycle
BMD	Ballistic Missile Defense
BPR	Business Process Reengineering
BRAC	Base Realignment and Closure
CFO	Chief Financial Officer
CIO	Chief Information Officer
CLS	Contractor Logistics Support
CMO	Chief Management Officer
COR	Contracting Officer Representative
DBS	Defense Business Systems
DCMO	Deputy Chief Management Officer
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
DMAG	Deputy Management Action Group
DoD	Department of Defense
DSB	Defense Science Board
DSCA	Defense Security Cooperation Agency
DTM	Directive-type Memorandum
EOP	Executive Office of the President
ERP	Enterprise Resource Planning
FAR	Federal Acquisition Regulations
FBWT	Fund Balance With Treasury
FCRA	Federal Credit Reform Act
FECA	Federal Employee Compensation Act
FFMIA	Federal Financial Management Improvement Act of 1996
FIAR	Financial Improvement and Audit Readiness
FIP	Financial Improvement Plan

Acronym	Definition
FM	Financial Management
FMF	Foreign Military Financing
FMFIA	Federal Managers' Financial Integrity Act of 1982
FMS	Foreign Military Sales
FY	Fiscal Year
GAO	Government Accountability Office
HIDS	Host-based Intrusion Detection System
HRF	Homeland Response Force
IG	Inspector General
IPERA	Improper Payments Elimination and Recovery Act
IPIA	Improper Payment Information Act of 2002
ISAF	International Security Assistance Force
ISR	Intelligence, Surveillance and Reconnaissance
IT	Information Technology
JTF-CAPMED	Joint Task Force - National Capital Region Medical
MAIS	Major Automated Information System
MDAP	Major Defense Acquisition Program
MDRFA	Military Debt Reduction Financing Account
MERHCF	Medicare-Eligible Retiree Health Care Fund
MFF	Multi-Functional Brigades
MHPI	Military Housing Privatization Initiative
MHS	Military Health System
MICP	Managers' Internal Control Program
MILSTRIP	Military Standard Requisitioning and Issues Procedures
MRF	Military Retirement Fund
NATO	North Atlantic Treaty Organization
NC3	Nuclear Command, Control and Communications
NDAA	National Defense Authorization Act
NGA	National Geospatial-Intelligence Agency
OCO	Overseas Contingency Operations
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)
PBL	Performance Based Logistics
PP&E	Property, Plant, and Equipment
PTS	Post Traumatic Stress

Acronym	Definition
QDR	Quadrennial Defense Review
R&D	Research and Development
SBR	Statement of Budgetary Resources
SCNP	Statements of Changes in Net Position
SFFAS	Statement of Federal Financial Accounting Standards
SIG	Senior Integration Group
SNC	Statement of Net Cost
START	Strategic Arms Reduction Treaty
TAS	Treasury Account Symbol
U.S.	United States
USACE	U.S. Amy 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
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
WCF	Working Capital Fund

This Page Left Blank Intentionally

APPENDIX B: USEFUL WEBSITES

Link	URL
American Recovery and Reinvestment Act	http://www.recovery.gov
Arms Export Control Act of 1976	http://www.gpo.gov/fdsys/pkg/USCODE-2010-title22/html/USCODE-2010-title22-chap39.htm
Base Realignment and Closure	http://www.defense.gov/brac
Chief Financial Officers Act of 1990	http://govinfo.library.unt.edu/npr/library/misc/cfo.html
Civilian Expeditionary Workforce Program	http://www.cpms.osd.mil/expeditionary
Department of Defense	http://www.defense.gov/
Defense Federal Acquisition Regulation Supplement	http://www.acq.osd.mil/dpap/dars/dfarspgi/current/index.html
Defense Finance and Accounting Service	http://www.dfas.mil
DoD Financial Management Regulation	http://comptroller.defense.gov/fmr
DoD Modeling and Simulation	http://www.dtic.mil/whs/directives/corres/pdf/500061p.pdf
DoD Strategic Management Plan	http://dcmo.defense.gov/publications/strategic-management-plan.html
Enterprise Transition Plan	http://dcmo.defense.gov/publications/enterprise-transition-plan.html
Federal Credit Reform Act	http://www.fms.treas.gov/ussgl/creditreform/fcratoc.html
Federal Employees' Compensation Act	http://www.dol.gov/compliance/laws/comp-feca.htm
Federal Financial Management Improvement Act	http://www.dol.gov/ocfo/media/regs/FFMIA.pdf
Federal Managers' Financial Integrity Act	http://whitehouse.gov/omb/financial_fmfia1982
Financial Improvement and Audit Readiness Plan Status Report	http://comptroller.defense.gov/FIAR
Foreign Assistance Act of 1961	http://www.gpo.gov/fdsys/pkg/USCODE-2010-title22/html/USCODE-2010-title22-chap32-subchapII.htm
DoD Budget Request	http://comptroller.defense.gov/budget.html
Government Management Reform Act of 1994	http://govinfo.library.unt.edu/npr/library/misc/s2170.html
GAO Report: High-Risk Series, An Update	http://www.gao.gov/new.items/d11278.pdf
Joint Chiefs of Staff	http://www.jcs.mil
Managers' Internal Control Program	http://comptroller.defense.gov/micp.html

Link	URL
National Defense Authorization Act for FY 1996	http://thomas.loc.gov/cgibin/bdquery/z?d104:SN01124:@@@L&summ2=m&TOM:/bss/d104query.html%7C
National Guard	http://www.nationalguard.mil/
National Military Strategy	http://www.jcs.mil//content/files/2011-02/020811084800_2011_NMS_-_08_FEB_2011.pdf
National Security Act of 1947	http://research.archives.gov/description/299856
National Security Strategy	http://www.whitehouse.gov/sites/default/files/rss_viewer/national_security_strategy.pdf
New START Treaty	http://www.state.gov/t/avc/newstart/index.htm
Office of Management and Budget Circulars (OMB)	http://www.whitehouse.gov/omb/financial_offm_circulars
Office of the Under Secretary of Defense (Comptroller)	http://comptroller.defense.gov/
Quadrennial Defense Review	http://www.defense.gov/qdr
Security Assistance Management Manual	http://www.dsca.osd.mil/samm/ESAMM/C00/0.02.htm
Sustaining U.S. Global Leadership: Priorities for 21st Century Defense	http://www.defense.gov/news/Defense_Strategic_Guidance.pdf
Statements of Federal Financial Accounting Standards and Interpretations	http://fasab.gov/accounting-standards/authoritative-source-of-gaap/
Treasury Financial Manual	http://www.fms.treas.gov/tfm/index.html
U.S. Africa Command	http://www.africom.mil
U.S. Air Force	http://www.af.mil
U.S. Army	http://www.army.mil
U.S. Central Command	http://www.centcom.mil
U.S. Code	http://uscode.house.gov/
U.S. European Command	http://www.eucom.mil
U.S. Marine Corps	http://www.marines.mil
U.S. Navy	http://www.navy.mil
U.S. Northern Command	http://www.northcom.mil
U.S. Pacific Command	http://www.pacom.mil
U.S. Southern Command	http://www.southcom.mil
U.S. Special Operations Command	http://www.socom.mil
U.S. Strategic Command	http://www.stratcom.mil
U.S. Transportation Command	http://www.transcom.mil

Department of Defense Agency Financial Report Fiscal Year 2012

Addendum A

This Page Left Blank Intentionally

ADDENDUM A, OTHER ACCOMPANYING INFORMATION

Other Accompanying Information provides additional details that support the Fiscal Year (FY) 2012 Department of Defense (DoD) Agency Financial Report (AFR). This addendum includes the following sections:

- Inspector General Summary of Management and Performance Challenges for FY 2012
- Managers' Internal Control Program
- Improper Payment and Payment Recapture Programs

INSPECTOR GENERAL SUMMARY OF MANAGEMENT AND PERFORMANCE CHALLENGES FOR FY 2012

The Reports Consolidation Act of 2000 requires that the AFR include a statement, prepared by the Department's Inspector General (IG) that summarizes what the IG 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 2012:

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 following tables summarize the seven challenges, the IG's assessment of the Department's progress in addressing these challenges, and the Department's management response.

1. IG-Identified Challenge: Financial Management

1-1A. Achieving Financial Statement Audit Readiness	IG Summary of Challenge

The Department financial management challenges 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. A key effort to addressing the Department's financial management challenges is its ability to produce auditable financial statements and achieve an unqualified opinion on those financial statements. Achieving auditable financial statements has proven to be a longstanding and daunting task and the success of the DoD financial improvement and audit readiness effort is dependent upon the Department being able to address the following key items:

- Successful resolution of previously identified material internal control weaknesses to ensure that internal controls are properly designed, implemented, and working effectively.
- Successful monitoring and resolution of new material internal control weaknesses identified as part of ongoing readiness efforts.
- Sustained improvement in internal controls and systems to provide consistent and repeatable results regarding financial data used in decision making and reporting.
- Effective development and implementation of the financial improvement effort by monitoring DoD progress in achieving milestones; developing comprehensive improvement initiatives across DoD functional areas; and holding managers accountable for the successful and timely implementation of those efforts.

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, Section 881, 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. 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 are identified as a result of DoD's iterative Financial Improvement and Audit Readiness (FIAR) process.

In October 2011, the Secretary of Defense directed significant changes in the Department's audit goals, including calling for audit readiness of the SBR in 2014. Additionally, Public Law 112-81, Section 1003, requires that the Department have a plan that includes interim objectives and a schedule of milestones for each military department and for the defense agencies to support the goal to validate the SBR by not later than September 30, 2014. Meeting the Secretary's accelerated 2014 milestone for auditability of the SBR will be a challenge for the Department. The Department must continue to develop and implement a comprehensive plan that identifies the interim objectives and schedule of milestones to achieve audit readiness of the SBR for the working capital and general funds. 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.

1-1B. Achieving Financial Statement Audit Readiness	IG Assessment of Progress

Although the Department is far from reaching an unqualified opinion on its consolidated financial statements, the Department has demonstrated improvements. Clearly, DoD senior leadership has placed an increased emphasis on and attention to addressing challenges in achieving audit readiness of its financial statements. We believe this increased attention and emphasis are essential to the Department meeting its own internal milestones as well as the 2017 audit readiness mandate.

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. Despite the pervasive and longstanding Department financial management issues, the U.S. Army Corps of Engineers and various Defense agencies, such as the Defense Commissary Agency, Defense Contract Audit Agency, and Military Retirement Fund, have received unqualified audit opinions. While much more work is necessary, it is encouraging that the Department is making progress in meeting its strategic goals, such as in August 2011, when the Army, Navy, and Air Force achieved unqualified opinions from Independent Public Accounting firms on Services Appropriations Received audit readiness assertions. The Department must sustain its achievements as well as advancing in the remaining significant areas. The DoD IG continues to identify and cite the same 13 material internal control weaknesses in its audit opinion on DoD's consolidated financial statements. 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

The Department continues to make progress towards meeting the 2014 audit readiness goal of the SBR; however, it is still uncertain whether the Department will meet the 2014 goal. The Department continues to learn and improve from the DoD IG audits of 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 type of audit, which resulted in disclaimers of opinion in FY 2010 and FY 2011. Although the USMC SBR received disclaimers, the USMC, the Navy, and the Department are using this experience to correct the weaknesses as well as prepare the other Military Components for their eventual SBR audit. The May 2012 FIAR Plan Status Report only addresses audit readiness of the SBR for the general funds. As the Comptroller has indicated, two Military Services will have to accelerate their efforts to achieve audit readiness of their SBR by 2014. For one Service, that acceleration requires a new approach. The Department will also have to accelerate efforts to achieve audit readiness for the Defense Agencies. Department efforts and meaningful progress in FY 2013 for the SBR audit readiness goal will be critical and should be a high visibility area.

1-1C. Achieving Financial Statement Audit Readiness	Department Response

The Department generally agrees with the IG's assessment of DoD's progress in achieving audit readiness. Over the last year, significant progress has been made by Military Departments, Defense Agencies, and other Defense organizations in support of audit readiness. At the beginning of FY 2012, Secretary Panetta directed the Department to accelerate several of the FIAR Plan goals with greater emphasis on the overall effort. Specifically, the Secretary directed the Department to:

- Achieve audit readiness of the SBR by the end of FY 2014.
- Increase emphasis on accountability of assets.
- Execute a full review of the Department's financial controls over the next two years and establish interim goals against which to assess progress.
- Ensure mandatory training for audit and other key financial efforts and establish, by the end of calendar year 2012, a pilot certification program for financial managers – similar to the one now in place for acquisition managers.
- Appropriately resource efforts to meet these goals.
- Meet the legal requirements to achieve full audit readiness for all DoD financial statements by 2017.

Achieving the 2014 SBR audit readiness goal will be challenging, but with the Secretary's involvement, the Department's ability to achieve this goal has increased significantly. The Secretary's commitment to and personal involvement in auditability has elevated audit readiness to an "all hands," DoD-wide effort. The impact can be seen in a variety of ways:

- Warfighters, from flag officers to enlisted personnel, are more aware, engaged, and committed to audit readiness.
- Appropriate senior executives across the Department, including those outside the financial community, have FIAR goals in their performance plans and are being held accountable.
- Military Departments, Defense Agencies, and other Defense organizations have refined, modified or developed Financial Improvement Plans (FIPs) that include interim milestones to accomplish SBR audit readiness consistent with the Secretary's direction for 2014. Progress is monitored and routinely reported in the FIAR governance process.
- Component FIPs better conform to DoD FIAR Guidance and provide more detail regarding discovery and corrective actions. The FIPs are reviewed monthly by the Office of the Under Secretary of Defense (Comptroller), and the quality is routinely reported in the FIAR governance process.
- Acquisition Decision Memorandums, issued by business information technology (IT) milestone decision authorities, now consistently contain FIAR goals and requirements.
- Component commands and subordinate organizations are more actively involved.
- Adequate funds for audit readiness activities have been maintained.
- Participation in FIAR training courses has significantly increased.

Even with the Secretary's commitment and involvement, the significant challenges to eliminating material weaknesses, strengthening internal controls, modernizing business and financial systems, and producing auditable financial statements remain. However, the Department is now better positioned to make meaningful progress, sustain improvements, maintain a strong control environment, and achieve auditability. In fact, progress has been made since the last AFR, as demonstrated by the following successful audits.

- Defense Information Systems Agency (DISA) received an unqualified opinion on its FY 2011 Working Capital Fund financial statements.
- TRICARE Management Activity – Contract Resource management received an unqualified audit opinion on its FY 2011 financial statements.
- Medicare-Eligible Retiree Health Care Fund received a qualified audit opinion on its FY 2011 financial statements.
- Navy received an unqualified audit opinion on its audit readiness assertion for existence and completeness of its ships and submarines, Trident missiles, and satellites.
- Navy received an unqualified audit opinion on its audit readiness assertion for the E-2D Advanced Hawkeye aircraft acquisition program.
- Air Force received an unqualified audit opinion on its audit readiness assertion for existence and completeness of aircraft, cruise missiles, and aerial targets/drones.

Information on the DoD FIAR Plan can be found in the semi-annual FIAR Plan Status Report.

1-2A. Modernizing Financial Systems (Enterprise Resource Planning)	IG Summary of Challenge

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. We believe that properly planned and integrated systems, with strong internal controls, are critical to provide useful, timely, and complete financial management data and to achieve auditability. However, timely and effective implementation of the Enterprise Resource Planning (ERP) systems is also critical for the Department to achieve its financial improvement and audit readiness goals. We believe the Department's progress in implementing ERPs, especially in FY 2013, is a critical challenge, and any implementation delays or systems that do not meet the intended objectives could jeopardize the Department's ability to meet its auditability goals.

1-2B. Modernizing Financial Systems (Enterprise Resource Planning)	IG Summary of Progress

The Department plans to spend more than $15 billion to further develop and implement ERP systems. These ERP systems have experienced cost increases and schedule delays ranging up to 13 years. Because of these schedule delays, the Department will continue using outdated legacy systems and diminish the estimated savings associated with transforming business operations through business system modernization. Schedule delays and poorly developed and implemented ERP systems also increase the risks that the SBR will not be auditable by September 30, 2014, and the goal of full financial statement audit readiness by September 30, 2017.

Further, without fully deployed ERPs, the Department may not be able to produce reliable financial data and auditable financial statements without resorting to heroic efforts, such as data calls or manual workarounds, and may not be able to provide consistent and reliable financial and reporting data on a recurring basis. For example, DoD reported in the May 2012 FIAR Plan Status Report that the Air Force ERP systems will not be fully deployed by 2014. As a result, the Air Force will rely on manual controls and legacy system enhancements in order to meet the goal of SBR audit readiness by September 30, 2014. The Department also reported that the accelerated goal for the SBR presents other challenges to the Air Force, such as, the time and resources required to conduct testing will increase because manual controls are generally less reliable and require more testing than system controls. The Department also reported that the difficulty of collecting supporting documents processed in multiple systems and reconciling data as it moves from one system to another is a challenge for the Air Force.

The Department has not reengineered established business processes to the extent necessary; oftentimes, it has customized commercial ERP systems to accommodate existing business practices. This leads to the need for system interfaces and weakens controls built into the ERP system. The Department reported that ERP systems were designed to replace numerous subsidiary systems, reduce the number of interfaces, and standardize and eliminate redundant data entry, while providing an environment for end-to-end business processes and serving as the foundation for sustainable audit readiness. However, the numerous interfaces between the ERP and the existing systems may be overwhelming and currently may not be adequately defined. Each interface presents a risk that the system will not function as designed and prevents linking all transactions in an end-to-end business process. The Department needs to ensure ERP system development addresses required business processes and functions.

Without the effective and timely development and implementation of ERP systems, and appropriate senior level governance, 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 to achieve long-term sustainability of the financial management improvements.

1-2C. Modernizing Financial Systems (Enterprise Resource Planning)	**Department Response**

The Department is committed to supporting improvements to financial processes through the implementation of ERP systems. In support of these efforts, the Department has been working diligently to improve business processes and develop its ERPs, improving oversight of the development of the ERPs and implementation of formal business process reviews in support of auditability.

While it is true that legacy systems will continue to be employed during the development and full deployments of the ERPs, the implementations that have already occurred throughout the Department have resulted in the ability to phase out dozens of legacy systems. Several of the Department’s ERPs have been or will be implemented to support the 2017 auditability goal. However, where we are dependent on legacy systems, the Component’s FIPS have incorporated actions necessary to ensure that accurate, reliable financial information is reported. Modernizing the Department’s business systems is a key aspect of our overall effort to achieve and sustain auditability. The Department plans to achieve the audit goals with a combination of both target and legacy systems. While the Department is taking pro-active steps to align individual ERP programs with auditability outcomes, we are also focused on delivering audit ready processes and controls that will remain outside the ERP systems. This will allow us to develop a sustainable business environment that can be cost-effectively audited.

The ERP programs, by their very nature, are designed to handle transactions in a defined end-to-end process, enforce process and execution standardization among implementing organizations, manage consolidated business data in a single repository that allows centralized access control, and facilitate the flow of information both within an organization and with external stakeholders. These design principles within the ERP directly enable capabilities essential to auditability, such as traceability of all transactions from source to statement; the ability to recreate a transaction; documented, repeatable processes and procedures; demonstrable compliance with laws, regulations and standards; and a control environment that is sufficient to reduce risk to an acceptable level.

Essentially, ERPs are acquired with industry best practices "to-be" processes embedded within them. Each of the Department's ERP programs went through significant up front blueprinting and gap analysis to determine which configuration or customization was necessary for the system to work within the business environment in which it was to be fielded. The Department has focused on properly enforcing compliance with the target financial management environment, built on a backbone of the core ERP systems, aligned with the Business Enterprise Architecture's end-to-end processes. In concert with the new Investment Review Board process currently being implemented, as required by the FY 2012 NDAA, these advances will ensure the retirement of legacy systems and the reduction of interfaces and necessary customization as required by the NDAA Business Process Review (BPR) requirement.

The Department's leadership is fully committed to improving ERP implementation and providing proper oversight of its development. Following the passage of the FY 2010 NDAA, the Department instituted a BPR assessment process updated to comply with new requirements of NDAA FY 2012. A combination of ERP implementation and associated BPR will help ensure the Department achieves its audit objectives.

1-3A. Improper Payments	IG Summary of Challenge

Improper payments have been a longstanding problem within the Department, often the result of unreliable data and/or lack of adequate internal controls which create an environment where fraud is more likely. As a result, the Department lacks assurance that the billions of dollars in payments it disburses annually are made correctly. Simply stated, the Department does not always know that it is paying the right person, the correct amount, at the right point in time.

The Department's inadequate financial systems and controls impede in making proper payments. In addition, the pace of operations and volume of Department spending creates additional risks for improper payments as well as affects the Department's ability to detect and recover improper payments. Transactions and processes (business and financial processes, controls, and systems) are neither standard nor sound in all cases. The High Dollar Improper Payment Report was inaccurate and incomplete because the Department did not develop a sound methodology or perform adequate oversight for collecting and reporting comprehensive data.

The Department has challenges with the completeness and accuracy of DoD's improper payment reviews and the information reported. In the FY 2011 DoD AFR, the Department's Under Secretary of Defense (Comptroller)/Chief Financial Officer

(USD(C)/CFO)) made significant disclosures about the limited completeness and accuracy of DoD efforts to identify and report on improper payments, including:

- The Department did not statistically sample Defense Finance and Accounting Service (DFAS) commercial payments for its FY 2011 reporting.
- Transactions and processes (business and financial processes, controls, and systems) were neither standard nor sound in all cases.
- The SBR is not auditable and as a result, the USD(C)/CFO cannot reconcile outlays to the quarterly or annual gross outlays reported in the SBR to ensure that all required payments for reporting purposes are captured.

These areas require improvement before the Department will be able to provide complete and accurate information on its estimated amount of improper payments.

The DoD IG has reported previously about the Department's "pay and chase" practice, where contractors are paid the billed invoice amounts before the Department determines what the correct billing amount should have been. This practice is especially concerning when used to support operations in Southwest Asia. The DoD IG and others have reported on multiple occasions where invoices were paid for work outside the scope of the contract or without adequate support. This type of approach not only increases the risk of improper payments but also increases the risk that the Department will never be able to detect and recover the improper payments. Specifically, over time the condition of contract files and availability of personnel diminishes. The ability to detect and collect on improper payments within aging contract files may diminish over time. The Defense Contract Audit Agency (DCAA) is a key component to identify improper payments in Department contracting. However, there is an emerging concern that the backlog of audits is growing and improper payments are going undetected because the DCAA cannot adequately respond to the growing demand for its services.

1-3B. Improper Payments	IG Summary of Progress

While the Department made strides to improve the identification and reporting of improper payments and took many corrective actions to implement recommendations made by the DoD IG, more work is needed to improve controls over payments processed throughout the Department. We commend the Department on aggressively pursuing recovery of identified improper payments, but unless the DoD continues to improve its methodology to review all its disbursements, it will understate its estimate of overpayments and will likely miss opportunities to collect additional improper payments.

After initial resistance to the IG assertion that the Department's methods used to estimate high dollar overpayments resulted in under-reporting the amount of improper payments, the Department recognized it needs to broaden its scope of review for identifying potential improper payments. The USD(C)/CFO asserted that DFAS will begin statistical sampling of commercial payments in FY 2012. The ability of DCAA to provide audit oversight for contract closeouts is critical to the Department's improper payments efforts. Leadership must maintain awareness on DCAA's ability to provide this critical service.

1-3C. Improper Payments	**Department Response**

The Department concurs with the DoD IG recognition of DoD's improvements in identifying, reporting, and recovering improper payments and in implementing corrective actions. The Department is committed to complying with all laws and regulations established to reduce improper payments. As reported in DoD IG Report No. D-2012-065, the Department is compliant with the requirements of the Improper Payments Elimination and Recovery Act (IPERA). Beginning in FY 2012, the Department instituted statistical sampling for commercial payments disbursed by DFAS.

Since the Department first reported on improper payments in the FY 2004 Performance and Accountability Report, improper payment rates have declined. The Office of Management and Budget (OMB) reported the government-wide FY 2011 error rate for improper payments at 5.49 percent, which is substantially higher than each of DoD's programs[1]. Further, OMB has not designated any of DoD's programs to be a high error program, as shown on the PaymentAccuracy.gov web site.

The Department does not agree with the IG's statement that deficiencies in the Department's initial High Dollar Improper Payment Report, as reported in DoD IG Report No. D-2011-050, present a significant management challenge. The cited report was based on information from Quarter 3, FY 2010 – more than two years ago, and all 13 open recommendations have been successfully closed.

The Department does not have a "pay and chase" practice, as cited above by the DoD IG, where contractors are paid before the Department determines the correct billing. In Audit Report No. D-2011-050, the DoD IG used the phrase, 'pay and chase' when referring to a DFAS review of travel pay among different systems. The DCAA performs risk-based voucher reviews to proactively keep contractor billings aligned with final amounts and rates, not 'pay and chase,' and it is an important part of the Department's audit readiness efforts. The DCAA is diligently working to reduce its current audit inventory and is making progress.

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

2-1A. Enhancing the 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. Even though the Defense acquisition workforce has grown over the last few years, the Department still faces significant challenges in order to sustain a successful and well trained Defense acquisition workforce. These challenges include: 17 percent of the acquisition workforce is eligible for full retirement today; 19 percent are eligible within 5 years; and personnel losses spiked up 3 percent from FY 2010 to FY 2011. The Department needs to continue to provide developmental opportunities to the Defense acquisition workforce to have personnel who can successfully manage complex acquisition programs in the Department. Regardless of the looming decline in the Defense budget, the vital role the acquisition workforce plays in providing the warfighters with new capabilities will remain. Previous Defense budget cuts decimated the capability of the acquisition workforce; a mistake the Department can ill afford to repeat.

[1] The Fiscal Year 2011 DoD Agency Financial Report showed the overall Department error rate at 0.18 percent; however, DFAS commercial payments included in this figure were an actual amount, not a statistical estimate.

2-1B. Enhancing the Acquisition Workforce	IG Assessment of Progress

The Department senior leadership continues to recognize the importance of fielding a capable acquisition workforce to effectively 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 has filled 6,400 new acquisition positions since 2008 and as of the second quarter 2012, the total acquisition workforce is over 151,000 personnel. The Defense Acquisition Workforce Development Fund budget estimate of $274.2 million in FY 2013 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. Sustained commitment and management attention is essential to ensure the improvements to the acquisition workforce are not lost or needlessly diminished.

The Under Secretary of Defense for Acquisition, Technology and Logistics (USD(AT&L)) emphasized strengthening the acquisition workforce as a priority in his October 7, 2011 initial guidance memorandum. The USD(AT&L) stated that since the levels of the acquisition workforce have grown over the last few years, they will increasingly turn their attention to improving the capability of the workforce they have.

The Department continues to use the Defense Acquisition Strategic Workforce Plan, April 2010, which outlines additional strategies the Department is employing to support an acquisition workforce that has the capacity and ability to appropriately manage and oversee acquisitions. They are closely partnering with the Defense Acquisition University and offering several continuous learning and classroom courses. The Defense Acquisition University incorporated better buying power into all of their learning assets, specifically creating a Better Buying Power Gateway on the Defense acquisition portal to serve as a central point of access to the latest information on the Better Buying Power initiatives.

2-1C. Enhancing the Acquisition Workforce	Department Response

The Department concurs with the IG's assessment.

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

The Department remains challenged in its management of major acquisition programs. The number of Major Defense Acquisition Programs (MDAPs) has decreased, from 111 in FY 2011 to 89 in FY 2012. 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. The Department 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, including the threat of sequestration in 2013, the Department will be challenged to evaluate the merits of all programs as to their usefulness and the need for further program terminations to remain within budget constraints.

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 continues to reprioritize and rebalance its investments in weapon systems and has made strides towards improving efficiency.

On September 14, 2010, the USD(AT&L) issued a directive geared at obtaining better buying power through greater efficiencies and productivity in defense spending. The Department continues to emphasize the importance of achieving better buying power and has been implementing this initiative to identify efficiencies, increase affordability and determine what goods and services should cost.

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 the affordability of the goods and services it purchases, looking beyond program cost estimates and determining what a program should cost. All ongoing programs are required to present should cost estimates at each milestone decision point, which will be used as a basis for contract negotiations and determining contract incentives.

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. In recent times, senior leadership has demonstrated sound stewardship by eliminating major acquisition programs that were underperforming, over budget, of questionable continuing investment.

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

The Department concurs with the IG's assessment.

2-3A. Contract Management	IG Summary of Challenge

The Department continues to experience inefficiencies and wasteful use of funds in its contracting efforts. The Department's continuing contracting challenges include obtaining adequate competition in contracts, defining contract requirements, overseeing contract performance, obtaining fair and reasonable prices, and maintaining contract documentation for contract payments.

The Department relies 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. The Department spends more than $200 billion annually on services, which amounts to more than 50 percent of the Department's contract spending.

The Department faces several challenges when it comes to contract oversight and administration. 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.

The Department continues to face challenges in obtaining fair and reasonable prices for parts. Audits first started identifying problems with price-based acquisition and commercial pricing back in the late 1990's, and it was not until 2008 that legislative changes allowed contracting officers to request information on labor costs, material costs, and overhead rates for commercial items.

More recently, the Department has moved to new performance-based logistics (PBL) or contractor logistics support (CLS) arrangements that have added a new challenge to obtaining fair and reasonable prices for parts, since the Services are now going back to the weapons systems contractors instead of other available sources to procure the parts. Normally, the Services would procure the parts from the Defense Logistics Agency which in turn would procure the parts from the original equipment manufacturer, not the weapons systems contractors. Paying excessive prices for parts procured from the weapons systems contractors that did not manufacture the items was reported back in the 1980's and resulted in the spare parts breakout initiative. Unfortunately, future budget constraints made breakout and cost/price analysis groups targets for workforce reductions. The Department also faces challenges in effectively using existing Government inventories of spare parts before procuring the same parts from private contractors through these PBL or CLS arrangements.

2-3B. Contract Management	IG Assessment of Progress

The Department continues to make efforts to strengthen contracting and has issued policy, procedures, and guidance addressing current contracting challenges. The Department began the Better Buying Power Initiative in 2010 and continues to implement this initiative to improve the way the Department acquires goods and services. In April 2011, the previous USD(AT&L) amplified the focus of the better buying power memorandum to maximize competition in situations where only one offer is received in a procurement utilizing competitive procedures. In his October 2011 initial guidance memorandum, the USD(AT&L) emphasized his commitment to improving efficiency through the Better Buying Power initiative, which he stated they will continue to refine and build upon to reduce costs and provide the highest possible value to the warfighter. The Department has also emphasized “affordability” in review of acquisition efforts and using peer review to improve quality of contracting processes across the Department.

The USD(AT&L) required each Military Department and Defense Component to establish a senior manager for the acquisition of services, who would be responsible for the planning and execution of service contracts. The Department has also organized the procurement of services into six categories in order to make decisions, share lessons learned, and institutionalize strategic sourcing.

In response to audits relating to PBL and CLS strategies, the USD(AT&L) for Logistics and Materiel Readiness issued guidance that created a standard practice of using existing on-hand and due-in government inventory. The guidance also stated that in these arrangements, stocking objectives should be adjusted accordingly when using commercial sources. Further, senior leadership directed that components should perform cost and price analysis on a sample of spare parts before exercising options.

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

- Implementing corrective actions on findings from the Commission on Wartime Contracting.
- Standardizing Contracting Officer Representative (COR) qualifications.
- Providing tools such as the DoD Contingency COR and Contingency Contracting Officer Handbook.
- Creating a 340-person reach-back center to award complex contracts and support contract closeout.

2-3C. Contract Management	**Department 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 in contract management. The Department continues to implement 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.
- The Director of Defense Pricing issued a memorandum on August 27, 2012, entitled "Taxonomy for the Acquisition of Services and Supplies & Equipment". Based on a review of the existing taxonomy and supported by the Senior Service Managers, the Department established a Logistics Management Services Portfolio Group. The revised taxonomy supports the Department's effort in fostering communication and strategic decisions.
- On August 29, 2012, the Defense Federal Acquisition Regulations Supplement (DFARS) Procedures, Guidance, and Instruction 237.102-77, Automated Requirements Roadmap Tool, was changed to add a link to the tool that enables requiring activities to develop and organize Performance Work Statements and Quality Assurance Surveillance Plans using templates.
- On June 29, 2012, the Defense Procurement and Acquisition Policy (DPAP) Directorate issued the final DFARS rule under the Better Buying Power initiative to promote more effective competition. This DFARS rule requires contracting officers to maximize competition when only one offer is received in competitive procurements. The DPAP Directorate has established a metric to monitor effective competition and is now reporting the data at quarterly competition advocates meetings.
- The Director of DPAP issued a memorandum on July 11, 2012, entitled "Increasing Opportunities for Small Business Set-asides under the Simplified Acquisition Thresholds," that reminds contracting officers of statutory requirements to set aside contracts for small businesses which play a vital role in contributing to the defense industrial base.
- The Director of DPAP issued a memorandum on July 26, 2012, entitled "Maximizing Small Business Utilization on Multiple Award Contracts." This memorandum reminds contracting activities to commit to using set-aside procedures, where appropriate, for all prospective new multiple award contracts with small businesses; to identify existing multiple award contracts with small businesses where orders may be appropriate; and to commit to using set asides.

- Published the Department of Defense Contracting Officer Representative (COR) Handbook on March 22, 2012. This handbook addresses key aspects of contract quality surveillance and the roles and responsibilities of the Contracting Officer, the Contracting Officer Representative (COR), and the requiring activity/COR management. It is intended to be a comprehensive resource for the Contracting Officer, COR management, and the first-time or the experienced COR.
- Published the 2nd Edition of the Defense Contingency Contracting Officer Representative Handbook on July 11, 2012, for use by CORs who are supporting contingency operations with basic tools and knowledge.
- Published the 4th Edition of the Defense Contracting Handbook on July 11, 2012. This pocket-sized handbook provides essential information, tools, and training for DoD Contingency Contracting Officers to meet the challenges they may face, regardless of the mission or environment.

3. IG-Identified Challenge: Joint Warfighting and Readiness

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

The Department will face many challenges in the near future in joint warfighting and readiness. Among them are a decreasing budget, a planned drawdown of forces from Afghanistan, the need to reset equipment and personnel across the Services, a return to full-spectrum training, and an enhanced focus on the Pacific theater. But the desired end-state remains the same: 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. A decrease in DoD’s budget will be felt across the Department, especially in areas like training and exercises. The Services and the Combatant Commands need to ensure training and exercises conducted are realistic, providing personnel the skills they will need to respond to threats wherever they occur in the future.

The planned drawdown of forces from Afghanistan will challenge the Department in many areas, simultaneously. The forces will have to be reintegrated into the total force and reset will have to occur; not just to equipment, but also personnel and units. The Services have announced plans to restructure themselves for future conflicts. The Army has announced plans to reduce its forces in Europe while the Air Force has identified a number of units for realignments. The Navy has stated that they plan to move more ships to the Pacific theater and the Marines continue to plan for a drawdown in Okinawa and relocating forces to Guam. The reintegration of forces comes with a continued need to take care of the service members and their families.

Those same units that will be undergoing changes in personnel strength, and possibly locations, will also need to have their equipment requirements addressed. Equipment the units will need to retain will need to be repaired; equipment the units are not retaining will need to be replaced with newer items of equipment. All of these challenges will require management visibility and vigilance to ensure the Department has what it needs, but also identifies excess, so it can be accounted for properly. The enhanced focus on the Pacific will also challenge the Department as it reaffirms existing relationships in the region and looks to establish new ones.

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

The Department is making progress to address the multitude of situations with drawdown in Afghanistan, resetting equipment, ensuring the long-term viability of the All-Volunteer force, but must also be ready to address new situations that will rise with the expected reduction in available resources and the rebalancing of the force. The National Security Strategy released in January 2012 placed increased emphasis on the Pacific theater. This will present challenges to all of the components of the Department as they shift their focus to the Pacific. The armed forces will have to train to fight conventional and unconventional scenarios, and they will be challenged to do this with diminishing resources while maintaining their readiness status. The Department will have to provide additional oversight to ensure that the equipment reset process is managed so that only unusable equipment is disposed and new equipment is fielded to the intended users. The Department will also have to provide the necessary levels of oversight to ensure that forces returning from Afghanistan, and their families, continue to receive the support they need.

As the drawdown continues in Afghanistan, 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 realignment of forces from Okinawa, Japan to Guam still faces formidable challenges which have impacted projected costs and schedules to the planned effort.

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 Operation Enduring Freedom, hedging against execution of other potential contingencies.

The withdrawal of forces from Iraq, combined with Presidential directives to reduce deployed numbers in Afghanistan, has reduced the stress on forces in the near 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. Additionally, even with the reduction of ground forces in the Central Command area of responsibility, it is anticipated the demand for Naval and Air Forces will continue unabated in the near term.

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

Cyber security is the technology, processes, and practices designed to protect networks, computers, programs, and data from attack, damage, or unauthorized access. As identified in the Department's strategy for operating in cyberspace, the continuing growth of networked systems, devices, and platforms means that cyberspace is an integral part of the capabilities the Department relies upon to complete its mission. The DoD networks are under constant attack from cyber security threats launched from the internet or from malicious software embedded in e-mail attachments, removable media, or embedded in the hardware DoD procures. Every connected device is susceptible to cyber vulnerabilities. According to recent reports from the Department of Homeland Security, reported computer security incidents for Federal agencies have increased from 5,503 in FY 2006 to 43,889 in 2011, an increase of approximately 700 percent over 6 years. As stated in the Department's cyberspace strategy, foreign nations are working to exploit DoD unclassified and classified networks, and some have already acquired the capacity to disrupt parts of DoD's information infrastructure. The Department faces significant challenges in three areas of potential adversarial activity: theft or exploitation of data; disruption or denial of access or service that affects the availability of networks, information, or network-enabled resources; and destructive action including corruption, manipulation, or direct activity that threatens to destroy or degrade networks or connected systems.

4-1B. Cyber Security	IG Assessment of Progress

It has been approximately two years since the Secretary of Defense directed the establishment of the U.S. Cyber Command to plan, coordinate, integrate, synchronize, and conduct activities to lead the day-to-day defense and protection of DoD information networks. Additionally, the Army, Navy, and Air Force have also established their own cyber operations commands. 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 Security System, which includes DoD's primary HIDS, is mostly complete and adjustments are being made. The addition of HIDS to DoD systems contributes to DoD's defense-in-depth strategy, which also is comprised of network and wireless intrusion detection systems.

While the Department has made progress in combating cyber attacks and breaches, it still faces a challenge in recruiting and hiring cyber security personnel. In testimony on March 20, 2012 to the House Committee on Armed Services, Subcommittee on Emerging Threats and Capabilities, the Commander, U.S. Cyber Command, acknowledged that U.S. Cyber Command was critically short of the skilled people needed to manage networks and protect U.S. interests in cyberspace. According to a recent Government Accountability Office (GAO) report, the Department reported a shortage of 9,000 cyber security personnel from a total of 97,000 total positions. The Commander, U.S. Cyber Command, stated that U.S. Cyber Command is reviewing recruitment and incentive programs to build and retain the best cyber defenders. Cyber security personnel are in high demand inside the Government and in private industry.

The Department must continue finding ways to recruit and retain the cyber personnel necessary to defend DoD's networks and the sensitive data contained within.

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

The Department continues to strengthen cyber security and address the threat posed by network attacks. The establishment of U.S. Cyber Command and the supporting Service Component Commanders has greatly increased the Department's ability to plan, coordinate, integrate, synchronize, and conduct activities to lead the day-to-day defense and protection of DoD information networks. Implementing a Department-wide enterprise Host-based Security System (HBSS), which includes a Host-based Intrusion Prevention (HIPS) module chosen in place of a host-based intrusion detection system, to extend active protection to the desktop level has been a key component of our defense-in-depth strategy as we take steps to effectively isolate the department's official-use networks from the Internet while maintaining connectivity. This has been undertaken in phases, as we first focused on Secret network implementation and then unclassified networks. This implementation has been directed through U.S. Cyber command tasking and fragmentary orders.

Implementation of the HBSS HIPS module has been particularly challenging, as individual Components have had to adapt their HIPS implementation to work with the existing legacy information systems running on their networks. Some of these legacy systems are still vital for warfighting support. The U.S. Cyber Command and the supporting Component Commanders continue to focus on implementation, with DISA's assistance in providing program office and field support to ensure future versions of HBSS and HIPS software are modified, as necessary, to enable more rapid implementation.

In regard to the Department's challenges to recruit and retain cyber personnel, the U.S. Cyber Command is aggressively working through the manning process to fulfill established requirements in a time of shrinking budgets. The 97,000 cyber security positions reported by the IG are based on the 2010 Information Assurance (IA) Workforce Annual Report. We concur that 9,000 positions were not filled across the Department; however, the 2011 report identified 79,691 cyber security positions, of which 93 percent were filled, and 74 percent of those positions were filled with personnel with a current cyber security certification in compliance with the DoD 8570.01-M, "Information Assurance Workforce Improvement Program." Additionally in 2011, 84 percent of all of the personnel in an IA position had a baseline IA certification. The gap between billets/positions and the number of them filled depend on a number of variables, to include the following:

- Lack of funding for the position.
- Training pipeline – lack of school seats my cause a shortage of personnel.
- Using personnel qualified for the position to man other requirements often known as Temporary Duty Assignment (often they are sent to Afghanistan or other operational environments to fill "temporary billets").
- Recruiting and retention programs can cause a lack of personnel availability. However, it does take time to work though the manpower process once a billet/position is identified – to budget, recruit, train, and assign a qualified person to a new position.

4-2A. Information Technology (IT) Acquisition System	IG Summary of Challenge

One of the focus areas of the DoD Chief Information Officer's (CIO's) 10-Point Plan for IT Modernization is to strengthen IT investments. Section 804 of the NDAA for FY 2010 required 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..." The DoD CIO's 10-Point Plan will include structuring IT programs, via smaller, frequent deliveries, implement an enterprise approach for the procurement of common IT hardware and software, obtain transparency of IT investments with a full DoD IT investment portfolio, and review major IT investments for performance, funding execution, and enterprise alignment.

4-2B. IT Acquisition System	IG Assessment of Progress

The Department has recognized that it needs to improve the outcomes of its acquisitions, deliver faster capability, and save billions through cost efficiencies. On June 23, 2011, the USD(AT&L) issued a Directive-Type Memorandum on Acquisition Policy for Defense Business Systems, which sets forth timeline requirements for automated information systems. The memorandum states that when Major Automated Information Systems employ the incremental acquisition approach, all functional capabilities must be achievable within five years of when the funds are first obligated. Additionally, the memorandum provides similar requirements for all other Automated Information Systems. While this memorandum sets more ambitious timelines to acquire automated information systems, the Department must continue to push forward with 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 continues to achieve key accomplishments in the overall timeliness and effectiveness of the IT acquisition process. The USD(AT&L) issued acquisition policy in Directive Type Memorandum (DTM) 11-009, "Acquisition Policy for Defense Business Systems," dated June 23, 2011, and change 1, dated December 9, 2011. This DTM requires the use of the Business Capability Lifecycle (BCL) model as the acquisition process for Defense Business Systems (DBS), assigns responsibilities, and provides procedures for meeting BCL and DBS requirements. 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.

The BCL is the overarching framework for the planning, design, acquisition, deployment, operations, maintenance, and modernization of DBS, in accordance with Title 10 U.S.C., Section 2222(f). This policy will be incorporated in the next update to DoD Instruction 5000.02, "Operation of the Defense Acquisition System." Additionally, the Department updated Business Case guidance in May 2012 to enhance business case content. The DTM 11-009 defines a business case as:

> "A summary of essential information necessary to enable effective management decisions resulting from the rigorous analysis and associated documentation produced by the Functional Sponsor and the [Program Manager]. The Business Case clearly defines and articulates the business problem, the desired outcomes, and the holistic plan for delivering the capability. As more knowledge is acquired progressing through the lifecycle, the Business case is updated for ongoing decision making."

Simply stated, the Business Case is one of the key program documents reviewed at an acquisition milestone for Major Automated Information System programs. The Department currently is working to incorporate BCL policy guidance into the Defense Acquisition University's Defense Acquisition Guide. Additionally, the Department is collaboratively exploring opportunities to further enhance DBS acquisition processes. An example of this effort is the Deputy Chief Management Officer (DCMO) working with Department-level Test and Engineering organizations to explore ways to improve DBS testing.

On October 6, 2011, the Deputy Secretary of Defense established the Deputy's Management Action Group (DMAG) to be his mechanism for executing a common management approach across the Departmental topics and processes for which he is responsible. The Deputy Secretary effectively merged a number of senior leadership bodies, including the Defense Business Systems Management Committee discussed in the 2011 response with the DMAG, to create a single body of senior leaders to consider the Department's wide range of management and business topics. The Department's senior leaders ensure the successful execution of the Strategic Management Plan and Annual Performance Plan, oversee the defense business systems investment management process, and monitor and take corrective action in the Department's efforts to improve its defense business operations. This new framework consolidates governance for the Department and creates increased efficiency and effectiveness in the Department's management processes.

5. IG-Identified Challenge: Health Care

5-1A. Medical Readiness	IG Summary of Challenge

In addition to providing health care for Active Duty personnel, managing the overall health of 9.7 million eligible beneficiaries is a continuing challenge for the Military Health System (MHS). Identifying unhealthy behaviors and providing appropriate interventions across the population is a challenge. 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, and could degrade medical readiness of military members.

5-1B. Medical Readiness	IG Assessment of Progress

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. Specifically, the Navy did not adequately identify and assess the risks associated with not expanding the specialty care in Guam although the beneficiary population was projected to increase substantially.

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. In addition, management needs to ensure nonmedical alternatives such as recreational and athletic facilities are in adequate condition and available to military community as well as cessation programs for unhealthy addictive behaviors such as cigarette smoking and alcohol use. 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."

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

The Department concurs with the IG's assessment. Through its initiative process, the MHS has chartered a new population health working group to specifically address the challenges of providing nonmedical alternatives for changing unhealthy behaviors, such as those leading to obesity and tobacco use. Additionally, the workgroup is tasked with the development of an Annual Health Assessment in the form of an intelligent questionnaire integrated into the patient workflow using existing technologies (e.g., Armed Forces Health Longitudinal Technology Application workflows, secure messaging). The health assessment will also draw from available clinical data and will provide quantitative and qualitative data about the wellness state of our beneficiaries. Additionally, the health assessment will support a personal prevention plan, providing specific feedback to the beneficiary to assist in altering unhealthy behaviors and provide an objective measure of the effectiveness of both the nonmedical and medical programs related to the wellness and health of our beneficiary population. The working group also is tasked with developing and monitoring pilot programs to address obesity and tobacco cessation through the expansion of wellness programs delivered on our bases, in facilities such as the recreation centers, and virtually through coaching programs delivered wherever they are required. Through the study of these pilot programs, combined with objective data from the health assessment, we will be able to tailor the most effective solution possible across the entire military health system.

5-2A. Cost Containment	IG Summary of Challenge

The MHS must provide quality care for approximately 9.7 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. Over the past decade, health care costs have grown substantially, and MHS costs have been no exception. The DoD budget for health care costs was approximately $53 billion in FY 2012, an increase of approximately 74 percent since FY 2005. The MHS costs have more than doubled, from $19 billion in FY 2001 to the Department's request of $48.7 billion for FY 2013. With these costs increases in mind, the Department proposed to implement a modest increase to enrollment fees while also making small adjustments to retail and mail order pharmacy co-pays. 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 12.5 percent of the 1,862 open cases at the beginning of FY 2012.

Increasing health care benefits also provides additional pressure to manage and contain costs.	
5-2B. Cost Containment	IG Assessment of Progress
The Department's efforts in controlling health care costs will continue to be a challenge as early indications are that DoD beneficiary fee increases are not likely to be fully approved. The MHS is focusing on many areas to manage per capita health care costs. Three managed care support contracts are in effect; however, award protests resulted in staggered implementation of the new generation TRICARE contracts. The contracts provide incentives for customer satisfaction and include the managed-care support contractors as partners in support of medical readiness. The Department continues to examine 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. The Department has identified areas that assist in managing costs, to include fraud management, and pharmaceuticals. Implementing the Quadruple Aim Concept should 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.	
5-2C. Cost Containment	**Department Response**
The Department concurs with the IG's assessment.	
5-3A. Rehabilitation and Transition Care	IG Summary of Challenge
The continued strengthening of comprehensive and integrated health care – from accession through active service, to rehabilitation, and when necessary, the transition to the Department of Veterans Affairs (VA) – is a major challenge for the MHS. In particular, the Department will need to remain focused for future years with providing adequate rehabilitation and transition care for wounded warriors associated with Southwest Asia and other such conflicts. Key areas requiring management attention also include rehabilitation and transition care for those affected with Traumatic Brain Injury, Post Traumatic Stress Disorder, and those in need of prosthetic services. 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. The Department should continue to strive to make the medical care and benefits transition program a streamlined, transparent, and timely process as wounded warriors move from the DoD system to the VA system.	
5-3B. Rehabilitation and Transition Care	IG Assessment of Progress
During this past year, the DoD IG has noted the need to provide timely access to specialty care, improvements in various training programs and plans, as well as improving medication management. While challenges remain, the DoD IG has identified notable initiatives within the Department for supporting the comprehensive care,	

healing, and transition of wounded warriors. Some specific initiatives were recovery team forums to develop individualized courses of action to address each wounded warrior's needs. In addition, another notable initiative addressed reducing the potential for exploitation of warriors, therefore avoiding negative consequences to morale, and the overall health and welfare of the warriors. Also, wounded warrior care centers were developing meaningful programs of constructive activities to assist with warriors' transition. These notable initiatives should continue Department-wide.

5-3C. Rehabilitation and Transition Care	**Department Response**

The Department concurs with the IG's assessment.

5-4A. Optimizing Health Care Governance	IG Summary of Challenge

Ensuring that the MHS is organized in the most effective and cost-efficient manner will continue to be a challenge. Transformation occurred in the MHS over the past years, including the consolidation of medical facilities and functions in the National Capital Region mandated by the 2005 Base Realignment and Closure (BRAC) process. The BRAC also provided the Department with the opportunity to evaluate changes in the MHS governance. In addition to improving the readiness and cost efficiency associated with realigning base structure, a primary objective of the BRAC process was to examine and implement opportunities for greater joint activity among the Military Departments. Considering increased joint activity during recapitalization of aging physical infrastructure will continue to be a challenge.

5-4B. Optimizing Health Care Governance	IG Assessment of Progress

The Department established governance reforms in March 2012 to explore opportunities to realize savings in the MHS through the adoption of common clinical and business processes and the consolidation of shared services. The TRICARE Management Activity will transition into the Defense Health Agency, a Market Manager will be appointed in each multi-Service market areas, and the Joint Task Force National Capital Region Medical (JTF CAPMED) will transition to a subordinate organization under the Defense Health Agency. The Department will continue to develop and execute the single authority JTF CAPMED and cross-Services San Antonio Military Health System governance models to provide greater insight when considering future governance transformation. Evaluating the variety of governance models may provide innovative solutions that can be used across the MHS.

The BRAC process addressed 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, merging the now-closed Walter Reed Army Medical Center and the Bethesda National Naval Medical Center, opened in November 2011. In addition, 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 and shared purpose.

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 and the replacement hospital project at Camp Pendleton. Planning for the facilities was adequate and met the ARRA's goals of transparency and accountability.

5-4C. Optimizing Health Care Governance	**Department Response**

The Department concurs with the IG's assessment.

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

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

A major national security goal of the U.S. is the establishment of a sovereign, stable, and self-reliant Iraq that contributes to the peace and security of the region and with which the U.S. can forge a long-term strategic partnership. Supporting the development of a professional Iraq Security Force, capable of providing for its internal and external defense, is essential to achieving these U.S. objectives.

Fundamental to establishing and nurturing this long-term security partnership is the role of the Office of Security Cooperation – Iraq (OSC-I), which was initially established in June 2011, expanded in October 2011, and subsequently transitioned to Chief of Mission and Department of State authority in December 2011. The OSC-I, operating under Chief of Mission authority but administered by DoD personnel, is charged with performing vital bilateral security cooperation and security assistance functions. Comprised of DoD military, civilian, and contractor personnel, the OSC-I represents a cornerstone capability for building an enduring foundation for a long-term security relationship with the Government of Iraq.

To facilitate continued support for developing the Iraq Security Forces, the Department transitioned most remaining essential training, equipping, and mentoring activities from United States Forces-Iraq to the OSC-I. Robust security cooperation and assistance programs, including very significant Foreign Military Sales of U.S. defense technology, are being developed and may be seen as an early indicator of the potential for building a strong, enduring U.S.-Iraq strategic partnership over the longer term.

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

While the OSC-I successfully transitioned from the Department of Defense to the Department of State authority by the end of 2011, the U.S. and Iraq governments did not conclude certain agreements that were envisioned by the command as necessary to enable OSC-I ability to become fully functional within Iraq's dynamic post-2011 operating environment. Senior OSC-I officials indicate that the absence of a post-2011 Security Agreement or Status of Forces Agreement was affecting aspects of their operations. Key areas cited by these officials as being impacted included land use agreements, force protection, passport/visa requirements, air and ground movement, and FMS site stand-up. The precise impact of these command concerns with respect to achieving short- and long-term OSC-I goals is unclear. However, having formal, follow-on Security and Status of Forces agreements was perceived to have potential value in clarifying and stabilizing Iraqi government support for day-to-day OSC-I operations and would benefit longer-term relationship and partnership building. It is imperative, therefore, that the political and legal framework and authorities necessary be established in a timely manner 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.

6-1C. Iraq Security Forces	**Department Response**
The Department acknowledges the IG's challenge.	

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

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 continue to assume the leading security operations role.
- Providing continued training, equipping, partnering and mentoring to professionalize the Afghan National Security Forces (ANSF), ensuring "quality, not just quantity."
- Withdrawing 23,000 U.S. combat forces from Afghanistan in 2012.
- Conducting a phased drawdown of U.S. combat forces in 2013 and 2014, and
- Continuing to enable the ANSF to assume and sustainably maintain lead responsibility for the security of the Afghan people and its government as International Security Assistance Force (ISAF) withdraws.

The Department must continue its efforts to develop the capability of the Afghan Ministries of Defense and Interior to administratively and 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 ANSF combat service support functional capabilities that NATO and U.S. Forces will need to develop for the ANSF to be able to reach its necessary security capability.

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-Qa'ida forces in the Northwest Frontier safe haven.

A significant challenge will be conducting the phased drawdown of U.S. and Coalition military forces and civilians while physically transporting personnel and equipment out of Afghanistan. The equipment will either have to be airlifted, or flow by land through Pakistan to the Port of Karachi for out-bound transportation by ship or by truck, rail and water links via the Northern Distribution Network in Central Asia.

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

The size of the Afghan National Army (ANA) and Afghan National Police (ANP) have grown at a very significant rate over the past two years, and the ISAF command is at or near the end of the expansion of the ANSF to 352,000 personnel. The focus of the train and equip effort has changed from growth to initiatives focused on the sustainment and professionalization of the force, with a priority on development of the officer and non-commissioned corps in the ANA and ANP. The partnering of US and Coalition units and training teams has enabled ANA units to accelerate improvement in their operational capability.

The success of the counterinsurgency campaign being conducted against the Taliban and extremist anti-government elements depends on how well the ANSF provides protection for the Afghan people and gains their trust, along with the effectiveness of governance. The responsibility to protect the Afghan people falls most directly on the ANP, which operates as the direct interface with the population in provinces and districts around the country. Of note in this area is the success of the Afghan Local Police initiative, supported by both ISAF and the Afghan Ministry of Interior (MoI), to develop, train, and equip part-time policemen at the village level to provide security in largely rural areas where the presence of the ANSF is insufficiently strong to prevent armed insurgent infiltration and activities. As of April 2012, the Afghan Local Police (ALP) strength was approximately 12,900 and on track to reach the goal of 30,000 at 99 MoI-approved sites across Afghanistan by the end of 2014. However, while the ALP works well when closely monitored by U.S. Special Forces, there is, as of yet, no well-defined plan to transfer control and supervision of the ALP to effective Afghan oversight. Without such a plan, as U.S. forces reduce, the risk that the ALP will dissolve or become abusive militia will increase.

The NATO Training Mission – Afghanistan/Combined Security Transition Command – Afghanistan (NTM-A/CSTC-A) has assisted the Ministry of Defense (MoD) and MoI to achieve considerable progress in increasing its institutional training capacity for specialized skills and leadership development, while continuing to improve training quality, reduce attrition, and improve recruitment.

In addition, U.S. and 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 continue to enter into more specialized and technical training programs requiring a higher level of comprehension.

Although challenges remain, most notably in the development of a functional and sustainable ANSF logistics/maintenance capability, the transfer of security and governance responsibilities to Afghan lead in provinces and districts across Afghanistan continues in accordance with established ISAF and Afghan government plans.

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. As the ANSF is reaching its end-strength of 352,000, redeployments of U.S. combat forces have begun and the transition to ANSF-led security is well underway. Despite the progress of the ANSF, challenges remain, and the focus has shifted to closing remaining ANSF capability gaps by 2015. Training and advising will be critical to the irreversibility of the ANSF lead for nationwide security, and the rolling conversion to Security Force Assistance (SFA) has already begun. Assembling sufficient quantities of SFA teams will be vital to the campaign as we reduce our force numbers, close and transfer bases, and prepare for 2015 and beyond.

7. IG-Identified Challenge: The Nuclear Enterprise

7-1A. Prior Decline of Focus on the Nuclear Enterprise	IG Summary of the Challenge

For the past several years, numerous government and non-government organizational reports 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, fourteen reports were issued that commented on the current state of the nuclear enterprise.

During the past fiscal year, the IG issued a classified report detailing the current security environment of the nuclear enterprise. Although the specific findings and recommendations of that report are classified, the report identified continuing weaknesses in security vulnerability analysis and security alert response times. The organizations referenced in the report responded positively to a majority of the findings and recommendations. The IG also issued a restricted report to determine the actions taken to implement the recommendations made in six DoD and Service specific reports regarding the DoD nuclear enterprise. A majority of the recommendations in those six reports have been closed.

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 DoD 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.

During FY 2012, the DoD IG reviewed follow-up progress on a 2002 report on Physical Security of Nuclear Weapons Located in the Continental United States. The U.S. Air Force has made significant progress in implementing corrective actions to correct the deficiencies identified in those reports. The DoD IG is currently reviewing the Cryptographic Modernization program for critical nuclear command and control networks.

The following reports were issued either by the DoD IG, the Nuclear Command and Control System (NCCS) Support Staff, the DSB, or the GAO since the issuance of the FY 2011 Management Challenges report.

- Report to Congress Pursuant to Public Law 110-417, Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, January 2012; "Department of Defense Review of the Findings and Recommendations Applicable to the Department of Defense Made in the Reports of the Commission to Assess the Threat to the United States from Electromagnetic Pulse Attack"
- Biennial Assessment and Report on the Delivery Platforms for Nuclear Weapons and the NCCS, National Defense Authorization Act of 2012, Section 1041, January 2012
- Report of the Safety, Security, Reliability, Sustainability, Performance, Military Effectiveness of the Trident II (D5) Strategic Weapon System Delivery Platform (National Defense Authorization Act of 2012, Section 1051), December 2011

- Nuclear Command and Control System Support Staff Assessment report on "NSPD-28 Requirement for Secure and Survivable Head of State Communications With Other Nations," September 2011
- Nuclear Command and Control System Support Staff Assessment report on "The Prime Nuclear Airlift Force," January 2012

  Nuclear Command and Control System Support Staff Assessment report on "Assurance of Security and Reliability of Nuclear Command, Control, and Communications (NC3) Equipment Using Commercial Off the Shelf Software, Hardware, and Firmware," March 2012
- Fiscal Year 2012 Annual Update to the Report Specified in Section 1251 of the National Defense Authorization Act for Fiscal Year 2010, February 16, 2011
- Fiscal Year 2011 Joint Surety Report, April 2012
- Joint Surety 2011 Report on the "Nuclear Weapons Stockpile Assessment"
- US Nuclear Physical Security Collaboration, December 15, 2011
- Interim Report of the Defense Science Board (DSB) Task Force on the Survivability of Systems and Assets to Electromagnetic Pulse (EMP) and other Nuclear Weapon Effects (NWE), August 2011
- Government Accountability Office Report, GAO-12-512T " Further Actions Needed by U.S. Agencies to Secure Vulnerable Nuclear and Radiological Materials," March 14, 2012
- Government Accountability Office, GAO-12-468, "Strategies and Challenges in Sustaining Critical Skills in Federal and Contractor Workforces," April 26, 2012
- Government Accountability Office, GAO-12-577R "Evaluation of Report on Feasibility of Increasing Air Transportation of Nuclear Weapons, Components, and Materials," May 4, 2012

Joint Chiefs of Staff. During FY 2012, the Chairman, Joint Chiefs of Staff (CJCS), reported that they have accomplished the following goals:

- The Joint Staff Deputy Directorate for Command, Control, and Nuclear Operations (J-36) continued to focus on oversight and implementation of command and control of nuclear forces and investment in the National Military Command System command centers. This was accomplished with improvements in guidance, training, and inspections.
- In support of these focus areas, J-36 briefed and trained members of the Joint Chiefs of Staff and Secretary of Defense successors to ensure nuclear command and control familiarity within the Department. Annual exercises that focus on nuclear policy and strategic deterrence presented opportunities for senior officials to learn about this unique environment and to contribute their expertise to develop realistic scenarios.

  In concert with the Defense Threat Reduction Agency (DTRA), J-36 performed operational and technical assessments of the nuclear enterprise. These assessments are formal reports staffed annually or as directed to support and clarify the Chairman's obligations to the Secretary of Defense and the President. They also provide an end-to-end look at the systems and procedural "health" of the enterprise while giving the Chairman measurable and executable decision tools for command and control of the nuclear mission set. Additionally, CJCS-directed Staff Assessment Visits ensured command center compliance with established Emergency Action

Procedures of the CJCS (EAP-CJCS). Assessment teams visited every Combatant Command Center over the course of the year. These visits focused on procedures, training, and execution within the Commander's battle staff.

J-36 worked with the Force Structure, Resources, and Assessment Directorate (J-8), the Air Force, and the DoD CIO to ensure the long-term viability of technical capabilities within the nuclear command and control system.

Department of the Air Force. The Air Force reported that they have accomplished the following goals since the FY 2011 Management Challenges Report:

- The Air Force established goals, objectives, and metrics within the 2012 Air Force Strategic Plan to assess the nuclear enterprise. The metrics create a comprehensive picture of Air Force efforts to achieve specific goals across the nuclear enterprise over the next several years. In addition, these metrics provided source data for the Air Force Enterprise Senior Leader Dashboard and allow for the necessary oversight through measurable and objective measures.
- The Air Force successfully completed the transfer of Continental United States Munitions Squadrons from Air Force Materiel Command to Air Force Global Strike Command on February 29, 2012.
- The Air Force developed an Air Force Nuclear Command, Control, and Communications (NC3) Integration Plan. Key components of this plan include: (1) establishment of a NC3 Community of Interest, a body of NC3 stakeholders across five Headquarters Air Force Directorates and seven Major Commands (MAJCOMs), charged with identifying Air Force NC3 shortfalls and coordinating solutions; (2) establishment of a baseline NC3 architecture, led by the Air Force Global Strike Command as the NC3 Chief Architect; and (3) identification of NC3 capability gaps, leading to MAJCOM prioritized investment.
- The Air Force developed and conducted the first of two in a series of deterrence-focused war games to address operational–level challenges in a multi-polar and proliferated nuclear world. Insights from the war games provided depth to additional joint tabletop exercises, enhanced engagements with key allies and partners, and contributed to deterrence-focused military advice to the Joint Chiefs of Staff.
- The Air Force built a "Human Capital Plan" for the nuclear enterprise consisting of several initiatives to develop personnel with nuclear expertise and ensure the right people with the right skills are assigned to critical positions. The Air Force established an Intercontinental Ballistic Missile (ICBM) weapons school track, creating a corps of personnel with in-depth knowledge and proficiency in ICBM operations. The AF introduced a series of courses to educate Airmen of all grades on nuclear deterrence operations.
- To strengthen positive inventory control of Nuclear Weapons Related Material (NWRM), the Air Force performed an engineering analysis to ensure 100 percent identification of all NWRM components. A robust screening process was developed, utilizing a "score card" evaluation method to standardize and streamline the procedures. The process enabled engineers to refine the list, removing 125 items that did not meet the criteria and adding 15 which did. This effort improved oversight of NWRM by ensuring manpower and resources were focused on items actually requiring these extensive control measures.
- The Air Force has undertaken an effort to revise, clarify, and consolidate guidance for the nuclear enterprise, including drafting a nuclear series of Air Force instructions. There is a plan in place to write or revise over 75 nuclear publications

which will properly align all nuclear enterprise policies and instructions.

The Air Force initiated a comprehensive review of the Air Force nuclear enterprise to assess the progress in completing identified objectives to reinvigorate and strengthen the enterprise and to formulate new objectives for continuous improvement.

Department of the Navy. The Navy reported that they have accomplished the following goals since the FY 2011 Management Challenges Report:

- The Navy completed the first-ever Navy Nuclear Weapons Comprehensive Biennial Self-Assessment. This assessment represents a significant first step in establishing a culture of continuous improvement and critical self assessment across the Navy's nuclear weapons enterprise.
- The Navy assessed all Echelon 1 and 2 fleet and shore commands with nuclear weapons responsibilities – a total of 23 organizations. This report and its findings were endorsed by the Chief of Naval Operations and the Secretary of the Navy.

7-1C. Prior Decline of Focus on the Nuclear Enterprise	**Department Response**

The Department's summary-level response to the IG's challenges and assessment of the Department's progress in 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

As previous Management Challenge reports have stated, the Department needs to sustain its focus on the nuclear enterprise, even in the face of probable funding reductions. The following elements are key to this sustainment:

- Continue to foster an environment that emphasizes the nuclear mission and promotes a reliable, safe, secure, and credible nuclear deterrent. The nuclear deterrent is essential to national security and must remain a high DoD priority.
- Continue reviews and studies of all critical elements of the nuclear enterprise to identify key deficiencies and methods for improvement.
- Monitor corrective action plans made as a result of previous reviews and studies that correct 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

The DoD CIO's National and Nuclear Command Capabilities Executive Management Board serves as an advocate, with some enforcement capabilities, to ensure issues are brought to leadership's attention. Organizations having nuclear command and control responsibilities are represented at the meetings, which include the appropriate representatives from other departments and agencies involved with the nuclear enterprise.

Continuous monitoring and evaluation of the nuclear enterprise by senior leadership helps sustain the progress. The Air Force Comprehensive Assessment of Nuclear Sustainment is finishing its fourth phase (AFCANS IV). The U.S. Strategic Command's 2010 Crystal Fortress Report, current studies directed by the DMAG, and the Navy's self-assessment, mentioned earlier, are all examples of engaged leadership.

The oversight of the Air Force nuclear enterprise by Air Force Global Strike Command and the Assistant Chief of Staff Strategic Deterrence and Nuclear Integration, U.S. Air Force (AF/A10), continues to be the most effective guarantor of continuing progress in the reliability and safety of the nuclear enterprise. The Air Force Global Strike Command, in particular, provides a more focused and active oversight of nuclear capable bombers and ICBMs than the Major Commands those forces were previously assigned to.

The Navy continues their use of the Nuclear Weapons Oversight Council, which develops Navy nuclear weapons policy for the Ballistic Missile Submarine fleet. The assessment work of the Navy Nuclear Weapons Comprehensive Biennial Self-Assessments may provide a mechanism in future years for evaluating the health of the Navy's nuclear weapons program.

The Administration proposed $11.6 billion in new budget authority for the National Nuclear Security Administration for FY 2013, a 1.7 percent decrease over the FY 2012 request. The budget request includes $7.6 billion for Weapons Activities, including the B61 Life Extension Program. Also, with the approval of the New Strategic Arms Reduction Treaty, the reduction of total warheads will increase the importance of the B61 Life Extension Program.

Continuing Concerns. The re-vitalization of the nuclear enterprise in recent years has been facilitated by increased funding levels for personnel staffing and training, systems and equipment acquisitions, and materiel maintenance. Continued advancements in these sectors cannot be sustained without sufficient financial commitment. Supply chain management issues, particularly involving the initial source of critical spare parts, could also be an issue of relevance in current and future fiscal years.

Additionally, the nature of deterrence involves a cadre of properly trained personnel in a constant state of readiness. This cadre is often out of the public eye. Potential reductions in funding for these activities can only result in a diminished state of readiness and increases the likelihood for an incident similar to what happened in the Minot and Taiwan incidents. During FY 2011 and 2012, the DoD IG classified audits' problems were noted in funding levels for sustainment activities. Recommendations were made to the appropriate service authority for corrective action.

Properly utilizing the limited existing nuclear expertise and growing more expertise continues to be a concern, especially within the Air Force. Expertise in the nuclear missile crew career field and potentially other career fields may take 5-7 years to reconstitute. In the meantime, actions to hire civilians with the needed nuclear expertise are being impacted by cuts in civilian personnel slots. At the same time, due to the increased emphasis on the nuclear enterprise, the demand for nuclear experience has grown: the Defense Threat Reduction Agency, Air Force Inspection Agency, the Air Staff, Air Force Nuclear Weapon Center, U.S. Strategic Command, and the Joint Staff all have a need for some of the limited existing nuclear expertise.

Finally, a lack of centralized management of nuclear command and control modernization and configuration hinders effectiveness. Some systems lack a program office, some nuclear command and control networks depend on funding from multiple commands within a service or multiple services. Synchronization between these separate organizations with separate priorities must coordinate on a plan to ensure programs remains on track. A single authoritative office with responsibility for configuration control would help alleviate this difficulty.	
7-2C. Keys to Improvements in the DoD Nuclear Enterprise	**Department Response**
The Department continues to make significant progress in improving the nuclear enterprise. Specifically, new strategic plans and self-assessments, such as the 2012 Air Force Strategic Plan and the Navy's first-ever Navy Nuclear Weapons Comprehensive Biennial Self-Assessment, are providing measurable oversight. While much work remains, including valuable recommendations provided by oversight reports and independent assessments, the Department continues to work with other Federal agencies, such as the Department of State and the Department of Energy, to provide responsible but innovative solutions through sustainment and modernization programs while still maintaining efficacy of the regimen put in place. The robust efforts of the Department and its interagency partners support a safe, secure, and effective nuclear deterrent.	

MANAGERS' INTERNAL CONTROL PROGRAM

The OUSD(Comptroller) leads DoD's *Federal Managers' Financial Integrity Act* (FMFIA) program, summarized in the Management Discussion and Analysis (MD&A) section of this report, designated as the Managers' Internal Control Program (MICP). Managers throughout the Department are 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 are identified in the FIAR guidance are required to include assurances related to financial reporting and financial systems in their programs.

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, identifies and assesses risk within the processes, identifies and tests internal controls, establishes controls found to be deficient, and reports on the results of these assessments and tests. The Department asserts that all Components with the exception of one, 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)*.

TYPES OF MATERIAL WEAKNESSES

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 appropriation 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.

Management-identified weaknesses are determined by assessing internal controls, as required by the FMFIA, the *Federal Financial Management Improvement Act* (FFMIA), and *OMB Circular No. A-123*, and fall into one of the following three categories:

1. FMFIA Section 2, Financial Reporting Material Weaknesses (see Table 1a).
2. FMFIA Section 2, Operations Material Weaknesses (see Table 1b).
3. FMFIA Section 4, Financial System Nonconformance Weaknesses (see Table 1c).

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT (FMFIA)

1. FMFIA Section 2, Financial Reporting Material Weaknesses. Under the oversight of the DoD Financial Improvement Audit Readiness (FIAR) Governance Board, discussed in the Department's FIAR Plan Status Report, DoD's assessment of its financial reporting identified the areas of material weakness listed in Table 1a. The table includes a column, entitled "Ref Table 2," that crosswalks the manager-identified areas of material weakness to similar areas of weakness identified by the DoD IG in Table 2.

Table 1a lists the DoD's manager-identified 18 categories of material weaknesses in the Department's Internal Control over Financial Reporting. There were no new weaknesses identified in FY 2012.

Table 1a. 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 2**	**Beginning Balance**	**New**	**Resolved**	**Reassessed**	**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
	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		**18**				**18**

Table 1a-1 provides the description and corrective action plan for each material weakness related to internal control over financial reporting.

Table 1a-1. FY 2012 Internal Control over Financial Reporting Material Weaknesses

	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
1	Appropriations Received: The Defense Agencies' processes do not effectively account for budgetary authority transactions and balances.	FY 2011	Defense Agencies	Components are implementing 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 (FBWT): The Department cannot reconcile transactions posted to the FBWT general ledger accounts with transactions reported and posted to the Department of the Treasury's FBWT accounts and ensure adequate support for FBWT transactions.	FY 2005	Army; Navy; DLA; DIA; NSA; SMA; USSOCOM; DTRA	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 2015
3	Financial Reporting Compilation: The Department cannot prepare accurate financial statements supported by general ledger balances and adequately documented and	FY 2007	Army, DLA, TRANSCOM	The Department continues to improve business processes and controls through the implementation of enterprise resource planning (ERP) systems that produce accurate, timely and auditable financial reports. In	FY 2015

Table 1a-1. FY 2012 Internal Control over Financial Reporting Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
	supported journal entries.			addition, the Department is implementing the Standard Financial Information Structure in systems of original entry and carried through the chain of systems. DFAS and Components are identifying root causes for abnormal balances and taking steps to change business processes to correct the problems. Components and DFAS are working to implement routine general ledger tie point analyses and reconciliations and analyzing general ledger posting logic to reduce the number of unsupported journal entries.	
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 is collaborating with the Department of the Treasury, OMB, and Federal partners to develop and implement a government-wide solution to capture the transaction-level detail needed to reconcile intragovernmental transaction activity. It is also developing standard business processes and data to capture trading partner information at the transaction level and support eliminations, as well as 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.	FY 2015

Table 1a-1. FY 2012 Internal Control over Financial Reporting Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
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.	FY 2003	MERHCF; SMA	Medical Components are implementing procedures to improve coding and financial reconciliations for military treatment facilities' operations as well as developing and implementing a methodology to reimburse military treatment facilities on a per capita basis. This methodology 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 cannot effectively account for transactions and balances in the civilian pay process.	FY 2011	Department-wide	Components are addressing the reliability and existence of supporting documentation retained within the applicable payroll, personnel and time and attendance systems. They also are identifying, assessing, and testing IT general and application controls. In addition, Components are also defining and prioritizing sub-processes into assessable units and evaluating the sufficiency of the current SSAE 16/SAS 70 efforts.	FY 2014
7	Military Pay: The Department cannot effectively account for transactions and balances in the military pay process.	FY 2011	Department-wide	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 2014

Table 1a-1. FY 2012 Internal Control over Financial Reporting Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
8	Accounts Receivable: The Department cannot accurately record, report, collect, and reconcile intragovernmental accounts receivable and accounts receivable due from the public.	FY 2003	Army; Air Force; DLA; SMA	Components are continuing to implement ERP systems to improve collections, age receivables, and minimize manual processes. They also are implementing the Standard Financial Information Structure in systems of original entry. This will improve the Tri-Annual Review process (DoD FMR 7000.14-R, Volume 3, Chapter 8) and overall order-to-cash process, and improve reconciliations between entitlement systems and accounting systems, including identification of aging accounts.	FY 2015
9	Contracts: The Department cannot effectively account for transactions and balances supporting the contracts procure-to-pay process.	FY 2003	Department-wide	Components are developing processes to improve timely deobligation of funds upon contract delivery or completion, perform regular reviews of obligation estimates, and require the use of data currently distributed from contract writing systems to support timely and accurately recording of obligations/deobligations of funds. They also are assessing the use and compliance by accounting systems of accounts payable data, ensuring payables and obligation estimates are recorded upon acceptance of goods or services and that accounting systems track obligations and disbursements by contract and line item.	FY 2014

Table 1a-1. FY 2012 Internal Control over Financial Reporting Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
10	(MILSTRIP Orders): The Department cannot effectively account for transactions and balances in the Military Standard Requisitioning and Issues Procedures (MILSTRIP) Orders procure-to-pay process.	FY 2011	Department-wide	Components are documenting processes and key controls and identifying and testing key controls in the requisition and issue of material, as well as testing the interfacing data between the logistics receipt processing systems and the financial systems. Components also are verifying the timely recording of accounts payable to ensure the payment does not occur prior to physical receipt of material and validating that returns are authorized and, if appropriate, a financial transaction is recorded.	FY 2014
11	Reimbursable Work Orders (Grantor): The Department cannot effectively account for transactions and balances supporting the Reimbursable Work Orders – Grantor procure-to-pay process.	FY 2011	Department-wide	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 2014
12	Transportation of People: The Department cannot effectively account for transactions and balances supporting the transportation of people.	FY 2011	Department-wide	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 2014

Table 1a-1. FY 2012 Internal Control over Financial Reporting Material Weaknesses					
	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
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	Components are following a strategy to first validate the existence and completeness of mission critical asset records in logistics and accounting systems. They also are developing a methodology to report property values, determine the appropriate property classifications, prepare for site visits to perform inventory counts, and implement property accountability policies and procedures.	FY 2017
14	General Purpose Equipment: The Department's practices do 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; NGA; USSOCOM; NSA; MDA	Components are validating the existence and completeness of general purpose equipment before moving forward to record the valuation of such equipment and identifying property in the possession of contractors and ensuring information in the property management systems is accurately reported.	FY 2017
15	Real Property Assets: The Department cannot provide assurance that real property asset quantities and values reported in the financial reports are accurate.	FY 2003	Army; Navy; DLA; WHS; NGA; USSOCOM; DIA	Components have implemented real property inventory requirements data standards. In addition, Components are implementing sustainable real property accountability and construction in progress (CIP) business processes and management controls; reconciling real property records to ensure assets exist and records are complete; and assessing the effectiveness of management controls.	FY 2017

Table 1a-1. FY 2012 Internal Control over Financial Reporting Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
				Additionally, the Components will periodically evaluate the quality of real property data by making comparisons 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 cannot 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	Components are implementing systems, processes, and controls to ensure the accuracy of site-level liability data to report environmental liabilities; updating guidance and training base-level environmental personnel on processes and cost to complete estimating practices; and standardizing cost estimating supporting documentation practices.	FY 2015
17	Inventory: The Department cannot accurately account for the quantity and value of inventory reported in its financial statements.	FY 2005	Army; Navy; Air Force; DLA	Components are developing physical inventory processes, including the reconciliation of quantities of inventory with data recorded in the accounting systems.	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	Components are implementing ERPs that will track OM&S purchases and issuances at a transaction level to address this weakness as well enhancing physical inventory processes to ensure accurate reporting.	FY 2017

2. FMFIA Section 2, Operational Material Weaknesses. The Components use an entity-wide, risk-based, self-assessment approach to establish and assess internal controls for mission-essential operations. Table 1b lists the material weaknesses disclosed from these annual assessments. The Department aligns its reported material weaknesses into 17 categories, as outlined in the Department of Defense Instruction (DoDI) Number 5010.40, "Managers Internal Control Program Procedures", dated July 29, 2010.

Table 1b. 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	Acquisition	1				1
2	Communications, Intelligence and/or Security	4				4
3	Comptroller and/or Resource Management	2				2
4	Contract Administration	1	1			2
5	Force Readiness	2				2
6	Personnel and/or Organizational Management	3	1		1[2]	3
7	Property Management	1				1
8	Supply Operations	1				1
	Total Operational Material Weaknesses	15	2		1	16

Table 1b-1 provides the description and corrective action plan for each material weakness related to internal control over operations in Table 1b.

Table 1b-1. FY 2012 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
1	<u>Acquisition</u>				
	The Department lacks processes to maximize the return on weapon system investments. In addition, the Department must find ways to deliver more capability to the warfighter at a lower cost.	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. This enables programs and individuals to be held accountable for policy implementation within milestone and funding	Reassessed annually based on incremental improve-ments

[2] Partially resolved resulting in reclassification to Reportable Condition

Table 1b-1. FY 2012 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
				decisions through the use of reporting metrics.	
2	Communications, Intelligence and/or Security				
a	Controls related to safeguarding Personally Identifiable Information (PII) are ineffective. Metrics demonstrate a need to strengthen the existing controls or develop new safeguarding policies.	FY 2011	Navy	The Navy plans to implement the use of individual unique identification numbers. In addition, the Navy will continue to monitor statistical data to evaluate whether high-risk breaches continue to decline.	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 developing and installing a training and certification system to track IA personnel certifications.	FY 2013[3]
c	Weaknesses exist in the Department's management and assurance of the reliability and security of the information technology infrastructures.	FY 2006	Navy; USAFRICOM	The Navy is developing and implementing instructions and policies for tracking equipment accounts supporting Navy contracts and a uniform equipment request and loan tracking system for managing and tracking information. USAFRICOM plans to assess its consolidated enterprise and to develop additional requirements; engineer, implement, operate, and maintain a joint enterprise network; and provide additional capabilities for the tactical local area network.	FY 2013[3]

[3] Target correction date was reported as FY 2012 in the FY 2011 Statement of Assurance. In FY 2012, the target correction date was reevaluated and extended to a future date

Table 1b-1. FY 2012 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
d	Internal assessments have identified weaknesses in the Department's cyber security controls, potentially increasing vulnerability of DoD systems.	FY 2011	OSD; USAFRICOM	The Department will continue ongoing actions to address weaknesses in the complex network of systems referred to as the DoD Information Network Systems. The Department is updating identified security controls to current industry standards. The DoD also is enhancing the system certification and accreditation process to incorporate risk management throughout the systems lifecycle. This includes implementing a continuous risk monitoring program that will identify weak security controls and assess corrections. The Joint Information Environment, scheduled for completion in FY 2018, is creating a shared infrastructure and single security architecture that gives better visibility of network activity at points of vulnerability. In FY 2013, DoD will continue to implement insider threat protection such as Public Key Infrastructure and data access monitoring.	FY 2013[3]
3	Comptroller and/or Resource Management				
a	The Department's current business processes, systems, and internal controls do not provide reliable, accurate and verifiable financial statements. Further, the financial management workforce needs to be well-trained to	FY 2011	Department-wide	The Department is implementing established guidance that will enable Components to improve their processes, systems and controls. The biannual FIAR Plan Status Report outlines the Department's and Components' progress and future plans for implementing ERPs and improving standard	FY 2017

[3] Target correction date was reported as FY 2012 in the FY 2011 Statement of Assurance. In FY 2012, the target correction date was reevaluated and extended to a future date

Table 1b-1. FY 2012 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
	ensure the Department's programs and payments comply with financial management laws and regulations.			operating procedures and controls related to producing financial statements by 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; 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 2013[4]
4	Contract Administration				
a	The Department's lack of well-defined requirements, the use of ill-suited business arrangements, and the inadequate 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
b	Clearing the backlog of contracts to be closed out continues to be a challenge for	FY 2012	DCMA	DCMA and Defense Contract Audit Agency (DCAA) have been partnering and evaluating an option that	FY 2014

[4] Target correction date was reported as FY 2012 in the FY 2011 Statement of Assurance. In FY 2012, the target correction date was reevaluated and changed to an earlier date due to a component correcting its material weakness

Table 1b-1. FY 2012 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
	the Department. The number of over-aged contracts increased 28% in FY 2012 (from approximately 28,000 in FY 2011 to 36,000 in FY 2012) and this number is expected to continue to rise. Over 75% of the current over-aged contracts are due to the lack of indirect rates. This causes unspent contract funds to be returned to the Department of the Treasury if not used by the end of the fiscal year.			would allow for a review of a sample of proposals within acceptable risk allowances; this will provide DCMA contracting officers the ability to settle indirect rates and close out overaged contracts. Additionally, DCMA and DCAA are working collaboratively in developing and implementing training, creating a standardized format for more effective and efficient dissemination of information.	
5	Force Readiness				
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 2013[5]
b	Air and Space Expeditionary Force Unit Type Code Reporting Tool (ART) reporting did not accurately reflect Air Force readiness. Specifically, Air Force officials did not accurately report Unit Type Code	FY 2010	Air Force	Rewrite AFI 10-401 procedures to expand the waiver process and perform validations.	FY 2013[5]

[5] Target correction date was reported as FY 2012 in the FY 2011 Statement of Assurance. In FY 2012, the target correction date was reevaluated and extended to a future date

Table 1b-1. FY 2012 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
	(UTC) readiness assessments at 12 of 14 wings reviewed. On average for calendar year 2008, commanders either did not report, or did not report in a timely manner, readiness assessments for 12% of 129,000 UTCs in ART. Additionally, Air Force officials did not process 24% of 116 tasking reclamas and 48% of tasking waivers in a timely manner.				
6	Personnel and/or Organizational Management				
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	DCAA has developed and implemented policies and procedures to ensure auditors receive sufficient training. DCAA plans to institute peer reviews, in order to confirm the progress made towards improving audit quality.	FY 2013[5]
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. DCMA projects that approximately 50% of its 8,000+	FY 2010	DCMA	DCMA is developing and implementing a formalized education, training, and certification program for all levels of employees.	FY 2014

[5] Target correction date was reported as FY 2012 in the FY 2011 Statement of Assurance. In FY 2012, the target correction date was reevaluated and extended to a future date

Table 1b-1. FY 2012 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
	workforce will have less than 5 years' experience within the next 5 years.				
c	OSD has identified 28 Mission Critical Occupations and two Mission Critical Function Groups with potential skillset gaps that may impact the ability to meet mission objectives	FY 2006	Department-wide	DoD has implemented a process to identify occupations and function groups with skill gaps and to develop corrective action plans to remediate identified gaps. The process includes conducting internal and external environmental scans of political actions, legal policies, needed workforce skills, organizational goals and constraints, impacts to the workforce, and strategic roles in accomplishing the mission and executing strategy. The scan determines current workforce supply, evaluates future demand for filling current and new positions, analyzes recruitment and retention of data, develops forecasts using data provided by Functional Community Managers, and conducts skill gap analyses to identify strategies for skill gap closure.	FY 2015
7	<u>Property Management</u>				
	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 will establish accountable records that will identify property, to include Government Furnished Property.	FY 2016[6]

[6] Target correction date was reported as "reassessed annually based on incremental improvements" in the FY 2011 Statement of Assurance. In FY 2012, the target correction date was reevaluated and changed to FY 2016

Table 1b-1. FY 2012 Internal Control over Operations Material Weaknesses					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
				OUSD (AT&L) will validate accountable property records and supporting documentation through existence and completeness testing.	
8	Supply Operations				
	The Department lacks management of supply inventories and responsiveness to warfighters' requirements.	FY 2011	Department-wide	The Department is improving Supply Change Management operations through better demand forecasting, asset visibility, and distribution processes including: 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 1c shows the resulting weakness.

Table 1c. 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 2**	**Beginning Balance**	**New**	**Resolved**	**Reassessed**	**Ending Balance**
1. Financial Management Systems	9	1				1
Total System Conformance Material Weaknesses	**9**	**1**				**1**

Table 1c-1 provides the description and corrective action plan for the material weakness related to internal control over financial systems.

TABLE 1c-1. FY 2012 Internal Control over Financial Systems Material Weakness					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
1	Financial Management Systems: 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

Summary of Financial Statement Audit

The following Table 2 lists the DoD IG's identified 13 areas of material weakness in the Department's financial statement reporting.

Table 2. 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**				**13**

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

OVERVIEW

This section reports on the Department's compliance with The Improper Payments Information Act (IPIA) of 2002, as amended by the Improper Payments Elimination and Recovery Act of 2010 (IPERA), that require agencies to report information on improper payments to the President and Congress in the annual Agency Financial Report (AFR) and the Departments payment recapture programs.

Beginning in FY 2006, OMB determined that all DoD payments are susceptible to the risk of error based on the large volume of transactions and high dollar amounts of annual disbursements. Since that time, the Department has reported on the following payment categories:

(1) Military Health Benefits

(2) Military Retirement

(3) Military Pay

(4) Civilian Pay

(5) Travel Pay

(6) Commercial Pay

In the FY 2007 AFR, the U.S. Army Corps of Engineers (USACE) began reporting travel improper payments, and in the FY 2009 AFR, began reporting commercial pay improper payments.

The DFAS, USACE, and TMA are the primary disbursing components within the Department. A few additional DoD disbursement operations also report annually:

- Army-Europe – reports travel improper payments
- Army-Korea – reports travel improper payments
- Department of the Navy reports Civilian Mariner (payroll) improper payments

The following tables, which are required by OMB Circular No. A-136, are included at the end of this section:

- Improper Payment Reduction Outlook (Table 4)
- Payment Recapture Audit Reporting (Table 5)
- Payment Recapture Audit Targets (Table 6)
- Aging of Outstanding Overpayment (Table 7)
- Disposition of Recaptured Funds (Table 8)
- Overpayments Recaptured Outside of Payment Recapture Audits (Table 9)

Risk Assessment

Because OMB determined that all DoD payments are risk susceptible, the Department maintains a more conservative position than required by IPERA and considers all payment categories as high risk, annually testing and reporting improper payments in all six categories. The DFAS also monitors changes in programs associated with OMB-mandated criteria (e.g., a large increase in annual outlays, regulatory changes, newly-established programs, etc.) to track troubling trends and implement corrective measures, as necessary. Numerous pre-payment and post-payment controls further minimize improper payments as well as improve estimates and identify corrective actions.

The USACE assessments for travel and commercial payments address the effectiveness of internal controls, such as pre-payment reviews, to prevent improper payments as well as system weaknesses identified internally or by outside audit activities. The USACE Financial Management System (CEFMS) provides internal system standards that adhere to U.S. Generally Accepted Accounting Principles as well as process controls, providing the process safeguards to monitor and ensure that pre-payment examination requirements are met. The USACE also monitors changes in programs to track trends and implement corrective actions, as necessary.

The TMA contracts with an external independent contractor (EIC) to provide an independent, impartial review of reimbursement methodologies and claims processing procedures used by TRICARE's purchased care contractors. The EIC's responsibility is to identify improper payments as a result of contractors' noncompliance with TRICARE payment/reimbursement policies, regulations, and contract requirements. The EIC manually reviews medical, Active Duty dental and pharmacy claims documentation and re-adjudicates processed claims submitted by the purchased care contractors to detect errors. Post-payment claims reviews are conducted on a recurring quarterly, semi-annual, and annual basis as contractually defined in the EIC and purchased care contracts. The TMA program managers also complete an annual risk assessment based on the evaluation of the quarterly and semi-annual claim reviews performed by the EIC or based on other reviews.

Statistical Sampling Process

The three primary Defense disbursing components (DFAS, TMA, and USACE) all use statistically valid, random sampling methods designed to meet or exceed OMB's requirements of a 90 percent confidence interval, plus or minus 2.5 percent, for estimating and projecting the Department's annual improper payments for each of the six programs identified in the Overview section. The smaller disbursing components (e.g., Army-Korea travel payments, or USACE travel pay) normally perform 100 percent post-payment reviews or a full review of payments above a certain dollar threshold with random sampling for lower-dollar payments. The TMA uses stratified random sampling for certain health claim categories.

Military Health Benefits. There are two types of payment samples: one for denied claims and one for non-denied claims (claims that were paid). In this way, TMA can be sure that claims were either paid or denied correctly. The TMA uses a stratified random sample process to select medical, pharmacy or dental claims for review.

Military Pay. The Department randomly samples 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 samples 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 the total Civilian Pay payments for the Department.

DFAS Commercial Pay. In FY 2012, DFAS implemented statistically valid, random sampling for commercial payments by site and system for payments that DFAS computes. Approximately 2,000 invoices were reviewed monthly across the DFAS sites.

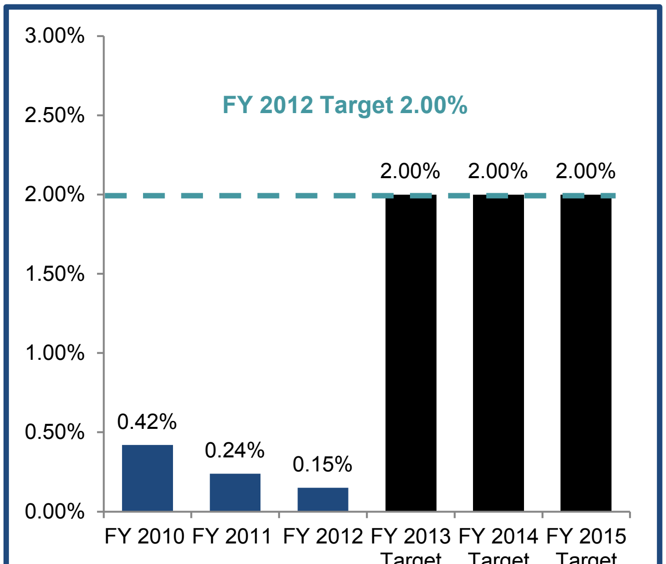
Disbursements in the Navy Enterprise Resource Planning (NERP) System that are computed by the Navy are reviewed by the Navy; however, its sampling and review plan was not in place early enough in FY 2012 to report improper payments in this year's AFR. The NERP disbursement universe for FY 2012 was approximately $1.4 billion.

Military Retirement and Annuitant Benefit Payments.

The monthly random sampling universe of military retirement payments includes both the retired and annuitant pay accounts. The FY 2012 scope of the pay reviews for retired and annuitant pay was expanded to include drilling reserve retiree offsets, Survivor Benefit Plans, transfers to/from the Temporary Disability Retired List to the Permanent List, and Veterans Affairs offsets. Special reviews continue for Combat Related Special Compensation, Concurrent Receipt of Disability Payment, daily payroll accounts, and other targeted areas.

Travel Pay. The DFAS reports the largest portion of the Department'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 DFAS randomly samples travel vouchers from each system on a monthly basis. 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 for Army-Europe, Army-Korea, Air Force, and Navy. Both Temporary Duty Travel (TDY) and Permanent Change of Station (PCS) travel vouchers are included in the post-payment reviews.

Figure A-1. Improper Payment Rate – Military Health Benefits



Note: TMA reports 12 months in arrears; i.e., the figures listed for FY 2012 are from FY 2011.

Root Causes of Error and Corrective Actions

Military Health Benefits. As shown in Figure A-1, the Department projects 0.15 percent in FY 2012 Military Health Benefits improper payments. The Department's purchased care contracts have had payment performance standards for processing military health benefit claims in place for many years. Specifically, if improper payments exceed 2 percent of total dollars paid out during the contract period, the contractor is subject to monetary penalties. Annual audits of payments made by managed-care support contracts are conducted. Overpayments discovered are projected to the review universe, and managed-care support contractors are liable for the total unallowed healthcare amounts paid.

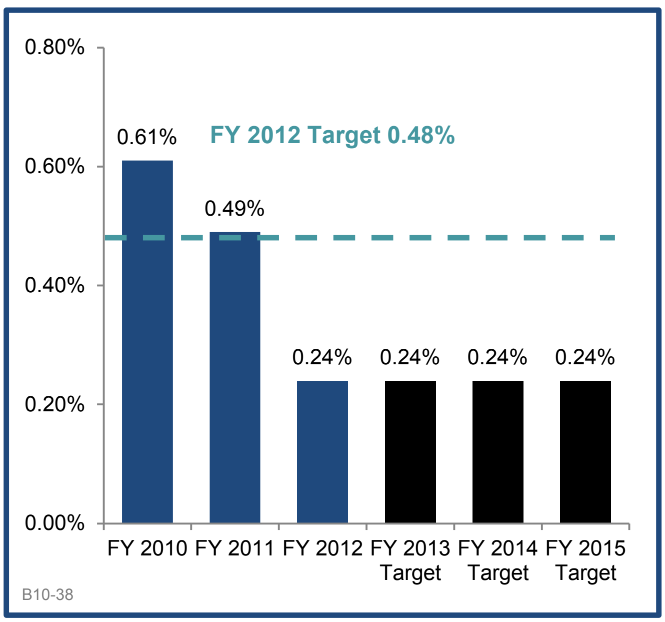
The purchased care contracts have a performance standard of 98 percent accuracy, so the contractor is incentivized to keep payment error rates as low as possible to increase contract awards. Actual error rates, however, have been consistently less than ½ of 1 percent. This contract design, combined with numerous pre-payment and post-payment controls, effectively minimizes improper payments for purchased care contracts and ensures the Government's risk for improper payments in the military health benefits program is minimized.

Root Causes. The primary reasons for payment errors in the Military Health Benefits program are:

- Incorrect pricing of medical procedures and equipment, 30 percent
- Cost-share/deductible miscalculations, 17 percent
- Other Health Insurance/government pay miscalculations, 13 percent
- All other causes combined, 40 percent.

Corrective Actions: TRICARE's third-party contractors are monetarily incentivized to reduce and eliminate improper payments through contractual performance standards. The fewer improper payments the contractors make, the less money is deducted from their contractual reimbursements.

Figure A-2. Improper Payment Rate – Military Pay



Military Pay. As shown in Figure A-2, the Department projects 0.24 percent in Military Pay improper payments based on reviews, estimates, and forecasts for October 2011 through September 2012. The decrease from FY 2011 is attributed to a change in DoD regulations (DoD Instruction (DODI) 1327.06)) that authorized Reservists the opportunity to carry forward accumulated leave from one period of Active Duty service to another, which had been the primary cause of underpayments in FY 2011.

Overpayments comprised 88 percent of the Military Pay improper payments, with less than 0.3 percent of the errors found through random reviews. These overpayments were reported as a result of separation debts ("out-of-service" debts, established after a member has left the service) and through collections reported by the Military Services.

Root Causes. The primary reasons for improper payments (mostly overpayments) identified through all procedures (random reviews, out of service debts, and collections) result from administrative and documentation errors:

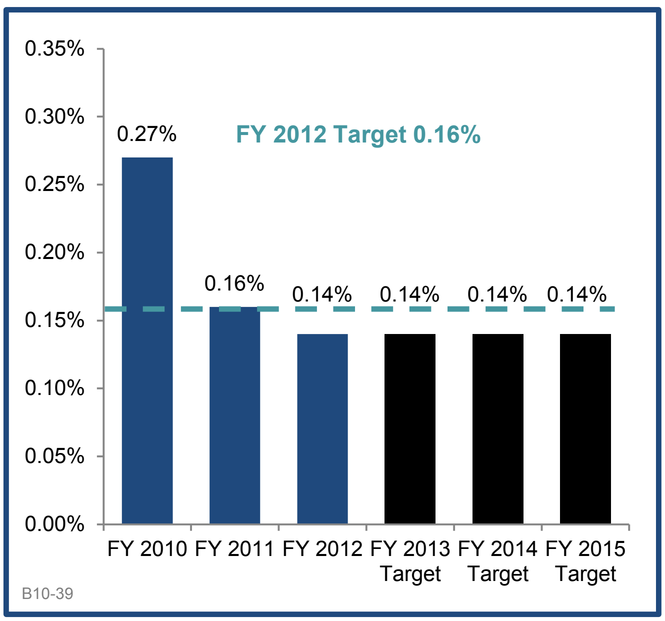
- Basic Allowance for Housing (38 percent) resulting from incorrect reporting of the entitlement.
- Base pay for Active Duty and incorrect Active Duty pay for Reservists (16 percent) resulting from incorrect reporting of the entitlement.
- Hostile fire/imminent danger pay (10 percent) resulting from incorrect reporting of the entitlement.
- Family separation allowance, Active and Reserve, (7 percent) resulting from incorrect reporting of the entitlement.
- Miscellaneous categories, including results from underpayments, account for 29 percent of all improper payments. (Miscellaneous categories are comprised of over 25 different entitlements.)

Nearly 100 percent of overpayments for Military Pay either were recovered or have an action in place to recover the overpayment. Collections for overpayments from current service members amounted to 61 percent of total recoveries with additional amounts identified through review of out of service debts (debts established and recovered after separation).

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, 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. As shown in Figure A-3, the Department projects 0.14 percent improper payments in Civilian gross pay, primarily overpayments, for FY 2012. Nearly 100 percent of the overpayments were identified through review of the accounts receivable due from current civilian employees. Because the

Figure A-3. Improper Payment Rate – Civilian Pay



employees remain employed with the Department, there is an action in place to recover the overpayment, generally through payroll offset.

Root Causes. The Civilian Pay improper payments are primarily caused by untimely or inaccurate entry of information into the pay systems.

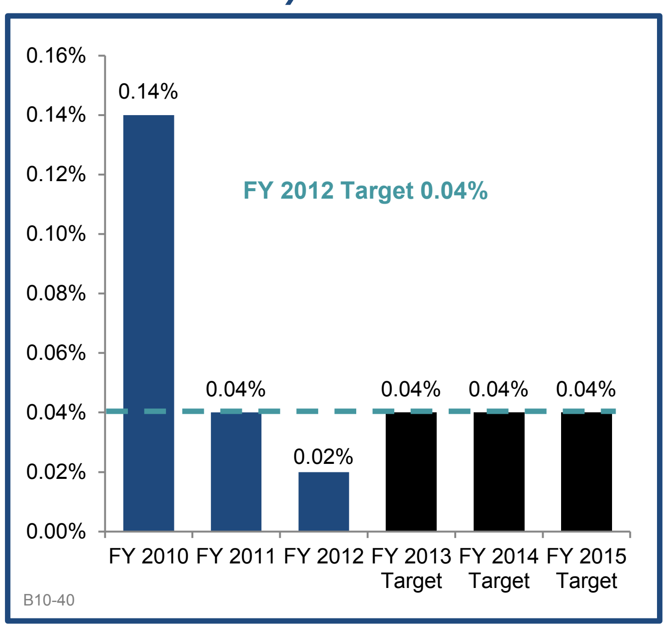
- Time and attendance, 45 percent
- Overseas and other allowances, 32 percent
- Late personnel actions, 23 percent

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 initial 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 creating a collection (Accounts Receivable) action to offset the overpayment. 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 of 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 future improper payments and participates at various conferences to instruct personnel on how to correctly submit information, such as changes to entitlements and to travel vouchers.

Figure A-4. Improper Payment Rate – Military Retirement



Military Retirement. Based on FY 2012 reviews, DFAS projects approximately 0.02 percent in improper payments for the total outlays in the Military Retirement program (refer to Figure A-4), with almost the entire amount related to payments made to deceased retirees and annuitants. The primary reason for the decrease from 0.14 percent in FY 2010 to 0.02 percent in FY 2012 is due to DFAS re-establishing a formal post-pay review section for Retired and Annuitant Pay, insourcing the function from a private sector contractor. This action enabled DFAS to expand reviews and identify processes needing additional attention or correction. The added reviews, coupled with ongoing review of deceased retiree and annuitant accounts, has allowed DFAS to provide a more comprehensive and concise accounting of outlays in military retirement.

Root Causes. Eligibility for military retired pay ends on the retiree's date of death. 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. 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 2012 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.

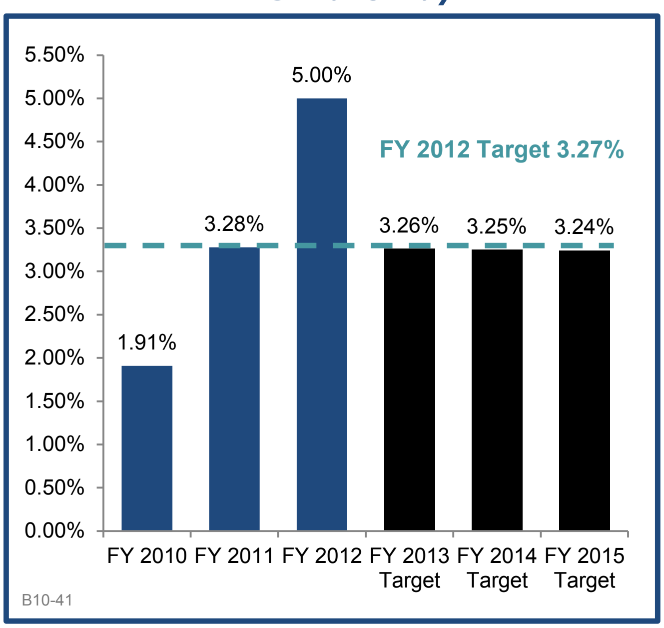
Corrective Actions. The Department's control processes to prevent, identify, and reduce overpayments to deceased retirees and annuitants include:

- 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;
- Validating Military Retiree existence if payments are returned and/or if account was suspended for several months due to bad check/correspondence address.

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 death master file 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 Department's expanded definition of acceptable source documents for notice of death has allowed DFAS to initiate earlier reclamation actions, thereby increasing faster recovery of funds paid after date of death.

DFAS Travel Pay. The FY 2012 projected improper payment rate of 5.0 percent, shown in Figure A-5, includes random reviews of DTS trip records for the Military Services and

Figure A-5. Improper Payment Rate – DFAS Travel Pay



WinIATS TDY and PCS for both civilian and military vouchers computed and disbursed by DFAS. (Travel disbursements made outside of DTS are also included in Table 4 footnotes.)

The DFAS Travel Pay improper payment rate increased from FY 2010 primarily due to (1) improvements in the DFAS post-pay review process, and (2) a WinIATS processing error for Military PCS vouchers that truncated social security numbers. The latter are considered "technical" improper payment errors, because travel reimbursements are not to be made without a complete social security number. The cause of the WinIATS errors is under review.

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.

DTS Root Causes. The primary reasons for DTS improper payments include:

- Per Diem (40 percent): The Department paid lodging incorrectly, reimbursed the traveler lodging expenses not validated by receipts, and/or paid meals at an incorrect rate.
- Reimbursable Expense (35 percent): The Department incorrectly paid airfare, non-travel related expenses, and/or rental car expenses.
- Missing Documentation (25 percent): The Department reimbursed lodging, airfare or rental car expenses without a receipt.

DTS Corrective Actions. 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 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 of debt and recovery of overpayments.

WinIATS Root Causes. The primary reasons for WinIATS improper payments:

- Improperly completed travel voucher (82 percent): Claim paid with incomplete information to include missing Approving Official (AO) signature or social security number (SSN) on DD Form 1351-2.
- Per Diem (11 percent): Per Diem/Meals & Incidental Expenses and Lodging paid at the incorrect rate, not at all, or when unauthorized.
- Reimbursable Expense (4 percent): Airfare, household goods storage, and lodging tax paid incorrectly or not at all.
- Other miscellaneous (3 percent.)

WinIATS Corrective Actions. The DFAS has established an extensive set of preventative and monitoring actions to prevent improper payments, including:

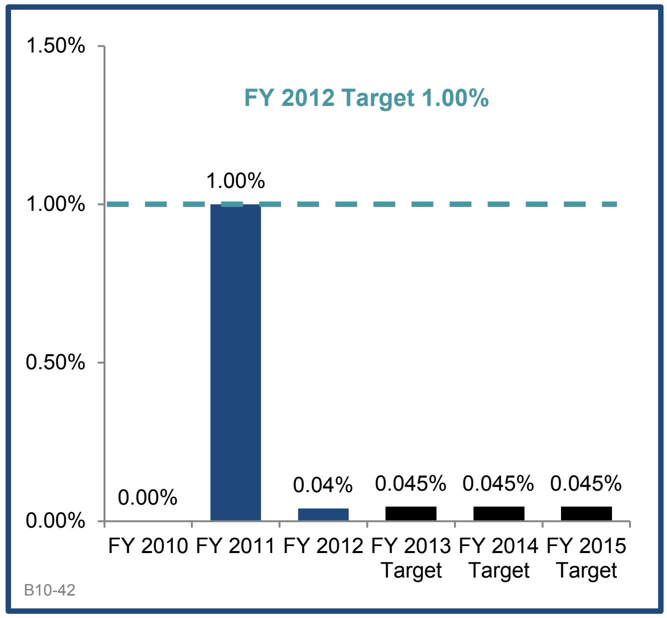
- Post-payment reviewers meet monthly with travel pay operations personnel to discuss findings and preventative measures.

- Travel Pay examiner training programs, based on post-payment review findings and recommendations, have been implemented.
- 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.
- WinIATS fielded a system update containing edits for the listing of invalid social security numbers (SSN), provided by the Social Security Administration, to mitigate invalid SSNs.

USACE Travel Pay. As shown in Figure A-6, USACE projects 0.06 percent of improper payments in Travel Pay. The USACE continues to educate travelers and travel Approving Officials (AO) through required training, as well as refresher training for seasoned travelers and approving officials. Additionally, all AOs are required to complete Fiscal Law training and the refresher course, as required, to maintain their certification eligibility

The USACE Finance Center (UFC) also performs a 100 percent audit of all airline credits issued against traveler's individually billed travel card accounts to ensure airline credits, issued as a result of flight changes, are properly recouped.

Figure A-6. Improper Payment Rate – USACE Travel Pay



Root Causes. Travel pay errors generally occur for two reasons:

- Travelers make mistakes when completing their travel vouchers; and/or
- AOs fail to properly review travel vouchers before approval.

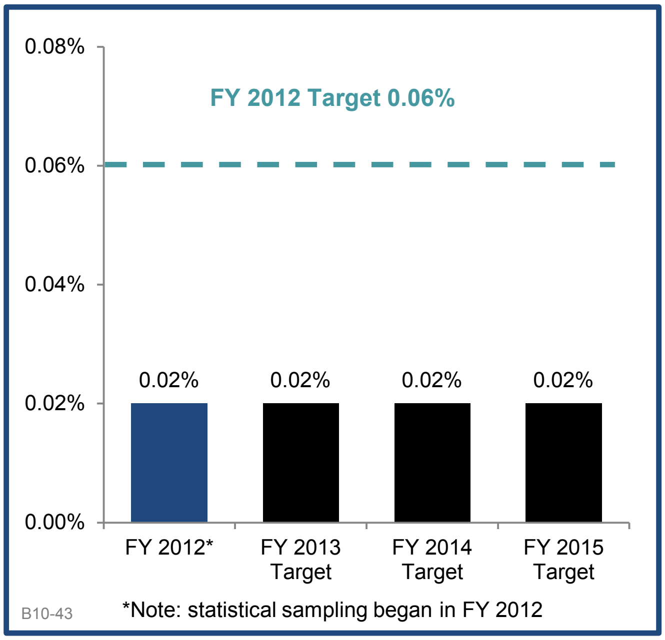
Corrective Action. When improper payments are identified, the UFC notifies the parties involved with the payments to determine the circumstances surrounding the error and to assist them in identifying business process improvements to prevent future recurrences.

DFAS Commercial Pay. In order to be fully compliant with IPERA, in FY 2012 DFAS began statistically sampling the contract and vendor pay systems to further ensure proper identification and recovery of improper payments and to publish a statistically valid improper payment estimate for Commercial Pay. The random review included DFAS computed payments entitled in the MOCAS contract payment system, the DFAS legacy commercial pay systems, and the Service Component ERPs. Fiscal Year 2012 is the first year that DFAS will report improper payments identified in the ERP systems.

As shown in Figure A-7, based on statistical sampling methods the FY 2012 estimated improper payment rate is 0.02 percent for total commercial payments; the dollar amount is

$100.1 million. In past years, DFAS reported actual improper payments in Commercial Pay and did not use a statistically valid estimation process. The actual Commercial Pay improper payments are $318.3 million, versus the estimated $100.1 million in improper payments derived from statistical sampling methods.

Figure A-7. Improper Payment Rate – DFAS Commercial Pay



The main reason for the difference between the FY 2012 actual amount of $318.3 million in improper payments and the $100.1 million in improper payments derived from statistical sampling is due to the sample design. The statistical sampling was based on the number of invoices processed, in compliance with OMB guidance, but the sample was not stratified by invoice amount; therefore, a $10 million invoice has the same chance of being sampled as a $100 invoice. Also, vendors are required by law to return overpayments, and large overpayments are always noticed more quickly than immaterial overpayments.

The DFAS identifies and prevents improper payments in DoD's five largest commercial payment systems through use of the pre-payment Business Activity Monitoring (BAM) tool, initially deployed in August 2008. These systems, which account for 91 percent of all DoD commercial payment dollars, include MOCAS, CAPS-Windows, IAPS, One Pay, and EBS. These types of preventative program activities consistently prove to be the most cost effective.

The DFAS identifies and monitors the root cause for all improper payments by researching supporting documentation and assigning a code that identifies the type of improper payment. In addition, improper payments detected by BAM in the pre-payment environment are reviewed and analyzed along with development of new integrity checks. Corrective action plans are developed through collaboration and monitored through DFAS post pay reviews and DFAS Site operational reviews. Developed project plans include testing and tracking of each individual Site plan.

Root Causes. The majority of errors in commercial pay improper payments are caused by input errors into the payment systems.

Corrective Actions. The ongoing corrective actions include:

- BAM refinements that reduce payments to the wrong vendor, which is the cause for approximately 3.2 percent of overall commercial pay improper payments.
- Continued analysis of DoD's legacy system Wide Area Work Flow rejections will increase electronic commerce and minimize manual intervention.

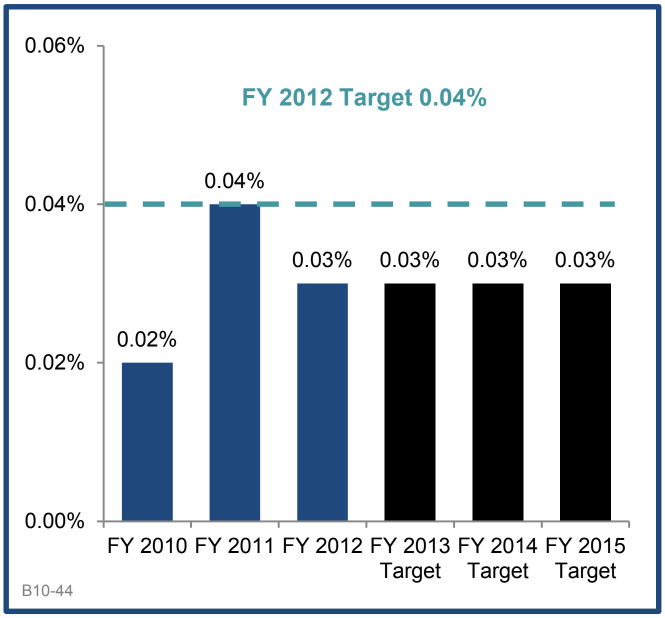
- Continued work with Contracting Officers to simplify contract terms and eliminate the need for manual calculations.

The Department is very pleased with the continuing success of its pre-payment review using BAM. Since its initial roll out in August 2008, more than $4.5 billion in improper payments have been prevented. The ongoing payment error analyses allow for the continual enhancement of BAM logic and improved disbursement accuracy.

Another initiative to reduce improper payments includes 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 and correct payment amounts before disbursement.

USACE Commercial Pay. As shown in Figure A-8, the USACE projects 0.03 percent in improper payments for Commercial Pay. The USACE functions as the real estate agency for the Department, as they have responsibility for leasing office space for all military recruiters. This applies to small offices in rural and semi-rural areas as well as larger spaces in more urban areas.

Figure A-8. Improper Payment Rate – USACE Commercial Pay



Root Cause. Commercial rental properties change hands fairly frequently; however, USACE is often not informed of the change in ownership. Therefore, improper payments occur as a result of the wrong lessor being paid (or an incorrect property manager). In these instances, staff is counseled to immediately notify the appropriate individuals when ownership or property management companies have changed to prevent future payment errors of this type.

In addition, some overpayments are identified during contract close-out. When an overpayment is identified, the final invoice is offset and/or an account receivable is established with a demand letter sent to recover the amount. Other errors are caused by input errors, such as improper identification of the Commercial Activity Government Entity (CAGE) code when establishing contracts in CEFMS. Many corporations have multiple CAGE codes.

Corrective Actions. When improper payments are identified, the USACE Finance Center notifies the parties involved with the payments to determine the circumstances and to assist in identifying business process improvements to prevent recurrences.

Recoveries of Improper Payments

In compliance with IPERA as well as the Debt Collection Improvement Act of 1996, the Department uses a number of methods to prevent, identify, and collect improper payments, to include contract claims auditing by an EIC utilized by TMA and internal DoD staff to recapture overpayments and manage debt collection. For example, DFAS has implemented a Centralized Offset Program (COP) to look across the Defense agencies for opportunities to offset debts within the first 90 days of delinquency. Once this deadline passes, DFAS transfers the debts to the Treasury Department, no longer waiting until day 180, as allowed by statute, to utilize all debt collection tools available earlier in the debt lifecycle to increase the likelihood of collecting the debt. During FY 2012, COP requested and confirmed nearly 1,200 offsets totaling approximately $13 million.

The Department also is working on initiatives to standardize Treasury FedDebt profiles for all DoD programs and establish new cross-servicing programs for many of our medical installations that are operated by TMA and the Army Medical Command. Referrals to Treasury for delinquent debt collection in these categories should increase dramatically during FY 2013.

The USACE Finance Center utilizes a data mining tool as part of its post-payment/payment recapture program. This tool searches to identify potential errors such as duplicate, missing, or suspicious invoices, as well as specific types of recurring payments. There are ten scenarios built into the data mining tool, which processes 100 percent of all contract payments. The use of a data-mining tool complements the pre-payment system edits built into CEFMS. Safeguards include a requirement for matching a receiving report with an invoice and prevent use of duplicate invoice numbers for the same obligation.

Program Improper Payment Reporting

Table 4, below, summarizes DoD's improper payment reduction outlook and total program outlays (payments) from FY 2011 through FY 2015.

Table 4. Improper Payment Reduction Outlook																			
	FY 2011					FY 2012					FY 2013 Estimate			FY 2014 Estimate			FY 2015 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 [7,8]	$ 12.6	0.24	$ 21.2	$ 9.0	$ 30.2	$ 20.9	0.15	$ 22.5	$ 8.8	$31.3	$ 20.3	2.00	$ 406.0	$ 20.6	2.00	$ 412.0	$ 21.6	2.00	$ 432.0
Military Pay[1,5]	$ 96.0	0.49	$ 209.1	$ 265.2	$ 474.3	$ 95.5	0.24	$ 197.8	$ 29.0	$226.8	$ 95.0	0.24	$ 228.0	$ 94.0	0.24	$ 225.6	$ 93.5	0.24	$ 224.4
Civilian Pay[2,5]	$ 58.2	0.16	$ 90.8	$ 0.1	$ 90.9	$ 59.0	0.14	$ 81.8	$ 0.04	$81.8	$ 57.5	0.14	$ 80.5	$ 57.0	0.14	$ 79.8	$ 56.5	0.14	$ 79.1
Military Retirement	$ 42.2	0.04	$ 18.8	$ 0.05	$ 18.9	$ 55.1	0.02	$ 12.8	$ 0.3	$13.1	$ 42.9	0.04	$ 17.2	$ 43.5	0.04	$ 17.4	$ 44.1	0.04	$ 17.6
Travel Pay[3,4,5]	$ 8.7	3.28	$ 238.2	$ 48.4	$ 286.6	$ 8.4	5.0	$ 363.9	$ 55.4	$419.3	$ 8.5	3.26	$ 277.1	$ 8.5	3.25	$ 276.3	$ 8.5	3.24	$ 275.4
DFAS Commercial Pay (Statistical Reviews)[6,9]	NA	NA	NA	NA	NA	$ 408.7	0.02	$ 89.6	$ 10.5	$100.1	$ 400.5	0.02	$ 80.0	$ 392.5	0.02	$ 78.5	$ 384.7	0.02	$ 76.9
USACE Travel Pay	$ 0.212	1.00	$ 2.0	$ 0.1	$ 2.1	$ 0.19	0.04	$ 0.76	$ 0.04	$0.80	$ 0.13	0.045	$ 0.1	$ 0.09	0.045	$ 0.04	$ 0.07	0.045	$ 0.03
USACE Commercial Pay	$ 30.5	0.04	$ 11.9	$ -	$ 11.9	$ 30.1	0.03	$ 8.8	$ -	$8.8	$ 30.0	0.03	$ 9.0	$ 30.0	0.03	$ 9.0	$ 30.0	0.03	$ 9.0

Note 1: Reduction in underpayments from FY11 to FY12 ($265.2M to $29.0M) primarily was due to leave accounting within the National Guard and Reserve components. Accounting instructions were changed/clarified by DoDI 1327.06, which allowed leave for National Guard/Reservists to be carried from one period of active service to another. This change alleviated the need to liquidate leave at the end of each period of Active Duty.

Note 2: Civilian Pay represents data from DFAS and Navy Civilian Mariner Pay.

Note 3: Travel Pay: DFAS Travel Pay represents travel vouchers settled from July 2011 through June 2012.

Note 4: Travel Pay includes travel data from Army, Navy, and Air Force for vouchers paid outside of DTS.

Note 5: Out-year projections for Travel, Civilian Pay, and Military Pay represent input from DFAS only. USACE computed its own out-year projections.

Note 6: Statistical sampling of commercial payments was initiated in FY 2012. In prior years, actual improper payments were reported.

Note 7: TMA reports 12 months in arrears; therefore, FY 2012 reporting represents FY 2011 data.

Note 8: TMA uses 2% as its out-year target because that is the contract performance standard.

Note 9: A description of the dollar amount of actual improper commercial payments identified during FY 2012 is on page A-61 of Addendum A.

Note 10: Because the Department does not currently have an auditable SBR, it is not possible for the Department to reconcile outlays to the quarterly or annual gross outlays reported therein; therefore, it is not yet possible to ensure all required payments for reporting purposes are captured. DoD is working hard to have an auditable SBR by 2014.

The Department utilizes internal payment recapture auditing processes to identify and recover outstanding overpayments. The Department's collections are shown in Tables 5 and 9.

Table 5. Payment Recapture Audit Reporting

	Amount Identified (CY)	Amount Recovered (CY)	% of Amount Recovered out of Amount Identified (CY)	Amount Outstanding (CY)	% of Amount Outstanding out of Amount Identified (CY)	Amount Determined Not to be Collectable (CY)	% of Amount Determined Not to be Collectable out of Amount Identified (CY)	Amount Identified (PYs)	Amount Recovered (PYs)	Amount Identified (CY+PYs)	Amount Recovered (CY+PYs)	Amount Outstanding (CY+PYs)
Military Pay[1,2]	$197.3M	$146.8M	74%	$50.5M	26%	$0.0M	0%	$325.1M	$302.7M	$522.4M	$449.5M	$72.9M
Civilian Pay[1]	$81.8M	$81.8M	100%	$ 0.0M	0%	$0.0M	0%	$250.3M	$250.3M	$332.1M	$332.1M	$0.0M
Military R&A[3]	$67.4M	$63.8M	95%	$3.6M	5%	$0.0M	0%	$175.3M	$163.5M	$242.7M	$227.3M	$15.4M
Travel Pay[4,6]	$1.9M	$0.1M	4%	$1.8M	96%	$0.0M	0%	$1.6M	$0.1M	$3.5M	$0.2M	$3.3M
DFAS Commercial Pay[5]	$125.8M	$114.2M	91%	$11.1M	9%	$0.5M	0%	$1.5B	$1.3B	$1.6B	$1.4B	$0.2B
USACE Travel Pay	$0.8M	$0.8M	100%	$ 0.0M	0%	$0.0M	0%	$1.1M	$1.1M	$1.9M	$1.9M	$0.0M
USACE Commercial Pay	$ 8.6M	$8.6M	100%	$0.0M	0%	$0.0M	0%	$50.8M	$50.2M	$59.4M	$58.8M	$0.6M

"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: Recoveries provided in the CY Military Pay includes collections reported in "Out of Service Debts", through the DFAS Debt Management Program. Debt recoveries, for purposes of the AFR, are tracked for twelve months from the time the debt is established. Resulting impact is that recoveries for collections and random review findings will not be realized until the end of FY13. Out of Service Debts account for $59.8M identified and $9.3M collected.

Note 3: FY 2012 amounts identified and recovered are based on 100 percent review of deceased retiree and annuitant accounts. FY 2012 recoveries will not be completed until December 31, 2012, as they are tracked for 120 days.

Note 4: Amounts for Current Year (CY) only include overpayments identified in the sampling of travel vouchers settled April 2011 through March 2012, as DFAS allows 120 days for the Service and Defense Components to resolve improper travel payments. The amount includes $624K in duplicate payments from FY 2011 to FY2012 in addition to the statistical sampling amount identified; however, the total excludes $341K in improper payments to foreign military students and amounts of $10 or less, both of which are non-recoverable pursuant to Regulation. It also excludes amounts recovered by Army Europe and Army Korea.

Note 5: Commercial Pay improper payments are based on date of payment. The Prior Years (PYs) data shown remains unchanged as these figures were reported to the OMB MAX database and previously published. Prior Years (PYs) amounts in the OMB MAX database does not reflect collections and adjustments in subsequent fiscal years.

Note 6: Travel Pay also includes travel data from Army, Navy, and Air Force for vouchers paid outside of DTS.

Note 7: As of September 30, 2012, for debts caused by improper payments incurred during FY 2011, collections from offsets totaled $6.03M; for debts caused by improper payments incurred during FY 2012, collections from offsets totaled $0.88M.

Table 6 shows the dollar amounts and percentage of overpayments the Department recovered during FY 2012. As reflected in Table 6, the Department has exceeded the OMB-established FY 2013 threshold to recover 85 percent of overpayments.

Table 6. Payment Recapture Audit Targets

Type of Payment	CY Amount Identify ($M)	CY Amount Recovered ($M)	CY Recovery Rate (Amount Recovered/ Amount Identified)	CY + 1 Recovery Rate Target	CY + 2 Recovery Rate Target	CY + 3 Recovery Rate Target
DoD-Wide[1,5]	$427.9	$360.2	84.2%	93.0%	93.0%	93.0%
DFAS[2,3]	$419.3	$351.6	83.9%	92.5%	92.5%	92.5%
USACE[4]	$8.6	$8.6	99.4%	99.0%	99.0%	99.0%

Note 1: The values shown in this table are not strictly "payment recapture" targets, as DoD performs the functions of recapture auditors internally and/or through the Department of Treasury's Debt Management Services. 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 identified by date paid.
Note 3: The DFAS values include Military Pay, Civilian Pay, Military Retirement and Annuitant Pay, Travel pay, and Commercial Pay amounts.
Note 4: The USACE values include Travel Pay and Commercial Pay amounts.
Note 5: See Table 9 for Tricare Management Activity (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 7 shows the dollar amount of DFAS overpayments outstanding as of September 30, 2012.

Table 7. Aging of Outstanding Overpayments

Type of Payment	CY Amount Outstanding (0 – 6 Months) ($M)	CY Amount Outstanding (6 Months – 1 Year) ($M)	CY Amount Outstanding (Over 1 Year) ($M)
Commercial[1]	$91.2	$3.5	$-

Note 1: The aging schedule is based on overpayments identified and paid from October 1, 2011 through September 30, 2012 and applies to DFAS only.

Table 8 shows that virtually all recovered FY 2012 funds were returned to the original appropriation and/or used for the original purpose.

Table 8. Disposition of Recaptured Funds						
Type of Payment	Agency Expenses to Administer the Program	Payment Recapture Auditor Fees	Financial Management Improvement Activities	Original Purpose ($M)	Office of Inspector General	Returned to Treasury
All	$-	$-	$-	$360.9M[1]	$-	$-
Note 1: Dollar amount represents the sum of Column 3 from Table 5 (Amount recovered (CY)).						

The Department does not currently utilize external payment recapture auditors to identify and recover outstanding overpayments. The Department's collections are shown in Tables 5 and 9.

Table 9. Overpayments Recaptured Outside of Payment Recapture Audits						
Agency Source	Amount Identified (CY)	Amount Recovered (CY)	Amount Identified (PYs)	Amount Recovered (PYs)	Amount Identified (CY+PYs)	Amount Recovered (CY+PYs)
TRICARE Management Activity (TMA) Health Benefits Contracts[1]	$4.3M	$2.2M	$57.0M	$41.2M	$61.3M	$43.4M
"M" represents millions. "B" represents billions.						
Note 1: TMA Contract improper payments and recoveries are reported 12 months in arrears to accommodate its 100 percent post-payment review.						

Accountability

The Under Secretary of Defense (Comptroller)/Chief Financial Officer is the Accountable Official for the Department, and accordingly, this individual ultimately is responsible for ensuring that, to the greatest extent possible, all DoD disbursements are made correctly and accurately.

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. This is further codified in DoD Financial Management Regulation (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 Department uses the BAM tool to identify potential improper commercial payments prior to disbursement.

The Department's ongoing migration from the legacy environment to ERP systems presents a number of challenges and opportunities to prevent and detect improper payments, as well as debt collection for recapturing overpayments. These issues are being addressed by stakeholders, though initially the new systems will add additional complexity, especially in terms of the audit readiness efforts currently at full throttle.

Barriers

With the advent of The Do Not Pay List, the Privacy Act can be a barrier in terms of the information that is legally allowed to be shared among federal agencies. Computer matching agreements can take months and sometimes years to finalize and therefore delay the ability to prevent improper payments based on information the Federal Government has access to but cannot legally share. However, there is legislation pending that may be able to address some of these delays without gutting the very necessary protections afforded by the Privacy Act. In the interim, the Department will continue using the means it currently has, including The Do Not Pay List, to prevent, detect, and recover improper payments.

Additional Comments

Because the Department currently does not have an auditable 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 working hard to become fully auditable by 2017. As part of this effort, each of the Defense disbursing components is working diligently to review and report on all payments that are subject to IPERA and ensure the processes used are compliant with laws and regulations. Nevertheless, the Department continually looks for opportunities to improve its methodologies, and the post-payment review teams are far from complacent. The Department looks forward to receiving recommendations from the DoD Inspector General's IPERA Compliance Review for FY 2012 as well as from the GAO's ongoing engagement on improper payments, as we move forward with FY 2013 corrective actions.

Department of Defense Agency Financial Report Fiscal Year 2012

Addendum B

This Page Left Blank Intentionally

The following Defense Security Cooperation Agency (DSCA) financial statements include programs executed on behalf of Executive Office of the President (EOP). The Department continues to report activity resulting from EOP allocation transfers within the Department of Defense (DoD) financial statements.

Consolidated Balance Sheet Security Assistance	Dollars in Thousands 2012 Consolidated	2011 Consolidated
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$ 22,811,082	$ 21,093,874
Total Intragovernmental Assets	**$ 22,811,082**	**$ 21,093,874**
Cash and Other Monetary Assets (Note 7)	$ 20,124,963	$ 18,160,143
Accounts Receivable, Net (Note 5)	50,338	51,430
Loans Receivable (Note 8)	836,068	983,831
Other Assets (Note 6)	26,737,655	25,231,799
TOTAL ASSETS	**$ 70,560,106**	**$ 65,521,077**
LIABILITIES (Note 11)		
Intragovernmental:		
Accounts Payable (Note 12)	$ 252,698	$ 334,081
Debt (Note 13)	224,158	340,909
Other Liabilities (Note 15 and 16)	657,368	661,264
Total Intragovernmental Liabilities	**$ 1,134,224**	**$ 1,336,254**
Accounts Payable (Note 12)	$ 270,627	$ 285,823
Employment Benefits (Note 17)	523	487
Other Liabilities (Note 15 and 16)	61,826,221	58,607,803
TOTAL LIABILITIES	**$ 63,231,595**	**$ 60,230,367**
NET POSITION		
Unexpended Appropriations – Other Funds	$ 3,800,488	$ 2,615,107
Cumulative Results of Operations – Other Funds	3,528,023	2,675,603
TOTAL NET POSITION	**$ 7,328,511**	**$ 5,290,710**
TOTAL LIABILITIES AND NET POSITION	**$ 70,560,106**	**$ 65,521,077**

Consolidated Statement of Net Cost Security Assistance	*Dollars in Thousands*	
	2012 Consolidated	2011 Consolidated
Program Costs		
Gross Costs	$ 30,711,596	$ 24,687,441
(Less: Earned Revenue)	(24,405)	(34,341)
Net Cost before Losses (Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 30,687,191	$ 24,653,100
Net Cost of Operations	**$ 30,687,191**	**$ 24,653,100**

Consolidated Statement of Changes in Net Position
Security Assistance

Dollars in Thousands

	2012 Earmarked Funds	2012 All Other Funds	2012 Eliminations	2012 Consolidated	2011 Earmarked Funds	2011 All Other Funds	2011 Eliminations	2011 Consolidated
Cumulative Results Of Operations								
Beginning Balances	$ 0	$ 2,675,603	$ 0	$ 2,675,603	$ 0	$ 2,338,200	$ 0	$ 2,338,200
Beginning balances, as adjusted	**$ 0**	**$ 2,675,603**	**$ 0**	**$ 2,675,603**	**$ 0**	**$ 2,338,200**	**$ 0**	**$ 2,338,200**
Budgetary Financing Sources:								
Appropriations used	$ 0	$ 5,229,397	$ 0	$ 5,229,397	$ 0	$ 5,391,067	$ 0	$ 5,391,067
Nonexchange revenue	0	26,310,214	0	26,310,214	0	19,599,436	0	19,599,436
Other Financing Sources:								
Other	0	0	0	0	0	0	0	0
Total Financing Sources	**$ 0**	**$ 31,539,611**	**$ 0**	**$ 31,539,611**	**$ 0**	**$ 24,990,503**	**$ 0**	**$ 24,990,503**
Net Cost of Operations (+/-)	0	30,687,191	0	30,687,191	0	24,653,100		24,653,100
Net Change	**$ 0**	**$ 852,420**	**$ 0**	**$ 852,420**	**$ 0**	**$ 337,403**	**$ 0**	**$ 337,403**
Cumulative Results of Operations	**$ 0**	**$ 3,528,023**	**$ 0**	**$ 3,528,023**	**$ 0**	**$ 2,675,603**	**$ 0**	**$ 2,675,603**
Unexpended Appropriations								
Beginning Balances	$ 0	$ 2,615,107	$ 0	$ 2,615,107	$ 0	$ 2,524,190	$ 0	$ 2,524,190
Beginning balances, as adjusted	**$ 0**	**$ 2,615,107**	**0**	**$ 2,615,107**	**$ 0**	**$ 2,524,190**	**$ 0**	**$ 2,524,190**
Budgetary Financing Sources:								
Appropriations received	$ 0	$ 6,420,180	$ 0	$ 6,420,180	$ 0	$ 5,485,905	$ 0	$ 5,485,905
Appropriations transferred (in/out)	0	(33)	0	(33)	0	0	0	0
Other adjustments (rescissions, etc.)	0	(5,369)	0	(5,369)	0	(3,921)	0	(3,921)
Appropriations used	0	(5,229,397)	0	(5,229,397)	0	(5,391,067)	0	(5,391,067)
Total Budgetary Financing Sources	**$ 0**	**$ 1,185,381**	**$ 0**	**$ 1,185,381**	**$ 0**	**$ 90,917**	**$ 0**	**$ 90,917**
Unexpended Appropriations	**$ 0**	**$ 3,800,488**	**$ 0**	**$ 3,800,488**	**$ 0**	**$ 2,615,107**	**$ 0**	**$ 2,615,107**
Net Position	**$ 0**	**$ 7,328,511**	**$ 0**	**$ 7,328,511**	**$ 0**	**$ 5,290,710**	**$ 0**	**$ 5,290,710**

Consolidated Budgetary Resources Security Assistance *Dollars in Thousands*	Budgetary Financing Accounts 2012 Combined	Budgetary Financing Accounts Restated 2011 Combined	Non-Budgetary Financing Accounts 2012 Combined	Non-Budgetary Financing Accounts Restated 2011 Combined
Budgetary Resources				
Unobligated balance, brought forward, October 1	$ 26,792	$ 128,339	$ 28	$ 7,110
Unobligated balance brought forward, October 1, as adjusted	26,792	128,339	28	7,110
Recoveries of prior year unpaid obligations	1,824,623	21,967	0	0
Other changes in unobligated balance	(1,749,780)	(30,090)	0	(3,986)
Unobligated balance from prior year budget authority, net	101,635	120,216	28	3,124
Appropriation (discretionary and mandatory)	8,164,557	29,458,905	0	0
Borrowing Authority (discretionary and mandatory)	0	0	1,627	(939)
Contract authority (discretionary and mandatory)	66,473,232	28,163,552	0	0
Spending authority from offsetting collections (discretionary and mandatory)	123,730	(23,946,735)	27,437	129
Total Budgetary Resources	**$ 74,863,154**	**$ 33,795,938**	**$ 29,092**	**$ 2,314**
Status of Budgetary Resources				
Obligations incurred	$ 74,719,974	$ 33,769,145	$ 1,953	$ 2,287
Unobligated balance, end of year:				
Apportioned	12,011	4,828	27,111	0
Exempt from Apportionment	22,690	0	0	0
Unapportioned	108,479	21,965	28	27
Unobligated balance brought forward, end of year	**$ 143,180**	**$ 26,793**	**$ 27,139**	**$ 27**
Total Budgetary Resources	**$ 74,863,154**	**$ 33,795,938**	**$ 29,092**	**$ 2,314**
Change in Obligated Balance				
Unpaid obligations, brought forward, October 1 (gross)	$ 96,993,018	$ 91,701,933	$ 2,462,224	$ 2,462,224
Obligated balance start of year (net), before adjustments	96,993,018	91,701,933	2,462,224	2,462,224
Obligated balance, start of year (net), as adjusted	96,993,018	91,701,933	2,462,224	2,462,224
Obligations incurred	74,719,974	33,769,145	1,953	2,287
Outlays (Gross)	(31,158,623)	(28,456,093)	(1,953)	(2,287)
Recoveries of prior year unpaid obligations	(1,824,622)	(21,967)	0	0
Obligated balances, end of year				
Unpaid Obligations, end of year (gross)	138,729,747	96,993,018	2,462,224	2,462,224
Obligated balance, end of year (net)	**$ 138,729,747**	**$ 96,993,018**	**$ 2,462,224**	**$ 2,462,224**
Budgetary Authority and Outlays, Net:				
Budget Authority, gross (discretionary and mandatory)	$ 74,761,519	$ 33,675,722	$ 29,064	$ (810)
Actual offsetting collections (discretionary and mandatory)	(123,730)	(96)	(179,092)	(158,740)
Budget Authority, net (discretionary and mandatory)	**$ 74,637,789**	**$ 33,675,626**	**$ (150,028)**	**$ (159,550)**
Outlays, gross (discretionary and mandatory)	31,158,623	28,456,093	1,953	2,287
Actual offsetting collections (discretionary and mandatory)	(123,730)	(96)	(179,092)	(158,740)
Outlays, net (discretionary and mandatory)	31,034,893	28,455,997	(177,139)	(156,453)
Distributed offsetting receipts	(26,310,214)	(23,946,831)	(177,139)	(156,453)
Agency Outlays, net (discretionary and mandatory)	**$ 4,724,679**	**$ 4,509,166**	**$ (177,139)**	**$ (156,453)**

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 has 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 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 (MILDEPs), 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; the *Office of Management and Budget (OMB) Circular No. A-136*, Financial Reporting Requirements; and the *DoD Financial Management Regulation*.

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 discernible.

The FMS Trust Fund accounting systems, including its sub accounts, and the accounts for funds appropriated for security assistance, are unable to fully implement all elements of USGAAP and the *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 data and information for major asset and liability categories largely from nonfinancial systems, such as MILDEPs' 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 DoD 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), MILDEPs, 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 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 Control Act*, as amended (AECA) (22 U.S.C. § 2751 et seq.); *the Foreign Assistance Act of 1961*, as amended (FAA), (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 sub accounts used by DoD 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 aggregation of balances (receipts minus disbursements) for all activities and programs.

The DoD 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)
- Special Defense Acquisition Fund (TAS 4116)

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 is a party to allocation transfers with other Federal agencies as a 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 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 entity. Exceptions include all U.S. Treasury-Managed Trust Funds, EOP, and all other funds specifically designated by OMB. The DSCA's appropriations are allocation transfers from the EOP that meet the OMB exception and all related activity are included in DSCA financial statements, which are reported as a separate section of the DoD financial statements.

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, MILDEP, 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, MILDEP, 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 MILDEPs, 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 sub-entity level trial balances may reflect known abnormal balances resulting largely from business and system processes. At the consolidated DSCA 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 MILDEPs 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, MILDEP, 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 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

The 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. The DSCA 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, DSCA cannot accurately identify most of its intragovernmental transactions because MILDEP 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 DoD 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 *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, DoD 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 MILDEPs, 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

Cash is the total of cash resources under the control of DoD which includes coin, paper currency, negotiable instruments, which are held for deposit in banks or other financial institutions and is classified as "nonentity" and is restricted.

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 DoD does not recognize all 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 FMF program on behalf of the EOP. Direct loans and loan guarantees are authorized by sections 23 and 24 of the *AECA* of 1976, as amended, Public Law (P.L.) 90-269, as amended, and section 503(a) 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 DoD 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, the 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 of 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 (FAR), 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 *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

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 may be evidenced by the availability of corroborating documentation generally support the summary level adjustments made to accounts payable and receivable. Unsupported disbursements and collections do not have supporting documentation for the transactions and most likely would not meet audit scrutiny. However, both supported and unsupported adjustments may have been made to the DSCA Accounts Payable and Receivable trial balances prior to validating underlying transactions required to establish the Accounts Payable/Receivable were previously made. As a result, misstatements of reported Accounts Payable and Receivables are likely present in the DSCA financial statements.

Due to noted material weaknesses in current accounting and financial feeder systems, the DoD is generally unable to determine whether undistributed disbursements and collections should be applied to Federal or non-Federal accounts payables/receivable at the time accounting reports are prepared. Accordingly, the FMS Trust Fund and accounts for funds appropriated for security assistance follow the DoD policy, which is to allocate supported undistributed disbursements and collections between Federal and non-Federal categories based on the percentage of distributed Federal and non-Federal accounts payable and accounts receivable. Both supported and unsupported undistributed disbursements and collections are then applied to reduce accounts payable and receivable accordingly.

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 *As of September 30*	*Dollars in Thousands* 2012	2011
Intragovernmental Assets		
Fund Balance with Treasury	$ 14,872,317	$ 15,121,753
Total Intragovernmental Assets	**$ 14,872,317**	**$ 15,121,753**
Non-Federal Assets		
Cash and Other Monetary Assets	$ 20,124,963	$ 18,160,143
Accounts Receivable	707,589	712,582
Other Assets	26,733,628	25,223,804
Total Non-Federal Assets	**$ 47,566,180**	**$ 44,096,529**
Total Nonentity Assets	**$ 62,438,497**	**$ 59,218,282**
Total Entity Assets	**$ 8,121,609**	**$ 6,302,795**
Total Assets	**$ 70,560,106**	**$ 65,521,077**

Nonentity Assets are assets for which the 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 non-Federal funds owed to the FMS Trust Fund country accounts that are in litigation at Department of Justice or collection status at DFAS. Some portion of these uncollected funds may be payable to the FMS Administrative Surcharge account, but are not discernible prior to collection.

Non-Federal 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 *As of September 30*	*Dollars in Thousands* 2012	2011
Fund Balance		
Appropriated Funds	$ 3,837,638	$ 2,632,921
Trust Funds	14,872,317	15,121,753
Other Fund Types	4,101,127	3,339,200
Total Fund Balance	**$ 22,811,082**	**$ 21,093,874**
Fund Balance Per Treasury Versus Agency		
Fund Balance per Treasury	$ 22,811,082	$ 21,093,874
Fund Balance per Agency	22,811,082	21,093,874
Reconciling Amount	$ 0	$ 0

The $4.1 billion reported as Fund Balances, Other Fund Types, consists of funds on deposit for the management of FMS Administration, Contract Administrative Services, Transportation, Attrition and General Services Administration Packing, Crating and Handling.

Status of Fund Balance with Treasury *As of September 30*	*Dollars in Thousands* 2012	2011
Unobligated Balances		
Available	$ 61,812	$ 4,829
Unavailable	108,507	21,992
Obligated Balance not yet Disbursed	**141,191,970**	**99,455,241**
Non-Budgetary FBWT	**26,310,220**	**23,946,837**
Non-FBWT Budgetary Accounts	**(144,861,427)**	**(102,335,025)**
Total Fund Balance	**$ 22,811,082**	**$ 21,093,874**

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 obligations 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. The Nonbudgetary FBWT consists of Contingency Operations provided to DoD 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.

Note 5. Accounts Receivable

Accounts Receivable *As of September 30*	*Dollars in Thousands* 2012 Gross Amount Due	Allowance for Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	$ 0	N/A	$ 0
Non-Federal Receivables (From the Public)	50,377	(39)	50,338
Total Accounts Receivable	**$ 50,377**	**$ (39)**	**$ 50,388**

Accounts Receivable *As of September 30*	*Dollars in Thousands* 2011 Gross Amount Due	Allowance for Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	$ 0	N/A	$ 0
Non-Federal Receivables (From the Public)	51,436	(6)	51,430
Total Accounts Receivable	**$ 51,436**	**$ (6)**	**$ 51,430**

The accounts receivable represent the 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 *As of September 30*	*Dollars in Thousands* 2012	2011
Nonfederal Other Assets		
Outstanding Contract Financing Payments	$ 2,985,170	$ 2,657,874
Advances and Prepayments	23,752,485	22,573,925
Total Non-Federal Other Assets	$ 26,737,655	$ 25,231,799
Total Other Assets	**$ 26,737,655**	**$ 25,231,799**

Contract terms and conditions for certain types of contract financing payments convey certain rights to the 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 $2.1 billion in contract financing payments and an additional $877 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 *As of September 30*	*Dollars in Thousands* 2012	2011
Cash	$ 20,124,963	$ 18,160,143
Total Cash, Foreign Currency, and Other Monetary Assets	**$ 20,124,963**	**$ 18,160,143**

Restricted Cash of $20.1 billion includes advance deposits from foreign nations in the Federal Reserve Bank which have not been transferred to the FMS 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 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 to the Secretary of Defense the authority to issue and guaranty loans through the designated administering agency, DSCA. The loans are issued to friendly, 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 the 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 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 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 account to the MDRFA account. 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 that correspond 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	**2012**	**2011**
Loans Receivable		
Direct Loans:		
Foreign Military Loan Liquidating Account	$ 847,442	$ 958,461
Foreign Military Financing Account	(27,111)	11,260
Military Debt Reduction Financing Account	15,737	14,110
Total Loans Receivable	**$ 836,068**	**$ 983,831**

Direct Loans Obligated *As of September 30*	*Dollars in Thousands* **2012**	**2011**
Direct Loans Obligated After FY 1992 (Allowance for Loss Method):		
Foreign Military Loan Liquidating Account:		
Loans Receivable Gross	$ 610,482	$ 735,510
Interest Receivable	1,659,237	1,573,671
Allowance for Loan Losses	(1,422,277)	(1,350,720)
Value of Assets Related to Direct Loans	$ 847,442	$ 958,461
Direct Loans Obligated After FY 1991 (Present Value Method):		
Foreign Military Financing Account:		
Allowance for Subsidy Cost (Present Value)	$ (27,111)	$ 11,260
Value of Assets Related to Direct Loans	$ (27,111)	$ 11,260
Military Debt Reduction Financing Account:		
Loans Receivable Gross	$ 0	$ 190,745
Interest Receivable	0	70,182
Allowance for Subsidy Cost (Present Value)	15,737	(246,817)
Value of Assets Related to Direct Loans, Net	$ 15,737	$ 14,110
Total Direct Loans Receivable	**$ 836,068**	**$ 983,831**

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 allowance of $15.7 million in the MDRFA is the unamorizited portion of the subsidy that results from a debit balance reflects 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 MDRFA account were originally FMFDLFA loans and were categorized as moderate to medium risk and were expected to have an increasing amount of defaults over the years, but since have defaulted. This was built into the original subsidy amount. As the loan matured, and then eventually defaulted, along with the U.S. Treasury borrowing rates falling below 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.

Total Amount of Direct Loans Disbursed *As of September 30*	*Dollars in Thousands* **2012**	**2011**
Direct Loan Programs		
Foreign Military Financing Account	$ 0	$ 0
Total	**$ 0**	**$ 0**

Schedule for Reconciling Subsidy Cost Allowance Balances For Post FY 1991 Direct Loans *As of September 30*	*Dollars in Thousands* **2012**	**2011**
Beginning Balance, Changes, and Ending Balance:		
Beginning Balance of the Subsidy Cost Allowance	**$ 235,558**	**$ 224,271**
Adjustments		
Loans Written Off	0	0
Subsidy Allowance Amortization	(224,184)	11,286
Total of the above Adjustment Components	**$ (224,184)**	**$ 11,286**
Ending Balance of the Subsidy Cost Allowance before Reestimate	**$ 11,374**	**$ 235,557**
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	**$ 11,374**	**$ 235,557**

Administrative Expenses

Administrative expenses for loans are not funded in the loan program account. The OMB funds administration of loans in the Foreign Military Financing Program Account (11*1082) since the dollar amount is so low.

NOTE 11. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

Liabilities Not Covered by Budgetary Resources *As of September 30*	*Dollars in Thousands* **2012**	**2011**
Intragovernmental Liabilities:		
Accounts Payable	$ 0	$ 1
Other	118	111
Total Intragovernmental Liabilities	**$ 118**	**$ 112**
Non-Federal Liabilities:		
Military Retirement and Other Federal Employment Benefits	523	487
Total Non-Federal Liabilities	**523**	**487**
Total Liabilities Not Covered by Budgetary Resources	**641**	**599**
Total Liabilities Covered by Budgetary Resources	**$ 63,230,954**	**$ 60,229,768**
Total Liabilities	**$ 63,231,595**	**$ 60,230,367**

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 $523.5 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			Dollars in Thousands
	2012		
As of September 30	Accounts Payable	Interest, Penalties, and Administrative Fees	Total
Intragovernmental Payables	$ 252,698	N/A	$ 252,698
Non-Federal Payables (To the Public)	270,627	0	270,627
Total Accounts Payable	**$ 523,325**	**$ 0**	**$ 523,325**

Accounts Payable			Dollars in Thousands
	2011		
As of September 30	Accounts Payable	Interest, Penalties, and Administrative Fees	Total
Intragovernmental Payables	$ 334,081	N/A	$ 334,081
Non-Federal Payables (To the Public)	285,823	0	285,823
Total Accounts Payable	**$ 619,904**	**$ 0**	**$ 619,904**

Accounts Payable includes amounts owed to Federal and non-Federal entities for goods and services received by 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 *As of September 30*	*Dollars in Thousands* 2012 Beginning Balance	Net Borrowing	Ending Balance
Agency Debt (Intragovernmental)			
Debt to the Treasury	$ 43,600	$ (9,633)	$ 33,967
Debt to the Federal Financing Bank	297,309	(107,118)	190,191
Total Debt	**$ 340,909**	**$ (116,751)**	**$ 224,158**

Debt *As of September 30*	*Dollars in Thousands* 2011 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**

The *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 DSCA and the Federal Financing Bank (FFB), acting under section 24 of the AECA, 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. For loan defaults, DSCA must pay the outstanding principle amounts guaranteed.

NOTE 15. OTHER LIABILITIES

Other Liabilities			Dollars in Thousands
	2012		
As of September 30	Current Liability	Noncurrent Liability	Total
Intragovernmental			
FECA Reimbursement to the Department of Labor	$ 45	$ 72	$ 117
Custodial Liabilities	0	657,251	657,251
Total Intragovernmental Other Liabilities	**$ 45**	**$ 657,323**	**$ 657,368**
Non-Federal			
Accrued Funded Payroll and Benefits	$ 118	$ 0	$ 118
Advances from Others	58,796,076	2,985,170	61,781,246
Contract Holdbacks	44,857	0	44,857
Total Non-Federal Other Liabilities	**$ 58,841,051**	**$ 2,985,170**	**$ 61,826,221**
Total Other Liabilities	**$ 58,841,096**	**$ 3,642,493**	**$ 62,483,589**

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**
Non-Federal			
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 Non-Federal 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

Contingent Liabilities includes $3.0 billion related to contracts authorizing progress payments based on cost as defined in the 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 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

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 FMS 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*
	2012			
As of September 30	Liabilities	Assured Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Pension and Health Actuarial Benefits				
FECA	$ 523	0.0	$ 0	$ 523
Total Military Retirement and Other Federal Employment Benefits	**$ 523**	**0.0**	**$ 0**	**$ 523**

Military Retirement and Other Federal Employment Benefits				*Dollars in Thousands*
	2011			
As of September 30	Liabilities	Assured Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Pension and Health Actuarial Benefits				
FECA	$ 487	0.0	$ 0	$ 487
Total Military Retirement and Other Federal Employment Benefits	**$ 487**	**0.0**	**$ 0**	**$ 487**

FEDERAL EMPLOYEES' COMPENSATION ACT (FECA)

Actuarial Cost Method Used and Assumptions:

The DSCA 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 the OMB's economic assumptions for 10-year Treasury notes and bonds. Interest rate assumptions utilized for discounting were as follows:

Discount Rates

2.3% in Year 1

3.1% 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) 2012 were also used to adjust the methodology's historical payments to current year constant dollars.

Federal Employees – Compensation Act (FECA)		
CBY	COLA	CPIM
2013	2.83%	3.65%
2014	2.03%	3.66%
2015	1.93%	3.72%
2016	2.00%	3.73%
2017+	2.03%	3.80%

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

Costs and Exchange Revenue *As of September 30*	*Dollars in Thousands* 2012	2011
Operations, Readiness & Support		
1. Gross Cost		
A. Intragovernmental Cost	$ 7,596,317	$ 3,416,436
B. Non-Federal Cost	$ 23,115,279	$ 21,271,005
C. Total Cost	$ 30,711,596	$ 24,687,441
2. Earned Revenue		
A. Intragovernmental Revenue	$ (327)	$ (738)
B. Non-Federal Revenue	$ (24,078)	$ (33,603)
C. Total Revenue	$ (24,405)	$ (34,341)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0	$ 0
Total Net Cost	**$ 30,687,191**	**$ 24,653,100**

Costs and Exchange Revenue *As of September 30*	*Dollars in Thousands* 2012	2011
Consolidated		
1. Gross Cost		
A. Intragovernmental Cost	$ 7,596,317	$ 3,416,436
B. Non-Federal Cost	$ 23,115,279	$ 21,271,005
C. Total Cost	$ 30,711,596	$ 24,687,441
2. Earned Revenue		
A. Intragovernmental Revenue	$ (327)	$ (738)
B. Non-Federal Revenue	$ (24,078)	$ (33,603)
C. Total Revenue	$ (24,405)	$ (34,341)
3. Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0	$ 0
Total Net Cost	**$ 30,687,191**	**$ 24,653,100**

Intragovernmental Costs and Revenues represent 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 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 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 *SFFAS No. 4*, "Managerial Cost Accounting Concepts and Standards for the Federal Government", as amended by *SFFAS No. 30*, "Inter-entity Cost Implementation".

Public costs and revenues are exchange transactions made between the reporting entity and a non-Federal entity.

The systems utilized by the DSCA for the FMS Trust Fund and the accounts for funds appropriated for security assistance do not track intragovernmental transactions by a customer at the transaction level. In Quarter 3 of FY 2010, the FMS Trust Fund incorporated the DoD trading partner process. The FMS Trust Fund adjusted expenses by reclassifying amounts between Federal and non-Federal expenses and accruing additional payables and expenses. Intradepartment revenues and expenses are then eliminated.

Intragovernmental costs and revenue represent transactions made between two reporting entities within the Federal Government.

The DSCA does not meet accounting standards. Information presented is based on budgetary obligations, disbursements, and collection 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 Changes in Net Position does not agree with the Appropriations on the Statement of Budgetary Resources. The difference of $1.7 billion is due to the FMS 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 *As of September 30*	*Dollars in Thousands* 2012	2011
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period.	$ 163,493,527	$ 121,409,053

On the Statement of Budgetary Resources (SBR), obligations incurred of $74.7 billion are direct and exempt from apportionment.

The SBR includes intraentity transactions, because the statements presented are combined, not consolidated.

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 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 *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 does not agree with the Appropriations Received on the Statement of Changes in Net Position. The difference of $1.7 billion is due to the FMS Trust Fund contract authority not being reported as Appropriations 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.

The Status of Budgetary Resources Apportioned line of the Budgetary SBR includes an abnormal balance that is the result of a trial balance submitted from the Military service. United States Standard General Ledger (USSGL) 4510 has a large abnormal that is offset by the same amount in USSGL 4610. The Service's system systemically make this posting to reverse funding to keep the trial balance and reconciliation in line.

The Fiscal Year (FY) 2011 Borrowing Authority (discretionary and mandatory) on the NonBudgetary SBR contains an abnormal balance due to an adjustment in Borrowing Authority and Undelivered Orders to Military Debt Reduction Financing Account and Foreign Military Financing Direct Loan Financing Account as required by the Office of Management and Budget.

NOTE 21. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

Reconciliation of Net Cost of Operations to Budget *As of September 30*	*Dollars in Thousands* **2012**	**2011**
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations incurred	$ 74,721,927	$ 33,771,432
Less: Spending authority from offsetting collections and recoveries (-)	(2,127,443)	(180,802)
Obligations net of offsetting collections and recoveries	**$ 72,594,484**	**$ 33,590,630**
Less: Offsetting receipts (-)	(26,310,214)	(23,946,831)
Net Budgetary Resources Obligated	**$ 46,284,270**	**$ 9,643,799**
Total resources used to finance activities	**$ 46,284,270**	**$ 9,643,799**
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 (-)	$ (42,084,474)	$ (9,093,975)
Resources that fund expenses recognized in prior Periods	0	(8)
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	26,489,306	24,105,570
Resources that finance the acquisition of assets (-)	(1,953)	(2,287)
Total resources used to finance items not part of the Net Cost of Operations	**$ (15,597,121)**	**$ 15,009,300**
Total resources used to finance the Net Cost of Operations	**$ 30,687,149**	**$ 24,653,099**
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 (+/-)	$ 42	$ 1

Reconciliation of Net Cost of Operations to Budget *As of September 30*	*Dollars in Thousands* 2012	2011
Total components of Net Cost of Operations that will Require or Generate Resources in future periods	**$ 42**	**$ 1**
Components not Requiring or Generating Resources:		
Revaluation of assets or liabilities	$ 0	$ 0
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	**$ 42**	**$ 1**
Net Cost of Operations	**$ 30,687,191**	**$ 24,653,100**

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

Due to the FMS 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.

Components Requiring or Generating Resources in Future Period. Other, is attributable to FECA actuarial expense.

Contributors to the Agency Financial Report

This Agency Financial Report is the reflection of devoted and hard-working people across the Office of the Secretary of Defense and the Department. They include uniformed Service Members, civilian personnel, and contractors, among them men and women from all walks of life who deploy and carry out their missions in harm's way. We owe all of them our gratitude. In particular, we want to thank the following individuals for their special contributions to this report.

Crystal D. Allen
Stan Azebu
Captain Ronalee Balog
Lyndi Balven
Scarlett Barkelew
Brent Barrow
Sally C. Beecroft
Jason Boykin
Aaron Bobinsky
Edward Bright
Marcia Case
Art Carabollo
Sharon Cave
Nina Chun
Lachlan M. Colquhoun
Timothy H. Courington
Donna Cox
Nick Crabtree
Gerald Davenport
Diana Davis
Thomas P. Dee
Monique Dilworth
Marc DiPaolo
Joseph Doyle
Jeffrey Eanes
Mark E. Easton
Daniel Folliard
Virginia Fortune
Greg Galusha
Linda J. Gileau
Sam Graham
David R. Gross
Robert F. Hale
Galen M. Heflin
Scott Henderson
Beth Hetman
Carl Inman
Patty Issler
Debra S. Jackson
Aaron Kim
Emily Kassenbrock
Tu Kim
Bryan Kitchens
Wanda Kucinich
Kevin Lannon
Joseph Leonard
Matthew A. Lytwyn
David Martin
Lisa Matusky
Michael J. Metzger
Drew Morgan
Anthony Nicoletos
Sharron Norris
Bette Otts
Barry Parel
Carol S. Phillips
Joseph O. Quinn
Lila Rayle
Paula J. Rebar
Sandra V. Richardson
Elizabeth Ridge
Pattie Rodgers
Angela M. Rogers
John P. Roth
Gary Sanders
Glenda Scheiner
Greg Schmalfeldt
Kathy Sherrill
Thomas C. Smith
Robert Francis Smith
Alecia Solomon
Gloria Steremberg
Justin Sweetman
Stephen Tabone
Sylvia Taylor-Porter
Bob Thompson
Kevin Urban
Rick Welcher
Keith Welk
Brent White
Anthony A. Wisdom
Kristin E. Wulff
Dwight Young
Gunther Zimmerman

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
or requests for copies of this report 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/fy2012.html

KNOW YOUR BUSINESS
CONTROL YOUR FUTURE