UNITED STATES DEPARTMENT OF DEFENSE

AGENCY FINANCIAL REPORT

FISCAL YEAR 2014

FOREWORD

Agency Financial Report (AFR)

This report, the U.S. Department of Defense Agency Financial Report (AFR) for Fiscal Year (FY) 2014, provides an executive-level overview of the Department, including our mission, organization, performance, highlights from the financial statements, internal controls and legal compliance, and challenges facing the Department. The Financial Section contains the agency-wide financial statements and notes, along with the Independent Auditor's Report. Additional and/or detailed information is available in the Other Information Section and appendices to this report.

The Department has produced the Agency Financial Report as an alternative to the Performance and Accountability Report (PAR). The AFR is intended to simplify and summarize information while providing transparent financial and performance reporting.

The Department will publish two additional required reports that provide varying details on financial and performance information:

Annual Performance Report (APR)

Published with the Department's annual budget submission in February 2015, the APR will provide a detailed description of performance measures and FY 2014 results.

Summary of Performance and Financial Information (SPFI)

The SPFI, published in February 2015 and available for viewing on the Under Secretary of Defense (Comptroller) public website, is a succinct summary of the FY 2014 financial and performance information previously reported in the AFR and APR, making the information more transparent and accessible to Congress, the public, and other key constituents.

U.S. Sailors and Marines conduct visit, board, search and seizure training in a rigid-hull inflatable boat in the Gulf of Aden.

Photo by Lance Cpl. Lonzo-Grei D. Thornton

ABOUT THE DEPARTMENT OF DEFENSE AGENCY FINANCIAL REPORT

The Department of Defense Agency Financial Report is required by law, including the Government Management and Reform Act of 1994 (GMRA) and the Chief Financial Officers Act of 1990. This report includes five main sections.

The **Message from the Deputy Secretary of Defense**, the Honorable Robert O. Work, introduces the Agency Financial Report.

The **Management's Discussion and Analysis (MD&A) Section** provides an executive-level overview of the Department of Defense (DoD) and our use of taxpayer resources in fiscal year 2014. The MD&A describes the Department's organization and strategic priorities, and provides summary-level reporting on DoD performance based on measurable objectives through the third quarter of FY 2014. The MD&A also includes a Financial Overview section, introduced by the Chief Financial Officer, that reports on FY 2014 financial highlights from the agency-wide consolidated financial statements, and updates on the Department's financial management improvement initiatives. The MD&A section ends with an overview of the Department's Managers' Internal Controls program, business and financial management systems' improvement strategy, and improper payments and recoveries program.

The **Agency-Wide Financial Statements Section** includes the FY 2014 Department of Defense financial statements and explanatory notes, required supplementary information, and the Independent Auditor's report on these statements and on the Department's internal controls.

The **Other Information Section** reports detailed information on material weaknesses in internal controls, improper payments and recoveries, "Freeze the Footprint" real property, the Schedule of Spending, and DoD Inspector General-identified significant performance and management challenges facing the Department, along with DoD management responses.

The **Appendices Section** includes the Defense Security Cooperation Agency – Security Assistance Accounts financial statements and explanatory notes, accounts the Department executes on behalf of the Executive Office of the President. The Appendices section also includes a list of acronyms and abbreviations, useful websites, and an index of figures and tables included throughout this report.

The estimated cost of report or study for the Department of Defense is approximately $179,000 in Fiscal Years 2014 – 2015.
This includes $68,000 in expenses and $111,000 in DoD labor.

Generated on 2014Nov13 RefID: 2-73362DA

This Page Left Blank Intentionally

Table of Contents

This Page Left Blank Intentionally

A MESSAGE FROM THE DEPUTY SECRETARY OF DEFENSE

We are living in a turbulent and challenging period – driven by unsettling events around the world, from terrorism in the Middle East to unrest in Eastern Europe to the threat of Ebola. So many of these global events call for the skills and organizational resources that only the United States military can provide.

At the same time, we have financial challenges within the Department of Defense. In recent years we have experienced a series of developments that have been like "canaries in a coal mine," warning us of impending problems. One was the reduction in the Defense budget in the Budget Control Act of 2011. A second was the triggering of sequestration in 2013, despite all expectations to the contrary. And a third was the Department's own Strategic Choices and Management Review, which pointed to the consequences for national security if further budget cuts are made in days ahead.

In short, the Department faces a new and challenging fiscal environment at the same time the Nation faces a rapidly changing security environment. And because of the unpredictable threats around the world, we face tough choices to ensure our Armed Forces retain their capabilities while we continue to pursue reforms to reduce our cost of doing business.

It is with these concerns in mind that the Department releases this report, which contains the most complete summary of the Department's finances and the use of nearly $582 billion in fiscal year 2014 appropriated funds. The information contained in these pages provides valuable insight into the Department's management of financial resources. It also should reassure the American public that the Department is committed to carefully managing their tax dollars.

This report also includes a brief update on our financial management improvement initiatives, including our audit readiness efforts and actions to resolve material weaknesses in our business controls necessary to support a financial audit. As Defense Secretary Chuck Hagel has stated, audits will demonstrate that the Department of Defense manages its money with the same confidence and precision that we bring to our military operations. In the final analysis, mission readiness and audit readiness are two sides of the very same coin.

I would encourage all concerned Americans to read this report. I am confident that they will come away with new appreciation for the Department's commitment to fiscal transparency and effectiveness.

Robert O. Work
Deputy Secretary of Defense

This Page Left Blank Intentionally

United States Department of Defense

Agency Financial Report

Fiscal Year 2014

Management's Discussion and Analysis

This Page Left Blank Intentionally

MANAGEMENT'S DISCUSSION AND ANALYSIS

DEPARTMENT OF DEFENSE OVERVIEW

One of the core responsibilities of the United States government is to protect the life and liberty of the American people, or as phrased in the Constitution, to "provide for the common defense." The *Department of Defense* (DoD) plays a critical role in defending and advancing the safety and security of American citizens and interests.

Today, the nation faces a rapidly changing security environment with dynamic and unpredictable threats around the world. Unrest and violence persist, creating a lack of stability and sectarian conflict, and threatening U.S. citizens. Following more than a decade of war, and with potential adversaries across the world continuing to develop significant capabilities, the Department of Defense is committed to protecting the American people, defending the national interest, and providing America's military with the resources to accomplish its mission.

Chuck Hagel
Secretary of Defense

Building on the *Defense Strategic Guidance* published in 2012, the Department delivered the *Quadrennial Defense Review (QDR) 2014* to Congress in March 2014. The QDR is a legislatively-mandated report, issued every four years, that evaluates the threats and challenges the nation will likely confront over the next 20 years. This QDR describes the tough choices the Department makes during this time of fiscal austerity to ensure our Armed Forces retain the capability to execute a wide range of missions to secure our nation's interests, now and in the future.

The Department's strategic priorities include rebalancing our focus and our forces to the Asia-Pacific region to preserve peace and stability; maintaining a strong commitment to security and stability in Europe and the Middle East; and sustaining a global approach to countering violent extremists and terrorist threats, with an emphasis on the Middle East and Africa. We will invigorate efforts to build innovative partnerships and strengthen our alliances, all while pursuing lower-cost, resourceful approaches.

Rebalancing to Asia-Pacific remains a key component of the defense strategy. The United States seeks to preserve peace and stability in a region that is increasingly central to U.S. political, economic, and security interests. Faced with North Korea's pursuit of long-range missiles and weapons of mass destruction, we are committed to maintaining peace and stability on the Korean Peninsula. The Department will maintain a robust footprint in Northeast Asia while enhancing our presence in Oceania and Southeast Asia.

Given our deep and abiding interests in a Europe that is free and at peace, the Department works with U.S. allies and partners to promote regional security. We are supporting Ukraine's Armed Forces in their current engagements in Eastern Ukraine, and have committed millions of dollars of non-lethal material and assistance.

U.S. Army Stryker armored vehicles convoy during operations in support of Steadfast Javelin II, a NATO-led exercise.

Photo by Airman 1st Class Jordan Castelan

More broadly, the Department is reinforcing our North Atlantic Treaty Organization (NATO) allies and upholding our commitment to collective self-defense. The Department participates in military exercises throughout the Baltic republics and Poland, with American aircraft flying Baltic air policing missions and American ships increasing patrols in the Black Sea.

The Department continues its responsible drawdown of U.S. forces in Afghanistan. With the projected end of the International Security Assistance Force (ISAF) combat mission, there will be 9,800 U.S. troops serving in Afghanistan at the end of calendar year 2014. These troops will focus on training, advising, and assisting the Afghan forces as part of the NATO Resolute Support Mission, as well as conducting limited counterterrorism operations. The Department also continues to finance the sustainment and professionalization of the Afghan National Security Forces (ANSF).

A U.S. Special Forces Soldier watches after a clearing operation in which two suspected insurgents were detained and IED materials were destroyed.

Photo by Pfc. David Devich

A U.S. Army National Guard Lieutenant guides vehicles in preparation for retrograde support mission at Camp Marmal, Afghanistan.

Photo by Staff Sgt. Peter Sinclair

The U.S. and our allies and partners seek to degrade and ultimately destroy the threat posed by the Islamic State of Iraq and the Levant (ISIL). In the last few months, the world has seen ISIL's barbarity up close, as its fighters advanced across western and northern Iraq and Syria and slaughtered thousands of innocent civilians. The DoD personnel in Iraq remain committed to building the capacity of the Iraqi Security Forces to defend their homeland. The DoD's "Advise and Assist" role will help the Iraqis take back territory lost to ISIL.

U.S. Air Force F-15E Strike Eagle aircraft flies over northern Iraq after conducting airstrikes in Syria.

Photo by Senior Airman Matthew Bruch

The last 12 years have reinforced the importance of the Military Services operating as a Joint Force, specifically in terms of combined intelligence, surveillance and reconnaissance, cyber operations, and unmanned aerial vehicles. In FY 2014, the Military Services actively participated in the Combatant Command-sponsored large Joint Force exercises, as well as innovative, low-cost, and small-footprint engagements across the globe. The Department invested in exercises and engagements across all Combatant Commands as a cost-effective way to provide U.S. presence and reassure allies.

The Department is focused on preparing for the future by rebalancing defense efforts in a period of increasing fiscal constraint. Our strategic priorities protect and advance U.S. interests and sustain America's leadership; responsibly and realistically take steps to rebalance major elements of the Joint Force, given the changing fiscal environment; and continue our efforts to control costs and improve use of resources in a period of fiscal austerity. Our sustained attention and engagement will be important in shaping emerging global trends.

Resources

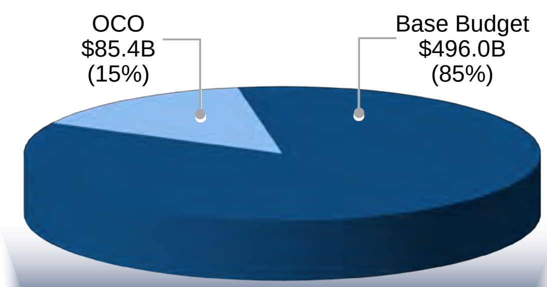
The FY 2014 Defense budget balanced capacity, capability, and readiness to protect the security interests of the United States within the funding constraints of the *Bipartisan Budget Agreement*. The key themes in the FY 2014 budget were to achieve a deeper alignment of our future force structure with resource availability, to maintain a mission-ready force, to emphasize institutional reforms by being even better stewards of taxpayer dollars, and to take care of our people and their families.

The DoD FY 2014 budget authority totaled $581.4 billion, composed of $496 billion in the base budget, and $85.4 billion in support of the Overseas Contingency Operations (OCO). Figure 1 displays the DoD FY 2014 budgetary authority by appropriation.

Despite decreasing resources, the Department must maintain its decisive technological edge. In FY 2014, the Department invested in emerging military capabilities, such as new and expanded cyber capabilities, nuclear deterrence, space, precision strike, and operationally responsive and persistent intelligence, surveillance, and reconnaissance assets.

The Department also continued its modernization efforts by funding three variants of the Joint Strike Fighter; a shipbuilding program that included two Virginia-class submarines, one Aegis destroyer, and four littoral combat ships; various unmanned aerial systems, such as the Reaper; development of the KC-46A tanker and procurement of P-8A aircraft; and a multi-faceted missile defense program.

Figure 1. DoD FY 2014 Budget Authority



Budget by Appropriation	$ in Billions
Military Personnel	$144.0
Operation and Maintenance	$262.5
Procurement*	$99.7
RDT&E	$62.9
Military Construction	$8.4
Family Housing	$1.4
Revolving Funds	$2.5
Total	**$581.4**

* Procurement includes $225M Iron Dome(P.L. 113-145)

B14-17

The littoral combat ship USS Independence at Joint Base Pearl Harbor-Hickam, Hawaii, during RIMPAC 2014 exercise. RIMPAC is a U.S. Pacific Fleet-hosted biennial multi-national maritime exercise to foster international cooperation and security on the world's oceans.

Photo by Mass Communication Specialist 1st Class Shannon E. Renfroe

We continue to pursue institutional reforms to reduce the cost of doing business. By controlling support costs and generating efficiencies, we have prioritized spending on combat power. Recently, the Department announced a 20 percent reduction in Headquarters budgets across the Department, beginning with the Office of the Secretary of Defense. We also have implemented acquisition reform efforts, most notably through the *Better Buying Power* initiatives that seek to achieve affordable programs by controlling costs, incentivizing productivity and innovation in industry and government, eliminating unproductive bureaucracy, promoting effective competition, and improving the professionalization of the acquisition workforce.

The force structure reductions that began with the FY 2013 budget continue. In accordance with the revisions to the January 2012 *Defense Strategic Guidance*, the FY 2014 budget reflected the choices made to achieve a modern, ready, and balanced force to meet the full range of potential military requirements. The Army and Marine Corps, in particular, made progress toward achieving their targeted active end states of 440,000 – 450,000 and 182,100 respectively.

Reserve Components are an important element of the Total Force, and the Department is focused on optimizing the active/reserve force mix, sustaining their readiness at appropriate levels. The reserves are trained, ready, and cost-effective forces that can be employed on a periodic operational basis while ensuring strategic surge capabilities for large-scale contingencies or other unanticipated national crises.

Paratroopers from the United States, France, Germany, the United Kingdom and the Netherlands participate in a mass parachute jump in Chef-du-Pont, France, to mark the 70th anniversary of D-Day.

Photo by SPC Joshua E. Powell

We recognize the demands that continue to be placed on the all-volunteer force and their families who give so much to defend the ideals and free institutions we often take for granted. Their dedication reminds us that preserving America's liberties often comes with a heavy cost.

We keep faith by supporting a variety of Military Family Assistance programs designed to improve military life, such as child care, non-medical counseling and Morale, Welfare and Recreation programs. The military healthcare system provides services to 9.6 million beneficiaries, including military retirees and their families, dependent survivors, and certain eligible Reserve Component members and their families. We seek to control healthcare costs and reasonable health care benefit reform as part of a balanced approach to cost containment, which is essential to fund the warfighting capabilities needed to maintain the Joint Force and to send our personnel into combat with the best possible training and equipment.

Looking Forward

Turmoil around the world continues, ranging from the threat presented by ISIL in Iraq and Syria to the potential of an Ebola pandemic. As reflected in the *Quadrennial Defense Review 2014*, the current strategic and budgetary environment compels us to think creatively and develop new ways to manage and employ the Joint Forces as we engage with the world. Force readiness decisions made today will continue to have an impact for years to come.

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. During these times of fiscal austerity, particularly with the potential to return to the *Budget Control Act of 2011* reduced funding levels, balancing between readiness, force structure sizing, and threats will remain a high priority.

U.S. Marines and Sailors prepare to board a Marine Corps KC-130J Super Hercules aircraft to deploy to West Africa in support of Operation United Assistance.

Photo by 1st Lt. Gerard R. Farao

U.S. Airmen board a C-17 Globemaster III aircraft to Monrovia, Liberia, carrying a modular medical treatment center and supplies in support of Operation United Assistance.

Photo by Senior Airman Kayla Newman

Operation United Assistance, a USAFRICOM-led operation, provides command and control, logistics, training, and engineering support to the U.S. government's efforts to contain the Ebola virus outbreak.

Organization

The Department of Defense maintains and uses armed forces to support and defend the Constitution and ensure the security of the United States, its possessions, and areas vital to its interest. This mission depends on our military and civilian personnel and equipment being in the right place, at the right time, with the right capabilities, and in the right quantities to protect our national interests. This has never been more important as America fights terrorists who plan and carry out attacks outside of the traditional boundaries of the battlefield.

The Department is one of the nation’s largest employers, with approximately 1.3 million personnel on active duty, 756,000 civilians, and 824,000 men and women in the Selected Reserve of National Guard and Reserve forces. Our military service members and civilians operate in every time zone and in every climate, and more than 450,000 of our employees

U.S. Sailors and civil service mariners on the joint high-speed vessel USNS Spearhead maneuver a rigid-hull inflatable boat into the water during Africa Partnership Station (APS) 2014 in the Gulf of Guinea. APS is an international security cooperation initiative facilitated by the Commander, U.S. Naval Forces Europe-Africa.

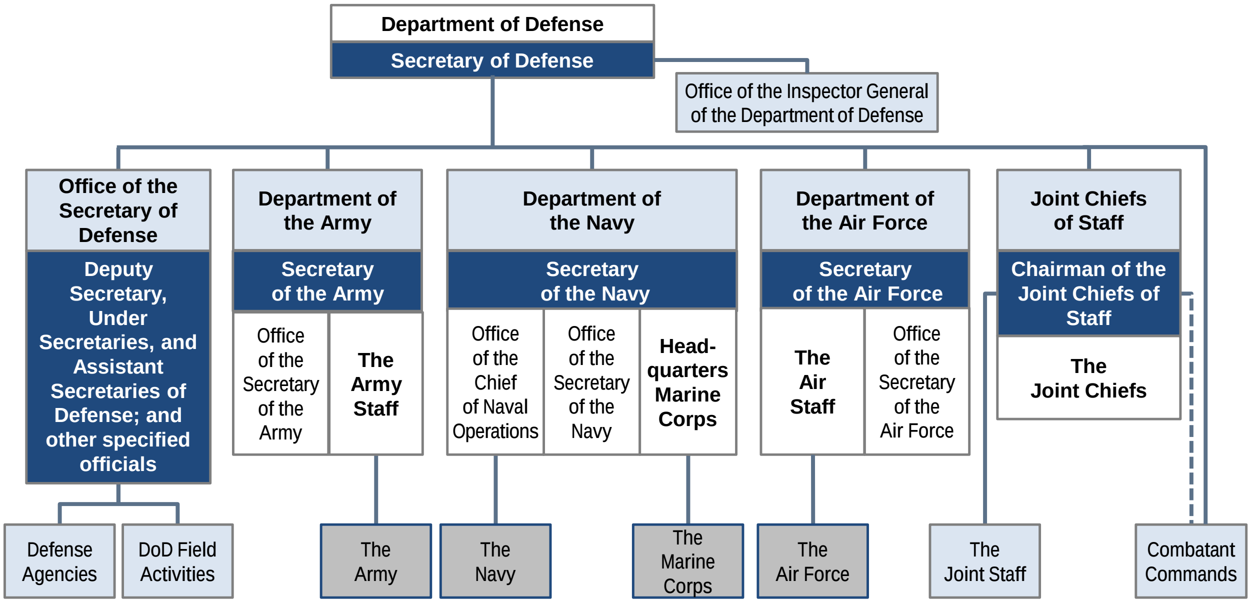
Photo by Mass Communication Specialist Seaman Justin R. DiNiro

serve overseas. There also are more than 2 million military retirees and family members receiving benefits.

The Department's real property infrastructure includes over 526,000 facilities (buildings and structures) located on 4,800 sites worldwide. These sites represent over 24.7 million acres that individually range in size from training ranges of approximately 3 million acres, such as Range No.1 at Nellis Air Force Base, to single weather towers or navigational aids isolated on sites of less than one one-hundredth (0.01) of an acre. To protect the security of the United States, the Department operates approximately 17,580 aircraft and 630 ships.

The *Secretary of Defense* is the principal assistant to the President in all matters relating to the Department, and he exercises authority, direction, and control over the Department. The Department currently 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* (DoD IG), 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 2. Department of Defense Organizational Structure



The Office of the Secretary of Defense

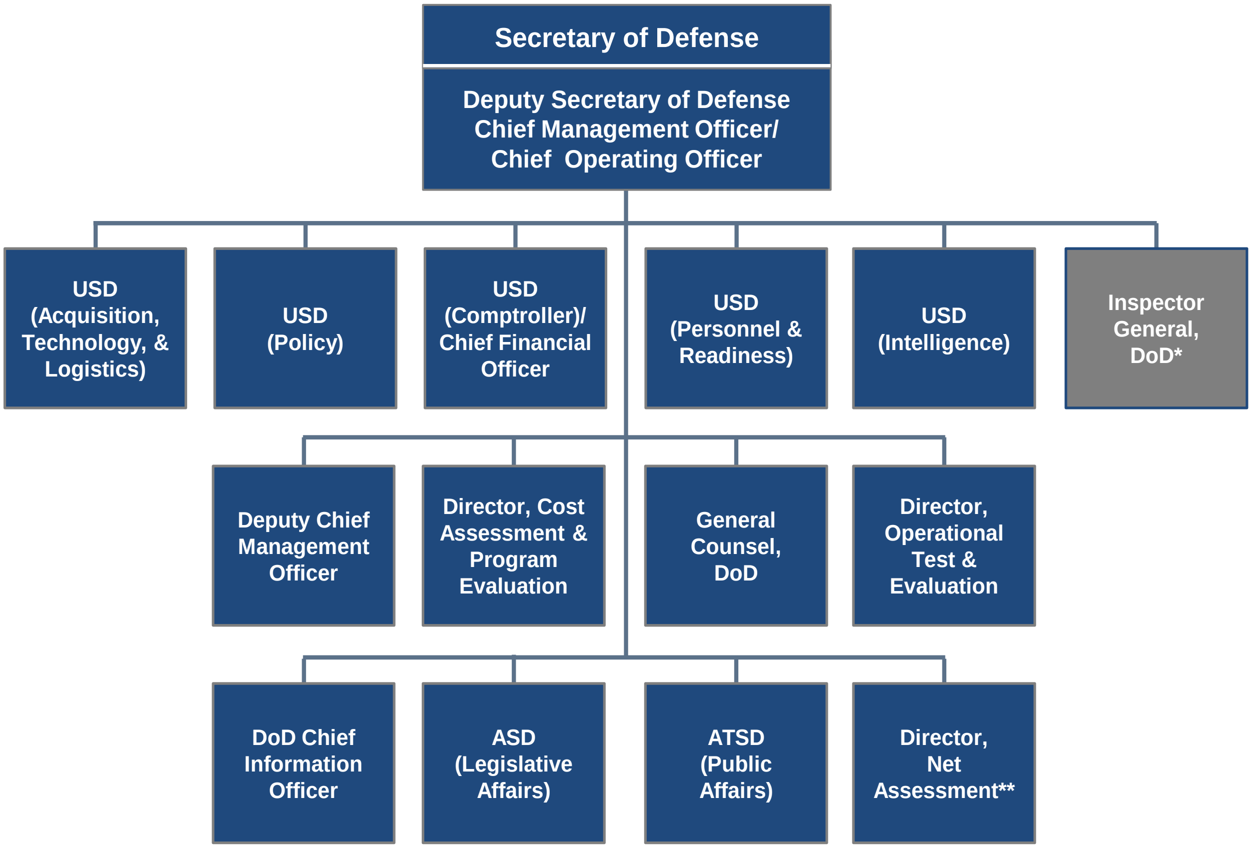
The function of OSD is to assist the Secretary of Defense in carrying out his duties and responsibilities and other duties as prescribed by law. The OSD is comprised of the Deputy Secretary of Defense, who also serves as the Chief Management Officer and Chief Operating Officer; the Under Secretaries of Defense (USDs); the Deputy Chief Management Officer (DCMO); the General Counsel of the Department of Defense; the Assistant Secretaries of Defense (ASDs); the Assistants to the Secretary of Defense; the OSD Directors, and their equivalents; their staff; the DoD IG; and the other staff offices within OSD established by law or by the Secretary.

President Barack Obama, right, Defense Secretary Chuck Hagel, center, and Army Gen. Martin Dempsey, chairman of the Joint Chiefs of Staff, salute the American flag as the national anthem plays during the ceremony to commemorate 9/11 at the Pentagon, Sept. 11, 2014.

Photo by Master Sgt. Adrian Cadiz

The OSD Principal Staff Assistants (PSAs) are responsible for the oversight and formulation of defense strategy and policy (Figure 3).

Figure 3. Office of the Secretary of Defense Principal Staff Assistants



** 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*
*** Alternative organizational placements are being considered for the Director, Net Assessment*

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 Army, the Chief of Naval Operations, the Chief of Staff of the 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

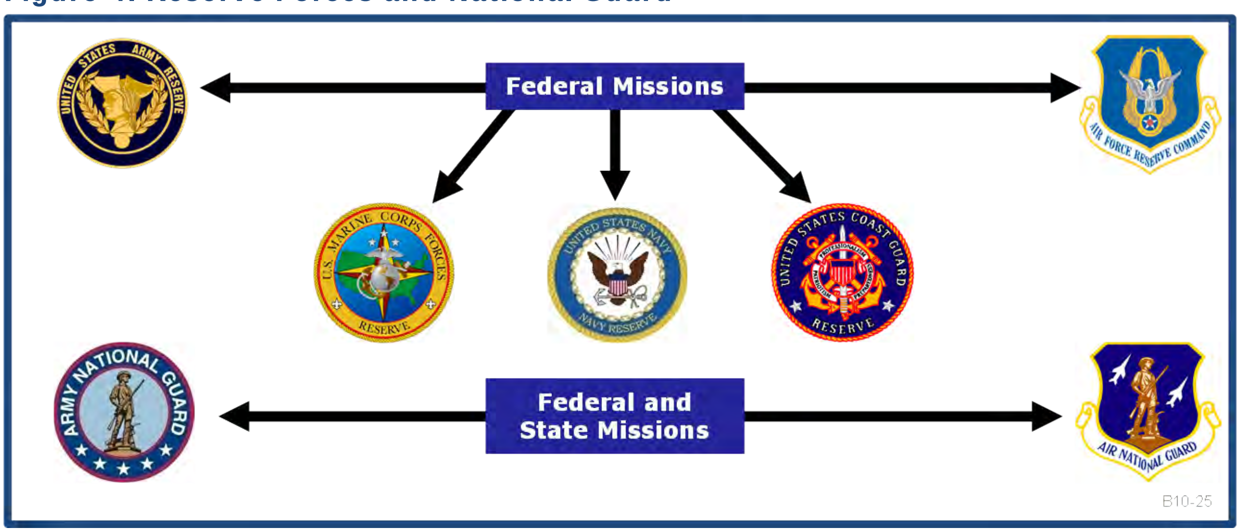
The Office of Inspector General, DoD is an independent unit within the Department that conducts and supervises audits and investigations relating to the Department's programs and operations. The DoD IG serves as the principal advisor to the Secretary of Defense on all audit and criminal investigative matters relating to the prevention and detection of fraud, waste, and abuse in 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 determines military action is required, these trained and ready forces are assigned or allocated to a Combatant Command responsible for conducting military operations.

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. The Reserve Component includes the Reservists of each Service and the National Guard, which has a unique dual mission with both Federal and State responsibilities (Figure 4). When commanded by the Governor of each state or territory, the National Guard can be called into action during local, statewide, or other emergencies, such as storms, drought, or civil disturbances (non-federalized service).

Figure 4. Reserve Forces and National Guard

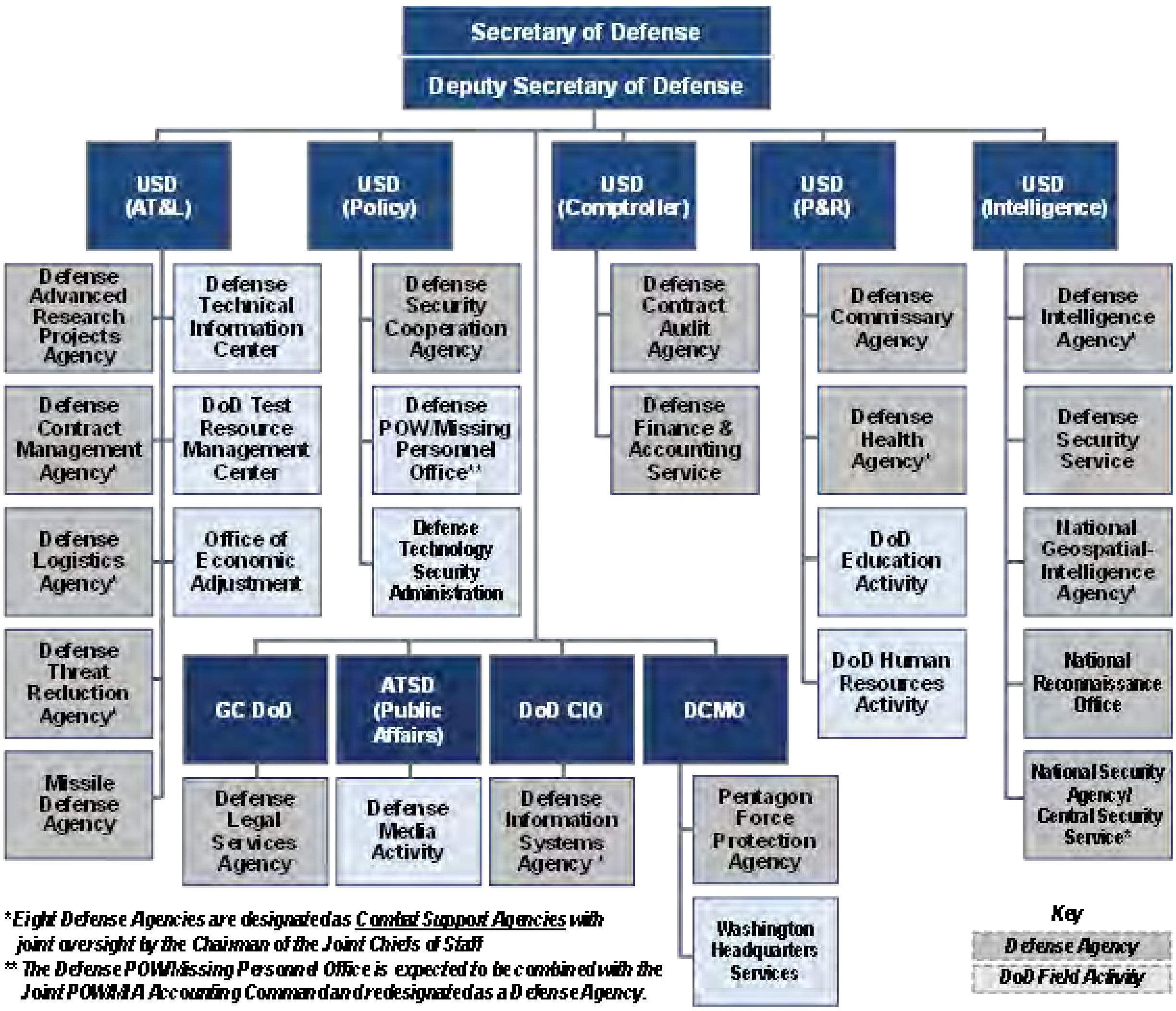


When ordered to active service or called into federal service for national emergencies, units of the Guard are placed under operational control of the appropriate Combatant Commander. The Guard and Reserve forces are recognized as indispensable and integral parts of the Nation's defense and fully part of the applicable Military Department.

Defense Agencies and DoD Field Activities

Defense Agencies and DoD Field Activities (Figure 5) are established as DoD Components by law, the President, or the Secretary of Defense to provide, on a DoD-wide basis, a supply or service activity common to more than one Military Department when it is more effective, economical, or efficient to do so. While Defense Agencies and DoD Field Activities fulfill similar functions, the former tend to be larger, normally provide a broader scope of supplies and services, and can be designated as Combat Support Agencies to directly support the Combatant Commands. Each of the 18 Defense Agencies and 9 DoD Field Activities operate under the authority, direction, and control of the Secretary of Defense through an OSD Principal Staff Assistant (PSA).

Figure 5. Defense Agencies and DoD Field Activities



Combatant Commands

The Commanders of the [Combatant Commands](#) (Figure 6) are responsible for accomplishing the military missions assigned to them. Combatant Commanders exercise command authority over assigned and/or allocated 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. Strategic Command (USSTRATCOM), U.S. Transportation Command (USTRANSCOM), and U.S. Special Operations Command (USSOCOM) are functional Combatant Commands, each with unique functions as directed by the President in the Unified Command Plan. Among Combatant Commands, the USSOCOM has additional responsibilities and authorities similar to a number of authorities exercised by the Military Departments and Defense Agencies, including programming, budgeting, acquisition, training, organizing, equipping, and providing Special Operations Forces, and developing Special Operations Forces strategy, doctrine, tactics, and procedures. The USSOCOM is reliant upon the Services for common support and base operating support.

In addition to supplying assigned and allocated 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 directly receiving Congressional appropriations.

Figure 6. Combatant Commands

PERFORMANCE OVERVIEW

The *Deputy Secretary of Defense*, as the Department's Chief Management Officer and Chief Operating Officer, is responsible for performance improvement in the Defense Department. Each year, in accordance with public law and OMB regulations[1], the Department develops and tracks performance measures to meet DoD Strategic priorities. For FY 2014, the Department continued to follow the *Quadrennial Defense Review (QDR) Report 2010* priorities. The *Quadrennial Defense Review 2014* was issued in March of 2014, and new performance measures associated with the most recent QDR are under development. The current performance measures were shaped by the following strategic goals:

1. Prevail in today's wars.
2. Prevent and deter conflict.
3. Prepare to defeat adversaries and succeed in a wide range of contingencies.
4. Preserve and enhance the all-volunteer force.
5. Reform the business and support functions of the Defense enterprise.

U.S. Marines leave the well deck of the amphibious dock landing ship USS Germantown in a combat rubber raiding craft during Amphibious Landing Exercise (PHIBLEX) 15 in Manila Bay, Philippines. PHIBLEX is a bilateral training exercise designed to improve the interoperability, readiness, and professional relationships between the USMC and partner nations.

Photo by Mass Communication Specialist Seaman Patrick Dionne

[1] *Government Performance and Results Act of 1993 (GPRA) (Public Law 103-62)*; *Government Performance and Results Modernization Act of 2010 (Public Law 111-352)*; *OMB Circular No. A-11, Preparation, Submission, and Execution of the Budget*

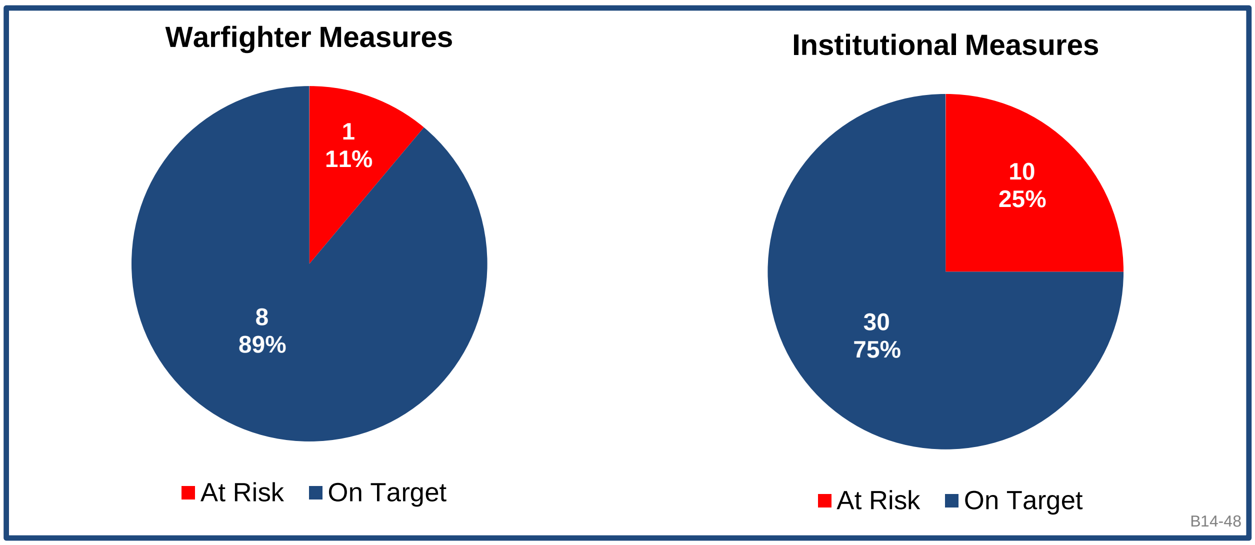
The Department's strategic priorities serve as the foundation for the strategic objectives, performance goals, and performance measures outlined in the Department's *Annual Performance Plan* (APP). The OSD Principal Staff Assistants are responsible for creating the performance measures, which are published each year in the *DoD Budget Request.* These performance measures encompass activities related to both the Department's warfighting mission and business (institutional) operations to create a holistic annual performance plan and budget submission.

This report provides an executive-level overview of DoD's performance through the third quarter, ending June 30, 2014, with fiscal-year end results published in the Annual Performance Report (APR) in the Department's budget submission in February 2015.

SUMMARY OF PERFORMANCE RESULTS

At the end of the third quarter, 89 percent of Warfighting measures were on track to meet the annual goals, while 11 percent did not meet third quarter targets and are considered "at risk" of not achieving their annual targets. Similarly, 75 percent of the Institutional measures are on track while 25 percent are at risk of not achieving their annual targets. However, the Department is currently re-evaluating those performance measures to conform to new strategic priorities identified in the *Quadrennial Defense Review 2014*, released in the Spring of 2014.

Figure 7. Performance Measure Results, Third Quarter FY 2014



Successes

The Department has been successful in meeting most of the key measures for third quarter, FY 2014, including those related to mission readiness and providing high quality care to wounded warriors. The Department has maintained its commitment to taking care of its people and has made considerable improvements in processing wounded warriors in a timely and effective manner.

Mission Readiness

Despite a challenging fiscal environment, the Department has remained committed to ensuring that our Nation's military remains ready to train, advise, and assist foreign security forces and their sustaining institutions to operate with or in lieu of U.S. forces. To that end, the Department requires that annually, 95 percent of General Purpose Force (GPF) units/teams deployed to support Combatant Command (COCOM) security force assistance (SFA) requirements receive focused SFA training. As of the end of the third quarter, FY 2014, 100 percent of GPF deployed to support SFA requirements receive focused SFA training, ensuring that warfighters in Afghanistan and elsewhere around the globe were trained and prepared to build partnership capacity.

In FY 2014, the Department took three priority actions with regard to the *Defense Institutional Reform Initiative*, a program that develops effective, accountable, professional and transparent partner defense establishments in partner countries that can manage sustain and employ national forces.

(1) Established a larger pool of advisors and technical experts, cohesively trained and employed, to meet growing engagement demand.

(2) Worked with DoD Components for exceptions to hiring freezes to improve program capacity.

(3) Worked more closely with Commands and Security Officers to improve defense institutions.

U.S. Air Force, U.S. Navy, Japan Air Self-Defense Force, and Royal Australian Air Force aircraft fly in formation over the Pacific Ocean in support of Cope North 2014. Cope North is an annual air combat tactics, humanitarian assistance and disaster relief exercise designed to increase the readiness and interoperability of the U.S. Air Force, Japan Air Self-Defense Force, and Royal Australian Air Force.

Photo by Tech. Sgt. Henry Hoegen

Achieving Audit-Ready Financial Statements

The *National Defense Authorization Act of 2010* mandated that the Department have audit-ready financial statements by 2017; accordingly, the Department made this requirement a priority goal. Achieving audit readiness means that the Department has strengthened internal controls and improved financial practices, processes, and systems so there is reasonable confidence the information can withstand review by an independent auditor.

The Department is currently focused on two Statement of Budgetary Resources (SBR) line items, "Obligations Incurred" and "Outlays," which closely relate to current year activity, or the "Schedule of Budgetary Activity" (SBA). For Quarter 3, the Department set a target of having 25 percent of the SBR "Obligations Incurred" line item validated as audit ready, and we achieved 51 percent.

Processing Wounded Warriors through IDES

Our Nation continues to be committed to the care and support of those who keep our country free and strong. Providing top-quality physical and psychological care to wounded warriors and assisting with the transition to veteran status is a Department priority. In FY 2014, the Department continued its work with the U.S. Department of Veterans Affairs (VA) to accelerate the transition of Wounded, Ill, and Injured (WII) Service members into Veteran status by reducing the disability evaluation processing time.

Athletes dive into a pool during the 2014 Warrior Games in Colorado Springs, Colo. The Warrior Games is an annual event allowing wounded, ill and injured Service members and veterans to compete in Paralympic sports including archery, cycling, shooting, sitting volleyball, track and field, swimming, and wheelchair basketball.

Photo by Airman 1st Class Scott Jackson

The Integrated Disability Evaluation System (IDES) is used to determine if Service members coping with wounds that may prevent them from performing their duties are able to continue serving. IDES is a joint process established by the VA and DoD that includes a single set of medical examinations and disability ratings. The goal is to close the gap between separation from active duty and receipt of VA benefits and compensation.

Despite numerous cross-agency challenges, the Department was able to meet its IDES goal. One indicator used to assess the efficiency and effectiveness of the IDES system is the percentage of Service members who meet DoD’s core IDES time and Service member satisfaction goals. In the third quarter of FY 2013, just 26 percent of Service members being processed through IDES met time and satisfaction goals; a year later, in the third quarter of FY 2014, the percentage rose to 79 percent. The Department is on track to achieve the fourth quarter goal of 80 percent.

Areas for Improvement

The Department successfully achieved 89 percent of its Warfighting measures, meeting or exceeding third quarter targets, indicating that they are on track to achieve their annual performance goals. However, the Department did not meet 25 percent of its third quarter targets for Institutional measures, indicating they are at risk for not achieving annual performance goals. There are improvement opportunities related to human intelligence and veterans transitioning into the civilian workforce.

Human Intelligence (HUMINT) Training

The Department set a target that by the third quarter, 62 percent of funded training seats at the HUMINT Joint Center of Excellence for Military Source Operations, Interrogation, and HUMINT-enabling training activities would be filled through student enrollments. However, only 45 percent of funded training seats were filled. Several factors that have limited the desired performance in FY 2014 – lingering restrictions based on the *Budget Control Act of 2011*, to include sequestration, the government shutdown, and an overall overstated training requirement based on uncertainty with continued operations in Afghanistan, Iraq, and Africa.

To gain efficiencies, the Department began to transition courseware to a distributed learning environment online. The first transition, for the Joint Source Validation Course, was not completed in the third quarter due to technical difficulties, which negatively impacted course enrollments. Once the course is fully transitioned to an online platform, 100 percent of the validated training requirement can be met. In addition to the online learning environment, the Department is establishing Mobile Training Teams to make training more accessible.

Career Readiness and Pre-Separation Training for Veterans

Our Nation can and should provide the best support possible to those who keep our country free and strong as they transition to civilian life. The Department is partnering with other federal agencies to ensure that all Service members participate in an effective program of pre-separation planning and education.

To this end, Service Members must complete a set of clear, comprehensive career preparation activities prior to leaving Active Duty status to be considered "career ready." These Career Readiness Standards (CRS), an integral component of the *Transition Assistance Program* (TAP), help to ensure Service members have the training and skills needed to succeed in civilian life. Completion of CRS activities is mandatory for all Service members retiring, separating, or being released after 180 days or more of Active Duty. The Commanders verify CRS completion during a mandatory event called "Capstone," no later than 90 days prior to transition.

U.S. Soldiers and civilians participate in the Morale, Welfare and Recreation's 9th Annual 5k Down and Dirty Mud Run, at Joint Base Lewis-McChord, Wash. The run consisted of 14 obstacles and is part of the Morale, Welfare and Recreation's efforts to promote healthy activities.

Photo by Sgt. Cody Quinn

For third quarter, the Department set a goal that 85 percent of eligible Service members would meet CRS prior to their separation. The Department did not meet this goal, verifying that only 26.4 percent of Service members had met CRS prior to separating.

Data gathering processes for this measure are immature and continue to evolve. Capstone, the process used to verify CRS by Commanders or Commanders' designees, was launched in October 2013 for some Military Services, but was not fully implemented until March 2014. The Department expects reported performance to improve as Capstone and improved data collection processes are implemented across installations to provide complete and timely data.

Another performance measure used to gauge how well the Department prepares Service members to transition to veteran status is the following: Verified percent of Service members who have separated and attended (a) pre-separation counseling, (b) a Department of Labor employment workshop, and (c) VA benefits briefings prior to their separation. This performance measure tracks the attendance rate to three specific classes/information briefings in accordance with the *Vow to Hire Heroes Act of 2011* (known as the VOW Act), while the CRS measure takes into account a broader spectrum of activities to achieve career readiness prior to separation. To calculate the results for the VOW Act performance measure, the *Defense Manpower Data Center* (DMDC) queries a TAP database for each separation reported to determine whether or not course completion and counseling session records are present for the Service member.

For third quarter, the Department set a goal of achieving 85 percent validation, but only 59.3 percent were validated. Data collection processes for these new measures are immature and continue to evolve. The Department is actively working with the Military Departments and DMDC to ensure that required TAP services are being delivered, identify the causes of data gaps, and enable Service TAP offices to more easily and accurately report completion of pre-separation counseling and course attendance. Progress is being made as a result of these efforts.

In summary, the Department's focus on mission readiness over the past year has resulted in success on 89 percent of its "warfighting" measures, including that 100 percent of General Purpose Force units/teams deployed to support Combatant Command security force assistance (SFA) requirements had received focused SFA training. Most importantly, the Department has maintained its commitment to caring for Service Members and their families who have borne the burden of more than a decade of war. While the Department did not meet 25 percent of its third quarter targets for Institutional measures, we have identified improvement opportunities related to human intelligence and veterans transitioning into the civilian workforce. The Department plans on building on the momentum of the successes of the past year to improve performance related to those and other measures.

A MESSAGE FROM THE CHIEF FINANCIAL OFFICER

It is a privilege for me to present the fiscal year (FY) 2014 financial statements for the Department of Defense. The information contained in this report reflects the Department's continued emphasis on responsible stewardship of taxpayer dollars and our commitment to providing transparent financial information to the public.

The 2014 fiscal year will be best remembered for beginning with a government-wide shutdown, for efforts to recover from the effects of sequestration, and for the funding constraints of the Bipartisan Budget Act of 2013. These circumstances presented significant challenges to the men and women entrusted with the Department's sacred mission to ensure the security of the United States.

But there is more to the story. Despite significant obstacles, FY 2014 will also be remembered for significant achievements in financial management. Despite diminishing funds, the Department skillfully realigned resources needed to support emerging global contingencies and counter threats to America's security. For example, in western Africa we set up isolation units and provided equipment in support of public health workers surging in from around the world to fight Ebola.

Also this year, for the first time in history, a military service – the U.S. Marine Corps – achieved a clean audit opinion on its Schedule of Budgetary Activity (SBA) for FY 2012, which reported on the receipt and use of FY 2012 funds. Following the Marine Corps' audit readiness approach, the Military Departments and many of the Defense Agencies also asserted audit readiness, and beginning in January 2015, over 90 percent of the Department's current year appropriations will be under audit or internal examination. This is a major achievement for the Department, thanks in large measure to DoD's commitment in implementing the Financial Improvement and Audit Readiness (FIAR) plan.

Setting the stage for additional gains across the board, we also took concrete action to improve the skills of the Department's financial management workforce. Until now, the Department lacked a framework that enabled us to emphasize certain courses and to ensure that proper training occurs at each point in an employee's career. Our new course-based certification program for the financial management (FM) workforce meets that need. It has been endorsed by Congress. And to date, approximately 47,000 DoD financial managers have launched their continuing education through the program – more than 98 percent of the financial management DoD Civilians and Active Duty military.

These improvements, and others, are reflected in the pages of this report. To be sure, much remains to be done, but the record contained here is a measure of just how far we have come. It's a record that the American people can view with confidence that their tax dollars are being responsibly managed.

Michael McCord

Michael McCord
Under Secretary of Defense (Comptroller)/
Chief Financial Officer

FINANCIAL OVERVIEW

The previous sections of this report provide an overview of the Department's operations in FY 2014 and a high-level overview of how the Department's met its performance goals and objectives as of the third quarter of FY 2014. The FY 2014 final results for all Department performance measures will be reported in the Department's Annual Performance Report, which will be available in February 2015.

The Department continues to make strides in its efforts towards producing auditable financial statements, as evidenced by the upcoming audits of the Army, Navy, and Air Force Schedules of Budgetary Activity (SBA) and the planned audit readiness assertion on the SBA by some of the Other Defense Agencies. Also, several DoD Components have received and maintained audit opinions on their full financial statements, some for many years.

Department-wide, we continue to replace, update, and consolidate outdated and redundant information technology (IT) systems, with plans to reduce the number of financial management systems from 327 to 120 by FY 2019. New data standards have been put in place to improve data quality and systems interoperability. Additionally, through the Managers' Internal Controls Program, the Department continues to identify and fix gaps in business practices, policies, and procedures that could leave room for errors or weaknesses.

With fewer systems and improved business processes, the Department can more readily achieve and sustain the reliability of reported financial information that meets the timeliness, reliability, and accuracy standards of an independent auditor.

A U.S. Soldier conducts fire phobia training as part of Steppe Eagle 2014, an annual exercise between the U.S. and several Central Asian partner nations designed to train participants in peace support operations.

Photo by Pfc. Lloyd Villanueva

At present, the Department cannot produce auditable financial statements and management cannot provide unqualified assurance as to the effectiveness of our internal controls over financial reporting. The Department currently lacks the ability to prove reliable and well-controlled business processes and consistently provide supporting documentation to auditors in a timely manner. The Department's Financial Improvement and Audit Readiness (FIAR) Initiative, which is briefly discussed later in this report, guides the Department's efforts to improve our financial management.

Figure 8. DFAS Statistics FY 2014

Description	FY 2014
Number of Pay Transactions	150.2 Million
Number of Commercial Invoices Paid	11.5 Million
Number of Travel Payments	5.8 Million
Number of General Ledger Accounts managed	228.6 Million
Amount Disbursed	$572 Billion
Amount of Military Retirement and Health Benefits Funds Managed	$772 Billion
Foreign Military Sales Cases Reimbursed by Foreign Governments	$424 Billion

Part of the challenge in successfully passing a financial statement audit lies with DoD's unique size and mission. For example, Figure 8 shows the magnitude of financial activities processed only by the Defense Finance and Accounting Service (DFAS) in FY 2014, and does not include transactions processed by other DoD entities, such as the U.S. Army Corps of Engineers or the Defense Health Agency. Although we have yet to achieve full auditability, the Department is confident that we know how taxpayer funds are spent, that employees and vendors are paid timely and appropriately, and that our overall financial operations are managed soundly in our efforts to protect and defend the nation.

Financial Highlights and Analysis

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, Financial Reporting Requirements, 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 supporting financial reports, are used to monitor and control budgetary resources. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

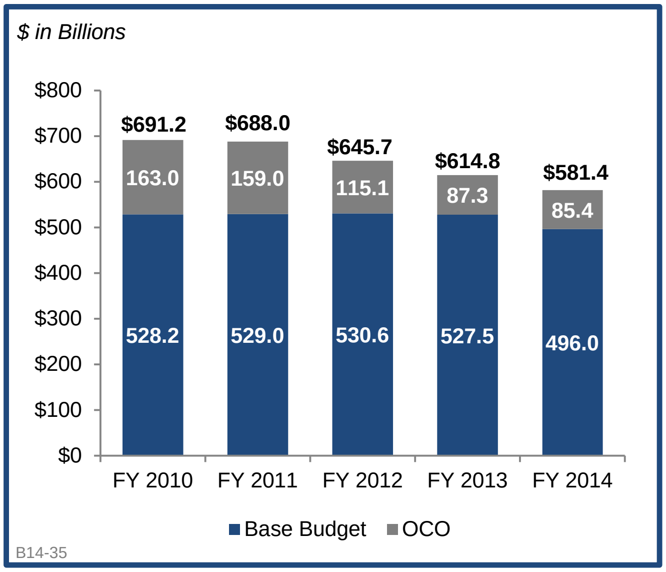
The Defense Finance and Accounting Service (DFAS) prepared the consolidated financial statements and explanatory notes, located in the Financial Information section of this report. The principal financial statements include:

- 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.

Figure 9. Trend in DoD Budget Authority



As discussed in the DoD Overview Section of this report and as depicted in Figure 9, the Department's FY 2014 budget authority total is $581.4 billion. The change in FY 2014 budget authority from FY 2013 is mostly attributable to sequestration actions required by the *Budget Control Act of 2011* and the Bipartisan Budget Agreement of 2013.

As shown in Figure 10, the Department reported $1.1 trillion in FY 2014 total budgetary resources. The total appropriations amount of $737.6 billion, reported on the Statement of Budgetary Resources, consists of DoD budget authority and appropriations provided by the U.S. Treasury for DoD military retirement and health benefits. The Department also receives appropriations to finance civil work projects managed by the *U.S. Army Corps of Engineers* (USACE). Current year Trust Fund receipts, including the Military Retirement Fund and the Medicare Eligible Retiree Health Care Fund, also are included in the SBR "Total Appropriations" line. Trust fund receipts, labeled "Temporarily not available," represent budget authority the Department will execute in future years to pay the current unfunded liabilities carried in these large funds.

Figure 10. Composition of DoD Total Budgetary Resources

Description	FY 2014 *($ in billions)*
DoD Budget Authority	$581.4
U.S. Treasury contribution for Military retirement and health benefits	84.3
Civil works projects executed by the USACE	4.3
Trust Fund Receipts	136.1
Trust Fund Resources Temporarily Not Available	(68.5)
Total Appropriations Reported on SBR	**$737.6**
Unobligated Balances from Prior Year Budget Authority	175.9
Spending Authority from Offsetting Collections	100.3
Contract and Borrowing Authority	70.6
Total Budgetary Resources	**$1,084.4**

Additional budgetary resources include $175.9 billion of unobligated balances stemming from prior year budget authority, $100.3 billion in spending authority from offsetting collections, and $70.6 billion of contract authority.

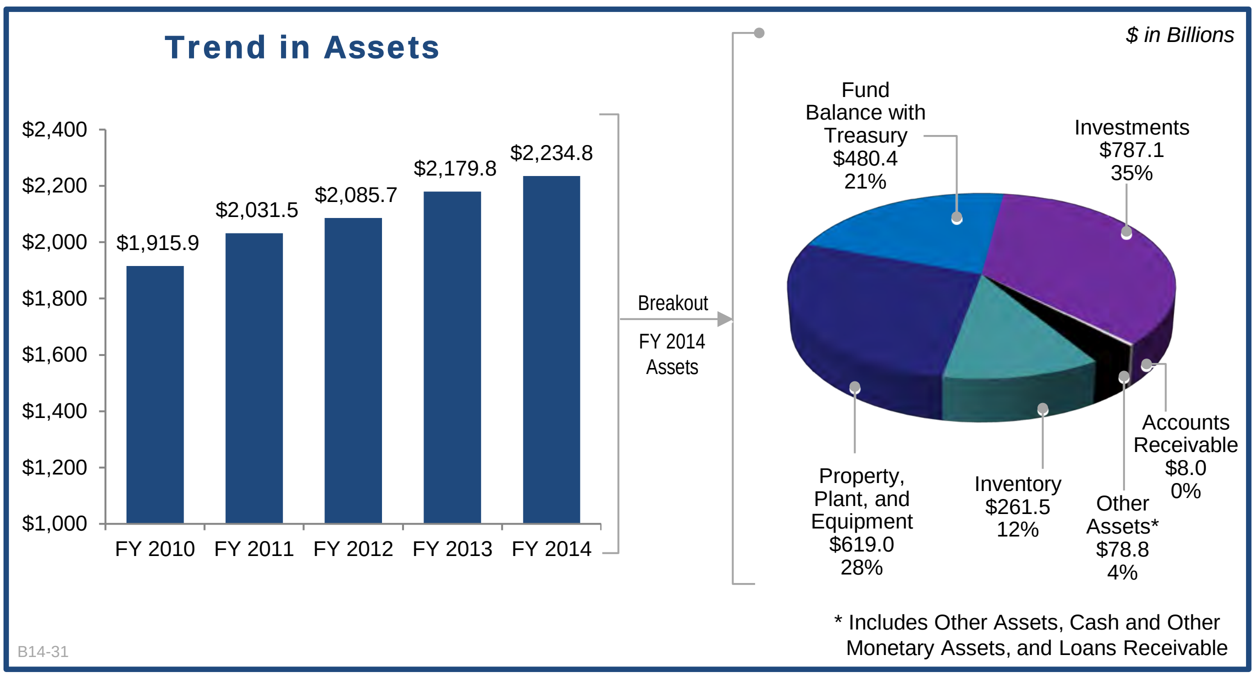
Of the $1.1 trillion in total budgetary resources, $933.7 billion was obligated and $891.1 billion of obligations was disbursed. The remaining unobligated budgetary resources balance relates to appropriations available to cover multi-year investment projects. These projects require additional time for delivery of goods and services. Expired appropriations remain available for valid upward adjustments to prior year obligations but are not available for new obligations.

Balance Sheet

The Balance Sheet, which reflects the Department's financial position as of September 30, 2014, reports amounts available to provide future economic benefits (Assets) owned or managed by the Department, amounts owed (Liabilities) requiring use of available assets, and the difference between them (Net Position).

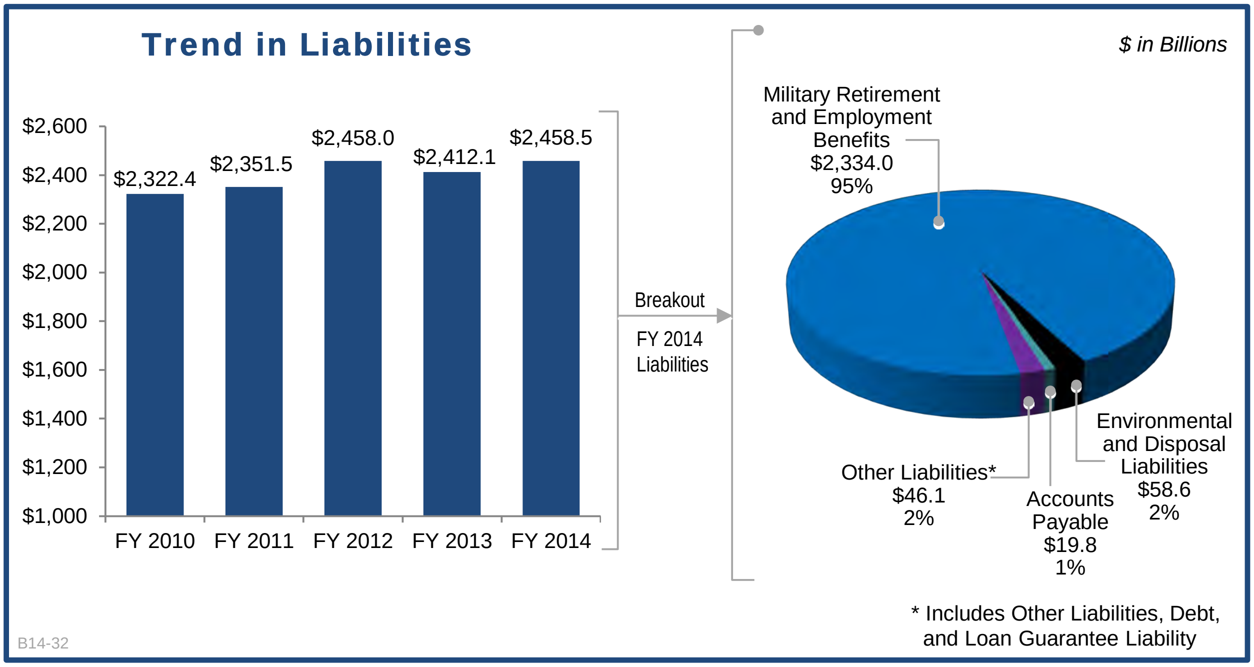
The $2.2 trillion in assets shown in Figure 11 represent amounts the Department owns and manages. Investments, General Property, Plant, and Equipment, and Fund Balance with Treasury (FBWT) represent 84 percent of the Department's assets. General Property, Plant, and Equipment is largely comprised of military equipment and buildings, structures, and facilities used to support the Department's mission requirements.

Figure 11. Summary of Total Assets



Total Assets increased $55 billion (3 percent) from FY 2013, largely due to a $72.3 billion increase in Investments in U.S. Treasury securities offset by a $20.6 billion decrease in General Property, Plant, and Equipment. Investments increased by $72.2 billion due to the $83.5 billion deposit of additional funds from the U.S. Treasury and military services to cover the normal growth of future military retirement and health benefits. Funds not needed to cover current benefits were invested in U. S. Treasury Securities. The $20.6 billion decrease in the Department's General Property, Plant, and Equipment is primarily the result of the ongoing audit readiness efforts to validate existence and completeness and improve the valuation of its assets.

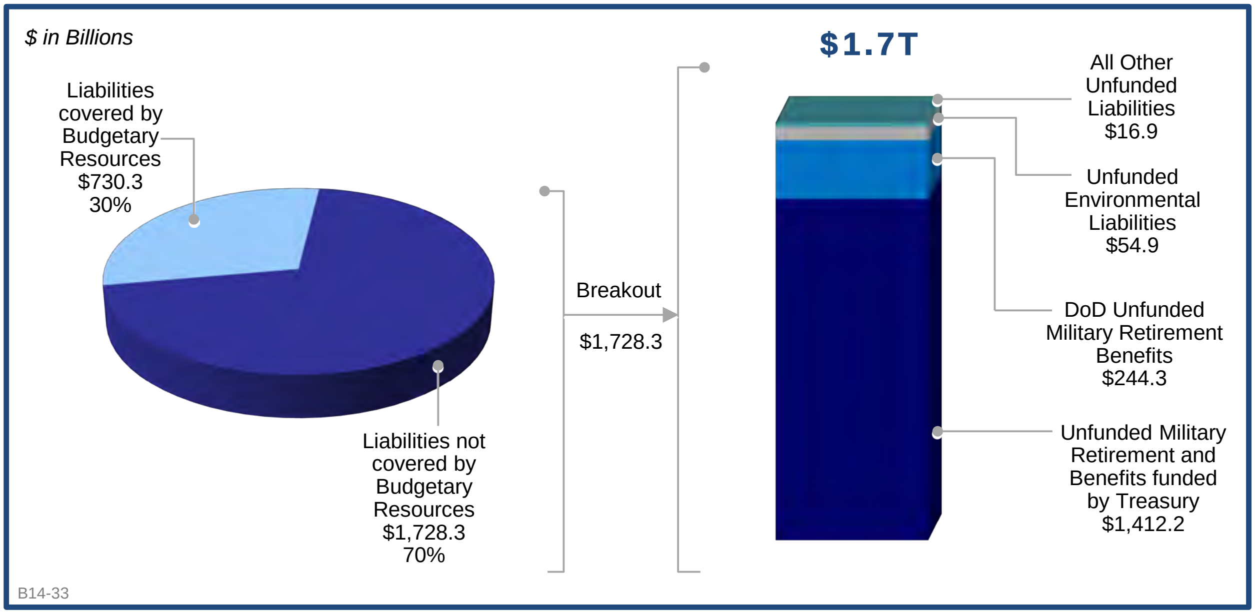
Figure 12. Summary of Total Liabilities



As seen in Figure 12, the Department's total liabilities increased $46.4 billion during FY 2014, almost exclusively due to upward adjustments in the estimated actuarial liability associated with military retirement pension and health care benefits. The Department's Office of the Actuary revised the cost basis for the estimate by $46.6 billion. The Department's $2.5 trillion of liabilities reported in FY 2014 are backed by the full faith and credit of the United States Government.

Figure 13 shows the $1.7 trillion in 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 $1.4 trillion actuarial liability accounts for approximately 82 percent of the total $1.7 trillion in liabilities not covered by budgetary resources. Additionally, the Department has resources available to cover approximately $670.9 billion of the remaining liabilities, primarily invested in U.S. Treasury securities.

Figure 13. Unfunded Liabilities



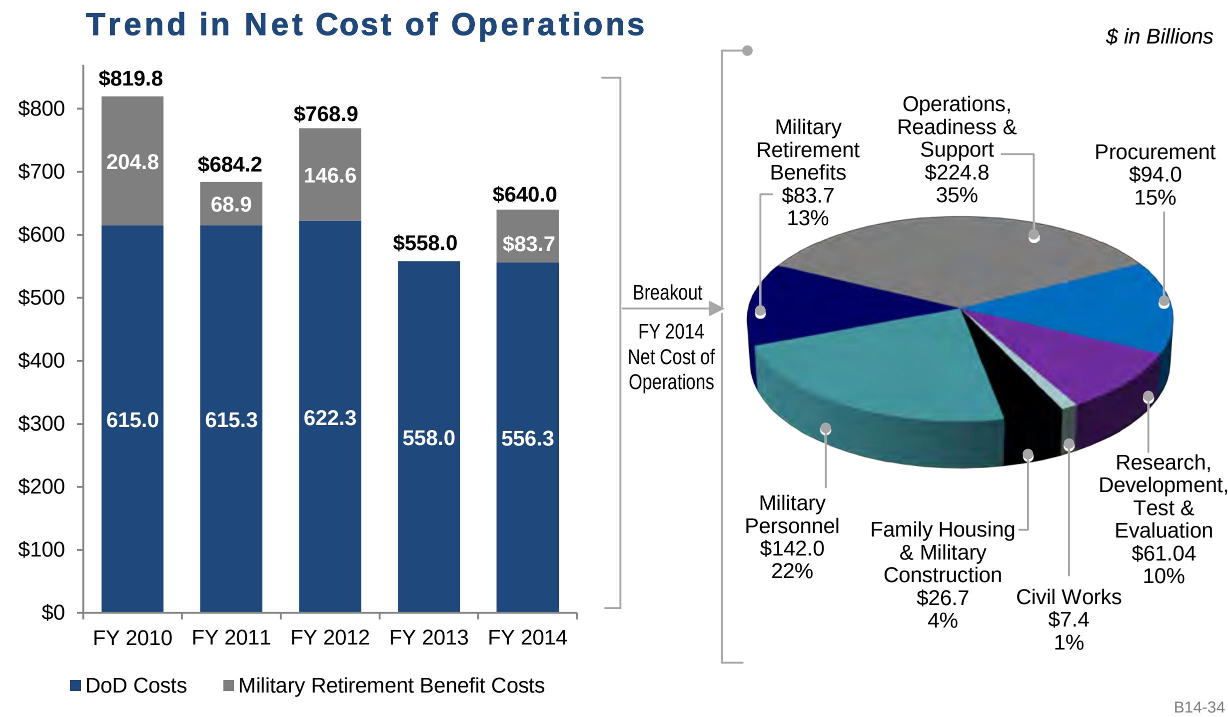
Statement of Net Cost

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 revenues earned from external sources to finance those expenses. Generally, the resulting balance of net cost is equivalent to the outlays reported on the Statement of Budgetary Resources (SBR), plus accrued liabilities, less the amount of assets purchased and capitalized on the Balance Sheet. The differences between reported outlays of the budgetary resources and reported net cost generally arise from when expenses are recognized.

The Department's costs incurred relate primarily to operations, readiness, and support activities, military personnel cost, and costs related to the Department's procurement programs. 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 $640 billion in net costs of operations during the fiscal year.

As depicted in Figure 14, the $640 billion in net cost of operations represents an $82 billion increase (15 percent) from FY 2013 reported net cost. A $69.7 billion change to the actuarial assumptions used to estimate and record accruals for future payments of military retirement and health care benefits increased the overall net cost of operations. The change resulted in a loss on the net cost of operations and also has the effect of increasing the liabilities on the Balance Sheet.

Figure 14. Summary of Net Cost of Operations



Statement of Changes in Net Position

The Statement of Changes in Net Position (SCNP) presents the total cumulative results of operations since inception and unexpended appropriations at the end of the fiscal year. The SCNP displays the components of net position separately to enable the user to better understand the nature of changes to net position as a whole. The statement focuses on how the net cost of operations as presented on the Statement of Net Cost is financed, as well as displaying the other items financing the Department’s operations. The Department's ending net position increased $8.6 billion during FY 2014. The increase reflects primarily the impact of the change in actuarial liability estimates, offset by the impact of the decrease in the value of property, plant, and equipment during FY 2014.

Financial Performance Summary

The Department’s financial performance is summarized in Figure 15 on the following page. 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 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 used to manage the Department’s operations successfully.

Figure 15. Financial Performance Summary

Dollars in Billions	FY 2014	FY 2013	Change	% Change
ASSETS				
Fund Balance with Treasury	$ 480.4	$ 482.7	($ 2.3)	-0.5%
Investments	787.1	714.8	72.3	10.1%
Accounts Receivable	8.0	11.7	(3.7)	-31.6%
Other Assets	78.8	77.0	1.8	2.3%
Inventory and Related Property, Net	261.5	254.0	7.5	3.0%
General Property, Plant and Equipment, Net	619.0	639.6	(20.6)	-3.2%
Total Assets	**$ 2,234.8**	**$ 2,179.8**	**$ 55.0**	**2.5%**
LIABILITIES				
Accounts Payable	$ 19.8	$ 21.7	($ 1.9)	-8.8%
Other Liabilities	46.1	51.5	(5.4)	-10.5%
Military Retirement and Other Federal Employment Benefits	2,334.0	2,280.6	53.4	2.3%
Environmental and Disposal Liabilities	58.6	58.3	0.3	0.5%
Total Liabilities	**$ 2,458.5**	**$ 2,412.1**	**$ 46.4**	**1.9%**
Total Net Position (Assets Minus Liabilities)	**($ 223.7)**	**($ 232.3)**	**$ 8.6**	**3.7%**
Total Financing Sources	646.5	727.2	(80.7)	-11.1%
Less Net Cost of Operations	640.0	558.0	82.0	14.7%
Net Change of Cumulative Results of Operations	**6.5**	**169.2**	**(162.7)**	**96.2%**
Total Budgetary Resources	**$ 1,084.4**	**$ 1,097.8**	**($ 13.4)**	**-1.2%**

FINANCIAL MANAGEMENT IMPROVEMENT INITIATIVES

Financial Improvement and Audit Readiness Initiative

As Secretary Hagel reported to Congress and told the men and women serving in the Department of Defense, getting our financial house in order is one of the Department's top priorities. Deputy Secretary Work has echoed *Secretary Hagel's message* and recently challenged leaders of the Defense Agencies and activities to be champions for Financial Improvement and Audit Readiness (FIAR) – to demand compliant processes and systems, to incorporate audit readiness in employee performance plans, and to be prepared to move out of audit readiness and into the business of being under continuous audit. The message is clear: The DoD leadership team is serious about improving financial management processes and controls over DoD resources.

Audit readiness is critically important for the Department of Defense. "Audit ready" means the Department has reasonable assurance about the effectiveness of its internal controls and financial practices, processes, and systems and their ability to withstand audit by an independent auditor. Financial statement auditability is not only required by law[2], but will demonstrate that the Department properly manages and is a good steward of taxpayer dollars.

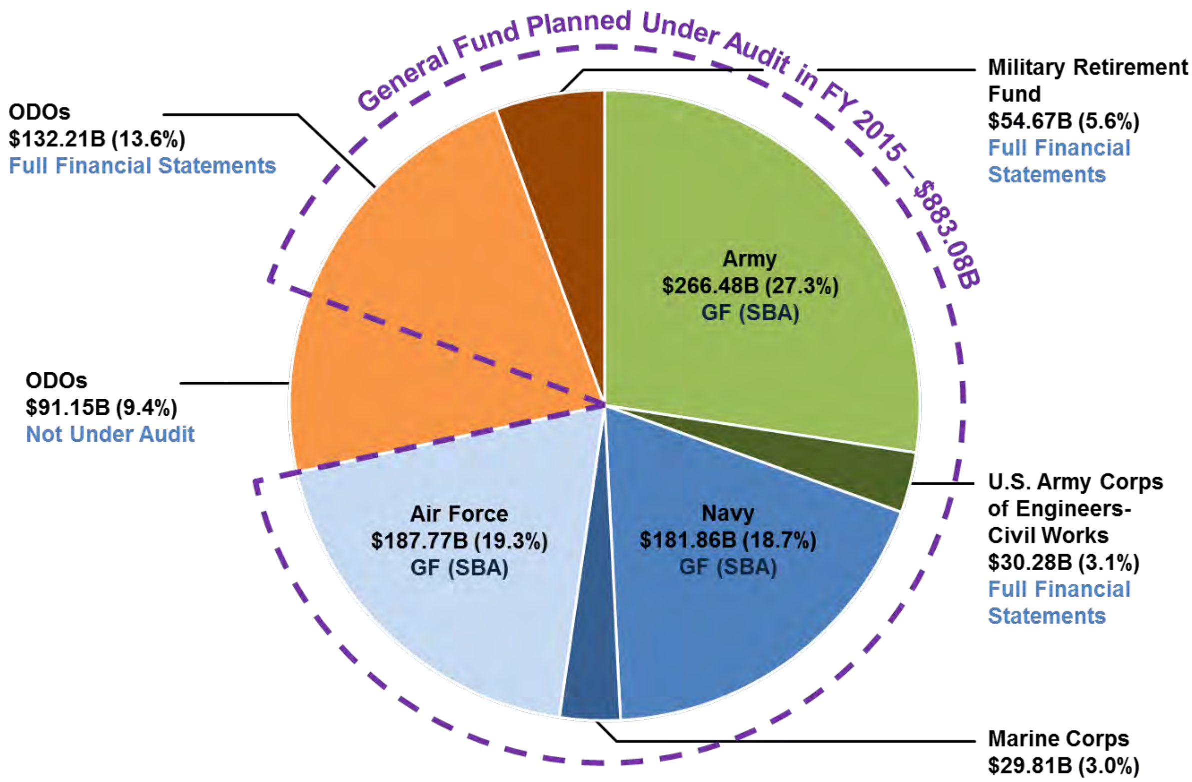
This year, the Department made substantial progress. The *U.S. Marine Corps* became the first Military Service to achieve an unmodified ("clean") opinion on its Schedule of Budgetary Activity (SBA) for FY 2012, which reported on the Marine Corps' receipt and use of funds in FY 2012. Achieving an opinion on the SBA shows that the Marine Corps' budgetary processes, controls, and systems, which are the same used in reporting both current and expired funds in the Statement of Budgetary Resources (SBR), can meet audit standards.

Following the Marine Corps' audit readiness approach, the Military Departments and many of the other Defense organizations (ODOs) asserted audit readiness on their FY 2015 appropriations, to be reported on a Schedule of Budgetary Activity (SBA). Beginning in January 2015, over 90 percent of the Department's current year appropriations will be under audit. Most of the other ODOs not under audit will begin SBA examinations or mock audits in FY 2015. All remaining ODOs will continue audit readiness activities and not be audited until the DoD Consolidated Financial Statements are audited in FY 2018.

[2] *Chief Financial Officers Act of 1990* ("CFO Act") (Public Law 101-576), as amended by the *Reports Consolidation Act of 2000*; the *Government Management Reform Act of 1994* (GMRA) (Public Law 103-356); *National Defense Authorization Act of 2010* (Public Law 111-84)

Figure 16 identifies the DoD Components that will be under audit in FY 2015 and their percent of the total DoD General Funds. The DoD Components have now expanded the audit readiness focus from budgetary data to all financial transactions to achieve the full goal of auditing full financial statements in FY 2018. Several DoD Components that have received and sustained audit opinions on their full financial statements, such as the U.S. Army Corps of Engineers Civil Works, will continue to prepare stand-alone financial statements.

Figure 16. General Funds Under Audit in FY 2015



Note: Based on FY 2013 Total Budgetary Resources.

In terms of our strategic warfighting mission and the size of the Department's annual budget and quantity of worldwide physical assets, no organization in the world can compare with the complexity of the U.S. Department of Defense. As the Department continues to emphasize improvements in its business processes and more and more of the DoD Components achieve audit readiness and complete audits successfully, the Department will demonstrate its effective stewardship of taxpayer dollars. Additional information on the Department's *Financial Improvement and Audit Readiness* Initiative, as well as the latest FIAR Plan Status Report, is available on the Under Secretary of Defense (Comptroller)'s public website.

Financial Management Certification Program

The DoD Financial Management (FM) Certification Program, sponsored by the Office of the Under Secretary of Defense (Comptroller), hit full stride in FY 2014. Ninety-eight percent of Active-Duty Military and Civilian FM personnel have transitioned into the program, and over 725 members have already achieved their required certification. The FM personnel in the Reserve Components will be transitioned in FY 2015, and we expect the wave of certifications awarded will increase steadily throughout the upcoming fiscal year.

The Certification Program is course-based rather than test-based, with course hour requirements aligned to FM and leadership competencies and other specific courses, namely, audit readiness, ethics, and fiscal law. There are three levels of FM Certification, and each level includes FM experience requirements. The FM workforce members must achieve certification within two years of assignment to an FM position. After meeting initial certification requirements, FM personnel must meet continuing education and training requirements every two years.

When we recognized that the inventory of FM courses would not be adequate to support a course-based certification program, the Comptroller team began to develop FM web-based training courses in 2012. Currently, 38 of these courses are available to the workforce, resulting in improved, cost-free access to training in key, substantive subject areas.

To date, over 38,000 FM web-based course completions have been recorded and over 6,000 of these course completions are in the Financial Improvement and Audit Readiness (FIAR) area. This metric's results indicate that the Program already is achieving one of its goals, which is to improve employee knowledge and skills in audit readiness.

As the FM Certification Program matures, the culture of continual professional development and training for all FM workforce members will become ingrained, proficiency in technical and leadership subject areas will increase, and support to the warfighters will keep pace with their needs.

More Disciplined Use of Resources

Continuing the reform agenda advanced in previous budgets, the Department reviewed all budgetary areas for potential savings in its "More Disciplined Use of Resources" campaign. Strategies to realize savings included restructuring the civilian workforce to meet key needs with fewer personnel; better leveraging of the reserve components; restructuring military treatment facilities; controlling health care costs by taking advantage of lower prices for private care; and restructuring or terminating weapons programs and military construction projects to focus on the most critical capabilities.

As a result of these efforts, the Department proposed approximately $37 billion in additional cost reductions over the period of FY 2014 through FY 2018 (Future Years Defense Program) from the amount of funds requested in the Department's FY 2014 President's Budget. The savings include:

- <u>Streamlining Business Practices and Support Services.</u> The Department saved $19 billion by streamlining business practices and support services, such as installation and administrative functions, contracting, and staffing.
- <u>Terminating or Restructuring Weapons Programs.</u> The Department saved $14 billion by identifying and terminating programs where the most important capabilities could be met by other means.
- <u>Restructuring and Delaying Military Construction Projects.</u> The Department saved $4 billion by funding only the most critical facility requirements and ensuring construction projects only support requirements after force structure adjustments.

The Department remains committed to performing its mission while operating efficiently, reducing costs, and effectively managing taxpayer dollars. As the military force structure draws down, the Department will continue to examine other opportunities to streamline installation support and management overhead to match capacity to the new force structure.

U.S. Sailors assigned to Naval Mobile Construction Battalion 11 pour concrete for a project at Camp Lemonnier, Djibouti.

Photo by Mass Communication Specialist 1st Class Jonathan Carmichael

INTERNAL CONTROLS OVERVIEW

MANAGERS' INTERNAL CONTROL PROGRAM

The Office of the Under Secretary of Defense (Comptroller) leads the Department's *Federal Managers' Financial Integrity Act* (FMFIA) program, known as the *Managers' Internal Control Program* (MICP). The Department's management has a fundamental responsibility to develop and maintain effective internal controls to provide reasonable assurance that obligations and cost are in compliance with applicable laws; funds, property, and other assets are safeguarded against waste, loss, and unauthorized use or misappropriation; revenues and expenditures are properly recorded and accounted for; and programs are efficiently and effectively executed in accordance with applicable laws and management policies. This is accomplished, in part, through leadership's strong, clear, and consistent "tone-at-the-top" that includes the empowerment and regular interface with subject matter experts embedded in each of a Component's key functional areas.

The MICP is dependent upon the shaping of an organizational culture that proactively implements continuous business process improvements to ensure timely, accurate, and complete financial and operational information. This continuous business process improvement methodology complements and relies upon stakeholders' understanding, documentation and assessment of their assigned functional areas. A comprehensive MICP also provides leadership the latitude to address related operational and financial risk before the mission is adversely impacted.

All Components are required to implement a robust program to establish and assess internal controls for all mission-essential operations. Components identified in the Department's *FIAR Guidance* are required to include assurances over the internal controls related to financial reporting and financial systems.

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.
- Hinders management's ability to prevent or detect a material misstatement of the financial statements.
- Impairs fulfillment of essential operations or mission.
- Identified previously as a "high risk" area.
- High impact of occurrence in terms of loss of dollars and loss of life.
- 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.
- Nonconformance with government-wide, financial management system requirements.

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

STATEMENT OF ASSURANCE

The leaders of the Department of Defense (the Department) recognize 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-123, Appendix D, "Compliance with the Federal Financial Management Improvement Act of 1996." The Department continues to focus on strengthening its Managers' Internal Control Program so that it can meet program objectives.

At present, the Department cannot produce auditable financial statements, and management cannot provide unqualified assurance as to the effectiveness of our internal controls over financial reporting. To improve its financial management and reinforce public confidence in its stewardship of taxpayer funds, the Department is committed to achieving financial auditability. Auditable financial statements require a sound framework of internal controls and an organizational culture that promotes the identification, prioritization, and mitigation of risks to financial reporting.

The Department conducted an assessment of the effectiveness of internal controls over financial reporting as required by OMB Circular A-123, Appendix A. This assessment determined that, while the Department continues to achieve measurable progress, it cannot provide reasonable assurance that internal controls over financial reporting were effective as of September 30, 2014. In addition, as of September 30, 2014, the Department's financial systems are not all in compliance with the FFMIA and OMB Circular A-123, Appendix D. Details of the material weaknesses are available in Other Information.

The Department conducted its assessment of the effectiveness of internal controls over operations per OMB Circular A-123, "Management's Responsibility for Internal Control." Based on this assessment, the Department provides 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, 2014. Details of identified material weaknesses are available in Other Information. The Department continues to prioritize efforts to address relevant Government Accountability Office high risk areas as well as management challenges identified by the Department of Defense Office of Inspector General, focusing attention on opportunities to strengthen internal controls.

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 establishing and sustaining a culture centered on an effective control environment.

Robert O. Work
Deputy Secretary of Defense

FY 2014 Improvements in Internal Controls

Despite significant challenges, the Department achieved important improvements in internal controls, which will better enable our ability to meet strategic priorities. A few of our accomplishments are highlighted below.

- Security. The *United States Special Operations Command* (USSOCOM) established a security professionals working group and created a single location to report, track, and archive all security incidents and violations. The single archive location will enable the working group to review previous incidents and violations and use the active archived reports to identify trends, patterns, and emerging threats to the Command's security program. The working group will adjust the Command's security education to address identified threats and vulnerabilities, from review of metrics of previous incidents.

- Financial Reporting. Independent public auditors performed attestation engagements (Statement on Standards for Attestation Engagement No. 16) and issued unqualified opinions, with no material weaknesses identified, on the effectiveness of select DFAS internal controls for Military Pay and Disbursing Operations, Civilian Pay and Disbursing Operations, and Contract Pay and Disbursing Operations.

- Charge Card Programs. The Department implemented new safeguards and controls to supplement oversight and legal compliance[3] in use of the Government travel charge card. Cardholders are now required to formally document and acknowledge their understanding of the DoD government travel charge card policy. Commanders and Agency Heads are responsible for periodic reviews of the effectiveness of the internal controls in their travel card program. Also this year, the Department issued the "Government Charge Card Guidebook for Establishing and Managing Purchase, Travel and Fuel Card Programs," which highlights important controls to identify, correct, and minimize fraud, waste, and abuse of charge cards.

- Standard Line of Accounting. This year, the Department began to implement the standard line of accounting (SLOA) in accounting systems. The SLOA is comprised of standard data elements that will allow different financial management systems to better interoperate. The SLOA is comprised of a subset of data elements in the DoD Standard Financial Information Systems language, and will be used to report financial information to OMB and the Department of the Treasury. The SLOA will improve the completeness and accuracy of financial information that is traded between different accounting systems and improve the reliability of financial reporting.

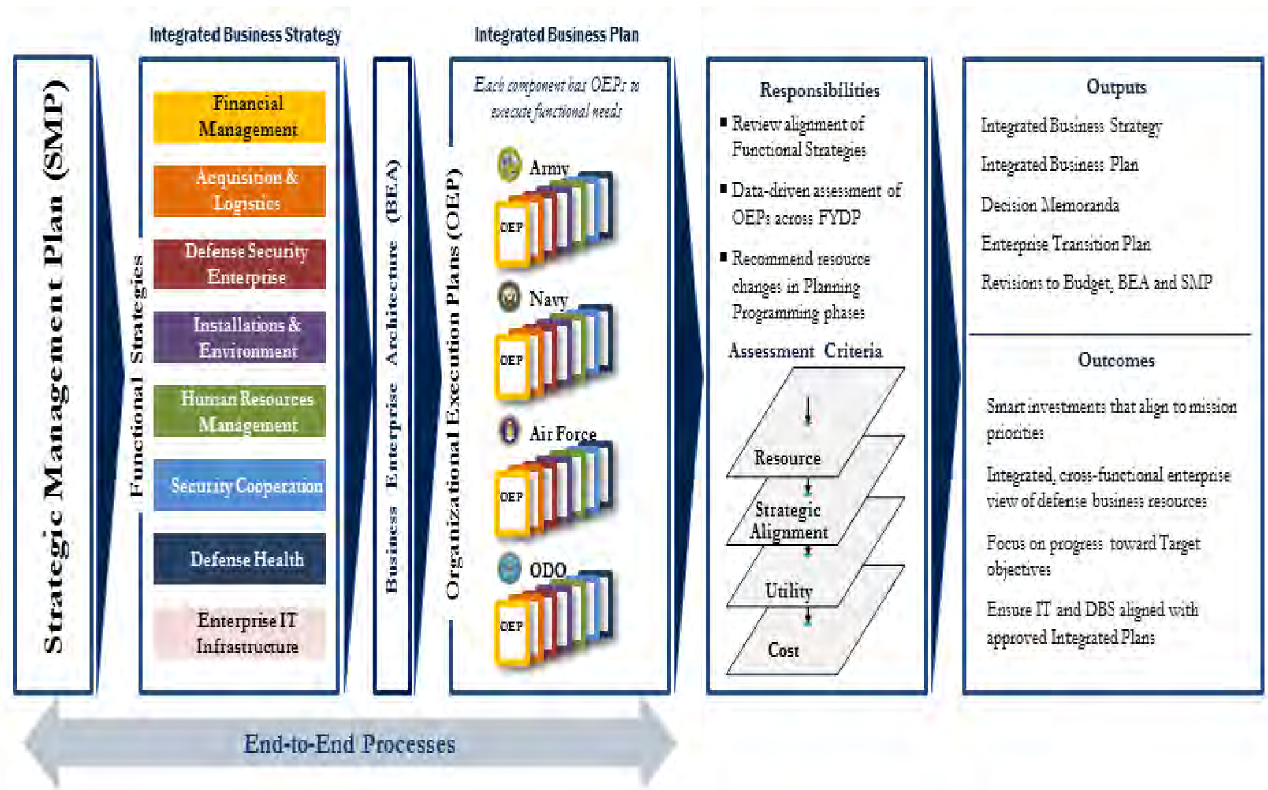
[3] *Government Charge Card Abuse Prevention Act of 2012* (Public Law 112-194)

BUSINESS AND FINANCIAL MANAGEMENT SYSTEMS

To successfully achieve and sustain improvements in our internal controls, financial management, and auditable financial reports, the Department is improving its business systems. Modernization and improved interoperability of DoD business systems is critical to efficiently respond to Warfighter needs and sustain public confidence in our stewardship of taxpayer funds.

Following passage of section 901 of the National Defense Authorization Act[4] for FY 2012, the Department significantly changed the requirements for investment reviews and the certification of defense business systems, which now must occur before funds (appropriated or non-appropriated) are obligated. The Department's investment review process ensures that decisions on investments in business systems align with the Defense-wide integrated business strategy (Figure 17). These decisions also ensure that systems eliminate redundancy and maximize operating efficiency through streamlining business processes and the availability of timely, accurate and useful business information.

Figure 17. The Department's Integrated Business Framework

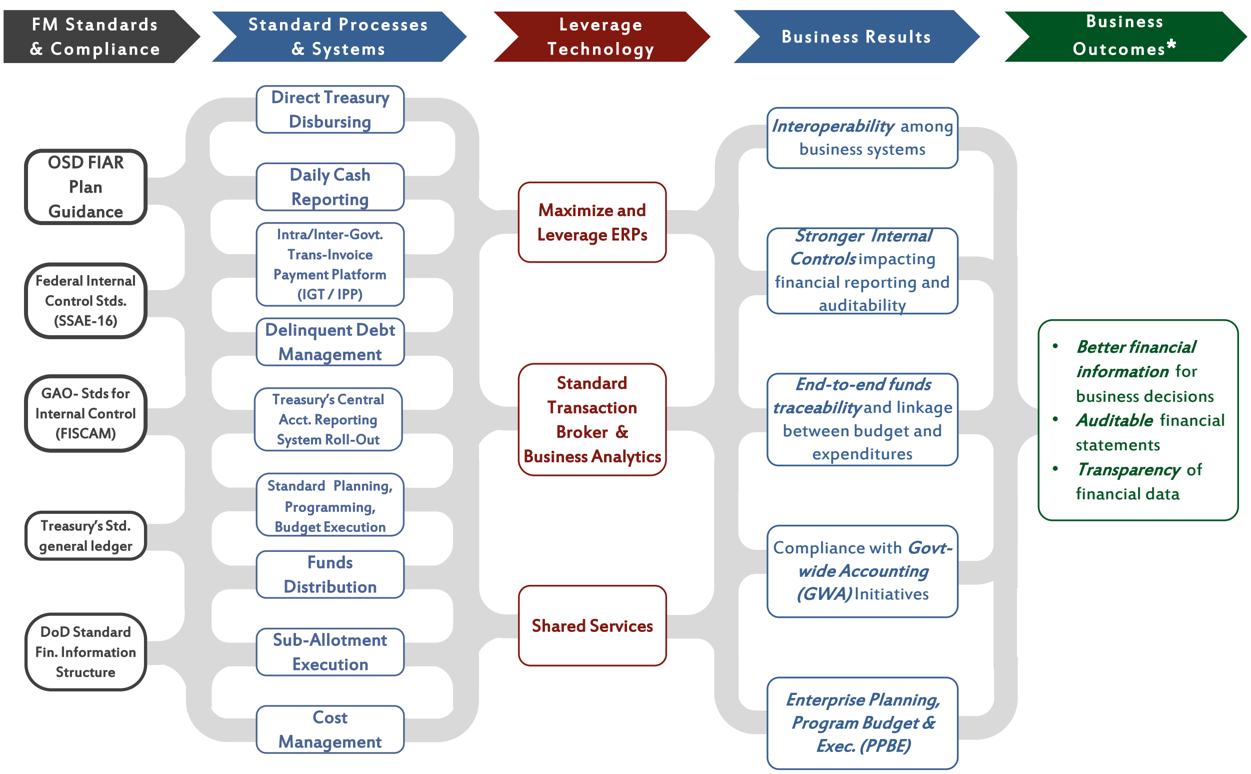


[4] Section 901 of the National Defense Authorization Act for FY 2012, codified at [10 U.S.C. 2222](), "Defense business systems: architecture, accountability, and modernization"

The Department's Financial Management (FM) Functional Strategy provides the Department's vision, initiatives, goals, target environment, and expected outcomes over the next five years. The strategy is designed to ensure the Department achieves and sustains auditability and financial management improvement objectives.

The key components of the FM strategy include setting data standards, process and system improvements, and leveraging technology throughout the FM community. Current enterprise-level initiatives include the *Standard Financial Information Structure*, the Department's first-ever *Standard Line of Accounting* to improve transaction quality. The Department also participates in Federal-wide process improvement initiatives, such as compliance with the President's transparency and open government initiatives, the U.S. Treasury Department's Government-wide accounting initiative, and direct-to-Treasury disbursing, as well as promoting the use of business analytics and maximizing existing enterprise resource planning (ERP) systems.

Figure 18. DoD Financial Management Improvement Initiatives



The FM functional strategy also provides the plans and means to retire and replace legacy financial systems to simplify the FM systems environment and infrastructure. Under the legacy systems reduction plan, financial management core and feeder systems should be reduced from 327 systems at the beginning of FY 2014 to 120 systems by the end of FY 2019.

The ERP systems are integral to implementing the strategic FM business process improvements, achieving the planned target environment and reductions in the number of legacy systems, and better enabling a sustainable audit environment. The ERPs provide a broad range of functionality to support DoD business operations in financial management, supply chain management, logistics, and human resource management. Some ERPs are fully fielded while others are in a state of development and deployment.

Army ERPs

General Fund Enterprise Business System (GFEBS) is the General Fund accounting, asset management, and financial system used to standardize, streamline, and share critical data across the active Army, Army National Guard, and Army Reserve. The GFEBS is a web-based ERP solution that uses commercial off-the-shelf (COTS) business enterprise software to compile and share accurate, up-to-date financial and accounting data.

Logistics Modernization Program (LMP) is one of the world's largest, fully-integrated supply chain, maintenance, repair and overhaul, planning, execution, and financial management systems. The LMP mission is to sustain, monitor, measure, and improve the modernized, national-level logistics support solution. By modernizing both the systems and the processes associated with managing the Army's supply chain at the national and installation levels, LMP will permit planning, forecasting, and rapid order fulfillment to supply lines, improved distribution, a reduced theater footprint, and a warfighter who is equipped and ready to respond to present and future threats.

Global Combat Support System – Army (GCSS-A) provides enterprise-wide visibility into various logistics areas and is a key enabler for the Army in achieving auditability. The GCSS-A provides the tactical Warfighter with supply, maintenance, property accountability, integrated materiel management center, management functionality, and support to tactical financial processes.

Integrated Personnel Pay System – Army (IPPS-A) is a hybrid solution using ERP software to deliver an integrated personnel and pay capability. The IPPS-A will provide the Army with an integrated, multi-Component personnel and pay system which streamlines Army Human Resources processes, enhances the efficiency and accuracy of Army personnel and pay procedures, and supports Soldiers and their families. The IPPS-A will improve internal controls to prevent erroneous military payments and loss of funds.

Navy ERPs

Navy Enterprise Resource Planning (Navy ERP) is an integrated business system that provides streamlined financial, acquisition, and supply chain management to the Navy's major systems commands.

Global Combat Support System – Marine Corps (GCSS-MC) is the core web-enabled, centrally-managed ERP for the Marine Corps. The GCSS-MC is focused on the acquisition and implementation of the initial set of logistics capabilities to deliver improved supply and maintenance management services. As the technology centerpiece of the Marine Corps' overall logistics modernization effort, GCSS-MC will provide advanced expeditionary logistics capabilities to ensure future combat efficiency.

Air Force ERPs

Defense Enterprise Accounting and Management System (DEAMS) is an automated accounting and financial management execution system for the Air Force and U.S. Transportation Command. The DEAMS creates an Air Force enterprise financial data view by providing an integrated accounting and finance solution to manage appropriated and working capital funds.

Air Force Integrated Personnel and Pay System (AF-IPPS) is a comprehensive, self-service, web-based solution that integrates personnel and pay processes into one system and maintains an official member record throughout the airman's career. A Federal Financial Management Improvement Act (FFMIA)-compliant system, AF-IPPS functionality will support audit readiness general and application controls. Full deployment is not projected until the fourth quarter of FY 2018.

Other Defense Organization ERPs

Defense Agency Initiative (DAI) is a system dedicated to address financial management improvements through standard end-to-end business processes delivered by commercial off-the-shelf (COTS) software. The DAI provides accounting, procure to payment, and time and attendance capability today, and will provide grants financial management and budget formulation capability in the future.

Deputy Secretary of Defense Bob Work addresses DoD leadership during the ODO FIAR Conference. He discussed budgetary concerns and the Department's way ahead.

Photo by Mass Communication Specialist 2nd Class Sean Hurt

Enterprise Business System (EBS) uses a commercial off-the-shelf product to manage Defense Logistics Agency's (DLA) supply chain management business. The EBS also includes Electronic Procurement, Real Property, Inventory Materiel Management and Stock Positioning, and Energy Convergence modules, providing DLA leadership with the tools to respond to new challenges and trends.

Improper Payment Reporting

The Federal government disburses more than $2 trillion in payments to individuals and other entities each year. Beginning in 2002, Congress enacted legislation to help ensure Federal entities have strong financial management controls in place to pay the correct amount to the appropriate recipient and to better detect and prevent improper payments.

In accordance with legislation[5] (collectively referred to in this report as IPERA) and Office of Management and Budget (OMB) Circular No. A-123, the Department reports on its improper payments, and the recovery of these payments, to the President (via OMB) and Congress in the following categories:

- Military Health Benefits
- Military Pay
- Civilian Pay
- Commercial Pay
- Military Retirement
- Travel Pay

The Department continually looks for opportunities to improve our improper payment methodologies. The Department is implementing recommendations reflected in the DoD IG's April 2014 review[6] of our improper payment program, as well as the recommendations identified by the Government Accountability Office (GAO) in its May 2013 report[7]. For example, based on GAO recommendations, DFAS enhanced the sampling methodology used in the Commercial Pay category to stratify the universe of payments by invoice dollar amount, in addition to stratifying by site and system. The Defense Health Agency (DHA) also modified its statistical sampling plan pursuant to the GAO's recommendation related to calculating underpayments. The DHA may award a recovery auditing contract in FY 2015 to recapture outstanding credit balances from vendor and contractor accounts.

As part of the Department's efforts to become fully auditable by FY 2017, each DoD disbursing activity is diligently reviewing and reporting on all payments that are subject to IPERA and ensuring the processes used are compliant with laws and regulations. Until all DoD disbursements can be reconciled with the amount reported on the Statement of Budgetary Resources, the Department cannot demonstrate that all payments subject to IPERA have been reviewed. The Department's efforts to achieve an auditable SBR by FY 2017 will increase the public's confidence in the Department's stewardship of taxpayer dollars and the integrity of the DoD improper payments program.

Refer to the Other Information section of this report for detailed reporting on improper payments and recoveries.

---

[5] *Improper Payments Information Act of 2002* (IPIA) (P.L. 107-300); *Improper Payments Elimination and Recovery Act of 2010* (IPERA) (P.L. 111-204); *Improper Payment Elimination and Recovery Improvement Act of 2012 (IPERIA)* (P.L. 112-248); *Recovery Auditing Act* (Section 831, Defense Authorization Act, for FY 2002) (P.L. 107-107)

[6] *DoD Efforts to Meet the Requirements of the Improper Payments Elimination and Recovery Act in FY 2013*

[7] *Significant Improvements Needed in Efforts to Address Improper Payment Requirements*

U.S. Sailors assigned to the amphibious assault ship USS Bataan rescue people in the Mediterranean Sea June 6, 2014. The Bataan and the guided missile frigate USS Elrod rendered assistance and provided food, water, medical attention and temporary shelter to 277 people after receiving a report that an Italian military marine patrol aircraft sighted six small vessels, one of which was sinking.

Photo by Mass Communication Specialist Seaman Apprentice Michael J. Lieberknecht

A U.S. Army UH-60 Black Hawk helicopter assigned to the Oklahoma Army National Guard releases water from a helicopter bucket May 5, 2014, near Guthrie, Oklahoma. Black Hawk crews assisted firefighters in battling wildfires that burned more the 6,000 acres and numerous homes in less than 24 hours.

Photo by Maj. Geoff Legler

United States Department of Defense

Agency Financial Report

Fiscal Year 2014

Financial Section

This Page Left Blank Intentionally

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 the table below.

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 $2.2 trillion, and more than 3 million military and civilian employees on installations in every state and around the world.

Four Principal Financial Statements

Statement	What Information It Provides
Balance Sheet	Reflects the Department's financial position as of the statement date (September 30, 2014). 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. The Statement of Budgetary Resources is the only principal financial statement prepared on a combined versus consolidated basis. As such, all intra-entity transactions are included in the balances reported in the statement.

Department of Defense Consolidated Balance Sheet Agency Wide As of September 30, 2014 and 2013	Dollars in Millions 2014 Consolidated	2013 Consolidated
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$ 480,352.3	$ 482,661.7
Investments (Note 4)	783,736.3	711,497.5
Accounts Receivable (Note 5)	1,466.5	1,284.2
Other Assets (Note 6)	1,440.6	1,757.6
Total Intragovernmental Assets	**$ 1,266,995.7**	**$ 1,197,201.0**
Cash and Other Monetary Assets (Note 7)	1,286.5	1,529.7
Accounts Receivable, Net (Note 5)	6,519.9	10,456.2
Loans Receivable (Note 8)	1,452.2	1,267.7
Inventory and Related Property, Net (Note 9)	261,496.8	253,997.5
General Property, Plant and Equipment, Net (Note 10)	618,997.2	639,611.9
Investments (Note 4)	3,371.9	3,333.9
Other Assets (Note 6)	74,716.5	72,466.9
TOTAL ASSETS	**$ 2,234,836.7**	**$ 2,179,864.8**
Stewardship Property, Plant & Equipment (Note 10)		
LIABILITIES (Note 11)		
Intragovernmental:		
Accounts Payable (Note 12)	$ 1,911.2	$ 1,574.7
Debt (Note 13)	1,392.3	1,174.7
Other Liabilities (Note 15)	8,746.8	12,887.7
Total Intragovernmental Liabilities	**$ 12,050.3**	**$ 15,637.1**
Accounts Payable (Note 12)	17,889.9	20,149.1
Military Retirement and Other Federal Employment Benefits (Note 17)	2,334,015.6	2,280,567.8
Environmental and Disposal Liabilities (Note 14)	58,581.4	58,333.9
Loan Guarantee Liability (Note 8)	56.8	45.8
Other Liabilities (Note 15)	35,945.4	37,393.5
TOTAL LIABILITIES	**$ 2,458,539.4**	**$ 2,412,127.2**
Commitments & Contingencies (Note 16)		
NET POSITION		
Unexpended Appropriations – Other Funds	$ 501,765.6	$ 499,735.3
Cumulative Results of Operations – Funds From Dedicated Collections (Note 23)	13,899.9	12,707.8
Cumulative Results of Operations – Other Funds	(739,368.2)	(744,705.5)
TOTAL NET POSITION	**$ (223,702.7)**	**$ (232,262.4)**
TOTAL LIABILITIES AND NET POSITION	**$ 2,234,836.7**	**$ 2,179,864.8**

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

Department of Defense Consolidated Statement of Net Cost Agency Wide For the Years Ended September 30, 2014 and 2013	*Dollars in Millions* 2014 Consolidated	 2013 Consolidated
Program Costs		
Gross Costs	$ 727,082.4	**$ 695,856.1**
Military Retirement Benefits	101,877.6	64,422.3
Civil Works	8,842.2	9,756.7
Military Personnel	143,294.9	146,052.1
Operations, Readiness & Support	272,780.6	292,918.2
Procurement	98,488.2	76,216.1
Research, Development, Test & Evaluation	68,741.5	70,147.0
Family Housing & Military Construction	33,057.4	36,343.7
(Less: Earned Revenue)	(93,915.1)	(75,009.7)
Net Cost before Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	**$ 633,167.3**	**$ 620,846.4**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	6,875.8	(62,838.6)
Net Cost of Operations (Note 18)	**$ 640,043.1**	**$ 558,007.8**

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

Department of Defense Consolidated Statement of Changes in Net Position Agency Wide For the Years Ended September 30, 2014 and 2013	*Dollars in Millions* 2014 Consolidated	 2013 Consolidated
Cumulative Results Of Operations		
Beginning Balances (Includes Funds from Dedicated Collections – See Note 23)	**$ (731,997.7)**	**$ (901,225.7)**
Budgetary Financing Sources:		
Other adjustments (rescissions, etc.)	(7.6)	0.0
Appropriations used	657,113.2	687,146.0
Nonexchange revenue	2,886.4	2,890.5
Donations and forfeitures of cash and cash equivalents	414.1	75.1
Transfers in/out without reimbursement	(220.6)	142.8
Other	(145.8)	(84.2)
Other Financing Sources		
Donations and forfeitures of property	10.6	9.9
Transfers in/out without reimbursement	56.6	(14.6)
Imputed financing	5,569.8	4,896.8
Other	(19,104.2)	32,173.5
Total Financing Sources	**$ 646,572.5**	**$ 727,235.8**
Net Cost of Operations (+/-)	(640,043.1)	(558,007.8)
Net Change	**$ 6,529.4**	**$ 169,228.0**
Cumulative Results of Operations (Includes Funds from Dedicated Collections – See Note 23)	**$ (725,468.3)**	**$ (731,997.7)**
Unexpended Appropriations		
Beginning Balances (Includes Funds from Dedicated Collections – See Note 23)	**499,735.3**	**528,955.6**
Budgetary Financing Sources:		
Appropriations received	675,748.6	710,120.8
Appropriations transferred in/out	(310.4)	(208.9)
Other adjustments	(16,294.7)	(51,986.2)
Appropriations used	(657,113.2)	(687,146.0)
Total Budgetary Financing Sources (Includes Funds from Dedicated Collections – See Note 23)	**$ 2,030.3**	**$ (29,220.3)**
Unexpended Appropriations (Includes Funds from Dedicated Collections – See Note 23)	**$ 501,765.6**	**$ 499,735.3**
Net Position	**$ (223,702.7)**	**$ (232,262.4)**

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

Department of Defense Combined Statement of Budgetary Resources Agency Wide For the Years Ended September 30, 2014 and 2013 **Page 1 of 2** *Dollars in Millions*	**Budgetary Financing Accounts**		**Non-Budgetary Financing Accounts**	
	2014 Combined	**2013 Combined**	**2014 Combined**	**2013 Combined**
Budgetary Resources				
Unobligated balance, brought forward, October 1	$ 143,813.4	$ 145,692.5	$ 46.8	$ 15.5
Recoveries of prior year unpaid obligations	49,442.5	63,172.6	0.0	0.0
Other changes in unobligated balance	(17,411.2)	(13,817.9)	0.0	0.0
Unobligated balance from prior year budget authority, net	**175,844.7**	**195,047.2**	**46.8**	**15.5**
Appropriations (discretionary and mandatory)	737,644.3	733,535.9	0.0	0.0
Borrowing authority (discretionary and mandatory)	0.0	0.0	368.0	26.9
Contract authority (discretionary and mandatory)	70,599.4	65,506.0	0.0	0.0
Spending authority from offsetting collections (discretionary and mandatory)	100,315.6	103,712.7	120.4	83.2
Total Budgetary Resources	**$1,084,404.0**	**$ 1,097,801.8**	**$ 535.2**	**$ 125.6**
Status of Budgetary Resources				
Obligations incurred	$ 933,688.6	$ 953,988.4	$ 488.1	$ 78.8
Unobligated balance, end of year:				
Apportioned	113,158.7	109,896.8	0.0	0.0
Exempt from Apportionment	2,603.4	4,046.6	0.0	0.0
Unapportioned	34,953.3	29,870.0	47.1	46.8
Total unobligated balance, end of year	**$ 150,715.4**	**$ 143,813.4**	**$ 47.1**	**$ 46.8**
Total Budgetary Resources	**$1,084,404.0**	**$ 1,097,801.8**	**$ 535.2**	**$ 125.6**
Change in Obligated Balance				
Unpaid obligations:				
Unpaid obligations, brought forward, October 1	$ 437,365.2	$ 468,570.2	$ 300.7	$ 541.8
Obligations incurred	933,688.6	953,988.4	488.1	78.8
Outlays (Gross)	(891,105.0)	(922,020.8)	(303.9)	(319.9)
Recoveries of prior year unpaid obligations	(49,442.5)	(63,172.6)	0.0	0.0
Unpaid obligations, end of year	**430,506.3**	**437,365.2**	**484.9**	**300.7**
Uncollected payments:				
Uncollected payments, Federal sources, brought forward, October 1	(77,203.9)	(77,953.4)	(52.4)	(83.5)
Change in uncollected payments, Federal sources	(118.7)	749.5	(22.8)	31.1
Uncollected payments, Federal sources, end of year	**(77,322.6)**	**(77,203.9)**	**(75.2)**	**(52.4)**
Memorandum Entries:				
Obligated balance, start of year	**$ 360,161.3**	**$ 390,616.8**	**$ 248.3**	**$ 458.3**
Obligated balance, end of year	**$ 353,183.7**	**$ 360,161.3**	**$ 409.7**	**$ 248.3**

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

Department of Defense Combined Statement of Budgetary Resources Agency Wide For the Years Ended September 30, 2014 and 2013 Page 2 of 2 *Dollars in Millions*	Budgetary Financing Accounts 2014 Combined	Budgetary Financing Accounts 2013 Combined	Non-Budgetary Financing Accounts 2014 Combined	Non-Budgetary Financing Accounts 2013 Combined
Budgetary Authority and Outlays, Net:				
Budget authority, gross (discretionary and mandatory)	$ 908,559.3	$ 902,754.6	$ 488.4	$ 110.1
Actual offsetting collections (discretionary and mandatory)	(161,764.4)	(167,910.0)	(97.5)	(126.7)
Change in uncollected customer payments from Federal sources (discretionary and mandatory)	(118.7)	749.5	(22.8)	31.1
Budget Authority, net (discretionary and mandatory)	**$ 746,676.2**	**$ 735,594.1**	**$ 368.1**	**$ 14.5**
Outlays, gross (discretionary and mandatory)	$ 891,105.0	$ 922,020.8	$ 303.9	$ 319.9
Actual offsetting collections (discretionary and mandatory)	(161,764.4)	(167,910.0)	(97.5)	(126.7)
Outlays, net (discretionary and mandatory)	**729,340.6**	**754,110.8**	**206.4**	**193.2**
Distributed offsetting receipts	(87,713.9)	(82,767.6)	0.0	0.0
Agency Outlays, net (discretionary and mandatory)	**$ 641,626.7**	**$ 671,343.2**	**$ 206.4**	**$ 193.2**

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

LIST OF NOTES TO THE 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, 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 (FMR)*. The accompanying financial statements account for all resources for which the Department is responsible unless otherwise noted. Information relative to classified assets, programs, and operations is excluded from the statements or otherwise aggregated and reported in such a manner that it is not 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 related to these limitations: (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.

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. Each WCF obtains 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 funds from dedicated collections. Funds from dedicated collections 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 funds from dedicated collections.

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.

These funds include South Dakota Terrestrial Wildlife Habitat Restoration, Inland Waterways, and Harbor Maintenance. The Department also receives allocation transfers for the Security Assistance programs meeting 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 is unable to meet all full accrual accounting requirements. This is primarily because many of the Department's financial and nonfinancial systems and processes were designed prior to the legislative mandate to produce financial statements in accordance with USGAAP. These systems were not designed to collect and record financial information on the full accrual accounting basis but 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, there will be instances when the Department's financial data is 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, and on occasion, will also receive congressional appropriations for working capital funds. These funds either expire annually, some 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.

In accordance with *Statement of Federal Financial Accounting Standards (SFFAS) Number 7 "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting,"* the Department recognizes nonexchange revenue when there is a specifically identifiable, legally enforceable claim to the cash or other assets of another party that will not directly receive value in return.

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 an entity to eliminate intra-entity activity and balances from consolidated financial statements 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 incorporating the necessary elements to 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.

Imputed financing represents the costs paid on behalf of the Department by another Federal entity. The Department recognizes imputed costs for (1) employee pension, post-retirement health, and life insurance benefits; (2) post-employment benefits for terminated and inactive employees to include unemployment and workers compensation under the Federal Employees' Compensation Act; and (3) losses in litigation proceedings.

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 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 the 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 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 reviewed and adjusted, as required, 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 including 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, as receivables from other federal agencies are considered to be inherently collectible. Claims for accounts receivable from other federal agencies are resolved between the agencies in accordance with 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 allowing 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 also operates the Armament Retooling and Manufacturing Support Initiative under *Title 10 United States Code 4551-4555*. This loan guarantee program was 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 and 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 information.

The *Federal Credit Reform Act of 1990* governs all amended direct loan obligations and loan guarantee commitments made after FY 1991. The Act requires the Department to estimate the cost of direct loans and loan guarantees at present value. The present value of the subsidy costs (i.e., interest rate differentials, interest subsidies, delinquencies and defaults, fee offsets and other cash flows) associated with direct loans and loan guarantees are recognized as a cost in the year the loan or loan guarantee is disbursed and reevaluated annually. The net present value of loans or defaulted guaranteed loans receivable is the amount of the gross loan or defaulted guaranteed loans receivable less the present value of the subsidy.

1.M. Inventories and Related Property

The Department values approximately 87 percent of resale inventory using the moving average cost method. An additional 11 percent (fuel inventory) is reported using the first-in-first-out method. The Department reports the remaining 2 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 out of stock 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 2014 and FY 2013, 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.

Many high-dollar items, such as aircraft engines, are categorized as OM&S rather than general equipment. As a result 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.

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 requiring repair to make it suitable for sale. Often, it is more economical to repair these items 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 yielding 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 non-marketable market-based U.S. Treasury securities issued to federal agencies by the U.S. Treasury's Bureau of the Fiscal Service. These securities are not traded on any financial exchange but are priced consistently with publically traded U.S. Treasury securities.

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

In some instances, the Department uses the estimated historical cost for valuing equipment. To establish a baseline, the Department accumulated information relating to program funding and associated equipment, equipment useful life, program acquisitions, and disposals. The equipment baseline is updated using expenditure, acquisition, and disposal information.

The USACE Civil Works General Property, Plant, and Equipment (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.

In addition, the Departments of the Air Force and Navy General Funds capitalize General PP&E acquisitions that are $1 million and greater. The remainder of the Department's General PP&E capitalization threshold is $250 thousand. These capitalization thresholds apply to asset acquisitions and modifications/improvements placed into service after September 30, 2013. General PP&E assets acquired prior to October 1, 2013 were capitalized at prior thresholds ($100 thousand for equipment and $20 thousand for 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 capitalizes improvements to existing General PP&E assets if the improvements equal or exceed the capitalization thresholds 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 working capital funds 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.

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 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 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 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 involving 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, consistent with *SFFAS No. 5*, nonenvironmental disposal liabilities are recognized when management decides to dispose of an asset. In addition the Department recognizes nonenvironmental disposal liabilities for nuclear-powered military equipment 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 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 have corroborating documentation for 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. As a result, misstatements of reported Accounts Payable and Receivable are likely in the Department's financial statements.

Due to noted material weaknesses in current accounting and financial feeder systems, the Department generally cannot determine whether undistributed disbursements and collections should be applied to federal or nonfederal 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 nonfederal categories based on the percentage of distributed federal and nonfederal accounts payable and accounts receivable. Unsupported undistributed disbursements and collections are also 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.

NOTE 2. NONENTITY ASSETS

Nonentity Assets		
Fund Balance with Treasury	$ 1,130.4	$ 1,184.0
Total Intragovernmental Assets	**$ 1,130.4**	**$ 1,184.0**
Other Assets	171.5	174.1
Total Non-Federal Assets	**$ 4,327.4**	**$ 8,398.1**
Total Nonentity Assets	**$ 5,457.8**	**$ 9,582.1**
Total Entity Assets	**$ 2,229,378.9**	**$ 2,170,282.7**

Nonentity assets are not available for use in the Department's normal operations. The Department has stewardship accountability and reporting responsibility for nonentity assets.

Intragovernmental Fund Balance with Treasury (FBWT) consists primarily of deposit funds and receipt accounts. Deposit funds represent amounts held temporarily until paid to the appropriate party. Receipt accounts represent amounts collected on behalf of the U.S. Treasury General Fund.

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

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

Non-Federal Other Assets consists of Advance Payment Pool Agreements (APPA) for research and development projects. The Department utilizes APPAs 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 2014	2013
Fund Balance		
Appropriated Funds	$ 466,263.1	$ 468,669.9
Revolving Funds	9,606.1	10,477.7
Trust Funds	2,262.3	1,666.0
Special Funds	902.6	686.2
Other Fund Types	1,318.2	1,161.9
Total Fund Balance	**$ 480,352.3**	**$ 482,661.7**
Fund Balance Per Treasury Versus Agency		
Fund Balance per Treasury	$ 480,346.1	$ 492,296.4
Less: Fund Balance per Agency	(480,352.3)	(482,661.7)
Reconciling Amount	**$ (6.2)**	**$ 9,634.7**

Other Fund Types primarily consist of deposit funds and receipt accounts. These funds represent receipts held temporarily for distribution to another fund or entity or held as an agent for others.

The Department shows a reconciling net difference of $6.2 million with the U.S. Department of the Treasury (Treasury) between the Department's financial statement records and Treasury. The Department received allocation transfers as the "child." As "parent," the Department issued allocation transfers to other Federal Government agencies for execution on behalf of the Department. For additional information, refer to Note 1, Significant Accounting Policies, Section 1C. Additionally, Fiduciary Activities are not reported in FBWT in accordance with *SFFAS 31, "Accounting for Fiduciary Activities*."

The Department's fund balance per Treasury (FBPT), in FY 2014 does not include $10.1 billion in canceling year authority while the FBPT in FY 2013 includes $9.1 billion in canceling year authority. During FY 2014, Treasury revised the Treasury Financial Manual to require a corresponding Treasury warrant returning canceling funds to Treasury in the year the funds cancel.

Status of Fund Balance with Treasury *As of September 30*	Dollars in Millions 2014	2013
Unobligated Balances		
Available	$ 115,757.0	$ 113,939.3
Unavailable	717,096.9	643,857.4
Total Unobligated Balance	**832,853.9**	**757,796.7**
Obligated Balance not yet Disbursed	**430,993.0**	**437,665.8**
Non-Budgetary FBWT	**1,530.5**	**1,654.7**
Non-FBWT Budgetary Accounts	**(785,025.1)**	**(714,455.5)**
Total Fund Balance	**$ 480,352.3**	**$ 482,661.7**

The Status of 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 set aside to cover future obligations. The unavailable balance consists primarily of funds invested in U.S. Treasury securities and 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 public laws establishing the funds.

Obligated Balance not yet Disbursed represents funds obligated for goods and services but not paid.

Non-Budgetary FBWT includes accounts without 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, and receivables.

NOTE 4. INVESTMENTS AND RELATED INTEREST

Investments and Related Interest					*Dollars in Millions*
	2014				
As of September 30	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities					
Nonmarketable, Market-Based					
Military Retirement Fund	$ 560,971.3	See Below	$ (20,188.8)	$ 540,782.5	$ 588,892.3
Medicare-Eligible Retiree Health Care Fund	235,537.5	See Below	(10,190.3)	225,347.2	254,136.4
US Army Corps of Engineers	8,610.7	See Below	(104.6)	8,506.1	8,564.7
Other Funds	2,915.0	See Below	(130.8)	2,784.2	2,873.8
Total Nonmarketable, Market-Based	**$ 808,034.5**		**$ (30,614.5)**	**$ 777,420.0**	**$ 854,467.2**
Accrued Interest	6,316.3			6,316.3	6,316.3
Total Intragovernmental Securities	**$ 814,350.8**		**$ (30,614.5)**	**$ 783,736.3**	**$ 860,783.5**
Other Investments					
Total Other Investments	$ 3,371.9	See Below	$ 0.0	$ 3,371.9	N/A
Amortization Method Used: Effective Interest					

Investments and Related Interest					*Dollars in Millions*
	2013				
As of September 30	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities					
Nonmarketable, Market-Based					
Military Retirement Fund	$ 494,977.7	See Below	$ (15,416.9)	$ 479,560.8	$ 522,376.6
Medicare-Eligible Retiree Health Care Fund	223,228.7	See Below	(8,291.7)	214,937.0	242,383.0
US Army Corps of Engineers	8,100.0	See Below	(127.3)	7,972.7	8,078.3
Other Funds	3,213.4	See Below	(114.9)	3,098.5	3,231.5
Total Nonmarketable, Market-Based	**$ 729,519.8**		**$ (23,950.8)**	**$ 705,569.0**	**$ 776,069.4**
Accrued Interest	5,928.5			5,928.5	5,928.5
Total Intragovernmental Securities	**$ 735,448.3**		**$ (23,950.8)**	**$ 711,497.5**	**$ 781,997.9**
Other Investments					
Total Other Investments	$ 3,333.9	See Below	$ 0.0	$ 3,333.9	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. 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 authorized funds 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 these funds. Cash generated 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. Governmentwide financial statements.

The U.S. Treasury securities provide the Department with authority to access funds to make future benefit payments or other expenditures. When the Department requires redemption of securities to make expenditures, the Federal Government will meet the requirement by using accumulated cash balances, 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 $1.7 billion in investments of the DoD Education Benefits Trust Fund, $846.1 million in investments of the Support for U.S. Relocation to Guam Activities Trust Fund, and $228.2 million in investments of the Voluntary Separation Incentive Trust Fund.

Other Investments consists of Military Housing Privatization Initiative limited partnerships. The Department invests in nongovernmental entities involved in the acquisition or construction of family housing and supporting facilities at Army, Air Force, Navy, and Marine Corps installations. The Department provides cash, land, or facilities as equity, but has no management role. A limited partnership arrangement operates purely as a private business and does not require Market Value Disclosure.

NOTE 5. ACCOUNTS RECEIVABLE

Accounts Receivable As of September 30	2014 Gross Amount Due		Allowance for Estimated Uncollectibles		Accounts Receivable, Net *Dollars in Millions*	
Intragovernmental Receivables	$	1,466.5		N/A	$	1,466.5
Non-Federal Receivables (From the Public)		7,099.2		(579.3)		6,519.9
Total Accounts Receivable	**$**	**8,565.7**	**$**	**(579.3)**	**$**	**7,986.4**

Accounts Receivable As of September 30	2013 Gross Amount Due		Allowance for Estimated Uncollectibles		Accounts Receivable, Net *Dollars in Millions*	
Intragovernmental Receivables	$	1,284.2		N/A	$	1,284.2
Non-Federal Receivables (From the Public)		11,262.8		(806.6)		10,456.2
Total Accounts Receivable	**$**	**12,547.0**	**$**	**(806.6)**	**$**	**11,740.4**

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

NOTE 6. OTHER ASSETS

Other Assets *As of September 30*	*Dollars in Millions* 2014		2013	
Intragovernmental Other Assets				
Advances and Prepayments	$	1,290.9	$	1,620.2
Other Assets		149.7		137.4
Total Intragovernmental Other Assets	**$**	**1,440.6**	**$**	**1,757.6**
Non-Federal Other Assets				
Outstanding Contract Financing Payments	$	70,104.9	$	68,594.7
Advances and Prepayments		4,431.5		3,681.4
Other Assets (With the Public)		180.1		190.8
Total Non-Federal Other Assets	**$**	**74,716.5**	**$**	**72,466.9**
Total Other Assets	**$**	**76,157.1**	**$**	**74,224.5**

Intragovernmental Other Assets are largely related to the Department's right to approximately 6.4 million barrels of crude oil, net book value of $124.9 million, held by the Department of Energy. Also included are pending offsets valued at $24.8 million from General Service Administration for returned inventory.

The Other Assets (With the Public) balance is largely the result of Advance Payment Pool Agreements (APPAs) for research and development projects. APPAs 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 Department, protecting the contract work from state or local taxation, liens or attachment by contractors' creditors, transfer of property, or disposition in bankruptcy. However, these rights should not be misconstrued to mean that ownership of contractors' work has transferred to the Department. The Department 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 $66.3 billion in contract financing payments and an additional $3.8 billion in estimated future payments to contractors upon delivery and government acceptance. Refer to Note 15, Other Liabilities, for further information.

Note 7. Cash and Other Monetary Assets

Cash and Other Monetary Assets		*Dollars in Millions*
As of September 30	**2014**	**2013**
Cash	$ 328.3	$ 430.7
Foreign Currency	958.2	1,099.0
Total Cash, Foreign Currency, and Other Monetary Assets	**$ 1,286.5**	**$ 1,529.7**

The majority of Cash and Foreign Currency represent nonentity assets and are restricted and unavailable to fund the Department's mission. Cash also includes unrestricted entity assets of $88.8 million comprised of undeposited collections, imprest funds and other cash.

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 other recoveries

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

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

Military Housing Privatization Initiative

The MHPI includes both direct loan and loan guarantee programs. The programs are authorized by the *National Defense Authorization Act for FY 1996* (PL 104-106, Section 2801) and includes a series of authorities allowing 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 obtains private sector capital to leverage government funds. The Department provides protection to private sector partners 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 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. Revenue offsets overhead costs for operation, maintenance, and environmental cleanup at the facilities.

The Army instituted an ARMS loan guarantee moratorium in FY 2004 and is in the process of closing this program.

Summary of Direct Loans and Loan Guarantees	*Dollars in Millions*	
	2014	2013
Loans Receivable		
Direct Loans:		
Military Housing Privatization Initiative	$ 1,452.2	$ 1,267.7
Total Direct Loans	**$ 1,452.2**	**$ 1,267.7**
Total Loans Receivable	**$ 1,452.2**	**$ 1,267.7**
Loan Guarantee Liability		
Military Housing Privatization Initiative	$ 56.8	$ 45.8
Armament Retooling & Manufacturing Support Initiative	0.0	0.0
Total Loan Guarantee Liability	**$ 56.8**	**$ 45.8**

Direct Loans Obligated	*Dollars in Millions*	
	2014	2013
Direct Loans Obligated After FY 1991 (Present Value Method):		
Military Housing Privatization Initiative		
Loans Receivable Gross	$ 1,493.4	$ 1,355.8
Allowance for Subsidy Cost (Present Value)	(41.2)	(88.1)
Value of Assets Related to Direct Loans, Net	**1,452.2**	**1,267.7**
Total Direct Loans Receivable	**$ 1,452.2**	**$ 1,267.7**

Direct Loans Receivable does not represent 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*	
	2014	2013
Direct Loan Programs		
Military Housing Privatization Initiative	$ 146.5	$ 241.3
Total	**$ 146.5**	**$ 241.3**

Subsidy Expense for Direct Loan by Program					*Dollars in Millions*
2014	Interest Differential	Defaults	Fees	Other	Total
New Direct Loans Disbursed					
Military Housing Privatization Initiative	$ 5.8	$ 18.1	$ 0.0	$ 0.0	$ 23.9
Total	**$ 5.8**	**$ 18.1**	**$ 0.0**	**$ 0.0**	**$ 23.9**
2013	Interest Differential	Defaults	Fees	Other	Total
New Direct Loans Disbursed					
Military Housing Privatization Initiative	$ 5.9	$ 34.9	$ 0.0	$ 0.0	$ 40.8
Total	**$ 5.9**	**$ 34.9**	**$ 0.0**	**$ 0.0**	**$ 40.8**
2014	Modifications	Interest Rate Reestimates	Technical Reestimates	Total	
Direct Loan Modifications and Reestimates					
Military Housing Privatization Initiative	$ 0.0	$ (8.3)	$ (53.0)	$ (61.3)	
Total	**$ 0.0**	**$ (8.3)**	**$ (53.0)**	**$ (61.3)**	
2013	Modifications	Interest Rate Reestimates	Technical Reestimates	Total	
Direct Loan Modifications and Reestimates					
Military Housing Privatization Initiative	$ 0.0	$ (10.7)	$ (84.0)	$ (94.7)	
Total	**$ 0.0**	**$ (10.7)**	**$ (84.0)**	**$ (94.7)**	
	2014	**2013**			
Total Direct Loan Subsidy Expense:					
Military Housing Privatization Initiative	$ (37.4)	$ (53.9)			
Total	**$ (37.4)**	**$ (53.9)**			

Subsidy Expense for Direct Loan by Program					
As of September 30, 2014	Interest Differential	Defaults	Fees	Other	Total
Budget Subsidy Rates for Direct Loans					
Military Housing Privatization Initiative	0.0%	0.0%	0.0%	0.0%	0.0%

Subsidy rates pertain to loan agreements contracted during the current fiscal year. There were no new loan agreements.

These rates cannot be applied to direct loans disbursed during the current reporting year to yield the subsidy expense. Subsidy expense for new loans disbursed in the current year results from disbursements of loans from current and prior year loan agreements. 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*	**2014**	**2013**
Beginning Balance, Changes, and Ending Balance:		
Beginning Balance of the Subsidy Cost Allowance	**$ 88.1**	**$ 162.1**
Add: Subsidy Expense for Direct Loans Disbursed during the Reporting Years by Component		
Interest Rate Differential Costs	5.8	5.9
Default Costs (Net of Recoveries)	18.1	34.9
Total of the above Subsidy Expense Components	**$ 23.9**	**$ 40.8**
Adjustments		
Subsidy Allowance Amortization	(9.5)	(10.4)
Other	0.0	(9.7)
Total of the above Adjustment Components	**$ (9.5)**	**$ (20.1)**
Ending Balance of the Subsidy Cost Allowance before Reestimates	**$ 102.5**	**$ 182.8**
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimates	$ (8.3)	$ (10.7)
Technical/Default Reestimate	(53.0)	(84.0)
Total of the above Reestimate Components	**(61.3)**	**(94.7)**
Ending Balance of the Subsidy Cost Allowance	**$ 41.2**	**$ 88.1**

Defaulted Guaranteed Loans *As of September 30* *Dollars in Millions*	**2014**	**2013**
Defaulted Guaranteed Loans from Post-FY 1991 Guarantees (Present Value Method):		
Armament Retooling & Manufacturing Support Initiative		
Defaulted Guaranteed Loans Receivable, Gross	$ 0.0	$ 0.7
Allowance for Subsidy Cost (Present Value)	0.0	(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	
2014		
Guaranteed Loans Outstanding		
Military Housing Privatization Initiative	$ 854.4	$ 854.4
Total	**$ 854.4**	**$ 854.4**
2013		
Guaranteed Loans Outstanding		
Military Housing Privatization Initiative	$ 670.8	$ 670.8
Total	**$ 670.8**	**$ 670.8**
2014		
New Guaranteed Loans Disbursed		
Military Housing Privatization Initiative	$ 183.5	$ 183.5
Total	**$ 183.5**	**$ 183.5**
2013		
New Guaranteed Loans Disbursed		
Military Housing Privatization Initiative	$ 222.5	$ 222.5
Total	**$ 222.5**	**$ 222.5**

Liabilities for Loan Guarantees *As of September 30*	2014	2013
	Dollars in Millions	
Liabilities for Loan Guarantee from Post 1991 (Present Value)		
Military Housing Privatization Initiative	$ 56.8	$ 45.8
Armament Retooling & Manufacturing Support Initiative	0.0	0.0
Total Loan Guarantee Liability (Post FY 1991)	**$ 56.8**	**$ 45.8**
Total Loan Guarantee Liability	**$ 56.8**	**$ 45.8**

Subsidy Expense for Direct Loan by Program

As of September 30 — *Dollars in Millions*

2014	Interest Differential	Defaults	Fees	Other	Total
New Loan Guarantees Disbursed					
Military Housing Privatization Initiative	$ 0.0	$ 11.3	$ 0.0	$ 0.0	$ 11.3
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	0.0	0.0	0.0
Total	**$ 0.0**	**$ 11.3**	**$ 0.0**	**$ 0.0**	**$ 11.3**
2013	**Interest Differential**	**Defaults**	**Fees**	**Other**	**Total**
New Loan Guarantees Disbursed					
Military Housing Privatization Initiative	$ 0.0	$ 33.7	$ 0.0	$ 0.0	$ 33.7
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	0.0	0.0	0.0
Total	**$ 0.0**	**$ 33.7**	**$ 0.0**	**$ 0.0**	**$ 33.7**
2014	**Modifications**	**Interest Rate Reestimates**	**Technical Reestimates**	**Total Reestimates**	**Total**
Modifications and Reestimates					
Military Housing Privatization Initiative	$ 0.0	$ 1.2	$ (3.0)	$ (1.8)	$ (1.8)
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	0.0	0.0	0.0
Total	**$ 0.0**	**$ 1.2**	**$ (3.0)**	**$ (1.8)**	**$ (1.8)**
2013	**Modifications**	**Interest Rate Reestimates**	**Technical Reestimates**	**Total Reestimates**	**Total**
Modifications and Reestimates					
Military Housing Privatization Initiative	$ 0.0	$ (0.9)	$ (0.3)	$ (1.2)	$ (1.2)
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	(1.1)	(1.1)	(1.1)
Total	**$ 0.0**	**$ (0.9)**	**$ (1.4)**	**$ (2.3)**	**$ (2.3)**

	2014	2013
Total Loan Guarantee		
Military Housing Privatization Initiative	$ 9.5	$ 32.5
Armament Retooling & Manufacturing Support Initiative	0.0	(1.1)
Total	**$ 9.5**	**$ 31.4**

The Department incurred two new loan guarantees after determining the projects were more advantageous to administer these projects as loan guarantees rather than direct loans.

Subsidy Expense for Direct Loan by Program

As of September 30, 2014	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%

Subsidy rates pertain to loan agreements contracted during the current fiscal year. There were no new loan agreements.

These rates cannot be applied to loan guarantees agreed to during the current reporting year to yield the subsidy expense. Subsidy expense reported in the current year also includes reestimates.

Schedule for Reconciling Loan Guarantee Liability Balances for Post-FY 1991 Loan Guarantees *As of September 30*	*Dollars in Millions* **2014**	**2013**
Beginning Balance, Changes, and Ending Balance		
Beginning Balance of the Loan Guarantee Liability	**$ 45.8**	**$ 12.7**
Add: Subsidy Expense for Guaranteed Loans Disbursed during the Reporting Years by Component		
Default Costs (Net of Recoveries)	11.3	33.7
Total of the above Subsidy Expense Components	**$ 11.3**	**$ 33.7**
Adjustments		
Interest Accumulation on the Liability Balance	1.5	1.7
Total of the above Adjustments	**$ 1.5**	**$ 1.7**
Ending Balance of the Loan Guarantee Liability before Reestimates	**$ 58.6**	**$ 48.1**
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimate	$ 1.2	$ (0.9)
Technical/Default Reestimate	(3.0)	(1.4)
Total of the above Reestimate Components	**$ (1.8)**	**(2.3)**
Ending Balance of the Loan Guarantee Liability	**$ 56.8**	**$ 45.8**

Administrative Expenses

Administrative Expenses are limited to separately identified expenses for administering pre-FY 1992 and post-FY 1991 Direct Loans and Loan Guarantee Programs. The Department does not maintain a separate program to capture 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* **2014**	**2013**
Inventory, Net	$ 95,250.2	$ 85,368.0
Operating Materiel & Supplies, Net	165,741.9	168,110.0
Stockpile Materiel, Net	504.7	519.5
Total Inventory and Related Property	**$ 261,496.8**	**$ 253,997.5**

Inventory, Net				Dollars in Millions
	2014			Valuation Method
As of September 30	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	
Inventory Categories				
Available and Purchased for Resale	$ 63,216.9	$ 21.3	$ 63,238.2	FIFO,LAC, MAC
Held for Repair	33,607.1	(3,345.1)	30,262.0	LAC,MAC
Excess, Obsolete, and Unserviceable	468.0	(235.8)	232.2	NRV
Raw Materiel	1,484.5	0.0	1,484.5	MAC,SP,LAC
Work in Process	33.3	0.0	33.3	AC
Total Inventory, Net	**$ 98,809.8**	**$ (3,559.6)**	**$ 95,250.2**	

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
FIFO = First In, First Out

Inventory, Net				Dollars in Millions
	2013			Valuation Method
As of September 30	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	
Inventory Categories				
Available and Purchased for Resale	$ 57,101.0	$ (3,402.3)	$ 53,698.7	FIFO,LAC, MAC
Held for Repair	34,312.3	(4,105.8)	30,206.5	LAC,MAC
Excess, Obsolete, and Unserviceable	6,967.1	(6,967.1)	0.0	NRV
Raw Materiel	1,412.4	0.0	1,412.4	MAC,SP,LAC
Work in Process	50.4	0.0	50.4	AC
Total Inventory, Net	**$ 99,843.2**	**$ (14,475.2)**	**$ 85,368.0**	

Legend for Valuation Methods:

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

Abnormal Balance

Inventory, Available and Purchased for Resale, Revaluation Allowance, includes an abnormal balance due to reduction in the cost of items during the Department's transition to LAC valuation. The Department inventory evaluation transition efforts are ongoing.

Inventory Restrictions

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

- War reserve materiel valued at $1.4 billion;
- Commissary items valued at $377.6 million held for purchase by authorized patrons; and
- Dispositions pending litigation or negotiation valued at $73.7 million.

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

General Composition of Inventory

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

- 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 on asset type and condition.

Items transferred from the Military Services and awaiting sale, disposal, or reuse are valued at $232.2 million.

Operating Materiel and Supplies, Net				*Dollars in Millions*
	2014			**Valuation Method**
As of September 30	**OM&S, Gross Value**	**Revaluation Allowance**	**OM&S, Net**	
OM&S Categories				
Held for Use	$ 138,507.5	$ 0.0	$ 138,507.5	SP, LAC, MAC
Held for Repair	27,235.5	(1.1)	27,234.4	SP, LAC, MAC
Excess, Obsolete, and Unserviceable	2,373.4	(2,373.4)	0.0	NRV
Total OM&S	**$ 168,116.4**	**$ (2,374.5)**	**$ 165,741.9**	
Legend for Valuation Methods:				
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses			NRV = Net Realizable Value	
SP = Standard Price			MAC = Moving Average Cost	

Operating Materiel and Supplies, Net				*Dollars in Millions*
	2013			**Valuation Method**
As of September 30	**OM&S, Gross Value**	**Revaluation Allowance**	**OM&S, Net**	
OM&S Categories				
Held for Use	$ 142,845.3	$ (8.7)	$ 142,836.6	SP, LAC, MAC
Held for Repair	25,285.3	(11.9)	25,273.4	SP, LAC, MAC
Excess, Obsolete, and Unserviceable	2,134.8	(2,134.8)	0.0	NRV
Total OM&S	**$ 170,265.4**	**$ (2,155.4)**	**$ 168,110.0**	
Legend for Valuation Methods:				
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses			NRV = Net Realizable Value	
SP = Standard Price			MAC = Moving Average Cost	

OM&S 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 when 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 to a category based on asset type and condition.

Stockpile Materiel, Net				*Dollars in Millions*
	2014			
As of September 30	Stockpile, Materiel Amount	Allowance for Gains (Losses)	Stockpile, Materiel, Net	Valuation Method
Stockpile Materiel Categories				
Held for Sale	$ 156.4	$ 0.0	$ 156.4	AC, LCM
Held for Reserve for Future Sale	348.3	0.0	348.3	AC, LCM
Total Stockpile Materiel	**$ 504.7**	**$ 0.0**	**$ 504.7**	
Legend for Valuation Methods:				
AC = Actual Cost			LCM = Lower of Cost or Market	

Stockpile Materiel, Net				*Dollars in Millions*
	2013			
As of September 30	Stockpile, Materiel Amount	Allowance for Gains (Losses)	Stockpile, Materiel, Net	Valuation Method
Stockpile Materiel Categories				
Held for Sale	$ 424.5	$ 0.0	$ 424.5	AC, LCM
Held for Reserve for Future Sale	95.0	0.0	95.0	AC, LCM
Total Stockpile Materiel	**$ 519.5**	**$ 0.0**	**$ 519.5**	
Legend for Valuation Methods:				
AC = Actual Cost			LCM = Lower of Cost or Market	

Stockpile Materiel 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 reclassifies from Materiel Held in Reserve to Materiel Held for Sale. The estimated market price of stockpile materiel held for sale as of fourth quarter, FY 2014, is $1.5 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					*Dollars in Millions*
	2014				
As of September 30	Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value
Major Asset Classes					
Land	N/A	N/A	$ 10,839.7	N/A	$ 10,839.7
Buildings, Structures, and Facilities	S/L	20 or 40	271,646.2	(130,690.4)	140,955.8
Leasehold Improvements	S/L	Lease term	508.6	(196.5)	312.1
Software	S/L	2 – 5 or 10	11,766.6	(8,363.4)	3,403.2
General Equipment	S/L	5 or 10	991,917.6	(571,601.8)	420,315.8
Assets Under Capital Lease[1]	S/L	Lease term	632.6	(461.8)	170.8
Construction-in-Progress	N/A	N/A	42,109.9	N/A	42,109.9
Other			891.8	(1.9)	889.9
Total General PP&E			**$ 1,330,313.0**	**$ (711,315.8)**	**$ 618,997.2**

[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					*Dollars in Millions*
	2013				
As of September 30	Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value
Major Asset Classes					
Land	N/A	N/A	$ 10,781.2	N/A	$ 10,781.2
Buildings, Structures, and Facilities	S/L	20 or 40	269,766.1	(127,980.0)	141,786.1
Leasehold Improvements	S/L	Lease term	403.8	(167.9)	235.9
Software	S/L	2 – 5 or 10	11,024.7	(8,038.9)	2,985.8
General Equipment	S/L	5 or 10	983,628.4	(547,669.3)	435,959.1
Assets Under Capital Lease[1]	S/L	Lease term	632.8	(438.5)	194.3
Construction-in-Progress	N/A	N/A	46,635.7	N/A	46,635.7
Other			1,035.8	(2.0)	1,033.8
Total General PP&E			**$ 1,323,908.5**	**$ (684,296.6)**	**$ 639,611.9**

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

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. Extensive efforts are in progress to achieve audit readiness. The ongoing discovery and validation phases identify adjustments to values resulting in current year gains/losses.

Other General Property, Plant, and Equipment includes assets awaiting disposition.

Heritage Assets and Stewardship Land

The Department's policy is to preserve its heritage assets including items of historical, cultural, educational, or artistic importance. The Department, with minor exceptions, uses the buildings and stewardship land in its daily activities and includes the buildings on the Balance Sheet as multi-use heritage assets.

Differences in heritage asset quantities from the FY 2013 ending to the FY 2014 beginning unit counts resulted from periodic reviews.

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

- Buildings and Structures are listed, or eligible for listing, on the National Register of Historic Places, including Multi-Use Heritage Assets.
- Archeological Sites are listed, or eligible for listing, on the National Register of Historic Places in accordance with Section 110 of the National Historic Preservation Act.
- Museum Collection Items are considered unique due to historical, natural, cultural, educational, artistic, technical, or architectural significance.

The Department is unable to identify quantities of heritage assets and stewardship land added through donation or devise due to limitations of the Department's financial and nonfinancial management processes and systems.

Categories	Measure Quantity	As of 9/30/13	Additions	Deletions	As of 9/30/14
Buildings and Structures	Each	55,996	53	(884)	55,165
Archeological Sites	Each	30,067	404	(28)	30,443
Museum Collection Items (Objects, not including fine art)	Each	1,247,150	868	(5,508)	1,242,510
Museum Collection Items (Objects, fine art)	Each	56,317	884	(247)	58,954

Differences in the heritage assets quantities from the FY 2013 ending to the FY 2014 beginning unit counts resulted from periodic reviews of museum collections.

Stewardship land includes both 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 at no cost, regardless of its use, is classified as Stewardship Land.

Stewardship land is categorized 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 9/30/13 *(Acres in Thousands)*	Additions	Deletions	As of 9/30/14
9110	Government Owned Land	6,552	0	0	6,552
9111	State Owned Land	5	0	0	5
9120	Withdrawn Public Land	15,396	0	(1)	15,395
9130	Licensed and Permitted Land	944	4	0	948
9140	Public Land	11	0	0	11
9210	Land Easement	379	0	0	379
9220	In-leased Land	124	0	0	124
9230	Foreign Land	297	0	0	297
	Grand Total				**23,711**
	Total – All Other Lands				**8,300**
	Total – Stewardship Lands				**15,411**

Differences in the stewardship land quantities from the FY 2013 ending to the FY 2014 beginning unit counts resulted from periodic reviews.

Assets Under Capital Lease *As of September 30*	*Dollars in Millions* 2014	2013
Entity as Lessee, Assets Under Capital Lease		
Land and Buildings	$ 260.0	$ 260.0
Equipment	372.6	372.9
Accumulated Amortization	(461.8)	(438.5)
Total Capital Leases	**$ 170.8**	**$ 194.4**

Note 11. Liabilities Not Covered by Budgetary Resources

Liabilities Not Covered by Budgetary Resources *As of September 30*	*Dollars in Millions* 2014	2013
Intragovernmental Liabilities		
Accounts Payable	$ 0.0	$ 2.2
Debt	1.5	1.7
Other	2,139.4	1,936.8
Total Intragovernmental Liabilities	**$ 2,140.9**	**$ 1,940.7**
Non-Federal Liabilities		
Accounts Payable	$ 139.9	$ 206.2
Military Retirement and Other Federal Employment Benefits	1,656,417.2	1,670,714.4
Environmental and Disposal Liabilities	54,855.7	54,593.4
Other Liabilities	14,700.0	15,726.6
Total Non-Federal Liabilities	**$ 1,726,112.8**	**$ 1,741,240.6**
Total Liabilities Not Covered by Budgetary Resources	**$ 1,728,253.7**	**$ 1,743,181.3**
Total Liabilities Covered by Budgetary Resources	**$ 730,285.7**	**$ 668,945.9**
Total Liabilities	**$ 2,458,539.4**	**$ 2,412,127.2**

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

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 expected to be completed by 2023. The related reimbursement to the Department from Arlington County and Falls Church, Virginia, is recorded as non-Federal accounts receivable.

Environmental and Disposal Liabilities represents the Department's liability for existing and anticipated environmental cleanup and disposal. Refer to Note 14, Environmental and Disposal Liabilities, for additional details.

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

Non-Federal Other Liabilities consists primarily 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 $560.9 billion in health benefit liabilities. Refer to Note 17, Military Retirement and Other Federal Employment Benefits, for additional details.

NOTE 12. ACCOUNTS PAYABLE

Accounts Payable			*Dollars in Millions*
	2014		
As of September 30	**Accounts Payable**	**Interest, Penalties, and Administrative Fees**	**Total**
Intragovernmental Payables	$ 1,911.2	N/A	$ 1,911.2
Non-Federal Payables (To the Public)	17,871.5	18.4	17,889.9
Total Accounts Payable	**$ 19,782.7**	**$ 18.4**	**$ 19,801.1**

Accounts Payable			*Dollars in Millions*
	2013		
As of September 30	**Accounts Payable**	**Interest, Penalties, and Administrative Fees**	**Total**
Intragovernmental Payables	$ 1,574.7	N/A	$ 1,574.7
Non-Federal Payables (To the Public)	20,138.9	10.2	20,149.1
Total Accounts Payable	**$ 21,713.6**	**$ 10.2**	**$ 21,723.8**

Accounts Payable includes amounts owed to Federal and non-Federal entities for goods and services received by the Department. The Department's systems do not track intragovernmental accounts payable transactions by customer. Buyer-side accounts payable are adjusted to agree with interagency seller-side accounts receivable by: (1) reclassifying amounts between Federal and non-Federal accounts payable, (2) accruing additional accounts payable and expenses, and (3) applying both supported and unsupported undistributed disbursements at the reporting entity level.

NOTE 13. DEBT

Debt As of September 30	2014 Beginning Balance	2014 Net Borrowing	2014 Ending Balance
			Dollars in Millions
Agency Debt (Intragovernmental)			
Debt to the Treasury	$ 1,174.7	$ 217.6	$ 1,392.3
Total Agency Debt	**$ 1,174.7**	**$ 217.6**	**$ 1,392.3**

Debt As of September 30	2013 Beginning Balance	2013 Net Borrowing	2013 Ending Balance
			Dollars in Millions
Agency Debt (Intragovernmental)			
Debt to the Treasury	$ 952.6	$ 222.1	$ 1,174.7
Total Agency Debt	**$ 952.6**	**$ 222.1**	**$ 1,174.7**

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., local governments or housing builders) default. For loan guarantees, the Department must pay the amount of outstanding principal guaranteed.

NOTE 14. ENVIRONMENTAL AND DISPOSAL LIABILITIES

Environmental and Disposal Liabilities *As of September 30*	**2014**	**2013**
Dollars in Millions		
Environmental Liabilities–Non-Federal		
Accrued Environmental Restoration Liabilities		
Active Installations – Installation Restoration Program (IRP) and Building Demolition and Debris Removal (BD/DR)	$ 10,125.1	$ 10,026.3
Active Installations – Military Munitions Response Program (MMRP)	3,548.0	3,416.9
Formerly Used Defense Sites – IRP & BD/DR	2,896.5	3,018.8
Formerly Used Defense Sites – MMRP	10,427.1	10,096.8
Other Accrued Environmental Liabilities – Non-BRAC		
Environmental Corrective Action	$ 1,673.4	$ 1,005.9
Environmental Closure Requirements	1,830.8	1,824.6
Environmental Response at Operational – Ranges	123.2	128.7
Asbestos	1,030.2	1,030.7
Non-Military Equipment	571.9	575.7
Other	998.0	1,107.9
Base Realignment and Closure Installations (BRAC)		
Installation Restoration Program	$ 3,121.3	$ 3,394.9
Military Munitions Response Program	796.1	690.3
Environmental Corrective Action/Closure Requirements	285.5	197.6
Asbestos	7.1	0.3
Environmental Disposal for Military Equipment/Weapons Programs		
Nuclear Powered Military Equipment/Spent Nuclear Fuel	$ 14,325.4	$ 14,076.4
Non-Nuclear Powered Military Equipment	36.4	36.4
Other Weapons Systems	131.9	147.5
Chemical Weapons Disposal Program		
Chemical Demilitarization – Chemical Materials Agency (CMA)	$ 882.6	$ 1,503.8
CAMD Demilitarization – Assembled Chemical Weapons Alternatives (ACWA)	5,770.9	6,054.4
Total Environmental Liabilities	**$ 58,581.4**	**$ 58,333.9**

Other Accrued Environmental Liabilities, Non-Base Realignment and Closure (Non-BRAC), Other consists primarily of Formerly Utilized Sites Remedial Action Program (FUSRAP) remediation of radiological contamination. The FUSRAP is a shared program between the Department and the Department of Energy's U.S. Atomic Energy and Weapons Program.

The unrecognized portion of the estimated total cleanup costs associated with General Property, Plant, and Equipment (PP&E) is currently $3.1 billion. The amount estimated is not complete and does not accurately reflect the Department's total unrecognized costs associated with General PP&E. The Department is implementing procedures to address deficiencies.

Types of Environmental Liabilities and Disposal Liabilities Identified

The Department has cleanup requirements for the Defense Environmental Restoration Program (DERP) for active installations, BRAC installations, and Formerly Used Defense Sites. The Department has additional cleanup requirements for active installations 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 from past waste disposal practices, leaks, spills, and other activity resulting in 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.

The Department follows the *Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA, Public Law 96-510)*, *Superfund Amendments and Reauthorization Act of 1986 (SARA, Public Law 99-499)*, *Resource Conservation and Recovery Act (RCRA, Public Law 94-580)* 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 with partial responsibility for environmental restoration. Failure to comply with agreements and legal mandates puts the Department at risk of incurring fines and penalties.

Laws concerning cleanup requirements for nuclear-powered naval vessels govern the Department's environmental policy and regulations. The *Atomic Energy Act of 1954*, as amended, assures the proper management of source, special nuclear, and byproduct materiel. The Department coordinates nuclear power actions with the Department of Energy. The *Nuclear Waste Policy Act of 1982 (Public Law 97-425)* requires owners and generators of high-level nuclear waste and spent nuclear fuel to pay their share of the cost of the program. The *Low-Level Radioactive Waste Policy Amendments Act of 1985 (Public Law 99-240)* 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)* directing the Department to destroy the unitary chemical stockpile per 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 project 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*, *DoD Modeling and Simulation Verification, Validation, and Accreditation*, and estimates liabilities based on data received during preliminary assessment and 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 charge costs to current operating periods. The Department expensed cleanup costs for General PP&E placed into service prior to October 1, 1997, unless costs are to be recovered through user charges. As costs are recovered, the Department expenses cleanup costs associated with 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 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 when the asset is placed into service.

In accordance with reporting requirements for asbestos, the Department reports liabilities for buildings and facilities containing both friable and non-friable asbestos. At this time the Department is unable to reasonably estimate an amount of the total cleanup costs related to friable and nonfriable asbestos. Of the Other Accrued Environmental Liabilities – Non-BRAC for Asbestos reported above, $8.7 million is related to the recognized cleanup costs for nonfriable asbestos.

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

The Department revised estimates resulting from overlooked or previously unknown contaminants, re-estimation based on different assumptions, and other changes in project scope. Although the Department is unaware of pending changes, environmental liabilities are subject to changes in laws and regulations, agreements with regulatory agencies, and advances in technology.

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

Accounting estimates for environmental liabilities use reasonable judgments and assumptions based on available information. Actual results may materially vary 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 differing from estimate parameters.

The Department is responsible for environmental restoration and corrective action for buried chemical munitions and agents; however, it is unable to provide a reasonable estimate because the extent of the buried chemical munitions and agents is unknown. The Department also cannot 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 may incur costs for restoration initiatives in conjunction with returning overseas Defense facilities to host nations. The Department is unable to provide a reasonable estimate because the extent of required restoration is unknown.

NOTE 15. OTHER LIABILITIES

Other Liabilities *As of September 30*	2014 *Dollars in Millions*					
	Current Liability		Noncurrent Liability		Total	
Intragovernmental						
Advances from Others	$	527.5	$	0.0	$	527.5
Deposit Funds and Suspense Account Liabilities		1,216.8		0.0		1,216.8
Disbursing Officer Cash		1,378.9		0.0		1,378.9
Judgment Fund Liabilities		600.4		0.0		600.4
FECA Reimbursement to the Department of Labor		591.0		698.0		1,289.0
Custodial Liabilities		767.3		2,170.0		2,937.3
Employer Contribution and Payroll Taxes Payable		430.0		0.0		430.0
Other Liabilities		366.9		0.0		366.9
Total Intragovernmental Other	**$**	**5,878.8**	**$**	**2,868.0**	**$**	**8,746.8**
Non-Federal						
Accrued Funded Payroll and Benefits	$	9,814.9	$	0.0	$	9,814.9
Advances from Others		4,725.6		0.0		4,725.6
Deposit Funds and Suspense Accounts		240.7		0.0		240.7
Nonenvironmental Disposal Liabilities						
Military Equipment (Nonnuclear)		151.8		73.9		225.7
Excess/Obsolete Structures		63.8		277.4		341.2
Conventional Munitions Disposal		0.0		2,078.3		2,078.3
Accrued Unfunded Annual Leave		10,410.6		0.0		10,410.6
Capital Lease Liability		161.1		6.5		167.6
Contract Holdbacks		963.2		25.0		988.2
Employer Contribution and Payroll Taxes Payable		599.9		0.0		599.9
Contingent Liabilities		194.3		5,969.3		6,163.6
Other Liabilities		189.1		0.0		189.1
Total Non-Federal Other Liabilities	**$**	**27,515.0**	**$**	**8,430.4**	**$**	**35,945.4**
Total Other Liabilities	**$**	**33,393.8**	**$**	**11,298.4**	**$**	**44,692.2**

Other Liabilities As of September 30	2013 Current Liability		2013 Noncurrent Liability		2013 Total	Dollars in Millions
Intragovernmental						
Advances from Others	$	733.0	$	0.0	$	733.0
Deposit Funds and Suspense Account Liabilities		1,242.6		0.0		1,242.6
Disbursing Officer Cash		1,577.7		0.0		1,577.7
Judgment Fund Liabilities		234.3		0.0		234.3
FECA Reimbursement to the Department of Labor		621.3		707.7		1,329.0
Custodial Liabilities		4,498.7		2,383.7		6,882.4
Employer Contribution and Payroll Taxes Payable		397.3		0.0		397.3
Other Liabilities		491.4		0.0		491.4
Total Intragovernmental Other	**$**	**9,796.3**	**$**	**3,091.4**	**$**	**12,887.7**
Non-Federal						
Accrued Funded Payroll and Benefits	$	9,857.5	$	0.0	$	9,857.5
Advances from Others		4,862.7		0.0		4,862.7
Deposit Funds and Suspense Accounts		377.7		0.0		377.7
Nonenvironmental Disposal Liabilities						
Military Equipment (Nonnuclear)		161.5		63.1		224.6
Excess/Obsolete Structures		79.2		218.9		298.1
Conventional Munitions Disposal		0.0		2,136.6		2,136.6
Accrued Unfunded Annual Leave		10,504.7		0.0		10,504.7
Capital Lease Liability		171.7		14.3		186.0
Contract Holdbacks		1,569.9		0.2		1,570.1
Employer Contribution and Payroll Taxes Payable		398.9		0.0		398.9
Contingent Liabilities		523.7		6,296.1		6,819.8
Other Liabilities		156.8		0.0		156.8
Total Non-Federal Other Liabilities	**$**	**28,664.3**	**$**	**8,729.2**	**$**	**37,393.5**
Total Other Liabilities	**$**	**38,460.6**	**$**	**11,820.6**	**$**	**50,281.2**

Advances from Others represent liabilities for collections received to cover future expenses or acquisition of assets.

Deposit funds and Suspense Accounts represent liabilities for receipts held in suspense temporarily for distribution to another fund or entity or held as an agent for others and paid at the direction of the owner.

Disbursing Officers Cash represents liabilities for currency on hand, cash on deposit at designated depositories, cash in the hands of deputy disbursing officers, cashiers and agents, negotiable instruments on hand, etc.

Custodial Liabilities represents liabilities for collections reported as non-exchange revenues where the Department is acting on behalf of another Federal entity.

Intragovernmental Other Liabilities primarily consists of unemployment compensation liabilities.

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

Contingent Liabilities include $3.8 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 amounts in excess of progress payments 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.

There are four agencies with delinquent Federal Employee Compensation Act (FECA) bills due to the Department of Labor (DOL):

- Army: $21,029,536
- Defense Media Activity: $9,569
- Defense Technology Security Administration: $625
- Defense Legal Services Agency: $2,090

Capital Lease Liability				Dollars in Millions
	2014 – Asset Category			
As of September 30	Land and Buildings	Equipment	Other	Total
Future Payments Due				
2015	$ 30.7	$ 0.0	$ 0.0	$ 30.7
2016	21.4	0.0	0.0	21.4
2017	21.9	0.0	0.0	21.9
2018	22.5	0.0	0.0	22.5
2019	21.6	0.0	0.0	21.6
After 5 Years	124.9	0.0	0.0	124.9
Total Future Lease Payments Due	**$ 243.0**	**$ 0.0**	**$ 0.0**	**$ 243.0**
Less: Imputed Interest Executory Costs	(75.4)	(0.0)	(0.0)	(75.4)
Net Capital Lease Liability	**$ 167.6**	**$ 0.0**	**$ 0.0**	**$ 167.6**
Capital Lease Liabilities Covered by Budgetary Resources				**$ 167.6**
Capital Lease Liabilities Not Covered by Budgetary Resources				**$ 0.0**

Capital Lease Liability				Dollars in Millions
	2013 – Asset Category			
As of September 30	Land and Buildings	Equipment	Other	Total
Future Payments Due				
2014	$ 30.1	$ 0.0	$ 1.1	$ 31.2
2015	30.7	0.0	0.0	30.7
2016	21.4	0.0	0.0	21.4
2017	22.1	0.0	0.0	22.1
2018	22.5	0.0	0.0	22.5
After 5 Years	146.4	0.0	0.0	146.4
Total Future Lease Payments Due	**$ 273.2**	**$ 0.0**	**$ 1.1**	**$ 274.3**
Less: Imputed Interest Executory Costs	(88.3)	(0.0)	(0.0)	(88.3)
Net Capital Lease Liability	**$ 184.9**	**$ 0.0**	**$ 1.1**	**$ 186.0**
Capital Lease Liabilities Covered by Budgetary Resources				**$ 186.0**
Capital Lease Liabilities Not Covered by Budgetary Resources				**$ 0.0**

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 39 legal actions with individual claims greater than the Department's FY 2014 materiality threshold of $147.4 million. These actions total approximately $13.0 trillion. Of this amount, the OGC classified claims totaling approximately $7.6 billion as "reasonably possible," $3.0 trillion as "remote," and

$10.0 trillion as "unable to determine the probability of loss." The Department also has 125 actions at approximately $6.5 billion above the individual Components' thresholds, but below the Department's materiality threshold.

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 budgetary resources. Currently, the Department has limited automated system processes by which it captures or assesses these potential liabilities; therefore, the amounts reported may not fairly present the Department's commitments and contingencies. 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*
	2014					
As of September 30	Liabilities		(Less: Assets Available to Pay Benefits)		Unfunded Liabilities	
Pension and Health Actuarial Benefits						
Military Retirement Pensions	$	1,560,498.4	$	(473,541.3)	$	1,086,957.1
Military Retirement Health Benefits		235,711.1		0.0		235,711.1
Military Medicare-Eligible Retiree Benefits		522,533.6		(197,347.5)		325,186.1
Total Pension and Health Actuarial Benefits	**$**	**2,318,743.1**	**$**	**(670,888.8)**	**$**	**1,647,854.3**
Other Benefits						
FECA	$	6,530.3	$	0.0	$	6,530.3
Voluntary Separation Incentive Programs		525.5		(219.9)		305.6
DoD Education Benefits Fund		1,367.5		(1,367.5)		0.0
Other		6,849.2		(5,122.2)		1,727.0
Total Other Benefits	**$**	**15,272.5**	**$**	**(6,709.6)**	**$**	**8,562.9**
Total Military Retirement and Other Federal Employment Benefits	**$**	**2,334,015.6**	**$**	**(677,598.4)**	**$**	**1,656,417.2**

Actuarial Cost Method Used: Aggregate Entry-Age Method
Assumptions: Effective Interest
Market Value of Investments in Market-based and Marketable Securities: $851.3 billion

Military Retirement and Other Federal Employment Benefits						*Dollars in Millions*
	2013					
As of September 30	Liabilities		(Less: Assets Available to Pay Benefits)		Unfunded Liabilities	
Pension and Health Actuarial Benefits						
Military Retirement Pensions	$	1,519,779.5	$	(416,190.0)	$	1,103,589.5
Military Retirement Health Benefits		243,049.7		0.0		243,049.7
Military Medicare-Eligible Retiree Benefits		502,399.5		(186,963.8)		315,435.7
Total Pension and Health Actuarial Benefits	**$**	**2,265,228.7**	**$**	**(603,153.8)**	**$**	**1,662,074.9**
Other Actuarial Benefits						
FECA	$	6,749.8	$	0.0	$	6,749.8
Voluntary Separation Incentive Programs		587.9		(265.6)		322.3
DoD Education Benefits Fund		1,369.3		(1,369.3)		0.0
Other		6,632.1		(5,064.9)		1,567.2
Total Other Actuarial Benefits	**$**	**15,339.1**	**$**	**(6,699.8)**	**$**	**8,639.3**
Total Military Retirement and Other Federal Employment Benefits	**$**	**2,280,567.8**	**$**	**(609,853.6)**	**$**	**1,670,714.2**

Actuarial Cost Method Used: Aggregate Entry-Age Method
Assumptions: Effective Interest
Market Value of Investments in Market-based and Marketable Securities: $773 billion

Military Retirement and Other Federal Employment Benefits *Dollars in Millions*	2014				
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	**$ 1,519,779.5**	**$ 243,049.7**	**$ 502,399.5**	**$ 587.9**	**$ 1,369.3**
Normal Cost Liability	32,462.4	9,934.4	11,807.3	0.0	142.6
Interest Cost	64,858.3	10,908.0	22,423.5	17.2	46.1
Plan Amendments	(21.7)	0.0	0.0	0.0	0.0
Experience Losses (Gains)	(22,572.8)	(4,264.3)	(3,769.0)	15.6	(59.8)
Other factors	0.0	0.0	0.0	0.0	152.0
Subtotal: Expenses before Losses (Gains) from Actuarial Assumption Changes	**74,726.2**	**16,578.1**	**30,461.8**	**32.8**	**280.9**
Actuarial (Gain)/Loss due to:					
Changes in trend assumptions	0.0	(16,298.3)	(19,416.7)	0.0	0.0
Changes in assumptions other than trend	21,591.7	2,644.8	18,352.0	2.3	0.0
Subtotal: Losses (Gains) from Actuarial Assumption Changes	**21,591.7**	**(13,653.5)**	**(1,064.7)**	**2.3**	**0.0**
Total Expenses	**96,317.9**	**2,924.6**	**29,397.1**	**35.1**	**280.9**
Less Benefit Outlays	(55,599.0)	(10,263.2)	(9,263.0)	(97.5)	(282.7)
Total Changes in Actuarial Liability	**$ 40,718.9**	**$ (7,338.6)**	**$ 20,134.1**	**$ (62.4)**	**$ (1.8)**
Ending Actuarial Liability	**$ 1,560,498.4**	**$ 235,711.1**	**$ 522,533.6**	**$ 525.5**	**$ 1,367.5**

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 2014 roll-forward amount:

Military Retirement Pensions	Inflation	Salary	Interest
Fiscal Year 2014	1.5% (actual)	1.0% (actual)	4.3%
Fiscal Year 2015	1.7% (estimated)	1.0% (estimated)	4.3%
Long Term	2.4%	2.5%	4.3%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Market Value of Investments in Market-Based and Marketable Securities: $593.0 billion* *Assumed Interest Rate: 4.3%*			

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 annual payments cover 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 actuarial liabilities annually using assumptions and actual experience. For the FY 2014 actuarial liability calculation, actuaries used the following assumptions:

MHRB Medical Trend	FY 2013 – FY 2014	Ultimate Rate FY 2038
Medicare Inpatient (Direct Care)	1.98%	5.15%
Medicare Outpatient (Direct Care)	4.25%	5.15%
Medicare Prescriptions (Direct Care)	2.50%	5.15%
Non-Medicare Inpatient (Direct Care)	5.90%	5.15%
Non-Medicare Outpatient (Direct Care)	6.00%	5.15%
Non-Medicare Prescriptions (Direct Care)	2.50%	5.15%
Non-Medicare Inpatient (Purchased Care)	1.45%	5.15%
Non-Medicare Outpatient (Purchased Care)	2.80%	5.15%
Non-Medicare Prescriptions (Purchased Care)	4.60%	5.15%
U.S. Family Health Plan (USFHP) (Purchased Care)	3.78%	5.15%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Assumed Interest Rate: 4.3%*		

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 2014 roll-forward amount:

MERHCF Benefits – Medical Trend	FY 2013 – FY 2014	Ultimate Rate FY 2038
Medicare Inpatient (Direct Care)	1.98%	5.15%
Medicare Inpatient (Purchased Care)	2.48%	5.15%
Medicare Outpatient (Direct Care)	4.25%	5.15%
Medicare Outpatient (Purchased Care)	4.25%	5.15%
Medicare Prescriptions (Direct Care)	2.50%	5.15%
Medicare Prescriptions (Purchased Care)	4.24%	5.15%
Medicare USFHP (Purchased Care)	3.86%	5.15%
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method *Market Value of Investments in Market-Based and Marketable Securities: $256.3 billion* *Assumed Interest Rate: 4.3%*		

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The $522.5 billion liability includes $510.4 billion for the Department, $10.8 billion for the Coast Guard, $1.3 billion for the Public Health Service and $80.4 million for National Oceanic and Atmospheric Administration (NOAA). The FY 2014 contributions from each of the Uniformed Services were $7.4 billion from the Department, $186.0 million from the Coast Guard, $27.4 million from the Public Health Service, and $1.3 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. An interest rate for wage benefits of 3.5 percent was assumed for year one and 3.5 percent for year two and thereafter. An interest rate for medical benefits of 2.9 percent was assumed for year one and 2.9 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) 2014 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**
2015	1.73%	2.93%
2016	2.17%	3.76%
2017	2.13%	3.86%
2018	2.23%	3.90%
2019+	2.30%	3.90%

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 2014 to the average pattern observed during the prior three charge back years, and (4) a comparison of the estimated liability per case in the 2014 projection to the average pattern for the projections for the most recent three years.

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 3.5 percent that was approved by the DoD Board of Actuaries.

The Market Value of Investments in Market-based and Marketable Securities: $1.8 billion.

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 3.1 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.

The Market Value of Investments in Market-based and Marketable Securities: $231.1 million.

Other Federal Employment Benefits

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

Note 18. General Disclosures Related to the Statement of Net Cost

Costs and Exchange Revenue		*Dollars in Millions*
As of September 30	**2014**	**2013**
Military Retirement Benefits		
Gross Cost		
Intragovernmental Cost	$ 5.4	$ 205.3
Non-Federal Cost	$ 101,872.2	$ 64,217.0
Total Cost	**$ 101,877.6**	**$ 64,422.3**
Earned Revenue		
Intragovernmental Revenue	$ (25,061.3)	$ (22,387.6)
Non-Federal Revenue	$ 0.0	$ 0.0
Total Revenue	**$ (25,061.3)**	**$ (22,387.6)**

Costs and Exchange Revenue *As of September 30*	*Dollars in Millions* 2014	2013
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 20,527.1	$ 8,018.2
Total Net Cost	**$ 97,343.4**	**$ 50,052.9**
Civil Works		
Gross Cost		
Intragovernmental Cost	$ 1,647.1	$ 1,465.1
Non-Federal Cost	$ 7,195.1	$ 8,291.6
Total Cost	**$ 8,842.2**	**$ 9,756.7**
Earned Revenue		
Intragovernmental Revenue	$ (709.3)	$ (1,135.5)
Non-Federal Revenue	$ (690.6)	$ (700.4)
Total Revenue	**$ (1,399.9)**	**$ (1,835.9)**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 7,442.3**	**$ 7,920.8**
Military Personnel		
Gross Cost		
Intragovernmental Cost	$ 33,926.5	$ 30,997.8
Non-Federal Cost	$ 109,368.4	$ 115,054.3
Total Cost	**$ 143,294.9**	**$ 146,052.1**
Earned Revenue		
Intragovernmental Revenue	$ (1,160.7)	$ (1,155.6)
Non-Federal Revenue	$ (94.3)	$ (3.1)
Total Revenue	**$ (1,255.0)**	**$ (1,158.7)**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 142,039.9**	**$ 144,893.4**
Operations, Readiness & Support		
Gross Cost		
Intragovernmental Cost	$ (49,742.3)	$ (49,139.9)
Non-Federal Cost	$ 322,522.9	$ 342,058.1
Total Cost	**$ 272,780.6**	**$ 292,918.2**
Earned Revenue		
Intragovernmental Revenue	$ 6,191.7	$ 8,896.7
Non-Federal Revenue	$ (54,104.7)	$ (40,099.7)
Total Revenue	**$ (47,913.0)**	**$ (31,203.0)**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ (13,651.3)	$ (70,856.8)
Total Net Cost	**$ 211,216.3**	**$ 190,858.4**
Procurement		
Gross Cost		
Intragovernmental Cost	$ 28,235.8	$ 31,638.1
Non-Federal Cost	$ 70,252.4	$ 44,578.0
Total Cost	**$ 98,488.2**	**$ 76,216.1**
Earned Revenue		
Intragovernmental Revenue	$ (1,725.4)	$ (2,104.6)
Non-Federal Revenue	$ (2,859.1)	$ (935.0)

Costs and Exchange Revenue *As of September 30*	*Dollars in Millions* 2014	2013
Total Revenue	**$ (4,584.5)**	**$ (3,039.6)**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 93,903.7**	**$ 73,176.5**
Research, Development, Test & Evaluation		
Gross Cost		
Intragovernmental Cost	$ 19,879.5	$ 20,817.3
Non-Federal Cost	$ 48,862.0	$ 49,329.7
Total Cost	**$ 68,741.5**	**$ 70,147.0**
Earned Revenue		
Intragovernmental Revenue	$ (4,408.4)	$ (5,105.0)
Non-Federal Revenue	$ (2,949.2)	$ (2,687.8)
Total Revenue	**$ (7,357.6)**	**$ (7,792.8)**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 61,383.9**	**$ 62,354.2**
Family Housing & Military Construction		
Gross Cost		
Intragovernmental Cost	$ 1,066.7	$ 1,494.7
Non-Federal Cost	$ 31,990.7	$ 34,849.0
Total Cost	**$ 33,057.4**	**$ 36,343.7**
Earned Revenue		
Intragovernmental Revenue	$ (5,521.8)	$ (7,147.1)
Non-Federal Revenue	$ (822.0)	$ (445.0)
Total Revenue	**$ (6,343.8)**	**$ (7,592.1)**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 0.0	$ 0.0
Total Net Cost	**$ 26,713.6**	**$ 28,751.6**
Consolidated		
Gross Cost		
Intragovernmental Cost	$ 35,018.7	$ 37,478.4
Non-Federal Cost	$ 692,063.7	$ 658,377.7
Total Cost	**$ 727,082.4**	**$ 695,856.1**
Earned Revenue		
Intragovernmental Revenue	$ (32,395.2)	$ (30,138.7)
Non-Federal Revenue	$ (61,519.9)	$ (44,871.0)
Total Revenue	**$ (93,915.1)**	**$ (75,009.7)**
Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 6,875.8	$ (62,838.6)
Costs Not Assigned to Programs	$ 0.0	$ 0.0
(Less: Earned Revenues) Not Attributed to Programs	$ 0.0	$ 0.0
Total Net Cost	**$ 640,043.1**	**$ 558,007.8**

The SNC represents the net cost of programs and organizations of the Department 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 required by *SFFAS No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government,"* amended by *SFFAS No. 30, "Inter-Entity Cost Implementation."*

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

The Department's systems do not track intragovernmental transactions by customer. 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. General Fund data is primarily derived from budgetary transactions (obligations, disbursements, and collections), data from nonfinancial feeder systems, and accruals (payroll expenses, accounts payable, and environmental liabilities). Working Capital Funds primarily record transactions on an accrual basis; however, the systems do not always capture actual costs timely.

Abnormal Balances

Operations, Readiness & Support Intragovernmental Gross Cost and Earned Revenue on the SNC have abnormal balances of $49.7 billion and $6.2 billion, respectively. The current business practice is to report most eliminations in this program group, resulting in the abnormal balance presentation.

Other Disclosures

The Department reclassified a portion of the elimination entry to Research, Development, Test & Evaluation from Operations, Readiness & Support to better align costs and revenues with program group. Comparative year amounts include offsetting differences of $174.0 million for Intragovernmental Gross Costs, Nonfederal Gross Costs, and Intragovernmental Earned Revenue with no change to the overall FY 2013 consolidated amounts. Net Costs increased for Operations, Readiness & Support and decreased for Research, Development, Test & Evaluation.

The Department's military retirement and postemployment costs are reported in accordance with *SFFAS 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."*

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

Other Disclosures

Other Financing Sources, Other consists primarily of nonexchange gains and losses necessary to reconcile the proprietary and budgetary amounts.

Reconciliation Differences

In accordance with OMB and U.S. Treasury guidance, Appropriations reported on the Statement of Budgetary Resources exceeds Appropriations Received on the Statement of Changes in Net Position by $61.9 billion.

Year Ended September 30, 2014 Reconciliation of Appropriations on the Statement of Budgetary Resources to Appropriations Received on the Statement of Changes in Net Position	*Dollars in Billions*
	Total
Appropriations, Statement of Budgetary Resources	$ 737.6
Less: Appropriations Received, Statement of Changes in Net Position	(675.7)
Total Reconciling Amount	**$ 61.9**
Items Reported in Net Cost of Operations, Statement of Changes in Net Position	
Trust and Special Fund Receipts	**136.1**
Items Reported as Reductions to Appropriations, Statement of Budgetary Resources	
Permanent and Temporary Reductions	**$ (73.9)**
Miscellaneous items	**(0.3)**
Total Reconciling Items	**$ 61.9**

NOTE 20. DISCLOSURES RELATED TO THE STATEMENT OF BUDGETARY RESOURCES

Disclosures Related to the Statement of Budgetary Resources *As of September 30*	*Dollars in Millions* **2014**	**2013**
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	$ 458,568.2	$ 458,821.6

Reconciliation Differences

In accordance with OMB and U.S. Treasury guidance, Appropriations reported on the Statement of Budgetary Resources exceeds Appropriations Received on the Statement of Changes in Net Position by $61.9 billion. Reference Note 19, Disclosures Related to the Statement of Changes in Net Position, for additional details.

The SBR FY 2013 column includes $109.7 billion more in budget authority than reported in the 2013 actual column of the President's FY 2015 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 Medicare-Eligible Retiree Health Care Fund.

The SBR FY 2013 column includes $585.4 million less in obligations than reported in the 2013 actual column of the President's FY 2015 Budget. The difference is primarily due to the timing of the recognition of obligations in accordance with OMB guidance.

In accordance with OMB guidance, the SBR FY 2013 column includes $82.8 billion less in net outlays than reported in the 2013 actual column of the President's FY 2015 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 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 primarily 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

Apportionment categories are determined in accordance with the guidance provided in OMB Circular No. A-11, "Preparation, Submission and Execution of the Budget." 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). The Department reported the following amounts of obligations incurred:

Year Ended September 30, 2014				Dollars in Billions
	Apportionment Category A	Apportionment Category B	Exempt From Apportionment	Total
Obligations Incurred – Direct	406.9	216.3	140.8	764.0
Obligations Incurred – Reimbursable	15.3	147.1	7.8	170.2
Total Obligations Incurred:	**$ 422.2**	**$ 363.4**	**$ 148.6**	**$ 934.2**

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 exceeding 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 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

In accordance with OMB guidance, $111.6 billion of General Fund appropriations received by the Department are also recognized on the SBR as appropriations received for trust and special funds. The primary difference is due to this OMB guidance requiring duplicate reporting on the SBR of the Military Services' contributions and U.S. Treasury's payments to the Military Retirement Trust Fund and Medicare-Eligible Retiree Health Care Fund.

The SBR includes intra-entity transactions because the statements are presented as combined.

The Department utilizes borrowing authority for the Military Housing Privatization Initiative. Borrowing authority is used in accordance with OMB Circular No. A-129, *Policies for Federal Credit Programs and Non-Tax Receivables*.

The Department received additional funding of $85.4 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* 2014	2013
Resources Used to Finance Activities		
Budgetary Resources Obligated:		
Obligations incurred	$ 934,176.7	$ 954,067.2
Less: Spending authority from offsetting collections and recoveries (-)	(211,124.0)	(230,340.8)
Obligations net of offsetting collections and recoveries	**$ 723,052.7**	**$ 723,726.4**
Less: Offsetting receipts (-)	(87,713.9)	(82,767.6)
Net obligations	**$ 635,338.8**	**$ 640,958.8**
Other Resources:		
Donations and forfeitures of property	$ 10.6	$ 9.9
Transfers in/out without reimbursement (+/-)	56.6	(14.6)
Imputed financing from costs absorbed by others	5,569.8	4,896.8
Other (+/-)	(19,104.2)	32,173.5
Net other resources used to finance activities	**$ (13,467.2)**	**$ 37,065.6**
Total resources used to finance activities	**$ 621,871.6**	**$ 678,024.4**
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided:		
Undelivered Orders (-)	$ (9,879.6)	$ 28,064.4
Unfilled Customer Orders	234.8	(1,767.8)
Resources that fund expenses recognized in prior Periods (-)	(16,077.7)	(92,516.0)
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	2,272.0	2,122.8
Resources that finance the acquisition of assets (-)	(90,108.0)	(105,940.4)
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 (-)	(359.2)	0.0
Other (+/-)	18,669.5	(32,309.2)
Total resources used to finance items not part of the Net Cost of Operations	**$ (95,248.2)**	**$ (202,346.2)**
Total resources used to finance the Net Cost of Operations	**$ 526,623.4**	**$ 475,678.2**
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in Future Period:		
Increase in annual leave liability	$ 151.2	$ 189.5
Increase in environmental and disposal liability	713.6	624.1
Upward/Downward reestimates of credit subsidy expense (+/-)	(94.5)	(24.8)
Increase in exchange revenue receivable from the public (-)	2,644.5	194.0
Other (+/-)	68,002.0	42,826.9
Total components of Net Cost of Operations that will Require or Generate Resources in future periods	**$ 71,416.8**	**$ 43,809.7**
Components not Requiring or Generating Resources:		
Depreciation and amortization	$ 46,734.8	$ 44,524.6
Revaluation of assets or liabilities (+/-)	(12,046.6)	3,528.3
Other (+/-)		
Trust Fund Exchange Revenue	(51,601.4)	(51,893.3)

Reconciliation of Net Cost of Operations to Budget *As of September 30*	*Dollars in Millions* **2014**	**2013**
Cost of Goods Sold	58,445.5	66,612.8
Operating Materiel and Supplies Used	29,960.0	12,936.2
Other	(29,489.4)	(37,188.7)
Total Components of Net Cost of Operations that will not Require or Generate Resources	**$ 42,002.9**	**$ 38,519.9**
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	**$ 113,419.7**	**$ 82,329.6**
Net Cost of Operations	**$ 640,043.1**	**$ 558,007.8**

The Reconciliation of Net Cost of Operations to Budget reconciles the cost reflected on the Statement of Net Cost to the budgetary information on the Statement of Budgetary Resources. This is accomplished by aligning budgetary obligations and non-budgetary resources available with the cost of the Department's operations.

Other Disclosures

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

	Dollars in Millions
Resources that Finance the Acquisition of Assets	$ 19,061.5
Revaluation of Assets or Liabilities	$ 675.3
Other Components not Requiring or Generating Resources	$ 4,649.4
Total Amount	**$ 24,386.2**

The following Reconciliation of Net Cost of Operations to Budget lines are presented as combined instead of consolidated due to intra-agency 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 non-exchange gains and losses to revalue assets, as well as reconcile the proprietary and budgetary amounts.

Other Resources or Adjustments to Net Obligated Resources that Do Not Affect Net Cost of Operations, Other primarily consists of non-exchange gains and losses to revalue assets, as well as reconcile the proprietary and budgetary amounts.

Components Requiring or Generating Resources in Future Period, Other consists primarily of future funded expenses.

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

NOTE 22. DISCLOSURES RELATED TO INCIDENTAL CUSTODIAL COLLECTIONS

The Department collected $3.8 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 relinquished to the U.S. Treasury.

The Department also reversed $6.6 million of incidental custodial collections received and reported in a prior year from the U.S. Treasury for premium refunds under the Defense Base Act Insurance Program.

NOTE 23. FUNDS FROM DEDICATED COLLECTIONS

Funds from Dedicated Collections					Dollars in Millions
	2014				
As of September 30	Harbor Maintenance Trust Fund	Rivers and Harbors Contributed and Advance Fund	Other Funds	Eliminations	Total Funds from Dedicated Collections
Balance Sheet					
Assets					
Fund Balance with Treasury	$ 117.0	$ 1,084.7	$ 1,367.9	$ 0.0	$ 2,569.6
Investments	8,407.5	0.0	879.4	0.0	9,286.9
Accounts and Interest Receivable	476.4	4.9	6.9	(0.2)	488.0
Other Assets	618.1	30.5	807.9	0.0	1,456.5
Total Assets	**$ 9,619.0**	**$ 1,120.1**	**$ 3,062.1**	**$ (0.2)**	**$ 13,801.0**
Liabilities and Net Position					
Accounts Payable and Other Liabilities	6.7	1,121.4	71.8	(7.2)	1,192.7
Total Liabilities	**$ 6.7**	**$ 1,121.4**	**$ 71.8**	**$ (7.2)**	**$ 1,192.7**
Cumulative Results of Operations	$ 9,612.3	$ (1.3)	$ 2,990.3	$ 1,298.6	$ 13,899.9
Total Liabilities and Net Position	**$ 9,619.0**	**$ 1,120.1**	**$ 3,062.1**	**$ 1,291.4**	**$ 15,092.6**

Statement of Net Cost					
Program Costs	$ 45.4	$ 342.1	$ 1,241.5	$ (102.3)	$ 1,526.7
Less Earned Revenue	0.0	(379.4)	(339.0)	0.1	(718.3)
Net Program Costs	45.4	(37.3)	902.5	(102.2)	808.4
Net Cost of Operations	**$ 45.4**	**$ (37.3)**	**$ 902.5**	**$ (102.2)**	**$ 808.4**

Statement of Changes in Net Position					
Net Position Beginning of the Period	$ 9,080.4	$ 2.0	$ 2,596.6	$ 0.0	$ 11,679.0
Net Cost of Operations	(45.4)	37.3	(902.5)	102.2	(808.4)
Budgetary Financing Sources	618.2	0.0	1,251.6	1,123.8	2,993.6
Other Financing Sources	(40.9)	(40.6)	44.6	72.6	35.7
Change in Net Position	**$ 531.9**	**$ (3.3)**	**$ 393.7**	**$ 1,298.6**	**$ 2,220.9**
Net Position End of Period	**$ 9,612.3**	**$ (1.3)**	**$ 2,990.3**	**$ 1,298.6**	**$ 13,899.9**

Funds from Dedicated Collections As of September 30	2013 Harbor Maintenance Trust Fund	Rivers and Harbors Contributed and Advance Fund	Other Funds	Eliminations	Total Funds from Dedicated Collections (Dollars in Millions)
Balance Sheet					
Assets					
Fund Balance with Treasury	$ 107.5	$ 1,093.5	$ 949.0	$ 0.0	$ 2,150.0
Investments	7,877.5	0.0	911.9	0.0	8,789.4
Accounts and Interest Receivable	448.8	3.9	5.0	(2.9)	454.8
Other Assets	659.6	30.0	804.9	0.0	1,494.5
Total Assets	**$ 9,093.4**	**$ 1,127.4**	**$ 2,670.8**	**$ (2.9)**	**$ 12,888.7**
Liabilities and Net Position					
Accounts Payable and Other Liabilities	13.0	1,125.4	74.2	(10.6)	1,202.0
Total Liabilities	**$ 13.0**	**$ 1,125.4**	**$ 74.2**	**$ (10.6)**	**$ 1,202.0**
Cumulative Results of Operations	$ 9,080.4	$ 2.0	$ 2,596.6	$ 1,028.8	$ 12,707.8
Total Liabilities and Net Position	**$ 9,093.4**	**$ 1,127.4**	**$ 2,670.8**	**$ 1,018.2**	**$ 13,909.8**

Statement of Net Cost					
Program Costs	$ 145.3	$ 340.9	$ 1,296.1	$ (123.1)	$ 1,659.2
Less Earned Revenue	0.0	(366.9)	(305.0)	0.1	(671.8)
Net Cost of Operations	**$ 145.3**	**$ (26.0)**	**$ 991.1**	**$ (123.0)**	**$ 987.4**

Statement of Changes in Net Position					
Net Position Beginning of the Period	$ 8,377.2	$ 4.8	$ 2,410.4	$ 0.0	$ 10,792.4
Net Cost of Operations	(145.3)	26.0	(991.1)	123.0	(987.4)
Budgetary Financing Sources	848.6	0.0	1,129.2	938.8	2,916.6
Other Financing Sources	(0.1)	(28.8)	48.1	(33.0)	(13.8)
Change in Net Position	**$ 703.2**	**$ (2.8)**	**$ 186.2**	**$ 1,028.8**	**$ 1,915.4**
Net Position End of Period	**$ 9,080.4**	**$ 2.0**	**$ 2,596.6**	**$ 1,028.8**	**$ 12,707.8**

The *SFFAS No. 43, "Funds from Dedicated Collections: Amending SFFAS 27, Identifying and Reporting Earmarked Funds,"* requires disclosure of Funds from Dedicated Collections separate from All Other Funds on the Balance Sheet. Funds must meet three criteria to be classified as funds from dedicated collections: (1) a statute committing the use of specifically-identified revenues provided by non-Federal sources for designated purposes; (2) explicit authority to retain the revenues; and (3) a requirement to separately account and report on the revenues. The Department's funds from dedicated collections are either special or trust funds and use both receipt and expenditure accounts to report activity to the U.S. Treasury. There has been no legislation significantly altering the purposes of the funds.

The Total column is shown as consolidated and relates only to Funds from Dedicated Collections. The Eliminations column includes eliminations associated with Funds from Dedicated Collections 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 as Funds from Dedicated Collections on the Balance Sheet.

The Department has the following Funds from Dedicated Collections:

Harbor Maintenance Trust Fund, *26 USC 9505*. The United States Army Corps of Engineers (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 administrative expenses incurred by the U.S. Treasury, USACE, and the Department of Commerce. Taxes collected from imports, domestics, passengers, and foreign trade are deposited into the Trust Fund. The Bureau of the Fiscal Service (BFS) manages and invests for the Trust Fund.

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 authorized by law, the Secretary of the Army may accept such funds and expend them in the immediate performance of such work. The funding is 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.

Other Funds from Dedicated Collections

Special Recreation Use Fees, *16 USC 460l-6a note*. The USACE charges and collects Special Recreation Use Fees at campgrounds located at lakes and reservoirs under their jurisdiction. Allowable fees include daily use fees, admission fees, recreational fees, annual pass fees, and other permit type fees. Receipts cover operation and maintenance of recreational sites.

Hydraulic Mining in California, Debris, *33 USC 683*. Operators of hydraulic mines allowing debris to flow 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. The USACE collects taxes and expends funds under the direction of the Department of the Army. Funds repay advances 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*. The USACE collects receipts for the leasing of lands acquired by the U.S. for flood control, navigation, and allied purposes (including the development of hydroelectric power). Funds received are appropriated and made available for use in the following fiscal year with 75 percent of funds provided to the state where the property is located. States may expend the funds for the benefit of public schools and public roads of the counties where the property is located, or for defraying county government expenses.

Maintenance and Operation of Dams and Other Improvements of Navigable Waters, *16 USC 803(f) and 810*. The Federal Energy Regulatory Commission (FERC) assesses charges against licensees when a reservoir or other improvement is constructed by the U.S. All proceeds from Indian reservations are credited to the Indians of the reservations. All other proceeds arising from licenses, except those established by the FERC for administrative reimbursement, are paid to the U.S. Treasury and allocated for specific uses. The Department of the Army is allocated fifty 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 owned by the U.S., or in construction, maintenance, or operation of headwater, or other improvements to navigable waters of the U.S.

Fund for Non-Federal Use of Disposal Facilities (for dredged material), *33 USC 2326*. Non-Federal interests may use dredged material disposal facilities under the jurisdiction of, or managed by, the Secretary of the Army if the Secretary determines use will not reduce the availability of the facility for project purposes. Fees may be imposed to recover capital, operation, and maintenance costs of the disposal facility from which the fees were collected.

Coastal Wetlands Restoration Trust Fund and Coastal Wetlands Planning, Protection, and Restoration Act, *16 USC 3951-3956*. The USACE, Environmental Protection Agency, and Fish and Wildlife Service are authorized to work with the State of Louisiana to achieve a goal of "no net loss of wetlands" in coastal Louisiana. The USACE is also responsible for allocating funds. Federal contributions are 75 percent of project costs or 85 percent if the state has an approved Coastal Wetlands Conservation Plan. This Trust Fund receives funding from the Sport Fish Restoration and Boating Trust Fund.

Inland Waterways Trust Fund, *26 USC 9506*. Excise taxes from the public are used by USACE for navigation, construction, and rehabilitation projects on inland waterways. The BFS manages and invests for the Trust Fund.

Defense Commissary Agency Surcharge Trust Fund, *10 USC 2685*. Surcharge on sales of commissary goods finance the Commissary System operating expenses and capital purchases, precluded by law from being paid with appropriated funds. Revenue is generated through a five percent surcharge applied to each sale. These funds finance commissary-related information technology investments, equipment, advance design modifications to prior year construction projects, and maintenance and repair of facilities and equipment.

NOTE 24. FIDUCIARY ACTIVITIES

Schedule of Fiduciary Activity *As of September 30*	*Dollars in Millions* **2014**	**2013**
Fiduciary net assets, beginning of year	**$ 141.9**	**$ 158.7**
Contributions	59.7	194.1
Investment earnings	0.6	12.4
Distributions to and on behalf of beneficiaries	(114.2)	(223.3)
Increase/(Decrease) in fiduciary net assets	**(53.9)**	**(16.8)**
Fiduciary net assets, end of period	**$ 88.0**	**$ 141.9**

Schedule of Fiduciary Net Assets *As of September 30*	*Dollars in Millions* **2014**	**2013**
Fiduciary Assets		
Cash and cash equivalents	$ 88.0	$ 141.9
Total Fiduciary Net Assets	**$ 88.0**	**$ 141.9**

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

Other Disclosures	*Dollars in Millions*			
	2014 – Asset Category			
As of September 30	**Land and Buildings**	**Equipment**	**Other**	**Total**
Entity as Lessee – Operating Leases				
Future Payments Due				
Fiscal Year 2015	$ 644.6	$ 10.1	$ 14.7	$ 669.4
Fiscal Year 2016	647.3	10.0	14.8	672.1
Fiscal Year 2017	637.2	10.0	14.9	662.1
Fiscal Year 2018	609.0	10.0	15.1	634.1
Fiscal Year 2019	747.9	10.0	15.2	773.1
After 5 Years	1,105.5	0.7	15.4	1,121.6
Total Future Lease Payments Due	**$ 4,391.5**	**$ 50.8**	**$ 90.1**	**$ 4,532.4**

Operating leases do not transfer the benefits and risks of ownership of capital leases. Payments are expensed over the life of the lease. Future year cost projections use the Consumer Price Index.

Office space is the largest component of land and building leases.

Other leases are primarily commercial leases with the general public and include automobile leases.

REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION

Federal financial reporting requires the Department 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 the Department 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, expenditures for: (1) Nonfederal Physical Property (federally-financed, but not federally owned) and (2) federally-financed Research and Development (R&D). Information on additional reporting requirements for Nonfederal Physical Property and R&D follows.

NON-FEDERAL PHYSICAL PROPERTY

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

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

Yearly Investments in State and Local Governments
For Fiscal Years 2014 through 2010
Dollars in Millions

Categories	2014	2013	2012	2011	2010
Transferred Assets:					
National Defense Mission Related	$ 1,113.2	$ 1,376.8	$ 1,445.4	$ 2,304.5	$ 2,126.2
Funded Assets:					
National Defense Mission Related	$ 12.4	$ 11.8	$ 7.7	$ 12.0	$ 0.0
Total	$ 1,125.6	$ 1,388.6	$ 1,453.1	$ 2,316.5	$ 2,126.2

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 2010 – FY 2014 for all DoD Components. The definition for each type of R&D Category and Subcategories are explained below.

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

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

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

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

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

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

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

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

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

Categories	2014	2013	2012	2011	2010
Basic Research	**$ 1,948.2**	**$ 1,841.5**	**$ 1,645.3**	**$ 1,816.6**	**$ 1,805.5**
Applied Research	5,500.6	5,477.4	5,819.3	6,848.3	5,758.4
Development					
Advanced Technology Development	5,253.3	4,898.3	5,868.0	6,024.3	6,353.4
Advanced Component Development and Prototypes	10,947.0	12,464.8	13,005.0	13,964.2	14,304.6
System Development and Demonstration	11,459.7	12,524.6	11,926.3	13,882.0	15,156.7
Research, Development, Test and Evaluation Management Support	5,262.5	4,906.5	5,640.5	5,659.2	5,503.6
Operational Systems Development	20,334.3	21,180.9	23,274.6	23,861.3	23,986.2
Totals:	**$ 60,705.6**	**$ 63,294.0**	**$ 67,179.0**	**$ 72,055.9**	**$ 72,868.4**

REQUIRED SUPPLEMENTARY INFORMATION

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

REAL PROPERTY DEFERRED MAINTENANCE AND REPAIRS

Real Property Deferred Maintenance and Repairs
As of September 30, 2014 — *Dollars in Millions*

Property Type	Current Fiscal Year (CFY)		
	1. Plant Replacement Value	2. Required Work (Deferred Maintenance & Repair)	3. Percentage
1. Category 1	$ 971,365	$ 101,531	10%
2. Category 2	$ 22,549	$ 3,690	16%
3. Category 3	$ 40,407	$ 4,899	12%

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.

Equipment Deferred Maintenance and Repairs

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

Equipment Deferred Maintenance and Repairs
For Fiscal Year Ended September 30, 2014

Major Categories	*Dollars in Millions*
1. Aircraft	$ 186.3
2. Automotive Equipment	$ 212.2
3. Combat Vehicles	$ 184.6
4. Construction Equipment	$ 25.3
5. Electronics and Communications Systems	$ 190.1
6. Missiles	$ 52.8
7. Ships	$ 419.0
8. Ordnance Weapons and Munitions	$ 33.4
9. All Other Items Not Identified to above Categories	$ 374.6
Total	**$ 1,678.3**

Statement of Disaggregated Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	2014							
	Military Personnel	Procurement	Research, Development, Test and Evaluation	Family Housing/ Military Construction	Military Retirement Benefits	Civil Works	Operations, Readiness & Support	2014 Combined
Budgetary Resources								
Unobligated balance, brought forward, October 1	$ 3,064.6	$ 51,855.3	$ 14,683.8	$ 14956.2	$ 0.0	$ 12,361.7	$ 46,891.8	$ 143,813.4
Recoveries of prior year unpaid obligations	6,235.9	8,417.4	2,873.6	1,666.5	0.0	362.0	29,887.1	49,442.5
Other changes in unobligated balance	(501.0)	(2,193.8)	(812.8)	(250.2)	0.0	0.0	(13,653.4)	(17,411.2)
Unobligated balance from prior year budget authority, net	8,799.5	58,078.9	16,744.6	16,372.5	0.0	12,723.7	63,125.5	175,844.7
Appropriations (discretionary and mandatory)	143,848.9	99,490.1	64,860.0	7,270.7	64,745.7	5,910.3	351,518.6	737,644.3
Contract Authority (discretionary and mandatory)	0.0	0.0	0.0	0.0	0.0	0.0	70,599.4	70,599.4
Spending Authority from offsetting collections (discretionary and mandatory)	1,313.6	2,965.8	9,240.9	6,556.6	0.0	10,094.8	70,143.9	100,315.6
Total Budgetary Resources	$ 153,962.0	$ 160,534.8	$ 90,845.5	$ 30,199.8	$ 64,745.7	$ 28,728.8	$ 555,387.4	$ 1,084,404.0
Status of Budgetary Resources:								
Obligations Incurred	149,606.3	108,388.0	76,482.2	14,736.6	64,745.7	17,741.5	501,988.3	933,688.6
Unobligated balance, end of year:								
Apportioned	496.1	47,647.1	11,360.2	13,128.6	0.0	9,565.9	30,960.8	113,158.7
Exempt from Apportionment	0.0	0.0	0.0	0.0	0.0	1,413.9	1,189.5	2,603.4
Unapportioned	3,859.6	4,499.7	3,003.1	2,334.6	0.0	7.5	21,248.8	34,953.3
Unobligated balance brought forward, end of year	$ 4,355.7	$ 52,146.8	$ 14,363.3	$ 15,463.2	$ 0.0	$ 10,987.3	$ 53,399.1	$ 150,715.4
Total Budgetary Resources	$ 153,962.0	$ 160,534.8	$ 90,845.5	$ 30,199.8	$ 64,745.7	$ 28,728.8	$ 555,387.4	$ 1,084,404.0

Statement of Disaggregated Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	2014							
	Military Personnel	Procurement	Research, Development, Test and Evaluation	Family Housing/ Military Construction	Military Retirement Benefits	Civil Works	Operations, Readiness & Support	2014 Combined
Change in Obligated Balance								
Unpaid obligations								
Unpaid obligations, brought forward, October 1 (Gross)	$ 13,736.0	$ 144,145.0	$ 43,493.3	$ 23,167.5	$ 5,345.2	$ 7,814.0	$ 199,664.2	$ 437,365.2
Obligations incurred	149,606.3	108,388.0	76,482.2	14,736.6	64,745.7	17,741.5	501,988.3	933,688.6
Outlays (gross)	(143,949.6)	(108,017.4)	(71,108.1)	(15,025.0)	(64,609.0)	(17,151.6)	(471,244.3)	(891,105.0)
Recoveries of prior year unpaid obligations	(6,235.9)	(8,417.1)	(2,873.6)	(1,666.5)	0.0	(362.0)	(29,887.4)	(49,442.5)
Unpaid Obligations, end of year	13,156.8	136,098.5	45,993.8	21,212.6	5,481.9	8,041.9	200,520.8	430,506.3
Uncollected Payments								
Uncollected customer payments from Federal Sources, end of year	(187.7)	(4,167.0)	(5,622.0)	(9,975.7)	0.0	(1,941.3)	(55,310.2)	(77,203.9)
Change in uncollected payments, Federal sources	50.1	(46.4)	(961.1)	(208.7)	0.0	138.3	909.1	(118.7)
Uncollected payments, Federal sources, end of year	(137.6)	(4,213.4)	(6,583.1)	(10,184.4)	0.0	(1,803.0)	(54,401.1)	(77,322.6)
Obligated balance, start of year	$ 13,548.3	$ 139,978.0	$ 37,871.3	$ 13,191.8	$ 5,345.2	$ 5,872.7	$ 144,354.0	$ 360,161.3
Obligated balance, end of year	$ 13,019.2	$ 131,885.1	$ 39,410.7	$ 11,028.2	$ 5,481.9	$ 6,238.9	$ 146,119.7	$ 353,183.7
Budget Authority and Outlays, Net:								
Budget Authority, gross (discretionary and mandatory)	$ 145,162.5	$ 102,455.9	$ 74,100.9	$ 13,827.3	$ 64,745.7	$ 16,005.1	$ 492,261.9	$ 908,559.3
Actual offsetting collections (discretionary and mandatory)	(1,363.6)	(2,915.0)	(8,279.8)	(6,347.8)	0.0	(10,132.9)	(132,725.3)	(161,764.4)
Change in uncollected customer payments from Federal Sources (discretionary and mandatory)	50.1	(46.4)	(961.1)	(208.7)	0.0	138.3	909.1	(118.7)
Budget authority, net (discretionary and mandatory)	$ 143,849.0	$ 99,494.5	$ 64,860.0	$ 7,270.8	$ 64,745.7	$ 6,010.5	$ 360,445.7	$ 746,676.2
Outlays, gross (discretionary and mandatory)	$ 143,949.6	$ 108,017.4	$ 71,108.1	$ 15,025.0	$ 64,609.0	$ 17,151.6	$ 471,244.3	$ 891,105.0
Actual offsetting collections (discretionary and mandatory)	(1,363.6)	(2,915.0)	(8,279.8)	(6,347.8)	0.0	(10,132.9)	(132,725.3)	(161,764.4)
Outlays, net (discretionary and mandatory)	142,586.0	105,102.4	62,828.3	8,677.2	64,609.0	7,018.7	338,519.0	729,340.6
Distributed offsetting receipts	0.0	(18.2)	0.0	0.0	(84,867.8)	(496.3)	(2,331.6)	(87,713.9)
Agency outlays, net (discretionary and mandatory)	$ 142,586.0	$ 105,084.2	$ 62,828.3	$ 8,677.2	$ (20,258.8)	$ 6,522.4	$ 336,187.4	$ 641,626.7

Statement of Disaggregated Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	**2013**							
	Military Personnel	Procurement	Research, Development, Test and Evaluation	Family Housing/ Military Construction	Military Retirement Benefits	Civil Works	Operations, Readiness & Support	2013 Combined
Budgetary Resources								
Unobligated balance, brought forward, October 1	$ 2,463.8	$ 63,347.7	$ 15,203.9	$ 16,057.9	$ 0.0	$ 8,610.1	$ 40,009.1	$ 145,692.5
Recoveries of prior year unpaid obligations	14,394.5	12,838.5	2,665.7	2,431.7	0.0	415.3	30,426.9	63,172.6
Other changes in unobligated balance	(406.3)	(1,770.8)	(825.5)	(301.7)	0.0	0.0	(10,513.6)	(13,817.9)
Unobligated balance from prior year budget authority, net	16,452.0	74,415.4	17,044.1	18,187.9	0.0	9,025.4	59,922.4	195,047.2
Appropriations (discretionary and mandatory)	146,740.1	95,634.8	60,131.7	6,995.5	63,194.3	10,431.7	350,407.8	733,535.9
Contract Authority (discretionary and mandatory)	0.0	0.0	0.0	0.0	0.0	0.0	65,506.0	65,506.0
Spending Authority from offsetting collections (discretionary and mandatory)	1,246.8	2,664.00	7,695.8	5,129.6	128.5	10,821.8	76,026.2	103,712.7
Total Budgetary Resources	$ 164,438.9	$ 172,714.2	$ 84,871.6	$ 30,313.0	$ 63,322.8	$ 30,278.9	$ 551,862.4	$ 1,097,081.8
Status of Budgetary Resources:								
Obligations Incurred	161,374.3	120,858.9	70,187.8	15,356.8	63,322.8	17,917.2	504,970.6	953,988.4
Unobligated balance, end of year:								
Apportioned	692.7	47,045.0	12,943.3	13,300.0	0.0	11,038.0	24,877.8	109,896.8
Exempt from Apportionment	0.0	0.0	0.0	0.0	0.0	1,319.5	2,727.1	4,046.6
Unapportioned	2,371.9	4,810.3	1,740.5	1,656.2	0.0	4.2	19,286.9	29,870.0
Unobligated balance brought forward, end of year	$ 3,064.6	$ 51,855.3	$ 14,683.8	$ 14,956.2	$ 0.0	$ 12,361.7	$ 46,891.8	$ 143,813.4
Total Budgetary Resources	$ 164,438.9	$ 172,714.2	$ 84,871.6	$ 30,313.0	$ 63,322.8	$ 30,278.9	$ 551,862.4	$ 1,097,801.8

Statement of Budgetary Resources *For the Years Ended September 30* *Dollars in Millions*	2013							
	Military Personnel	Procurement	Research, Development, Test and Evaluation	Family Housing/ Military Construction	Military Retirement Benefits	Civil Works	Operations, Readiness & Support	2013 Combined
Change in Obligated Balance								
Unpaid obligations								
Unpaid obligations, brought forward, October 1 (Gross)	$ 11,975.7	$ 151,469.5	$ 47,712.4	$ 28,530.9	$ 4,643.2	$ 8,374.7	$ 215,863.8	$ 468,570.2
Obligations incurred	161,374.3	120,858.9	70,187.8	15,356.8	63,322.8	17,917.2	504,970.6	953,988.4
Outlays (gross)	(145,219.5)	(115,344.9)	(71,741.2)	(18,288.5)	(62,620.8)	(18,062.6)	(490,743.3)	(922,020.8)
Recoveries of prior year unpaid obligations	(14,394.5)	(12,838.5)	(2,665.7)	(2,431.7)	0.0	(415.3)	(30,426.9)	(63,172.6)
Unpaid Obligations, end of year	13,736.0	144,145.0	43,493.3	23,167.5	5,345.2	7,814.0	199,664.2	437,365.2
Uncollected Payments								
Uncollected customer payments from Federal Sources, end of year	(126.9)	(4,239.5)	(5,720.5)	(12,277.8)	0.0	(2,176.7)	(53,412.0)	(77,953.4)
Change in uncollected payments, Federal sources	(60.8)	72.5	98.5	2,302.1	0.0	235.4	(1,898.2)	749.5
Actual transfers, uncollected payments, Federal sources	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Uncollected payments, Federal sources, end of year	(187.7)	(4,167.0)	(5,622.0)	(9,975.7)	0.0	(1,941.3)	(55,310.2)	(77,203.9)
Obligated balance, start of year	$ 11,848.8	$ 147,230.0	$ 41,991.9	$ 16,253.1	$ 4,643.2	$ 6,198.0	$ 162,451.8	$ 390,616.8
Obligated balance, end of year	$ 13,548.3	$ 139,978.0	$ 37,871.3	$ 13,191.8	$ 5,345.2	$ 5,872.7	$ 144,354.0	$ 360,161.3
Budget Authority and Outlays, Net:								
Budget Authority, gross (discretionary and mandatory)	$ 147,986.9	$ 98,298.8	$ 67,827.5	$ 12,125.1	$ 63,322.8	$ 21,253.5	$ 491,940.0	$ 902,754.6
Actual offsetting collections (discretionary and mandatory)	(1,186.1)	(2,741.0)	(7,794.5)	(7,431.7)	(128.5)	(10,963.5)	(137,664.7)	(167,910.0)
Change in uncollected customer payments from Federal Sources (discretionary and mandatory)	(60.8)	72.5	98.5	2,302.1	0.0	235.4	(1,898.2)	749.5
Budget authority, net (discretionary and mandatory)	$ 146,740.0	$ 95,630.3	$ 60,131.5	$ 6,995.5	$ 63,194.3	$ 10,525.4	$ 352,377.1	$ 735,594.1
Outlays, gross (discretionary and mandatory)	$ 145,219.5	$ 115,344.9	$ 71,741.2	$ 18,288.5	$ 62,620.8	$ 18,062.6	$ 490,743.3	$ 922,020.8
Actual offsetting collections (discretionary and mandatory)	(1,186.1)	(2741.0)	(7,794.5)	(7,431.7)	(128.5)	(10,963.5)	(137,664.7)	(167,910.0)
Outlays, net (discretionary and mandatory)	144,033.4	112,603.9	63,946.7	10,856.8	62,492.3	7,099.1	353,078.6	754,110.8
Distributed offsetting receipts	0.0	(0.8)	0.0	0.0	(79,998.2)	(806.7)	(1,961.9)	(82,767.6)
Agency outlays, net (discretionary and mandatory)	$ 144,033.4	$ 112,603.1	$ 63,946.7	$ 10,856.8	$ (17,505.9)	$ 6,292.4	$ 351,116.7	$ 671,343.2

Statement of Disaggregated Budgetary Resources ***For the Years ended September 30*** *Dollars in Millions*	**Non-Budgetary**		
	Other	**2014 Combined**	**2013 Combined**
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 46.8	$ 46.8	$ 15.5
Borrowing Authority (discretionary and mandatory)	368.0	368.0	26.9
Spending Authority from offsetting collections (discretionary and mandatory)	120.4	120.4	83.2
Total Budgetary Resources	**$ 535.2**	**$ 535.2**	**$ 125.6**
Status of Budgetary Resources:			
Obligations Incurred	$ 488.1	$ 488.1	$ 78.8
Unobligated balance, end of year:			
Unapportioned	47.1	47.1	46.8
Unobligated balance brought forward, end of year	**$ 47.1**	**$ 47.1**	**$ 46.8**
Total Budgetary Resources	**$ 535.2**	**$ 535.2**	**$ 125.6**

Statement of Disaggregated Budgetary Resources	Non Budgetary		
For the Years ended September 30 *Dollars in Millions*	Other	2014 Combined	2013 Combined
Change in Obligated Balance			
Unpaid obligations:			
Unpaid obligations, brought forward, October 1 (gross)	$ 300.7	$ 300.7	$ 541.8
Obligations incurred	488.1	488.1	78.8
Outlays (gross)	(303.9)	(303.9)	(319.9)
Unpaid obligations, end of year	**484.9**	**484.9**	**300.7**
Uncollected payments:			
Uncollected payments, Federal sources, brought forward, October 1	(52.4)	(52.4)	(83.5)
Change in uncollected customer payments, Federal sources	(22.8)	(22.8)	31.1
Uncollected payments, Federal sources, end of year	**(75.2)**	**(75.2)**	**(52.4)**
Obligated balances, start of year	248.3	248.3	458.3
Obligated balance, end of year (net)	**$ 409.7**	**$ 409.7**	**$ 248.3**
Budget Authority and Outlays, Net:			
Budget Authority, gross (discretionary and mandatory)	488.4	488.4	110.1
Actual offsetting collections (discretionary and mandatory)	(97.5)	(97.5)	(126.7)
Change in uncollected customer payments from Federal Sources (discretionary and mandatory)	(22.8)	(22.8)	31.1
Budget authority, net (discretionary and mandatory)	**$ 368.1**	**$ 368.1**	**$ 14.5**
Outlays, gross (discretionary and mandatory)	303.9	303.9	319.9
Actual offsetting collections (discretionary and mandatory)	(97.5)	(97.5)	(126.7)
Outlays, net (discretionary and mandatory)	**206.4**	**206.4**	**193.2**
Agency outlays, net (discretionary and mandatory)	**$ 206.4**	**$ 206.4**	**$ 193.2**

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

November 17, 2014

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

SUBJECT: Independent Auditor's Report on the Department of Defense FY 2014 and FY 2013 Basic Financial Statements (Report No. DODIG-2015-033)

We are providing the subject report to be published in the Department of Defense FY 2014 Agency Financial Report in conjunction with the Department of Defense FY 2014 and FY 2013 Basic Financial Statements provided to us in draft on November 4, 2014. The report includes our disclaimer of opinion on the basic financial statements and our required Report on Internal Control Over Financial Reporting and Compliance With Applicable Provisions of Laws, Regulations, Contracts, and Grant Agreements. We are issuing our disclaimer of opinion to accompany the Department of Defense FY 2014 and FY 2013 Basic Financial Statements, and therefore, this audit report should not be disseminated separately from those statements.

The Army's inability to provide us with the documentation needed to complete our work in a timely manner jeopardized our ability to meet the statutory and OMB mandated due date for this opinion report. We look forward to working with Department in the future to address these issues.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5945 (DSN 329-5945).

Lorin T. Venable

Lorin T. Venable, CPA
Assistant Inspector General
Financial Management and Reporting

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

November 17, 2014

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

SUBJECT: Independent Auditor's Report on the Department of Defense FY 2014 and FY 2013 Basic Financial Statements (Report No. DODIG-2015-033)

Report on the Basic Financial Statements

Public Law 101-576, "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, 2014, and 2013, and the related consolidated statement of net cost, consolidated statement of changes in net position, combined statement of budgetary resources, and notes to the basic statements (basic financial statements).

Management's Responsibility for the Annual Financial Statements

The annual financial statements are the responsibility of DoD management. Management is responsible for (1) preparing financial statements that conform with generally accepted accounting principles in the United States (U.S. GAAP); (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that they met broad control objectives of Public Law 97-255, "Federal Managers' Financial Integrity Act of 1982" (FMFIA); (3) ensuring that DoD's financial management systems fully comply with Public Law 104-208, "Federal Financial Management Improvement Act of 1996" (FFMIA) requirements; and (4) complying with applicable laws and regulations.

Auditor's Responsibility

Our responsibility is to express an opinion on the basic financial statements based on conducting the audit in accordance with U.S. generally accepted government auditing standards and the Office of Management and Budget (OMB) Bulletin No. 14-02, "Audit Requirements for Federal Financial Statements," October 21, 2013. However, based on the matters described in the Basis for Disclaimer of Opinion paragraph, we were unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

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. DoD management asserted to us that DoD FY 2014 and FY 2013 Basic Financial Statements would not substantially conform to U.S. GAAP and that DoD financial management and feeder systems were unable to adequately support material amounts on the basic financial statements as of September 30, 2014. Accordingly, we did not perform all the auditing procedures required by generally accepted government auditing standards and OMB Bulletin 14-02 to determine whether material amounts on the basic financial statements were presented fairly. We considered the scope limitation in forming our conclusions on the basic financial statements.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we could not obtain sufficient appropriate evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the DoD FY 2014 and FY 2013 Basic Financial Statements. Thus, the basic financial statements may have undetected misstatements that are both material and pervasive.

Emphasis of Matter

As discussed in Note 1.O to the basic financial statements, DoD has elected to change its capitalization thresholds for General Property, Plant and Equipment in FY 2014. We did not modify our opinion with respect to this matter.

Other Information in the Annual Financial Statements

We performed our audit to form an opinion on the basic financial statements as a whole. DoD management presented the Management's Discussion and Analysis, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Information for additional analysis as part of the annual financial statements; these elements are not required parts of the basic financial statements. Therefore, we do not express an opinion or provide any assurance on the information. We reviewed the other information for inconsistencies with the audited basic financial statements. Based on our limited review, we did not find any material inconsistencies between the information and the basic financial statements and applicable sections of OMB Circular No. A-136 (Revised), "Financial Reporting Requirements," September 18, 2014, and DoD Regulation 7000.14-R, "Financial Management Regulation," volume 6b, "Form and Content of the Department of Defense Audited Financial Statements."

Report on Compliance With Applicable Provisions of Laws, Regulations, Contracts, and Grant Agreements

We limited our audit to determining compliance with provisions of applicable laws and regulations, contracts, and grant agreements that have direct and material effect on the basic financial statements, and compliance with OMB regulations and audit requirements for financial reporting because management represented that instances of noncompliance identified in prior audits continue to exist. Therefore, we did not determine whether DoD complied with all applicable laws and regulations, contracts, and grant agreements related to financial reporting. Providing an opinion on compliance with certain provisions of laws and regulations, contracts, and grant agreements was not an objective of our audit, and accordingly, we do not express such an opinion.

See Attachment for additional details on internal control and compliance with legal and other regulatory requirements.

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. DoD officials expressed their continuing commitment to address the problems this report outlines.

This report will be made publicly available pursuant to section 8M, paragraph (b)(1)(A) of the Inspector General Act of 1978, as amended. However, this report is intended solely for the information and use of Congress; the OMB; the U.S. Government Accountability Office; the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD; and the DoD Office of Inspector General. It is not intended to be used and should not be used by anyone else.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5945 or (DSN) 329-5945.

Lorin T. Venable

Lorin T. Venable, CPA
Assistant Inspector General
Financial Management and Reporting

Attachment: As stated

Report on Internal Control Over Financial Reporting

Internal Control Compliance

In planning our audit, we considered DoD's internal control over financial reporting. We did this to determine our procedures for auditing the basic financial statements appropriate to the circumstances, for the purposes of expressing our opinion on the basic financial statements, but not appropriate to the purpose of expressing an opinion on the effectiveness of the internal control. Accordingly, we do not express an opinion on internal control over financial reporting.

Management Responsibilities

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 the requirements of applicable laws and regulations; and safeguarded assets against misappropriation and abuse.

Auditor's Responsibilities

Our purpose was not to express an opinion on internal control over financial reporting, and we do not do so. However, the following material weaknesses and a significant deficiency exist that could adversely affect DoD's financial operations.

Previously Identified Material Weaknesses

Management acknowledged that previously identified material weaknesses continued. 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 DoD's financial statements will not be prevented, or detected and corrected on a timely basis. The following material weaknesses continue to exist.

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 assets are properly safeguarded to deter fraud, waste, and abuse and that performance measurement information be 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 basic 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 Financial 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 services provided. DoD acknowledged that it was unable to accurately record, report, collect, and reconcile intragovernmental accounts receivable, as well as accounts receivable 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, acquired on behalf of the Government (e.g., the Government will ultimately hold title) 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 it is uncertain of the accuracy of 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 on time.
- 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 Deficiency

Management acknowledged that a previously identified deficiency continues to exist. 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 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 continues 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 relating to the DoD process for reporting contingent legal liabilities continue to exist. For example:

- The DoD Office of General Counsel stated in its legal representation letters that it was unable to express an opinion on the likely outcome of 28 of 39 pending legal actions, totaling $10 trillion in claims.

DoD corrected a portion of this significant deficiency. In prior years, DoD excluded from its legal representation letters, cases that individually did not exceed the DoD Agency-wide individual reporting threshold, but in aggregate exceeded this threshold. DoD included these cases in FY 2014. These financial management control 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. Internal control work we conducted as part of our prior audits would not necessarily disclose all material weaknesses and significant deficiencies. We did not identify material weaknesses that were not reported as such in DoD's FMFIA report.

Report on Compliance with Applicable Provisions of Law, Regulations, Contracts, and Grant Agreements

U.S. generally accepted government auditing standards and OMB guidance require auditors to report on entities' compliance with selected provisions of laws and regulations, contracts, and grant agreements. Management is responsible for compliance with existing laws and regulations, contracts, and grant agreements related to financial reporting. Management has also acknowledged to us that previously reported instances of noncompliance continue to exist. Therefore, we did not determine whether DoD complied with selected provisions of all applicable laws and regulations, contracts, and grant agreements related to financial reporting. We caution that other noncompliance may have occurred and not been detected. Furthermore, the results of our limited procedures may not be sufficient for other purposes. Our objective was not to, and we do not, express an opinion on compliance with applicable laws, regulations, contracts, and grant agreements. Because of other scope limitations discussed in this report, we limited our work to determining compliance with selected provisions of the applicable laws and regulations.

Antideficiency Act

Section 1341, title 31, United States Code (31 U.S.C. § 1341 [1990]), limits DoD and its agents to making or authorizing 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 required by 31 U.S.C. § 1517 (2004), DoD and its agents are prohibited from making or authorizing expenditures or 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 2014, DoD reported one ADA violation.

DoD Regulation 7000.14-R, "Financial Management Regulation," volume 14, chapter 7, "Antideficiency Act Report," November 2010, limits the time from identification to reporting of ADA violation to 15 months. Four investigations of potential ADA violations have been open for more than 15 months.

Compliance With FFMIA Requirements

FFMIA requires DoD to establish and maintain financial management systems that comply substantially with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. For areas in which an agency is not in compliance, OMB A-136 requires the agency to identify remediation activities planned or underway to bring the systems into substantial compliance with FFMIA. DoD is applying appropriate financial resources to achieve audit-readiness. Financial-system resources include resources for designing and achieving an audit-ready systems environment, including new-system deployment costs, other than the Enterprise Resource Planning (ERP) systems. It also includes the resources to make needed and cost-effective changes to legacy systems that will be part of the audit-ready systems environment. ERPs will be an essential part of DoD's audit-readiness efforts. However, DoD reported in FIAR Plan Status Report, May 2014, that not all ERPs will be deployed by 2014 and 2017 audit readiness dates. Therefore, DoD will continue to rely on legacy systems to meet the audit-readiness dates.

For FY 2014, DoD did not substantially comply with FFMIA. The Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, acknowledged to us that 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 continue. The financial management and feeder systems did not substantially comply with the Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2014. Therefore, based on the representation of DoD, we did not substantiate whether DoD complied with FFMIA and OMB implementation guidance.

Recommendations

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

Attachment 1
Page **7** of **7**

This Page Left Blank Intentionally

United States Department of Defense

Agency Financial Report

Fiscal Year 2014

Other Information

This Page Left Blank Intentionally

OTHER INFORMATION

MANAGERS' INTERNAL CONTROL PROGRAM

The Department's management has a fundamental responsibility to develop and maintain effective internal controls to ensure Federal programs operate and Federal resources are used efficiently and effectively to achieve desired objectives. As discussed in the Management's Discussion and Analysis, managers throughout the Department are accountable for ensuring effective internal controls in their areas of responsibility. All DoD Components are required to establish and assess internal controls for financial reporting, mission-essential operations, and financial management systems.

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 2a, with detail in Table 2a-1).
2. FMFIA Section 2, Non-Financial Operations Material Weaknesses (see Table 2b, with detail in Table 2b-1).
3. FMFIA Section 4, Financial System Nonconformance Weaknesses (see Table 2c, with detail in Table 2c-1).
4. FFMIA, Compliance with Section 803(a), FFMIA.

Table 1. DoD IG-Identified Material Weaknesses in Internal Controls Over Financial Reporting					
Audit Opinion: Disclaimer					
Restatement: No					
Areas of Material Weakness	**Beginning Balance**	**New**	**Resolved**	**Consolidated**	**Ending Balance**
Accounts Payable	1				1
Accounting Entries	1				1
Environmental Liabilities	1				1
Government Property in Possession of Contractors	1				1
Intragovernmental Eliminations	1				1
Operating Materials and Supplies	1				1
Reconciliation of Net Cost of Operations to Budget	1				1
Statement of Net Cost	1				1
Financial Management Systems	1				1
Fund Balance with Treasury	1				1
General Property, Plant & Equipment	1				1
Inventory	1				1
Accounts Receivable	1				1
Total Material Weaknesses	**13**				**13**

SUMMARY OF MANAGEMENT ASSURANCES

1. FMFIA SECTION 2, FINANCIAL REPORTING MATERIAL WEAKNESSES. Under the oversight of the DoD Financial Improvement Audit Readiness (FIAR) Governance Board, discussed in the *FIAR Plan Status Report*, the Department's assessment of the effectiveness of its internal controls over financial reporting identified 17 areas of material weakness in FY 2014. Table 2a lists the material weaknesses in internal controls over financial reporting, captured by end-to-end process and the assessable unit for the material weakness, and incorporates changes from the weaknesses reported in the *DoD Agency Financial Report for FY 2013*.

Table 2a. Summary of DoD-Identified Material Weaknesses in Internal Controls over Financial Reporting (FMFIA Section 2)

Statement of Assurance: No assurance

End-to-End Process	Areas of Material Weakness	FY 2014 Beginning Balance	New	Resolved	Consolidated	Reassessed	FY 2014 Ending Balance
Budget-to-Report	Fund Balance with Treasury (FBWT)	1					1
	Financial Reporting Compilation	1					1
	Intragovernmental Eliminations	1					1
Hire-to-Retire	Health Care Liabilities	1					1
	Civilian Pay	1					1
	Military Pay	1					1
Order-to-Cash	Accounts Receivable	1					1
Procure-to-Pay	Contract/Vendor Pay	1					1
	Reimbursable Work Orders (Budgetary)	1					1
	Transportation of Things	0	1				1
	Transportation of People	1					1
Acquire-to-Retire	Financial Reporting of Valuation of Equipment	1					1
	Real Property Assets	1					1
	Environmental Liabilities	1					1
Plan-to-Stock	Inventory	1					1
	Operating Materials & Supplies (OM&S)	1					1
	Military Standard Requisitioning and Issue Procedures (MILSTRIP)	1					1
Total Financial Reporting Material Weaknesses		**16**	**1**				**17**

Table 2a-1 provides a brief description of each of the material weaknesses in financial reporting, with corrective actions and the target correction year.

Table 2a-1. Brief Description of Material Weaknesses in Internal Controls over Financial Reporting

	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
1	Fund Balance with Treasury (FBWT) • Ineffective processes and controls to reconcile transactions posted to the Department's FBWT accounts with the Department of Treasury's (Treasury) records. • Collections and Disbursements are reported to Treasury but are not recorded in the Department's general ledger. • Ineffective processes to provide sufficient and accurate documentation to support FBWT transactions and reconciling items.	FY 2005	Department-wide	• Track and reconcile collection/disbursement activity from the core financial systems and associated feeder systems to the Department's general ledgers and to Treasury accounts. • Develop an auditable FBWT reconciliation process, to include implementation of internal controls that ensure reconciling differences are resolved in a timely and accurate manner.	FY 2015
2	Financial Reporting Compilation • Ineffective processes and controls to prepare accurate financial statements supported by general ledger balances that align with Department strategic and performance plans. • Inability to reconcile detail-level transactions with the general ledgers and to provide adequate supporting documentation for adjustment entries. • Accounting balances are unsupported due to inadequate financial management systems and related processes and procedures. • Inconsistent procedures for recording Journal Vouchers and Standard Business Transactions (SBT) and retention procedures to ensure maintaining of proper supporting documentation.	FY 2007	Department-wide	• Implement a Standard Financial Information Structure (SFIS) to standardize financial reporting that aligns with the Department's mission. • Implement controls that ensure adequate documentation exists to validate and support journal entries. • Develop controls, processes, and policy and procedures that include the reconciliation of the Defense Agency Initiative (DAI) Trial Balance to the financial statements. • Identify root causes for abnormal balances on the Report on Budget Execution and Budgetary Resources (Standard Form-133s) and develop mitigating internal controls.	FY 2015

Table 2a-1. Brief Description of Material Weaknesses in Internal Controls over Financial Reporting					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
3	Intragovernmental Eliminations • Ineffective processes and controls to collect, exchange, and reconcile intragovernmental buyer and seller transactions, resulting in unsupported adjustments. • Inability to provide valid and complete supporting documentation in a timely manner.	FY 2008	Department-wide	• Implement enterprise resource planning (ERP) systems and SFIS structure to correctly report, reconcile, and eliminate intragovernmental balances. • Identify and implement reconciliations that provide for validation of the seller/buyer transactions. • Implement controls to ensure adequate documentation exists to validate and support journal entries.	FY 2017
4	Health Care Liabilities • Insufficient financial reporting and accounting for all health care costs and the lack of processes to reconcile Medical Expense and Performance Reporting System data.	FY 2003	Department-wide	• Complete the implementation of new Enterprise Resource Planning (ERP) core financial systems for each Service in order to record accrual-based, patient-level cost accounting data. • Develop and implement methodology for per capita rate to address the auditor identified weakness related to direct care.	FY 2017
5	Civilian Pay • Ineffective processes and controls to record civilian pay transactions and personnel actions in a timely, complete, and accurate manner. • This includes unreliable supporting documentation for personnel actions and timekeeping, and inadequate reconciliations between Defense Civilian Pay System (DCPS) and the general ledger.	FY 2011	Department-wide	• Evaluate the sufficiency of the current SSAE 16 efforts. This includes determining whether the assessment includes all complete end-to-end processes. • Develop and implement a methodology to reconcile DCPS to the general ledger. • Implement controls to ensure supporting documentation exists, is reviewed, approved, validated, retained, and readily available.	FY 2015

Table 2a-1. Brief Description of Material Weaknesses in Internal Controls over Financial Reporting					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
6	Military Pay • Ineffective processes and controls to record military pay transactions and personnel actions in a timely, complete, and accurate manner. This includes unreliable supporting documentation for personnel actions, and lack of reconciliations between Defense Joint Military Pay System (DJMS) and the general ledger.	FY 2011	Department-wide	• Implement control processes that ensure supporting documentation exists, is reviewed, approved, validated, retained, and readily available. • Implement reconciliations to address the completeness of data entered into the Defense Joint Military Pay System.	FY 2015
7	Accounts Receivable • Ineffective processes and controls to ensure complete and accurate recording and sufficient documentation to support accounts receivable and related accruals. • Lack of proper accounting and reporting for accounts receivable collections.	FY 2003	Department-wide	• Implement ERP systems to improve collections of public accounts receivables, aging of receivables, and minimize manual processes. • Implement process improvements, such as training, guidance, and policy changes. • Develop documentation in sufficient detail to address the edit checks and validations performed. • Utilize the Tri-Annual Review process to monitor the status of dormant reimbursable agreement receivables and unfilled orders. Reviews will evaluate timeliness, accuracy, and completeness for closeout when applicable.	FY 2015
8	Contract/Vendor Pay • No standard process or format governing purchase request development, linkage with contract data, and payment. • Untimely contract closeout and deobligation of funds. • Insufficient policies governing the recording of obligations and accruals.	FY 2003	Department-wide	• Implement controls to validate receipt and acceptance. • Implement training, guidance and management oversight. • Develop interfaces between data standardization repositories.	FY 2017

Table 2a-1. Brief Description of Material Weaknesses in Internal Controls over Financial Reporting					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
9	Reimbursable Work Orders • Inability to reconcile Reimbursable Work Order buyer and seller balances/transaction details to field activity systems in a complete and timely manner. • Lack of evidence to support receipt and acceptance of goods and services, and the validity of open obligations. • Inability to verify the timely and accurate collection of disbursements, and validate that recorded reimbursable agreements meet the time, purpose, and amount criteria.	FY 2011	Department-wide	• Implement controls to validate receipt and acceptance of goods and services. • Implement training, improved guidance, and management oversight related to Tri-Annual Reviews. • Develop interfaces between data standardization repositories and accounting systems of record.	FY 2017
10	Transportation of Things • No effective controls are in place to prevent unauthorized use of Transportation Account Codes (TAC) or unauthorized shipments from occurring. • The Department does not have standardized processes and procedures for Transportation of Things to support management evaluations, examinations, and audits.	FY 2014	Navy	• Develop controls, processes, and policy and procedures for Transportation of Things. • Implement control processes that ensure supporting documentation exists and is adequately reviewed, approved, and retained.	FY 2017
11	Transportation of People • Inadequate controls over transportation of people processes. This includes inadequate segregation of duties, lack of reconciliations, and untimely voucher filing.	FY 2011	Department-wide	• Develop 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. • Monitor open travel obligations and enforce supervisory review to ensure timely submission of travelers' vouchers.	FY 2017

Table 2a-1. Brief Description of Material Weaknesses in Internal Controls over Financial Reporting					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
12	Financial Reporting of Valuation of Equipment • Ineffective processes and controls to account for quantity and value of military and general equipment.	FY 2003	Department-wide	• Continue efforts to ensure that assets are recorded in the appropriate Accountable Property System of Record and can be reconciled to the general ledgers. • Apply controls and procedures to manage equipment accountability, including adequate documentation to support ownership. • Re-emphasized the importance of valuation by having the Services report progress and impediments quarterly. • Report quarterly on progress in establishing accountable records for all GFP assets, correcting policy deficiencies, and ensuring controls are in place when property is furnished on contracts.	FY 2017
13	Real Property Assets • Ineffective processes and controls to account for the quantity and value of real property. • Inaccurate and untimely recording of transactions when construction in progress is transferred to real property accounts. • Inadequate real property documentation.	FY 2003	Department-wide	• Implement business processes and management controls to reconcile real property records, and to ensure assets exist and records are complete. • Implement periodic evaluations over the quality of real property data by making comparisons with physical assets and annual reconciliations.	FY 2017
14	Environmental Liabilities • Inability to provide assurance that clean-up costs for all of its ongoing, closed, and disposal operations are identified, consistently estimated, and appropriately reported. • Unable to consistently report environmental liability disclosures and supporting documentation is not properly maintained and readily available for all environmental sites.	FY 2001	Department-wide	• Implement systems, processes, and controls to ensure the accuracy of site-level liability data to report environmental liabilities. • Develop “cost to complete” guidance and training procedures.	FY 2016

Table 2a-1. Brief Description of Material Weaknesses in Internal Controls over Financial Reporting					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
15	Inventory • Insufficient policies and procedures to support inventory transactions, journal vouchers, and inventory valuation. • Lack of clear audit trails to trace transactions from source documentation to the reported total dollar values on the Inventory line item on the financial statements. • Lack of controls to provide assurance that inventory recorded in the financial statements exists and is complete.	FY 2005	Department-wide	• Develop methodology and inventory condition code reports to support monthly journal vouchers (JV) related to inventory. • Review all pre- and post-trial balance adjustments, determine reason for the adjustments, and trace to supporting documentation. • Develop methodology to value inventory in the absence of historical costs.	FY 2017
16	Operating Materials &Supplies (OM&S) • Historical cost data is not maintained as required by Generally Accepted Accounting Principles (GAAP). • Inability to perform and document annual physical inventories of OM&S and maintain clear audit trails to permit the tracing of transactions from source documentation. • Government-owned/ Contractor managed inventory is not accounted for in DoD accountable property system.	FY 2005	Department-wide	• Document business and financial processes and controls to include tracking inventory values to historical cost. • Develop interim auditable solution for Government owned/Contractor managed inventory. • Identify and document the current inventory reconciliation processes, including key controls and financial transactions.	FY 2017
17	Military Standard Requisitioning and Issue Procedures (MILSTRIP) • Insufficient documentation of business and financial processes and controls to include transactions not accurately reconciled to the financial management systems of record and ineffective reconciliation process for unliquidated obligations (ULO).	FY 2013	Navy	• Document business and financial processes to identify root causes, review and prioritize Federal Information System Controls Audit Manual (FISCAM) control testing, and ensure a comprehensive ULO reconciliation process.	FY 2015

2. FMFIA Section 2, Non-Financial Operations Material Weaknesses. The DoD Components use an entity-wide, risk-based, self-assessment approach to establish and assess internal controls for mission-essential operations. The material weaknesses in non-financial operational areas are categorized in separate reporting categories.

Table 2b lists the FY 2014 material weaknesses in the internal controls over non-financial operations. The Department did not identify any new material weaknesses in operations in FY 2014; however, the Department consolidated the Areas of Material Weaknesses to comply with OMB Circular A-136, *Financial Reporting Requirements*.

Table 2b. Summary of DoD-Identified Material Weaknesses in Internal Controls over Non-Financial Operations (FMFIA Section 2)

Statement of Assurance: Qualified

Area of Material Weakness	Beginning Balance	New	Resolved	Consolidated[8]	Reassessed	Ending Balance
Acquisition	1					1
Security	3			2		1
Information Technology	1					1
Comptroller and/or Resource Management	3			2		1
Contract Administration	2			1		1
Force Readiness	1					1
Personnel and/or Organizational Management	3			2		1
Property Management	1					1
Supply Operations	1					1
Total Non-Financial Operations Material Weaknesses	**16**			**7**		**9**

[8] Per OMB's revised Circular No. A-136, Financial Reporting Requirements, the column titled "Consolidation" has been added to Table 2b. This column represents the number of Department-wide material weaknesses from the beginning balance reported from preceding years and consolidated.

Table 2b-1 provides a brief description of each of the nine material weaknesses in internal controls over non-financial operations, the associated corrective actions, and the target correction year provided by the reporting Components.

Table 2b-1. Brief Description, DoD-Identified Material Weaknesses in Internal Controls Over Non-Financial Operations

	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
1	Acquisition				
	• DoD continues to experience program cost and schedule increases in its Major Defense Acquisition Program Portfolio • Knowledge-based acquisition practices have not been consistently implemented across the acquisition portfolio.	FY 2011	Department-wide	• Continue development and implementation of Better Buying Power initiatives designed to improve the operation of the defense acquisition system and enhance the skill of the acquisition workforce. • Issue revised acquisition policy that implements key BBP initiatives and improves system performance.	Reassessed Annually based on Incremental Improve-ments
2	Security				
	• There are weaknesses in DoD's management and assurance of the reliability and security of information technology infrastructures. • Personally Identifiable Information (PII), which consisted of sensitive employee information, was improperly disposed of in recycle bins. • Lack of effective oversight of Security Managers regarding Common Access Card (CAC) retrieval, which potentially lead to an inadvertent compromise of sensitive information.	FY 2006	Department-wide	• Develop and implement a uniform equipment request and loan tracking system for managing and tracking information. • Create baseline metrics and define security administration compliance for information, personnel, and industrial security programs. • Develop enhanced Ethics and Security Awareness training at all levels to ensure that personnel are trained to prevent the compromise of classified information.	FY 2015
3	Information Technology				
	• DoD financial and business management systems and processes are costly to maintain and operate, are not fully integrated and do not provide information that is reliable, timely, and accurate.	FY 2010	Department-wide	• Complete relevant FISCAM testing, implement process standardization, and ensure compliance with information systems requirements in order to achieve FISCAM control objectives.	FY 2017

Table 2b-1. Brief Description, DoD-Identified Material Weaknesses in Internal Controls Over Non-Financial Operations

	Material Weaknesses	Year Identified	DoD Components	Corrective Actions	Target Correction Year
4	Comptroller and Resource Management				
	• DoD's current business processes, policies and internal controls do not provide reliable, accurate and verifiable financial statements. • The financial management workforce lacks adequate training in all financial management-related functions and the implementation of effective financial management processes, and procedures. • Funds control process weaknesses resulted in the inability to adequately track funds consistent with existing laws and regulations. The lack of adequate funds control led to several Anti Deficiency Act violations.	FY 2011	Department-wide	• Implement established guidance to enable Components to improve their processes, systems, and controls. • Conduct competency gap analyses of current and expected future financial management workforce and develop training programs and guidance for strategic workforce planning. • Enhance systems for tracking funds, publishing guidance, and scheduling training for personnel who perform funding-related functions.	FY 2017
5	Contract Administration				
	• DoD must strategically manage services acquisition (SA), define outcomes, and capture data to do so. • DoD continues to face challenges meeting FY competition goals and needs to address ill-suited contract arrangements as well as utilize incentives. • Acquisition workforce needs to be appropriately sized, trained and equipped to meet the Department's needs.	FY 2009	Department-wide	• Adopted standard taxonomy for services, appointed senior managers for acquisition of services in each Military Department, appointed Functional Domain Experts, goals established within 12 Services Portfolio Groups and monitor progress. Established Functional Integrated Product Team (SA FIPT). • Better Buying Power 2.0 initiatives to boost competition are on-going such as quarterly MilDep briefings at the Business Senior Integration Group meetings, sharing best practices, etc. DoD achieved FY 14 competition rate of 58.7% against the goal of 58.0%.	Reassessed Annually based on Incremental Improvements

Table 2b-1. Brief Description, DoD-Identified Material Weaknesses in Internal Controls Over Non-Financial Operations					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
	Contract Administration (cont'd)			• Deployed Contracting Competency Assessment to assess proficiencies of workforce. Results will be used for workforce planning and training forecasts.	
6	Force Readiness				
	• There is a lack of diversity within the Sea, Air, and Land (SEAL) Special Operations Forces which indicates a potential operational weakness. The Global War on Terrorism identified the need for an operational need for SEALs with diverse backgrounds. • USTRANSCOM did not conduct quarterly Joint Patient Movement Expeditionary System (JPMES), which potentially hinders USTRANSCOM personnel from deployment readiness during Defense Security Cooperation Agency (DSCA) and other contingency events.	FY 2011	Department-wide	• Implement diversity outreach initiatives that will review outreach and awareness activities to ensure that the Special Operations Forces is recruiting candidates with diverse backgrounds and skills. • Finalize training plans for JPMES and conduct quarterly training exercises.	FY 2018
7	Personnel and/or Organizational Management				
	• DCMA did not prioritize and execute skills-based, on-the-job training that provided its employees with the competencies and practical skills needed to execute their job duties. • The Department identified multiple inconsistencies in time keeping procedures.	FY 2009	Department-wide	• Develop Defense Acquisition University (DAU) accredited courses and on-line learning assets to enhance the skills of the DCMA workforce. • Implement a plan to address time and attendance issues, and conduct inspections of Command directorates to determine whether they are in compliance with time and attendance guidance.	FY 2016

Table 2b-1. Brief Description, DoD-Identified Material Weaknesses in Internal Controls Over Non-Financial Operations					
	Material Weaknesses	**Year Identified**	**DoD Components**	**Corrective Actions**	**Target Correction Year**
8	Property Management				
	• The Department has not effectively trained staff or enabled sufficient tools to address accountability requirements in place to adequately oversee and execute personal property transactions, including government furnished property in the hands of contractors.	FY 2011	Department-wide	• Establish procedures and training on property management policies. • Validate accountable property records and supporting documentation through existence and completeness testing. • Establish accountable records that will identify property, to include Government Furnished Property.	FY 2016
9	Supply Operations				
	• The Government Accountability Office identified Department-wide weaknesses in the areas of asset visibility, inventory management, and materiel distribution.	FY 2011	Department-wide	• Improve Supply Chain Management operations through better demand forecasting, asset visibility, and distribution processes.	Reassessed Annually based on Incremental Improve-ments

3. FMFIA Section 4, Financial System Nonconformance Weaknesses. The Department requires financial system conformance with federal requirements and reports. The Department reported one weakness that includes a wide range of pervasive problems related to financial systems.

Table 2c. Conformance with Financial Management System Requirements (FMFIA Section 4)						
Statement of Assurance: Systems do not conform to financial management system requirements						
Non-Conformances	**Beginning Balance**	**New**	**Resolved**	**Consolidated**	**Reassessed**	**Ending Balance**
1. Financial Management Systems	1					1
Total System Conformance Material Weaknesses	**1**					**1**

Table 2c-1, below, provides the description and corrective action plan for the material weakness related to internal control over financial systems.

Table 2c-1. Brief Description, 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	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

Federal Financial Management Improvement Act (FFMIA)

The DoD IG and the audit agencies within the Military Services have reported on the Department's noncompliance with FFMIA. The Department'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 2d reflects the Department's compliance with FFMIA.

Table 2d. Compliance with Section 803(a) of FFMIA		
	Agency	Auditor
1. System Requirements	Lack of substantial compliance noted	Lack of substantial compliance noted
2. Accounting Standards	Lack of substantial compliance noted	Lack of substantial compliance noted
3. U.S. Standard General Ledger at Transaction Level	Lack of substantial compliance noted	Lack of substantial compliance noted

IMPROPER PAYMENT AND PAYMENT RECAPTURE PROGRAMS

As previously discussed in the Management Discussion and Analysis section, beginning in 2002 Congress enacted legislation[9] (collectively referred to as IPERA in this report) to help ensure Federal entities have strong financial management controls to better detect and prevent improper payments, and to report on these programs to the President and Congress in the annual Agency Financial Report. The Department's improper payments and payment recapture programs are reported in this section in the following subcategories:

I. Risk Assessment
II. Statistical Sampling Process
III. Root Causes of Errors and Corrective Actions
IV. Program Improper Payment Reporting
V. Recapture of Improper Payment Reporting
VI. Accountability
VII. Agency Information Systems and Other Infrastructure
VIII. Statutory and Regulatory Barriers
IX. Additional Information
X. Agency reduction of improper payments with the Do Not Pay Initiative

The Department reports improper payments in the following six categories:

Military Health Benefits – Disbursed by Treasury for the Defense Health Agency (DHA)

Military Pay – Disbursed by Defense Finance and Accounting Service (DFAS)

Civilian Pay – Disbursed by DFAS

Commercial Pay (vendor and contract payments) – Disbursed by DFAS, the Navy, and the U.S. Army Corps of Engineers (USACE)

Military Retiree and Annuitant Benefit Payments – Disbursed by DFAS

Travel Pay – Disbursed by DFAS, the Army, the Navy, the Air Force, and USACE

The DFAS, USACE, and DHA are the primary disbursing components within the Department. The Army, Navy, and Air Force report on travel improper payments that are not disbursed by DFAS.

I. Risk Assessment[10]

DFAS. The DFAS performed a risk assessment of its disbursements using Office of Management and Budget (OMB) criteria contained in *OMB Circular No. A-123, Appendix C*, Management's Responsibility for Internal Control. The DFAS also monitors changes in programs associated with OMB-mandated criteria (for example, a large increase in annual outlays, regulatory changes, or newly-established programs) to track unfavorable trends to allow early implementation of corrective actions.

[9] *Improper Payments Information Act of 2002* (IPIA), as amended by *The Improper Payments Elimination and Recovery Act of 2010* (IPERA) and *The Improper Payments Elimination and Recovery Improvement Act of 2012* (IPERIA)

[10] Refer to detail at *Under Secretary of Defense (Comptroller) > Financial Management > Reports > Government-wide Improper Payment Reporting* for Reporting Component Risk Assessments.

USACE. The USACE risk 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 U.S. Corps of Engineers Financial Management System (CEFMS) provides internal system standards that adhere to U.S. generally accepted accounting principles, as well as process controls that provide the 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.

DHA. The DHA risk assessment process is managed through contracts with an external independent contractor (EIC) to provide an independent, impartial review of reimbursements and claims processing procedures used by DHA's care contractors. The EIC identifies improper payments resulting from the contractors' noncompliance with DHA payment/reimbursement policies, regulations, and contract requirements. The risk level of programs is evaluated based on results of these compliance reviews.

Navy. Because the Navy's FY 2013 reporting included only six months of data, the Navy determined that its commercial payment disbursements would be high risk for FY 2014, when an entire year of transactions could be reviewed.

II. Statistical Sampling Process[11]

The primary disbursing Components use statistically valid sampling methods designed to meet or exceed OMB's requirements of 90 percent confidence level, plus or minus (±2.5) percentage points, to estimate and project the Department's annual improper payments for each payment type. The smaller disbursing Components 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. All Department sampling plans were approved by OMB in FY 2013, and updated plans for DFAS Commercial Pay, DHA Military Health Benefits, and USACE Travel Pay were submitted to OMB for FY 2014.

Military Health Benefits. The EIC compliance reviews include three sample types: a payment sample, to ensure payment accuracy by identifying underpayment and overpayments; a denied payment sample, to ensure proper claim denial; and an occurrence sample, to ensure the accuracy in reporting healthcare data, regardless of payment accuracy. Paid samples are conducted as a stratified random sample based on paid amounts; denied samples are conducted as a stratified random sample based on billed amounts; and occurrence samples are conducted as a simple random sample with no stratification.

- Payment Samples: Samples for paid claims include between 4 and 12 strata, depending on the composition of the claims in the universe. Mathematical formulas are used to identify optimal strata boundary points, and sample sizes are calculated to yield an estimate with a minimum of 90 percent confidence ± 2.5 percentage points.

[11] Refer to detail at *Under Secretary of Defense (Comptroller) > Financial Management > Reports* for Reporting Components Statistical Sampling Plans.

- Denied Payment Sample: Denied payment samples are limited to claims with $0 government payment. The denied payment sample is similar in design to the payment sample, but the denied sample is stratified based on billed amount because the paid amount for a denied claim is equal to $0.
- Occurrence Samples: Occurrence samples are intended to monitor and evaluate the accuracy of TRICARE Encounter Data (TED) record coding, versus the accuracy of the payment, by the Third Party Payment Contractors (TPPCs). These records are selected using a simple random sample. A sample of up to 350 records is selected for each occurrence sample, and each record in the sample contains approximately 90 data fields that are evaluated for accuracy. The results from occurrence samples are used to monitor data accuracy only and do not affect the improper payment error rates; however, TPCCs are required to correct any improper payments identified during occurrence reviews.

The DHA continually evaluates the accuracy and design of its sampling methodologies for all contracts and implements revisions, if warranted by the distribution of audit universes or the outcome of compliance reviews. Based on recent GAO recommendation, DHA is reevaluating its sampling methodology for FY 2015 AFR reporting.

Military Pay. On a monthly basis the Department statistically samples Military Pay accounts stratified by 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). The DFAS selects the accounts for each Component to review, and DFAS produces annual estimates of improper payments.

Civilian Pay. On a monthly basis, DFAS statistically samples Civilian Pay accounts stratified by Army, Air Force, Navy/Marine Corps, and Defense Agencies.

Commercial Pay

DFAS. In FY 2014, DFAS refined its statistical sampling methodology for the Commercial Pay program to incorporate GAO and DoD OIG recommendations. The agency assessed the risk of improper payments computed within the entitlement systems. Seven systems[12] were identified as "at risk" of making improper payments based on historical post-payment and self-identified reviews, and the volume of outlays. These seven systems cover approximately 94 percent of the Commercial Pay program outlays.

The DFAS designed a stratified random sample by dollar amount to consider the wide-range of amounts within each of the seven contract and vendor pay systems. The overall variable sample size was calculated for the combined systems to produce a point estimate with a 95 percent confidence interval and a margin of error of ±2.5 percent, and was allocated to each stratum with the Neyman Allocation method. Samples were randomly selected using the SPSS statistical software from the seven systems as a whole. Each invoice within the stratum had an equal probability of selection.

[12] Computerized Accounts Payable System for Windows (CAPS), Defense Agencies Initiative (DAI), Enterprise Business System (EBS), General Funds Enterprise Business System (GFEBS), Integrated Accounts Payable System (IAPS), Mechanization of Contract Administrative Services (MOCAS), and One Pay (ONEPAY).

The sampling framework, designed by DFAS statisticians and reviewed by the DFAS Internal Review office, addressed the GAO and DoD OIG audit recommendation. The sampling framework also was submitted to OMB, and no issues were noted.

Navy. The Navy samples the contract and vendor payment population for those payments computed in its Enterprise Resource Planning (ERP) system. The standardized sampling framework was developed by the Navy's Financial Management Office and approved by statisticians in the Navy's Center for Cost Analysis, as well as by OMB. Trained Navy financial management staff extract data from the ERP and provide payment samples to the Commands. The Commands then review these payments to ensure they are legal and proper.

USACE. The post-payment reviews were conducted using a statistically valid (95 percent confidence level, ±2.5 percentage points) sample taken from the entire USACE Commercial Pay universe. In addition, the USACE Finance Center (UFC) used pre-payment controls, post payment contract audits, and data mining to prevent and identify improper payments in Commercial Pay.

Military Retiree and Annuitant Benefit Payments. On a monthly basis, DFAS statistically samples military retirement payments stratified by the retired and annuitant pay accounts. The reviews for retired and annuitant pay include sampling drilling reserve units, 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, newly established accounts, and other targeted areas.

Travel Pay

The Department. The Department's travel payments include those computed, paid, and reported independently by the military services and other Defense agencies. Department travel, as depicted in Table 3 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, Air Force, and Navy.

The DFAS reports the largest portion of DoD's travel payments made by the Defense Travel System (DTS), and Windows Integrated Automated Travel System (WinIATS) for the Department of the Army and select Defense Agencies. On a monthly basis, DFAS statistically samples DTS travel vouchers stratified by Military Service and the aggregate of the Defense Agency vouchers. The DFAS also statistically samples monthly WinIATS travel vouchers, stratified by Army activity and type of payment, for both Temporary Duty Travel (TDY) and Permanent Change of Station (PCS).

USACE. The UFC processes USACE travel payments using the CEFMS and WinIATS. The payment population includes both TDY and PCS travel voucher reimbursements. All PCS and TDY vouchers over $2,500 are 100 percent reviewed for accuracy. The remaining vouchers are statistically sampled at 95 percent confidence level, ±2.5 percentage points.

III. Root Causes of Errors and Corrective Actions

Military Health Benefits. The DHA projects a 0.87 percent error rate for Military Health Benefits improper payments for FY 2014. The DHA's purchased-care contracts are designed to include payment accuracy performance standards for processing military health benefit claims. Specifically, if improper payments exceed the payment accuracy performance standard, as stipulated in TRICARE policy manuals, or exceed more stringent purchased-care performance standards, the contractors are subject to financial penalties. Conversely, and if a contract requirement, if the purchased-care contractor's improper payments fall below the DHA TRICARE policy requirement or unique contract performance standard(s), the purchased-care contractor may receive a financial incentive award.

Purchased-care contractor payment accuracy performance is analyzed during the EIC quarterly and semi-annual compliance reviews. In addition to these reviews, annual reviews are conducted on claims representing underwritten healthcare costs that are paid by the managed-care support contractors (MCSCs). Confirmed overpayments are projected to the sample universe, and the MCSCs are liable for the total extrapolated error amount.

For the past several years, purchased-care contractors have been held to payment accuracy performance standards with either contract financial penalties or incentives, depending on the contract type and requirement(s). This contract design encourages contractors to keep payment error rates as low as possible to avoid financial penalties, or to obtain increased contract financial awards. Actual error rates have been consistently less than one percent. This contract design, combined with numerous pre- and post-payment controls, effectively curtails improper payments by the Department's purchased-care contractors and ensures the Government's risk for improper payments in the military health benefits program is low.

The formula used to calculate the DoD improper payment rate for the military health benefits program was changed in FY 2014. Specifically, the error rate is calculated as a percent of dollars paid versus dollars billed, and the errors identified in random samples were extrapolated using a weighted formula. Accordingly, the FY 2013 error rate cannot be directly compared with prior years.

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

- Incorrect pricing of medical procedures and equipment, 37 percent
- Lack of authorization or pre-authorization, required prior to receiving medical care, 16 percent
- Cost-share/deductible miscalculations, 10 percent
- All other causes combined, 37 percent

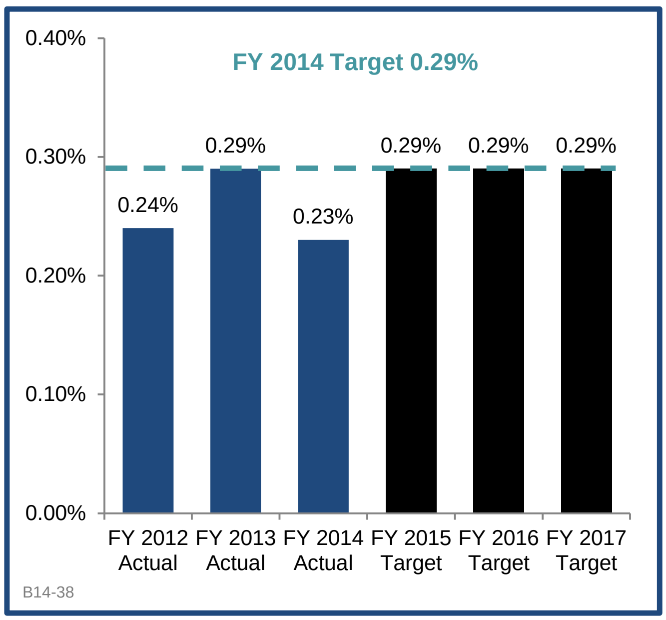
Corrective Actions. The DHA purchased-care contractors are monetarily incentivized or dis-incentivized, through payment accuracy performance standards, to reduce and/or eliminate improper payments. The fewer improper payments the contractors make, the less money is deducted from their reimbursements.

Additionally, details of the EIC compliance reviews are shared with the purchased-care contractors, DHA Program Offices, purchased-care contract Contracting Officers, and Contracting Officer Representatives to coordinate appropriate corrective action plans with the respective purchased-care contractor.

- Upon completion of an EIC compliance review, respective contractors review results, formulate an action plan to mitigate future findings and derive a process to avoid future improper payments.
- If warranted, contractor claims processing systems are modified to meet the Department's healthcare policy, reimbursement, or benefit requirements.
- If there is the potential that additional healthcare claims were processed in error, special ad hoc reports are pulled and adjustment actions are taken as appropriate.

Each purchased-care contractor has its own business process for evaluating compliance review results and conducting root cause analyses to ensure the accuracy of future claims payment and developing internal corrective action plans. If required, DHA Contracting Officers and Contracting Officer Representatives issue contractor corrective action plans to remedy and track noncompliance with TRICARE healthcare policy/regulations and purchased-care contract requirements.

Figure 19. Improper Payment Rate – Military Pay1



Military Pay. As shown in Figure 19, the Department estimates a 0.23 percent error rate in FY 2014 Military Pay, based on reviews and estimates from October 2013 through September 2014. Overpayments, which comprise 94 percent of the Military Pay improper payments, were not found in statistical sampling, but in debts established after a member has left the Military Service and through Active Duty debt collections reported by the Military Services.

Root Causes. The primary reason for recurring Military Pay errors is the high turnover in military payroll clerks. This primary reason is often the underlying cause of the next most common causes of Military Pay errors – the large amount of untimely or inaccurate information entered into pay systems, and administrative and documentation errors that occur during and between monthly pay periods (many Service Members are paid multiple times per month.) Entitlement changes, especially for deployed Service Members, can greatly change the amount due. Changes must be corrected in the following month's pay. Nonetheless, nearly 100 percent of improper payments for Military Pay are recovered when identified, or a collection action has been established to recover the amount.

The primary types of Military Pay improper payments result from administrative and documentation errors as described above. These entitlements are:

- Basic Allowance for Housing (50 percent) resulting from incorrect reporting of the entitlement.
- Base pay for Active Duty and incorrect Active Duty pay for Reservists (11 percent) resulting from incorrect reporting of the entitlement.
- Hostile fire/imminent danger pay (11 percent) resulting from incorrect reporting of the entitlement.
- Overseas Housing Allowance (6 percent) resulting from incorrect reporting of the entitlement.
- Family separation allowance, Active and Reserve, (6 percent) resulting from incorrect reporting of the entitlement.
- Miscellaneous categories, including results from underpayments, account for 16 percent of all improper payments. Miscellaneous categories include over 25 different entitlements.

Corrective Actions. Corrective actions taken include instituting more comprehensive training programs with standard desk procedures to provide a reference for new clerks. In addition, the Department, primarily through DFAS, advises the Military Services of the results of payment reviews and the associated root causes of the errors. The DFAS provides the Military Service financial managers with monthly reports on the results of statistical reviews, including the reasons for and dollar value of errors and year-to-date trends, to inform their training plans.

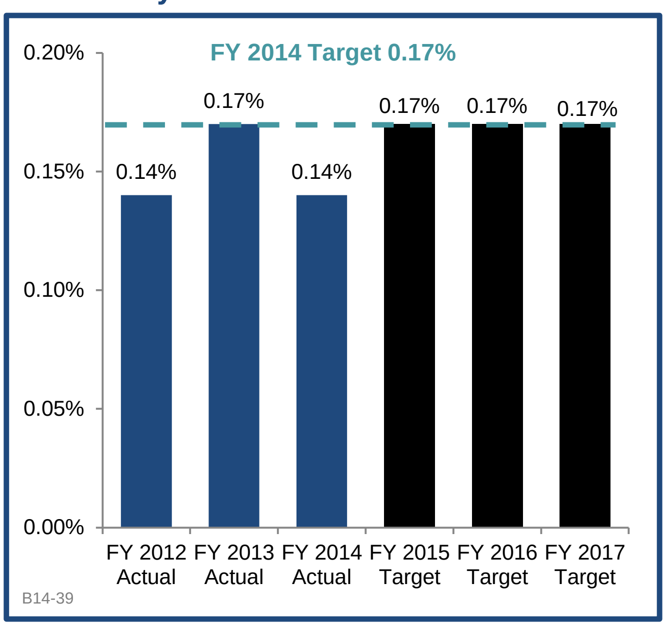
Independent public auditors performed a Statement on Standards for Attestation Engagement No. 16 (SSAE 16), completed June 2014, on the effectiveness of select internal controls for DFAS Military Pay and Disbursing Operations and issued an unqualified opinion with no material weaknesses identified.

Civilian Pay. As shown in Figure 20, the Department projects a 0.14 percent error rate for Civilian gross pay payments, primarily overpayments, for FY 2014.

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

- Time and attendance, 36 percent
- Overseas and other allowances, 43 percent
- Late personnel actions, 21 percent

Figure 20. Improper Payment Rate – Civilian Pay



The Defense civilian payroll systems, like most government payroll systems, base their time and attendance submissions on anticipated versus actual hours worked; therefore, the Department must correct overpayments and underpayments in a subsequent pay period.

Errors in overseas Civilian Pay accounts often occur due to payment of an entitlement that erroneously continued after the employee has returned to the United States. These improper payments often result from inaccurate personnel actions generated by human resources offices. Corrections subsequently are generated by human resource offices and transmitted to the civilian payroll system. These corrections result in re-computing pay and allowances and 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 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 also 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 to help prevent improper payments.

Independent public auditors performed a Statement on Standards for Attestation Engagement No. 16 (SSAE 16) on the effectiveness of select internal controls for DFAS Civilian Pay and Disbursing Operations, completed June 2014, and issued an unqualified opinion with no material weaknesses identified.

Commercial Pay

DFAS. The DFAS implemented an improved sampling methodology in FY 2014, stratified by invoice dollar amount, to conduct statistically valid reviews of invoices computed in the Mechanization of Contract Administrative Services (MOCAS) contract payment system, the DFAS legacy commercial pay systems (IAPS, ONEPAY, CAPS), and the Army (GFEBS) and Defense Agency Component ERPs (DAI and EBS.)

Based on the revised statistical sampling[13] methods, the FY 2014 total estimated commercial improper payments is $2.9 million, with a 95 percent confidence interval between $2.8 million and $3.1 million, and an estimated 0.01 percent error rate. The DFAS also collects data on contractor-identified improper payments and regularly performs analyses to inform its preventative efforts.

Root Causes. The majority of errors in Commercial Pay improper payments are caused by vendor billing errors. Improper payments identified from quarterly random sample reviews include:

- Voucher Examiner Error – No deduction taken from the invoice to offset progress payments, 28 percent;
- Vendor Billing Errors, 28 percent;
- Interest penalties, 28 percent (underpayments);

[13] Refer to detail at *Under Secretary of Defense (Comptroller) > Financial Management > Reports* for Reporting Components Statistical Sampling Plans.

- Overpayment Entitlement Errors, 14 percent; and
- Miscellaneous errors, 2 percent.

Business Activity Monitoring (BAM) Tool. Using the BAM tool, DFAS identifies and prevents improper payments in DoD's five largest commercial payment systems, which includes MOCAS, CAPS-Windows, IAPS, One-Pay, and EBS. These systems account for 87 percent of all DoD commercial payment dollars. The DAI and GFEBS ERPs initially did not feel BAM would be cost-effective. Recently, the Army requested an overview to determine if BAM would prove helpful for GFEBS at a reasonable price.

Since the Department rolled out BAM in August 2008, pre-payment reviews have prevented more than $8.4 billion in improper payments. Ongoing payment error analyses allow for the continual enhancement of BAM logic and improved disbursement accuracy.

This year, DFAS refined or developed new system edits (also called integrity checks) to improve BAM's ability to identify improper payments before disbursement. Some examples of the success of these new edits and integrity checks in preventing improper payments in FY 2014 include:

- A Wrong Vendor Paid enhancement that detected over $12 million in potential improper payments.
- A modification to the Invoice Outlier (unexpected result) edit broadened the ability to detect potential overpayments. Since July 2013, over $52 million in potential improper payments were identified that, without this modification, might not have been identified.

The DFAS identifies and monitors the root cause for all improper payments by researching supporting documentation and assigning an assessment (reason) code that identifies the type and cause of the improper payment. In addition, root causes of improper payments detected by BAM are reviewed and analyzed monthly and through other formal reviews. Root cause analysis is shared with the DFAS payment offices on a monthly basis and is used to identify areas for operational improvement. The information is also used to implement refinements to BAM and develop new integrity checks.

Corrective Actions. Corrective actions include:

- Ongoing training for pay technicians to increase their ability to compute and input accurately.
- The MOCAS contract input team initiated a new report that identifies contracts with recoupment rates that will receive a 100 percent review from a lead to ensure accurate input.
- Continued work with Contracting Officers to simplify contract terms and eliminate the need for manual calculations.
- The MOCAS front-end analysis team, which reviews high dollar invoices for accuracy, changed their process from sampling the entire population in queue to sampling the population that is getting ready to disburse. This change facilitates more focused reviews on areas of risk.

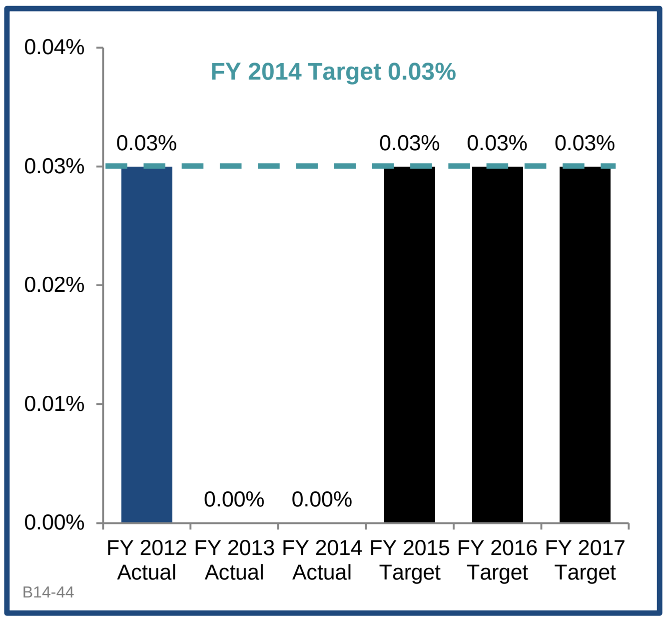
- Continued electronic commerce improvement initiatives, such as the automation of third party payments, aimed at minimizing manual intervention and improving quality.

The DFAS currently is adding Procedures Guidance and Instruction (PGI) data to enhance detection capability within MOCAS. The PGI is an initiative that created special payment instruction codes and fields. These new data elements present an opportunity for new integrity checks to be created within the BAM tool for MOCAS.

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.

Independent public auditors performed a Statement on Standards for Attestation Engagement No. 16 (SSAE 16) on the effectiveness of select internal controls for DFAS Contract Pay and Disbursing Operations and issued an unqualified opinion with no material weaknesses identified (completed April 2014).

Figure 21. Improper Payment Rate – USACE Commercial Pay



USACE. As shown in Figure 21, USACE projects a zero percent error rate in improper payments for Commercial Pay for FY 2014. The USACE functions as the real estate agency for the Department, with responsibility for leasing office space for all military recruiters. This responsibility applies to small offices in rural and semi-rural areas as well as larger spaces in more urban areas.

Navy. The Navy projects a zero percent error rate in improper payments for Commercial Pay for FY 2014. Preventing, detecting, and correcting improper payments is a top priority for the Navy. The Navy's commitment to compliance with IPERA and its amendments include activities such as:

- Reconciling the payment universe to ensure all programs are captured for review.
- Reviewing programs to identify additional corrective actions to achieve reduction targets.
- Identifying and designating Senior Accounting Officials at the Military Service level for the Navy and the Marine Corps to oversee and report on their improper payment programs.

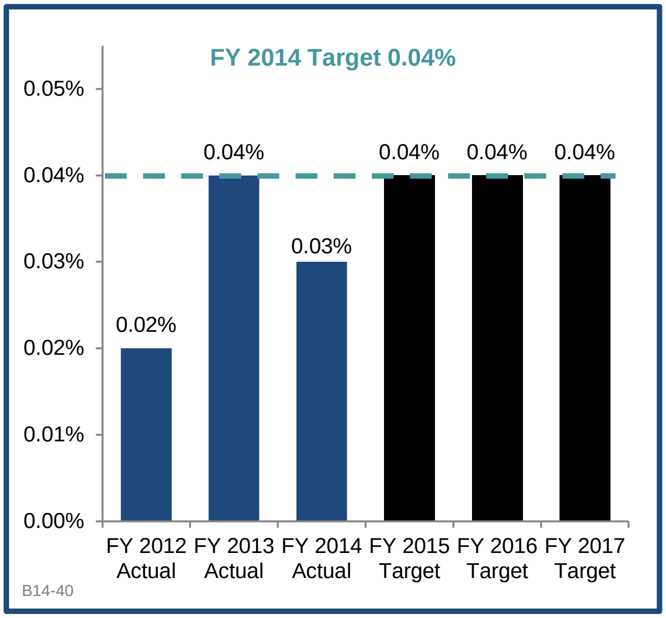
The Navy's continuing emphasis on accountability and integrity, at every level, underscores its commitment to achieve the goals set forth in IPERA. The Navy continues to report progress through monthly performance reviews with the Assistant Secretary of the Navy for Financial Management and Comptroller as well as through monthly financial operations metrics meetings with the OUSD(C) Deputy Chief Financial Officer.

Management has taken several additional steps to ensure its ERP adheres to IPERA requirements.

- Assigned responsibility for monitoring oversight of the Navy's IPERA Program.
- Identified Oversight Officials, responsible for preparing and updating the Navy's annual IPERA sampling plans, drawing monthly samples, and reviewing and monitoring IPERA test results.
- Issued desk procedures and provided training to staff that identifies step-by-step instructions on how to conduct IPERA reviews, and in the event that improper payments are identified, how to identify root causes and corrective actions to address them.
- Issued the Navy ERP Compliance Guide to the Commands in the Navy ERP in June 2013. The handbook defines and standardizes procedures associated with IPERA requirements.

Military Retirement. Based on FY 2014 reviews, DFAS projects a 0.03 percent error rate for improper payments in the Military Retirement program (refer to Figure 22), with almost the entire amount related to payments made to deceased retirees and annuitants.

Figure 22. Improper Payment Rate – 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 possible financial hardship to the Service Member's annuitant by expediting the correct calculation and processing of the monthly benefit. Family members or executors are required to return any overpayments 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 2014 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's existence if payments are returned and/or if benefit 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, are used to detect improper payments. The Department takes a proactive approach to ensure the accuracy of Military Retiree payments by 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 enhancing faster recovery of overpaid funds. Refer to the Do Not Pay discussion, later in this section, for discussion on the Department's use of the Social Security Death Master File.

Travel Pay.

Department. The Department projected a 7.0 percent error rate for travel improper payments for FY 2014, representing Military DTS trip records and WinIATS Temporary Duty (TDY) and Permanent Change of Station (PCS) vouchers for both civilians and military members, which are computed and disbursed by DFAS. In addition, the 7.0 percent error rate includes travel reimbursements disbursed outside of DFAS by the Army, Navy, and Air Force.

DTS Root Causes. The primary reasons for DTS improper payments are voucher input errors by the traveler and/or the approving official's failure to catch the error(s) before reimbursement occurs. The errors identified in the sample include:

- Per Diem (51 percent): The Department incorrectly reimbursed the traveler for lodging expenses without validating the claim with receipts, and/or reimbursed for meals at an incorrect rate.
- Reimbursable Expense (24 percent): Because of traveler mistakes when completing vouchers in DTS, the Department incorrectly reimbursed airfare, non-travel related expenses, and/or rental car expenses.
- Missing Documentation (25 percent): The Department reimbursed claimed lodging, airfare or rental car expenses that were not supported with a receipt.

DTS Corrective Actions. On a quarterly basis, DFAS provides the Defense Travel Management Office (DTMO) 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. Any improper payments identified are forwarded to the appropriate Debt Management Monitor to establish a debt and recover the improper payment. Also, the Department has implemented a DTMO Compliance Tool, discussed in the Do No Pay discussion later in this section.

WinIATS Root Causes. The primary reasons for WinIATS improper payments are voucher input errors by the traveler and/or the approving official's failure to catch the error(s) before reimbursement occurs. The error types include:

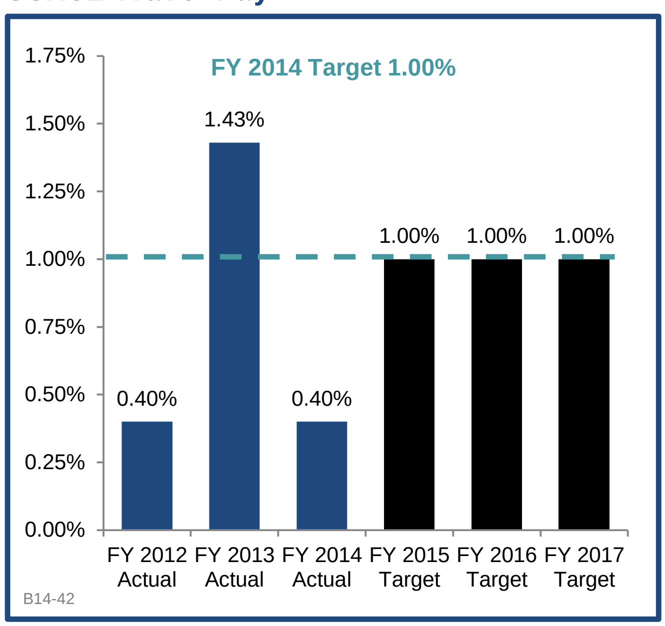
- Per Diem (91 percent): Per diem/meals and incidental expenses and lodging paid at the incorrect rate, not at all, or when unauthorized.
- Reimbursable Expense (2 percent): Airfare, household goods storage, and lodging tax paid incorrectly or not at all.
- Other miscellaneous (7 percent).

WinIATS Corrective Actions. The DFAS implemented several steps 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, are ongoing.
- Pre-payment validations and cross checks have been implemented to ensure the traveler was not previously reimbursed for the same trip through WinIATS or another travel system, therefore avoiding a duplicate payment.

USACE. The Army Corps of Engineers reduced its Travel Pay error rate from 1.43 percent to 0.40 percent over the course of the past 12 months (refer to Figure 23). The USACE implemented refresher training for all approving officials and travelers, which dramatically impacted the error rate. Also, the USACE Finance Center (UFC) performs a 100 percent audit of all airline credits issued against travelers' individually billed travel card accounts. This ensures that all airline credits, issued as a result of flight changes, are properly recouped.

Figure 23. Improper Payment Rate – USACE Travel Pay



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

- Travelers make mistakes when completing their travel vouchers.
- Approving Officials (AO) fail to properly review travel vouchers before approval.

Corrective Actions. The USACE continues to educate travelers and travel AOs through required training, including refresher training for seasoned travelers and AOs. Additionally, all AOs are required to complete fiscal law training every three years to maintain their certification eligibility.

When improper payments are identified, the UFC notifies the parties involved to determine the circumstances surrounding the error and to assist them in identifying business process improvements to prevent future recurrences. These areas are also covered thoroughly in refresher training.

HURRICANE SANDY

In FY 2013, the Department received approximately $112.7 million for Hurricane Sandy-related repairs and assistance, which was distributed among the three Military Departments. The funds provided to both the Department and the U.S. Army Corps of Engineers (USACE) were rolled into programs that already were reporting improper payment estimates; therefore, no new sampling or estimation methodologies were required under *OMB Memorandum 13-07*, Accountability for Funds Provided by the Disaster Relief Appropriations Act.

The U.S. Army Corps of Engineers (USACE) – Civil Works received over $5 billion for Hurricane Sandy-related repairs and assistance, and used transactional identifiers for commercial and travel payments related to these disaster-related disbursements to review all for accuracy. No improper payments were found related to the Hurricane Sandy travel and Commercial Pay disbursements.

- The USACE uses multiple processes to mitigate the risk of improper payments for all programs, including those associated with Hurricane Sandy. The USACE Financial Management System (CEFMS) provides internal system standards that adhere to Generally Accepted Accounting Principles (GAAP) as well as system and process controls

The USACE also uses post-payment recovery audit processes via data-mining to mitigate and recover improper payments. The USACE data-mining uses ten different scenarios to identify possible improper payments. Any items identified as a potential improper payment are reviewed for a final determination and recovery action initiated if improper. Post-payment audits/recoveries also are conducted via statistical sampling, 100 percent review, other audits/review, as well as through voluntary refunds and analysis.

IV. Program Improper Payment Reporting

Table 3 summarizes DoD's improper payment reduction outlook and total program outlays (payments) from FY 2013 through FY 2017.

Table 3. Improper Payment Reduction Outlook																			
	FY 2013					FY 2014					FY 2015 Estimate			FY 2016 Estimate			FY 2017 Estimate		
Program	Outlays ($B)	IP (%)	IP Over ($M)	IP Under ($M)	IP Total ($M)	Outlays ($B)	IP (%)	IP Over ($M)	IP Under ($M)	IP Total ($M)	Outlays ($B)	IP (%)	IP ($M)	Outlays ($B)	IP (%)	IP ($M)	Outlays ($B)	IP (%)	IP ($M)
Military Health Benefits [1,2]	$ 20.5	0.32	$ 60.3	$ 7.3	$ 67.6	21.2	0.87	153.1	31.4	184.4	$ 21.8	1.75	$381.4	$ 22.6	1.75	$395.5	23.5	1.75	410.5
Military Pay[3]	$ 98.7	0.29	$258.5	$ 28.1	$286.6	110.6	0.23	234.4	15.3	249.8	$ 94.0	0.29	$272.6	$ 93.5	0.29	$271.2	93.5	0.29	271.2
Civilian Pay[3]	$ 57.0	0.17	$ 96.4	$ 0.0	$ 96.4	55.6	0.14	80.0	0.00	80.0	$ 57.0	0.17	$96.9	$ 56.5	0.17	$ 96.1	56.5	0.17	96.1
Military Retirement[3]	$ 56.6	0.04	$ 19.9	$ 0.01	$ 19.9	56.5	0.03	19.3	0.07	19.3	$ 43.5	0.04	$ 17.4	$ 44.1	0.04	$ 17.6	44.1	0.04	17.6
DoD Travel Pay[4,5,7]	$ 7.3	6.5	$421.1	$ 53.7	$474.8	6.6	7.0	424.7	33.5	458.2	$ 8.5	Note 7	Note 7	$ 8.5	Note 7	Note 7	8.5	Note 7	Note 7
DFAS Commercial Pay[3]	$ 352.6	0.03	$ 49.4	$ 67.9	$117.3	305.0	0.01	2.8	0.10	2.90	$ 392.5	0.03	$117.8	$ 384.7	0.03	$115.4	384.7	0.03	115.4
USACE Travel Pay	$ 0.16	1.43	$ 2.1	$ 0.175	$ 2.28	0.15	0.4	0.6	0	0.6	$ .15	1.0	$1.5	$ 0.15	1.00	$1.5	$0.15	1.0	$1.5
USACE Commercial Pay	$ 21.7	0.0	$ 0.0	$ 0.0	$ 0.0	18.7	0	0	0	0	$ 20.0	0.03	$ 6.0	$ 20.0	0.03	$ 9.0	$20.0	.03	0
Navy ERP Commercial Pay[6]	$1.2	0.0	$0.0	$ 0.0	$ 0.0	4.4	0	0	0		$ 4.5	N/A	N/A	$ 4.5	N/A	N/A	$4.5	N/A	N/A

Note 1: DHA reports 12 months in arrears; therefore, FY 2014 reporting represents FY 2013 data. The error rate increase resulted from a small number of high-dollar claim errors assessed that significantly affected the annual error rate.

Note 2: DHA now uses 1.75% as its out-year target because that is the new contractual performance standard. The FY 2015-2017 outlays estimates were calculated using the OMB CPI-U Annual Averages and Percent Change Table. As DHA reports 12 months in arrears the FY 2013 CPI-U medical percent change was used to calculate the FY 2014 outlay estimates, while the FY 2015 and 2016 medical percent changes were used to calculate the FY 2016 and 2017 outlay estimates respectively.

Note 3: Out-year reduction targets for Mil Pay, Civ Pay, Mil Retirement, and DFAS Commercial Pay represent a continuation of the very low IP rates experienced in FY 2014.

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

Note 5: DoD Travel Pay represents DFAS and Navy travel vouchers settled from July 2013 through June 2014; Army and Air Force follow the normal fiscal year.

Note 6: Since no improper payments were identified for FY 2014, out-year reduction targets are not applicable.

Note 7: Modified out-year reduction targets are under development for DoD Travel Pay and will be included in the FY 2015 AFR.

V. Recapture of Improper Payment Reporting

DTS Compliance Tool. In December 2012, the Department established the Travel Policy Compliance Program, mandated by the National Defense Authorization Act for Fiscal Year 2012. Managed by the DTMO, the program was established to ensure travel claims do not exceed reasonable or actual expenses as well as to minimize inaccurate, unauthorized, overstated, inflated, or duplicate travel claims. The Travel Policy Compliance Tool, an automated application, reviews DTS travel vouchers in near real time and identifies potential improper payments. If a potential improper payment is identified, travelers and their Approving Official are notified via e-mail to either submit a corrected claim or explain why the claim is correct. Service administrators can run reports to review all identified errors and track corrections.

The DTMO Compliance Program not only ensures travel claims are paid in accordance with regulations and assists in recouping funds, but it also mitigates budget cuts for travel, improves post-pay audits, educates travelers and administrators on travel policy, and identifies travel trends, training needs, and opportunities for greater controls in the future.

Beginning in December 2012, a limited number of organizations from all four Military Services selectively used the Travel Policy Compliance Tool as part of a pilot that included three areas of inquiry. As of September 30, 2014, all DoD Components using DTS are actively using the Compliance Tool, and all DTS vouchers are being examined using the ten areas of inquiry. In FY 2014, as a result of all DoD Components using the tool, the pilot ended and the efforts transitioned to a full program.

As of September 30, 2014:

- $8,062,602 in errors were identified.
- $619,340 in payment errors were corrected without any funds due back to the Government.
- $912,076 in errors were corrected and are awaiting collection.
- $1,947,449 in errors were corrected and the funds have been recovered.

The DTMO has identified over 40 additional queries and currently is working to add these queries based on availability of funds. In addition to examining DTS vouchers, the Compliance Tool Program has expanded to include additional data sources, such as Government Travel Charge Card (GTCC) data, and is now comparing amounts claimed on vouchers with amounts charged on the GTCC to identify potential overpayments. As new data sources become available, they may be used to identify additional errors.

Use of the Compliance Tool provides a mechanism to greatly facilitate DoD's collections and improve our recovery rate for Travel Pay overpayments. In addition, funds recovered from prior years can be re-allocated for use in current year appropriations, in accordance with Public Law 111-204, The Improper Payments Elimination and Recovery Act of 2010.

DFAS. For the most part, the Department continues to use its internal staff and procedures to identify and recovery overpayments. The DFAS recovery percentages remain close to the 85th percentile, as required by OMB; therefore, it would not be cost-effective to contract with a private sector firm to perform this function, which although not paid with appropriated funds, would still cost the Department time and money in technical and other forms of contractor assistance. The DFAS has not used an external recovery audit firm, as it historically had not proven cost-effective. The use of the BAM tool on the front-end of commercial payment transactions continues to provide a successful means of both preventing improper payments and thereby reducing the need to pursue overpayment recoveries.

In compliance with IPERA, as well as the *Debt Collection Improvement Act of 1996*, the Department uses a number of other methods to prevent, identify, and collect improper payments. For example, DFAS has implemented a Centralized Offset Program 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 2014, the Centralized Offset Program requested and confirmed 784 offsets totaling approximately $14 million.

USACE. The UFC utilizes a data mining tool as part of its post-payment/payment recapture program. This tool searches for 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 searches 100 percent of all USACE commercial payments. The use of a data-mining tool complements the pre-payment system edits built into CEFMS. Payment safeguards include a requirement to match a receiving report with an invoice and thereby prevent use of duplicate invoice numbers for the same obligation.

DLA. The Defense Logistics Agency run a fuels tax recovery program that is not, strictly speaking, a recovery audit exercise; nonetheless, this program recovered about $13 million in each of the last two fiscal years and predicts that FY 2014's recoveries will compare favorably with this figure. Tax recoveries fluctuate depending on changing tax laws and the amount of DLA's energy business.

DHA. The DHA uses a number of different mechanisms to prevent, identify, and collect improper payments, to include claims auditing by an EIC and internal DoD agencies for all private-sector payments. This process utilizes post-payment review techniques, performed internally and by external contractors, paid from the proceeds of recovered funds.

Contract payments comprise a large volume of transactions with high-dollar values; therefore, DHA is vigilant to ensure payment accuracy. In addition to the post-payment reviews, the DHA also utilizes various internal manual and automated prepayment initiatives to prevent overpayments and underpayments.

The DHA conducted a pilot study to evaluate its ability to identify and recover funds that are owed from private health care providers, resulting from overpayments that occurred as a result of secondary insurance payment errors. The pilot study will provide an accurate assessment of the potential recoveries and cost effectiveness if a full recovery audit is initiated, and will review ten of the largest-volume institutional providers. The pilot results indicated that this type of account review would be cost-effective, and a Request for Proposal may be issued in FY 2015.

Table 4 summarizes the recovery auditing identifications and collections for 2014.

Table 4. Payment Recapture Audit Reporting

Program	Type of Payment	Amount Subject to Review (CY)	Actual Amount Reviewed and Reported (CY)	Amount Identified for Recovery (CY)	Amount Recover-ed (CY)	% of Amount Recover-ed out of Amount Identified (CY)	Amount Outstand-ing (CY)	% of Amount Outstand-ing out of Amount Identified (CY)	Amount Determi-ned Not to be Collectab-le (CY)	% of Amount Determi-ned Not to be Collectab-le out of Amount Identified (CY)	Amounts Identified for Recovery (PYs)	Amounts Recover-ed (PYs)	Cumulati-ve Amounts Identified for Recovery (CY+PYs)	Cumulati-ve Amounts Recove-red (CY+PYs)	Cumulati-ve Amounts Outstandi ng (CY+PYs)	Cumulati-ve Amounts Determi-ned Not to be Collectab-le (CY+PYs)
DTMO Compliance Tool [1]	DTS Travel	$ 8.0B	$ 8.0B	$ 6.5M	$ 1.95M	27%	$ 4.2 M[2]	60%	$0.55M[3]	7.0%	$1.2M	$140K	$8.2B	$2.1M	$5.5M[4]	$675K
USACE[5]	Contract Pay	$ 18.7	$ 18.7	$ 0.0M	$ 0.0M	N/A	$ N/A	N/A	$ 0.0M	0%	$ 59.4M	$ 59.4M	$ 59.4M	$ 59.4M	$ 0.0M	$ 0.0M

"K" represents thousands; "M" represents millions; "B" represents billions.

Note 1: The Defense Travel Management Office's (DTMO) Compliance Tool began as a pilot in December 2012, and transitioned to full implementation, with all DTS organizations participating as of fiscal year end.

Note 2: Action not taken to correct $3.5M as of September 30, 2014. Travelers were notified of $600K in August and $1.9M in September 2014.

Note 3: $545K in errors were eliminated through voucher correction; therefore, no collection is necessary. Additionally, the amount identified for recovery was reduced from $7.0M by the $545K.

Note 4: $1M of this amount is being collected through a repayment plan.

Note 5: USACE uses its Oracle data mining tool within CEFMS to perform recovery auditing on contract payments.

Table 5 summarizes DoD's annual targets related to its payment recapture audit efforts for FY 2014 through FY 2017.

Table 5. Payment Recapture Audit Targets

Program	Type of Payment	CY Amount Identified ($M)	CY Amount Recovered ($M)	CY Recovery Rate (Amount Recovered/ Amount Identified)	CY + 1 Recovery Rate Target	CY + 2 Recovery Rate Target	CY + 3 Recovery Rate Target
DTMO (DTS)	Travel	$ 6.5M[1]	$ 1.95M	27.0%	40%	55%	85%
USACE	Commercial	$ 0.0	$ 0.0	0.0%	100.0%	100.0%	100.0%

Note 1: This figure does not include the errors determined to not be overpayments ($545K).

Table 6 presents an aging schedule of overpayments collected outside of efforts of payment recapture audits.

Table 6. Aging of Outstanding Overpayments

Program	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)
DFAS Commercial Pay	Commercial[1,2]	4.40	1.60	-
Military Retirement	Pension[2]	1.50	-	-

Note 1: Figures based on overpayments identified and paid during FY 2013.
Note 2: After 120 days, most debts are transferred to Treasury for collection.

Table 7 presents a summary of how cumulative amounts recaptured have been used.

Table 7. Disposition of Recaptured Funds

Program	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
USACE[1]	Commercial	$20,000 per annum	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
DTMO (DTS)[2]	Travel	Under Review	$ N/A	$ 0.0	$ 0.0	$ 0.0	$ 0.0

Note 1: No overpayments identified; therefore, no funds recovered in FY 2014 using recovery auditing.
Note 2: No recoveries have yet been re-allocated.

Table 8 summarizes improper payments identified and recovered outside of payment recapture audits for the years 2004-2014.

Table 8. Overpayments Recaptured Outside of Payment Recapture Audits						
Source of Recovery	**Amount Identified (CY)**	**Amount Recovered (CY)**	**Amount Identified (PY)**	**Amount Recovered (PY)**	**Cumulative Amount Identified (CY+PYs)**	**Cumulative Amount Recovered (CY+PYs)**
DFAS Commercial Pay[1]	$ 162.30M	$ 156.30M	$ 141.60M	$ 137.20M	$ 1.9B	$ 1.8B
Military Retirement[2]	$ 19.30M	$ 17.80M	$ 19.90M	$ 18.30M	$ 281.90M	$ 263.40M
Military Pay[3 4]	$ 236.90M	$ 198.50M	$ 258.50M	$ 219.30M	$ 1.02M	$ 867.30M
Civilian Pay[3]	$ 80.00M	$ 80.00M	$ 96.40M	$ 96.40M	$ 508.50M	$ 508.50M
DoD Travel Pay	$ 4.70M	$ 0.03M	$ 3.70M	$ 0.10M	$ 11.90M	$ 0.33M
USACE Commercial Pay[7]	$ 5M	$ 5M				
USACE Travel Pay[5]	$ 0.6M	$ 0.6M	$ 0.7M	$ 0.5M	$ 2.1M	$ 1.9M
Defense Health Agency (DHA) Health Benefits Contracts[6]	$ 4.4M	$ 4.4M	$ 136.1M	$ 245.1M	$ 140.5M	$ 249.5M
"M" represents millions. "B" represents billions.						

Note 1: Overpayments are based on the date payment was made or debt incurred. Prior year amounts shown in the OMB Max database do not reflect further collections or adjustments made in subsequent fiscal years.

Note 2: FY 2014 amounts identified and recovered are based on 100 percent review of deceased retiree and annuitant accounts. Recoveries normally run 90 days behind; therefore, FY 2014 recoveries will not be completed until December 31, 2014.

Note 3: In-service collection dollars are used as a proxy for recovery amounts because actual results from statistical reviews are negligible.

Note 4: Recoveries provided in CY for Military Pay include out-of-service debt collections. Because debt recoveries are tracked for 12 months for AFR purposes, collections may not be realized until the end of FY 2015.

Note 5: The balance of USACE Travel Pay recoveries are in the process of collection through salary offset or have been appealed to the Civilian Board of Contract Appeals for final determination.

Note 6: DHA contract improper payments and recoveries are reported 12 months in arrears to accommodate its 100 percent post-payment review.

Note 7: These recoveries resulted from self-identified overpayments, not a recovery auditing program.

VI. Accountability

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

Certifying Officer Legislation, *10 U.S.C. 2773a,* holds Certifying and Disbursing Officers accountable for government funds. In accordance with this law, 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 captured in the *DoD Financial Management Regulation (DoDFMR), Volume 5, Chapter 33*, entitled "Certifying Officers, Accountable Officials, and Review Officials." The Department's efforts to recover overpayments from a recipient must be undertaken in accordance with the debt collection procedures outlined in the *DoDFMR, Volume 5,Chapter 28*, "Management and Collection of Individual Debt," and *DoDFMR, Volume 10, Chapter 18,* "Contractor Debt".

The DoD FMR contains other policies that specifically address Improper Payments (*DoDFMR Volume 4, Chapter 14)* and Recovery Auditing (*DoDFMR* Volume 10, Chapter 22). Beginning in Quarter 3, FY 2013, all reporting DoD Components were required to begin downloading their improper payment reports to the DFAS ePortal, as the Office of the Deputy Chief Financial Officer's Accounting & Finance Policy Directorate was designated as the Executive Agent to manage this information and its associated reporting requirements. This centralized electronic system allows the reporting Components to access improper payment information without regard to the time zone in which they are located. More importantly, it allows management to ensure all Components' submissions are timely and accurate.

Tracking Corrective Action Plan Progress. A new mechanism will be used beginning FY 2015 to track corrective action plan progress. The Financial Improvement and Audit Readiness (FIAR) Directorate uses a tool called the Notice of Findings and Recommendations Tracker, or NFR Tracker, to monitor audit readiness tasks and corrective actions. This tool provides a method to record corrective actions for each Improper Payment program, to set milestones and interim goals, and to monitor progress toward more long-term objectives. The tool will also be configured to notify officials, via e-mail, when milestone dates are approaching, and also will require a justification when a milestone or goal misses its deadline.

Because DoD Travel currently has the highest error rate among all DoD-reported programs, initial focus will be placed here to achieve measurable progress more quickly. The Department is very focused on reducing overall Travel spending; reducing improper payments and increasing recoveries is another way to reach that goal.

VII. Agency Information Systems and Other Infrastructure

The Department has much of the information and infrastructure needed to reduce improper payments. The Department uses the BAM tool and the Do Not Pay portal to identify potential improper payments prior to disbursement.

The Department's ongoing migration from a legacy system environment to new ERP systems presents a number of challenges and opportunities to prevent and detect improper payments. This migration also can enhance the Department's ability to improve its debt collection and recovery auditing abilities. The Department is addressing these areas both from a payment integrity as well as audit readiness perspective.

VIII. Statutory and Regulatory Barriers

The primary barriers in preventing improper payments in Military Pay are the statutory entitlements and regulatory monthly pay schedule. For DHA collections, there are contractual requirements that allow up to 270 days, instead of the standard delinquency deadline of 180 days, to be transferred to the Treasury under the Debt Collection Improvement Act of 1996.

IX. Additional Information

The Department is positioning itself to be fully compliant with additional elements required by the Improper Payments Elimination and Recovery Improvement Act (IPERA) for FY 2014 reporting. As part of the effort toward auditability, each of the Defense disbursing Components is diligently reviewing and reporting on all payments that are subject to IPERA, and ensuring the processes used are compliant with laws and regulations.

The Department continually looks for opportunities to improve its methodologies, and the post-payment review teams are far from complacent. The Department is implementing recommendations from both the DoD Inspector General's IPERA Compliance Review for FY 2013 (DoDIG Report No. D-2014-059), and from the GAO Report No. GAO-13-227 on improper payments, to guide our progress in our future improper payment efforts.

X. Agency Reduction of Improper Payments with the Do Not Pay Initiative

The Do Not Pay (DNP) Initiative (detailed reporting in Table 9), as currently implemented, is programmed to look at the vendor, the invoice amount, and the dollar amount of the payment. Improper payments may still occur at some later point due to reasons that DNP does not detect. For example DNP cannot detect a duplicate payment, because the vendor name, invoice amount, and payment amount would still be correct; the duplicate invoices would not appear on the match list.

DFAS. The DFAS sends a weekly batch file to the DNP database and receives results the next day. The DFAS then researches these results to determine if the proposed payment is proper based on established business rules. To date, DFAS has not identified any potential improper payments using the DNP list.

The DFAS bumps against all the DNP databases with the exception of the DEBT Check, for which we already have a process in place called the Treasury Offset Program, and the Credit Alert System, which does not apply to Commercial Payments. In addition to the weekly non-Treasury disbursed pre-payment review, a small group of Treasury-disbursed payments are checked: pre-payments on a weekly basis, and post-payments on a monthly basis.

USACE. The USACE matches its payment files daily in the DNP Portal to prevent any improper payments.

DHA.

Individual Payments. The DHA processes relatively few (1 – 5) case recoupment refunds each month for small dollar amounts ($5 – $5,000). The Single Online Search service is utilized pre-payment for 100 percent of all case recoupment refunds to verify (1) a business or individual has not been placed on the List of Excluded Individuals/Entities (LEIE), and (2) an individual has not died. Any matches will be referred to the DHA Office of General Counsel.

Vendor, Contract Payments. The DHA processes approximately 200 routine payments per month for 23 unique contractor payees. The Single Online Search service is utilized pre-payment once a month to verify a DHA contractor payee has not been placed on the Excluded Parties List System (EPLS) or the List of Excluded Individuals/Entities (LEIE). Any matches are referred to the assigned Contracting Officer. The risk, however, lies outside of DHA because DHA contractors are not required to utilize the Do-Not-Pay database, and there is no current mechanism in place to require the contractors to use the Do-Not-Pay databases at the prepayment phase to comply with IPERA.

Navy ERP. Navy ERP transactions are included in the DFAS Do Not Pay Figures.

Table 9. Implementation of the Do Not Pay Initiative to Prevent Improper Payments Death Master File (DMF) Matching and Excluded Parties List (EPLS)						
	# of Payments Reviewed	$ of Payments Reviewed	# of Payments Stopped	$ of Payments Stopped	# of Improper Payments Reviewed and Not Stopped	$ of Improper Payments Reviewed and Not Stopped
DFAS Non-Treasury Disbursing Office (NTDO)	$11,950,521*	$733,384,581,004**	0	0	0*	0*
DFAS Reviewed Treasury Disbursing Office (TDO)	41,464	$ 5,103,958,963	0	0	0*	0*
USACE Reviews with the DMF	420,877	$ 16,207,916,851	0	0	0	0
DHA Reviews with DMF & EPLS	336	$ 297,806,052	0	0	0	0
* DNP specifically looks at the vendor. Improper payments identified at some later point are improper due to other reasons that DNP does not have the capability to detect. For example: DNP cannot detect duplicate payments. ** Data is based on Invoice and invoice amount vs. payment. The data represents invoices in a non-pay status submitted on a weekly basis so the invoice can be submitted multiple times per month.						
Navy ERP transactions included in DFAS DNP figures.						
USACE transmits 100% of its pending commercial payments on a daily basis to match against the Death Master File (DMF) and the Excluded Parties List System (EPLS).						

Military Retiree and Annuitant Pay – File Matching with the DMF outside of DNP

For the past ten years, before the Do Not Pay initiative, the Defense Manpower Data Center (DMDC) has had a computer matching agreement with the Social Security Administration (SSA) to use its Death Master File to identify potential accounts that need to be suspended or cancelled as a result of a retiree's or annuitant's passing. As part of the end-of-month processing, DFAS produces two files (one for retirees, one for annuitants) that are sent to DMDC to match or "bump" against the monthly DMF file. The results are compiled and forwarded to DFAS.

DFAS then runs its match process to suspend pay accounts (but not cancel) and to notify next of kin that this action was based on information received from SSA. This correspondence contains instructions on how to close out the account or reactivate if the death was mistakenly reported by SSA; however, this is rare.

The vast majority of these monthly benefits are paid via Electronic Funds Transfer. The disbursement system suspends payment to prevent additional benefits from being improper paid. Any EFT payment that was mistakenly disbursed is automatically reclaimed from the bank account after the official notification of death is processed. The normal recovery rate hovers around 95 percent within 60 days of the official death confirmation.

FREEZE THE FOOTPRINT

As part of the Federal initiative to promote efficiencies, the Department is committed to effectively managing its inventory of real property assets and disposing of excess properties. As reflected in the Future Years Defense Program, the Department proposed $4 billion in savings, when compared to the FY 2014 budget request, by funding only the most critical facilities and ensuring construction projects support only requirements remaining after force structure adjustments.

Through our partnership with General Services Administration (GSA) and Office of Management and Budget, the Department's "Freeze the Footprint" plan ensures that our total square footage of domestic office and warehouse inventory does not exceed the square footage baseline that existed in FY 2012.

As reflected in Table 10, in FY 2013 the Department reduced the total square footage in its owned offices and warehouses by nearly 10 million square feet (SF), or 3 percent. The 10 million SF decrease is comprised of the reduction in DoD Military Departments' and Washington Headquarters Services (WHS) office and warehouse space that offset a slight increase experienced by the United States Army Corps of Engineers civil works assets. This reduction in real property square footage was achieved through a variety of methods, though the current austere funding environment significantly constrained demolition as an option for eliminating real property assets that are structurally too old and worn out.

Table 10. Freeze the Footprint Baseline Comparison

Baseline Comparison – Total DoD Office and Warehouse Square Footage			
(SF in Millions)	FY 2012 Baseline	FY 2013 Data	Change (FY 2012 – FY 2013)
Square Footage	313.52	303.55	-9.97

Note: As reported in the DoD Annual Freeze the Footprint Report for 2014.

Additionally for FY 2013, the Department's GSA occupancy agreement square footage was reduced from the FY 2012 baseline, with over 319 thousand SF (2 percent) no longer leased by the Department. Though Annual Operating Costs (AOC) are required to be reported in the Federal Real Property Profile (FRPP), actual operating costs are not currently available at the constructed asset level for the Department's real property inventory. For reporting purposes at this time, AOC is calculated using a mathematical formula to reasonably break out consolidated data and increase the result by inflation to try to reflect individual asset costs. The use of the inflation factor explains the slight increase in operating costs reported in Table 11.

Table 11. Reporting of O&M Costs – Owned and Direct Lease Buildings

Reporting of O&M Costs – Owned and Direct Lease Buildings			
($ in millions)	FY 2012 Reported Costs	FY 2013 FRPP Data	Change (FY 2012 – FY 2013)
Operating and Maintenance Costs	1,396	1,398	1.73

SCHEDULE OF SPENDING

The Schedule of Spending (SoS) provides an overview of how and where the Department spends (obligates) its money during the year. Specifically, the SoS presents the Department's total budgetary resources and total fiscal year-to-date obligations, on a combined basis. The SoS uses the same underlying data that is used to produce the combined Statement of Budgetary Resources (SBR), but reports the obligations by the items or services purchased (object class), such as personnel compensation, assets, grants, etc.

The Department recognizes the importance of providing this spending summary and has been working diligently to capture and ensure accurate and complete object class data in the financial systems. As of the end of FY 2014, all Defense Agencies' financial information was integrated in the Department's financial reporting system, which will greatly reduce manual effort in producing the SoS, and will continue to work on improving the object class data; however, the Department was unable to produce the Schedule of Spending for this year's reporting.

The Department is working with the Office of Management and Budget to produce a reliable Schedule of Spending and will publish this schedule in the Department's FY 2015 Agency Financial Report.

INSPECTOR GENERAL'S STATEMENT OF MANAGEMENT AND PERFORMANCE CHALLENGES FOR FY 2014

Each year, the Inspector General, DoD (DoD IG) prepares a statement that summarizes what he considers to be the most serious management and performance challenges facing the Department and a brief assessment of the Department's progress in addressing these challenges. The DoD IG cited challenges are in addition to those identified by the Government Accountability Office in its February 2013 biennial report, entitled *High Risk Series, An Update*.

For FY 2014, the DoD IG identified challenges in the following seven categories:

- Financial Management
- Acquisition Processes and Contract Management
- Joint Warfighting and Readiness
- Cyber Security
- Health Care
- Equipping and Training Afghan National Security Forces
- The Nuclear Enterprise

Detailed discussion of the DoD IG's statement and the Department management's response follows.

U.S. and Colombian paratroopers track during a free fall as part of Fuerzas Comando 2014 at the Colombian National Training Center on Fort Tolemaida, Colombia. The U.S. Service Members are assigned to Special Operations Command South. The jump symbolizes the strong partnership between both nations.

Photo by Maj. Edward Lauer

SUMMARY OF IDENTIFIED CHALLENGES

1. IG-Identified Challenge: Financial Management

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

The Department's financial management challenges impair its ability to provide reliable, timely, and useful financial and managerial data to support operating, budgeting, and policy decisions. Gaps in the financial framework harm the accuracy, reliability, and timeliness of budgetary and accounting data and financial reporting, reducing the effectiveness of decisions made by leaders at all levels. The key to solving the Department's financial management problems is the production of auditable financial statements and receiving unmodified opinions on them.

Achieving auditable financial statements is a long-standing and daunting task. The success of the DoD financial improvement and audit readiness (FIAR) effort depends on the Department's ability to accomplish the following:

- Resolve material internal control weaknesses to ensure internal controls are properly designed, properly implemented, and working effectively.
- Sustain improvement in internal controls and systems to provide consistent and repeatable financial data used in decision making and reporting.
- Effectively develop and implement 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 timely implementation of these efforts.

Congress requires the Department to validate its Statement of Budgetary Resources (SBR) and the other DoD financial statements as audit ready by September 30, 2014, and September 30, 2017, respectively. However, the Department continues to struggle with effective and timely development and implementation of their business transformation efforts. Furthermore:

- *Public Law 111-383, Section 881* requires the Department to establish interim milestones to achieve audit readiness of its financial statements earlier than 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 SBR, such as "civilian pay, military pay, supply orders, contracts, and the funds balance with the Treasury."
- *Public Law 112-81, Section 1003* requires 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 of validating the SBR as audit ready by September 30, 2014. The Department must aggressively pursue the development and implementation of comprehensive improvement initiatives and must monitor progress according to interim milestones. The Department may need to revise these initiatives and milestones as it identifies additional deficiencies and corrective actions as a result of DoD's iterative FIAR process.
- *Public Law 112-239, Section 1005(b)(1)* requires that the plans to achieve audit readiness of the SBR "by September 30, 2014, include steps to minimize one-time fixes and manual work-arounds, be sustainable and affordable, and not delay the full auditability of financial statements."

- *Public Law 113-66, Section 1003(a)* requires that the Secretary of Defense ensure that a full audit of the DoD financial statements for FY 2018 is performed and the results of the audit submitted to Congress not later than March 31, 2019.

Although the Department did not meet the 2014 deadline for full SBR audit readiness, the Department continues to make progress. Because the Department recognized that it could not achieve SBR audit readiness by 2014, an incremental approach to achieving SBR audit readiness was implemented. The Department has chosen to address SBR audit readiness incrementally by focusing on the current year information contained in the SBRs of the General Funds.

Specifically, the limited scope FY 2015 SBR audits will be on current-year appropriation activity and transactions, which the Department calls the "Schedule of Budgetary Activity" (SBA). As a result, the Department's initial audit efforts will focus on the SBA. The Department plans on achieving audit readiness for the SBR by the 2017 due date that was originally planned for all financial statements. Since the 2014 deadline for SBR audit readiness has been a challenge for the Department, meeting the 2017 deadline for all DoD financial statements to be audit ready remains an even more significant challenge as the Department must also focus on the audit readiness of the remaining portions of the SBR, implementation of the enterprise resource planning systems (ERPs), and achieving audit readiness of the full financial statements. Additionally, results of the FY 2015 SBA audits may identify additional internal control weaknesses that require corrective action, which may further delay the Department's plans for achieving audit readiness.

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 full SBR for both the General and Working Capital Funds. In addition, the interim milestones must address the existence and completeness of each major category of DoD assets, which includes general equipment, real property, inventory, and operating material and supplies, to achieve audit readiness of the full financial statements.

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

Although the Department is far from reaching an unmodified opinion on its financial statements, it has made progress. The DoD senior leadership has placed an increased emphasis on achieving this goal. The DoD IG believes this increased senior leadership emphasis is essential to the Department's ability to meet its internal milestones as well as to make progress in achieving full SBR audit readiness and meet the 2017 audit readiness mandates.

Despite pervasive and long-standing Department financial management problems, the U.S. Army Corps of Engineers – Civil Works, and various Defense agencies, such as the Defense Commissary Agency and Defense Contract Audit Agency, and the Military Retirement Fund, have received unmodified audit opinions. The Department must sustain its achievements as well as advance in the remaining significant areas.

The Department continues to make progress toward meeting the 2014 audit readiness goal of the SBR; however, the Department has modified its strategy based on the U.S. Marine Corps (USMC) audit experience. The Military Services now plan to assert audit readiness on the SBA. The USMC encountered many challenges during this first type of audit, which resulted in disclaimers of opinion in FY 2010 and FY 2011. However, progress was seen in the Corps' ability to produce supporting documentation on transactions within the SBA, and the USMC achieved an unqualified opinion on its FY 2012 SBA. As a result, the USMC is undergoing subsequent SBA audits. The USMC, the Navy, and the Department are using USMC experience to correct weaknesses, as well as prepare the other Military Services for their eventual SBR audits.

The May 2014 FIAR Plan Status Report (FPSR) only addressed audit readiness for certain aspects of the SBR and stated that the Department did not expect every Component to achieve a clean audit opinion on its SBA in FY 2015. The Department reported in the November 2011 FPSR, and continued to report in the May 2014 FPSR, that it had significantly changed its audit goals to include achieving audit readiness of the General Fund SBR by the end of FY 2014, in addition to achieving audit readiness of all DoD financial statements by the end of FY 2017. However, in the November 2012 FPSR, the Department reported it would limit first-year SBR audits in FY 2015 to audits of schedules containing only current-year appropriation activity, that is, a Schedule of Budgetary Activity (SBA).

Additionally, in the May 2013 FPSR, the Department reported that the initial audits of the General Fund SBA would not include balances from prior year activity. The Department would also begin audits of the complete SBR only after achieving successful audits of current-year appropriation activity. Meaningful progress in FY 2014 for the SBR audit-readiness goal will be critical, and this will continue to be a high-visibility area.

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

The Department generally agrees with the DoD IG's assessment of the Department's status and progress in achieving financial statement audit readiness. The Department's goal of achieving audit readiness on the SBR remains the same. However, the strategy for achieving that goal has been modified to limit the scope of initial audits.

The Department has focused consistently on achieving SBR audit readiness by September 30, 2014. Audit readiness means strengthening internal controls and improving financial practices, processes, and systems used to manage the Department's budgetary resources so there is reasonable confidence the information can withstand an audit by an independent auditor. The Department modified the strategy to limit the scope of initial audits to focus on current year budgetary transactions reported on a Schedule of Budgetary Activity (SBA). The SBAs rely on the same internal controls and financial practices, processes, and systems as the SBR and contain a substantial subset of the financial information reported on the SBR.

The change in strategy was based on lessons learned from the U.S. Marine Corps SBR audit. The Marine Corps was unable to produce documentation supporting historical transactions associated with SBR beginning balances quickly enough to meet the audit timelines. Historical documentation (for example, requisitions, receiving reports, and invoices) exists primarily in paper form and is dispersed across various commands and activities. The Marine Corps was, however, able to produce documentation for current-year transactions, and in December 2013, the Marine Corps became the first DoD Military Service to receive an unmodified (clean) audit opinion on its FY 2012 SBA.

The Department's modified strategy implements a sensible and cost effective approach to validating SBR audit readiness by way of SBA audits in FY 2015 through FY 2017. Beginning balances will be addressed during the SBA audits and will be audit ready by September 30, 2017, prior to full financial statement audits in FY 2018. This sensible approach has been favorably received by the Government Accountability Office (GAO) and the DoD IG.

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

To develop effective financial-management processes throughout the Department, the Department has begun to implement new financial management systems and business processes. The DoD IG believes properly planned and integrated systems, with strong internal controls, are critical to providing useful, timely, and complete financial management data and to achieving auditability. Timely and effective implementation of the enterprise resource planning systems (ERPs) is critical for the Department to achieve its financial improvement and audit readiness goals.

The Department noted in the May 2014 FIAR update that the ERPs continue to be essential to the Department's audit readiness efforts. However, not all ERPs will be fully deployed for the FY 2015 SBA audits or the 2017 readiness deadlines. This will require the Department to continue to rely on legacy systems.

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

The Department plans to spend about $15 billion to develop and implement ERPs. These systems have experienced cost increases and schedule delays. The Department noted that some ERPs will not be fully deployed by the 2014 and 2017 audit readiness dates, and therefore, it must continue to rely on legacy systems. This will increase the risk that the audits of the FY 2015 SBR, or a schedule of current year budget activity, will not be successful and may not result in unmodified opinions, and that the Department will not meet the goal of full financial statement audit readiness by September 30, 2017. Reliance on legacy systems, along with schedule delays and poorly developed and implemented ERPs, will diminish the savings expected from transforming operations through business system modernization.

Furthermore, without fully deployed ERPs, the Department will be challenged to produce reliable financial data and auditable financial statements without resorting to extreme efforts, such as data calls or manual work-arounds, to provide financial data on a recurring basis. For example, the Department reported in the May 2014 FIAR Plan Status Report that the Air Force ERPs will not be fully deployed by 2014. As a result, the Department may need to rely on a combination of ERPs and legacy business and financial systems to conduct the SBA and SBR audits.

The Department has not reengineered its business processes to the extent necessary. Instead, it has often customized commercial ERPs to accommodate existing processes, which creates a need for system interfaces and weakens controls built into each ERP system. The ERPs were designed to replace numerous subsidiary systems, reduce the number of interfaces, standardize data, eliminate redundant data entry, and provide an environment for end-to-end business processes while being a foundation for sustainable audit readiness. However, the numerous interfaces between the ERPs and existing systems may be overwhelming and inadequately defined. Each interface presents a risk that the system might not function as designed, and each prevents the linking of all transactions in an end-to-end process. The Department needs to ensure ERP system development addresses the required business processes and functions.

Without the effective and timely development and implementation of ERP systems, and without senior-level governance, the Department will continue to struggle to improve its financial management processes, achieve long-term sustainability of those improvements, and timely, and meaningful financial management information for internal and external users. Recent audits continue to find that system program managers have not configured systems to report U.S. Government Standard General Ledger financial data using the DoD Standard Financial Information Structure (SFIS).

Additionally, other audits have found that the Department has not sufficiently reengineered its business enterprise architecture processes nor incorporated the functionality in ERP systems. The Department has established certification requirements, and the Deputy Chief Management Officer and Deputy Chief Financial Officer have established validation and certification procedures for implementing SFIS requirements and ensuring business process reengineering has taken place; however, these procedures were not stringent enough to ensure compliance. The Department needs to continue to improve its validation and certification procedures.

1-2C. Modernizing Financial Systems	**Department Response**

The Department is committed to improving financial processes through the implementation of ERPs. In support of these efforts, the Department has been working diligently to improve business processes and oversee the development of the ERPs in support of auditability.

While it is true that legacy systems will continue to be used, the ERPs that have been implemented resulted in phasing out dozens of legacy systems. Several of the Department's ERPs support the 2017 auditability goal. Where the Department is dependent on legacy systems, the Components' Financial Improvement Plans incorporate those actions necessary to ensure that accurate, reliable financial information is reported.

Modernizing DoD 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 taking proactive steps to align individual ERP programs with auditability outcomes, we also are 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 detail 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 ERPs directly enable the capabilities that are essential to 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 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 ERPs' programs went through significant, up-front blueprinting and gap analysis to determine which configuration or customization would be necessary for the system to work within its particular business environment. The Department has focused on properly enforcing compliance with the target financial management environment, built on a backbone of the core ERP systems and aligned with the Business Enterprise Architecture's end-to-end processes.

The Department's investment management process ensures:

- Investments are aligned to functional strategies;
- The Department makes more informed investment decisions;
- Legacy systems that are no longer required are eliminated;
- Enhanced interoperability, and
- The Department transforms to an environment where business applications can be rapidly deployed on a common computing infrastructure.

The investment review process also ensures each investment is an appropriate use of taxpayer dollars and aligns to the Department's business architecture and our shared goal of delivering agile, effective and efficient business solutions that support and enable our warfighters.

To implement this investment management process, the Deputy Chief Management Officer issued guidance to ensure the Department continues to treat its business system investments with the purpose and discipline that will enable cost savings to be redirected to critical operational needs of the warfighter. The guidance, updated annually, includes an integrated business framework to align broad, DoD strategy with functional and organizational strategy to guide system implementations. The integrated business framework uses Functional Strategies and Organizational Execution Plans (OEP) to help achieve the Department's target business environment.

The Financial Management (FM) Functional Strategy describes the Department's financial management business mission area's strategic vision, goals, target environment, and expected outcomes over the next five years. Key components of the FM functional strategy include FM data standards, process/system improvements, and how to leverage technology to assist the Department improve efficiency and effectiveness of FM processes.

In response to OSD Principal Staff Assistants' (PSA) functional strategies, the Military Departments and Defense Agencies develop OEPs that describe how their business system portfolios will achieve the PSA's directions and initiatives. The OEPs also provide more detailed information on how information technology investments align to the functional strategy initiatives.

1-3A. Improper Payments	**IG Summary of Challenge**

Improper payments, a long-standing problem in the Department, are often the result of unreliable data, a lack of adequate internal controls, or both, which increases the likelihood of fraud. As a result, the Department lacks assurance that billions of dollars of annual payments are disbursed correctly. The Department's inadequate financial systems and controls hamper its ability to minimize improper payments. In addition, the pace of operations and volume of Department spending create additional risk for improper payments, and both hinder the Department's ability to detect and recover those improper payments.

The Department faces difficulties in the completeness and accuracy of its improper payment reviews and the information reported. Additionally, the lack of an auditable Statement of Budgetary Resources (SBR) leaves the Department unable to reconcile outlays to the quarterly or annual gross outlays reported in the SBR to ensure all required payments for reporting purposes have been captured. These areas require improvement before the Department will be able to provide complete and accurate information on its estimated amount of improper payments.

1-3B. Improper Payments	**IG Assessment of Progress**

Although 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.

The Department complied with five of the six improper payment reporting requirements for FY 2013. Although improper payment rates for the reported payment programs were below the Office of Management and Budget established threshold, the Department did not achieve its improper payment reduction targets for five of eight payment programs with established targets. Further, for the second consecutive year, one of the payment programs did not meet its target rate. Not attaining reduction targets indicates that additional corrective actions are needed to reduce improper payments. In addition, the Department had deficiencies in the methodologies for five of the nine payment program areas that could affect the reliability of DoD's improper payments estimates.

We commend the Department on aggressively pursuing recovery of identified improper payments, but unless it continues to improve its methodology for reviewing all its disbursements, it likely will not identify and accurately estimate the amount of improper payments. As a result, the Department will likely miss opportunities to identify causes of improper payments and implement effective corrective actions to prevent future improper payments.

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

The Department appreciates DoD IG's recognition of our efforts to minimize improper payments and our aggressive pursuit to recover identified improper payments. The Department has addressed the sampling methodology deficiencies to improve the integrity of the post-payment review results, and we continue to take ownership and corrective actions to address the recommendations in the latest DoD IG and GAO reports.

While the Department continually strives to reduce improper payments, it should be noted that the payment error rates experienced in most of DoD's programs already are very low, many lower than half of one percentage point (detailed reporting on the DoD improper payment program is addressed in the found in the "Other Information" section of this report).

The Department is collaborating with OMB to consider establishing more reasonable tolerance levels around the target reduction goals that consider the cost effectiveness of required remediation plans when the goals are not met or when actual payment error rates are very low. All of these actions, coupled with the Department's progress toward achieving audit readiness, will increase public confidence in the Department's stewardship of taxpayer dollars as well as strengthen the fundamentally sound DoD improper payments program.

A Marine walks ahead of a legged support system at Marine Corps Training Area Bellows on Oahu, Hawaii. The legged system is designed to carry supplies, including water, food and ammunition, through rough terrain.

Photo by Cpl. Matthew Callahan

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

2-1A. Enhancing the Acquisition Workforce	IG Summary of Challenge

The Department's senior leadership remains dedicated to continuously improving the size and the capabilities of its acquisition workforce. While the Department has made progress in growing its workforce to meet the demands placed on it by the volume and complexities of its programs and contracts, the Department needs to shift its focus to sustain the number of resources needed to execute the acquisition mission and increase opportunities for training and development.

In addition to improving the professionalism of the acquisition workforce, which is an initiative of Better Buying Power 2.0 (explained in Section 2-1B, below), Department leaders remain concerned over the effects of budget uncertainty and cuts. The budget instability decreases morale and negatively impacts the ability to recruit, train, and retain skilled acquisition professionals. The Department also faces significant challenges in the acquisition community resulting from an aging workforce. Over the next decade, over 50 percent of the acquisition workforce will be eligible for retirement. Accordingly, it will be critical that the Department plan for and invest in targeted training, education, and certification of the acquisition workforce left to succeed those leaving.

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

Since reaching a maximum strength of 152,326 civilian and military personnel in 2012, the Department has since seen a decline of 1.3 percent in overall strength, to 150,247 personnel, in the third quarter of FY 2014. The issues related to the DoD acquisition workforce, however, do not relate only to the number of resources, but to the quality and the capability of the personnel the Department employs. For FY 2015, the Department plans to invest approximately $500 million using the Defense Acquisition Workforce Development Fund, of which the President requested $212.9 million in direct appropriations from Congress to support strategic objectives and continuous improvement of the defense acquisition workforce. Keeping in line with current initiatives, the funding will support both the remaining hiring of personnel to complete the rebuilding initiative and limited hiring for critical needs. It also will support training, development, and improvement of the acquisition workforce needed to increase buying power; modernize and reset our military force; improve acquisition outcomes; and ensure future technological superiority. As efforts in these areas continue, oversight and commitment remains imperative.

2-1C. Enhancing the Acquisition Workforce	Department Response

The Department concurs with the DoD IG's statements on the challenge and progress made in enhancing the acquisition workforce. Consistent with the President's FYs 2014 and 2015 budget requests and the *Quadrennial Defense Review 2014* (QDR) objectives, strong leadership emphasis and initiatives will continue to move us toward objectives to improve acquisition productivity, increase buying power, and increased efficiencies. A necessary element of achieving these objectives requires continuous improvement and resources to sustain and strengthen the capability and professionalism of the acquisition workforce.

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

The Department remains challenged in its management of Major Defense Acquisition Programs (MDAPs), which declined from 85 in 2012 to 80 in 2013. While the number of programs within DoD's portfolio decreased between FY 2012 and FY 2013, the overall cost of the programs increased by $14.1 billion. Furthermore, DoD programs cannot stay within the confines of cost and schedule estimates, as demonstrated by cost growth of over $14.1 billion and average schedule delays of over two months. With the expectation that defense budgets will continue to decline in the future, it will be more important than ever for the Department to identify opportunities to reduce costs and achieve efficiencies in its processes throughout the lifecycle.

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

Four years ago, DoD implemented the first iteration of the Better Buying Power and two years later, implemented the second set of initiatives known as Better Buying Power 2.0. While there is evidence that progress was made in areas such as program affordability, life-cycle costing and bottom-up estimating, competitive contracting, and program management, the cost and schedule growth attributable to the acquisition of major defense programs remained significant and demonstrated the need for additional work.

The DoD IG audits continue to identify significant programmatic issues, such as poorly defined requirements, duplicate and redundant capabilities, incomplete system testing, improper fielding, and procurement quantities in excess of what is needed to successfully execute its mission. The enormity of the investment in weapon systems acquisition and the role it plays in making U.S. forces capable warrants continued oversight and a long-term commitment to process improvement. The need to continue support for the warfighter and the potential for savings argue against complacency.

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

Weapons Systems Acquisition has been and continues to be a high priority for DoD leadership. This commitment is reflected in the Department's *Better Buying Power (BBP) Initiatives* and more recently in the interim revision of *DoD Instruction 5000.02*, which describes the policies applicable to the defense acquisition system. The DoDI 5000.02 revision, issued in November 2013, institutionalizes many of the BBP initiatives. Key policy changes include affordability constraints for every program; a requirements decision point to ensure requirements are well understood, technically achievable, and affordable; enhanced emphasis on thoughtful business arrangements, to include better use of contract incentives and maintenance of a competitive environment; more effective developmental and operational testing – and much more.

Department acquisition leadership aggressively monitors implementation of these policies via the Under Secretary of Defense for Acquisition, Technology, and Logistics (USD AT&L) Business Senior Integration Group, program decision events, and careful review of periodic reports. Our objective is continuous, incremental improvement based on pragmatism and evidence.

2-3A. Contract Management	IG Summary of Challenge

The Department continues to struggle to provide consistent effective oversight of its contracting efforts. The Department continues to face contracting deficiencies in these areas: obtaining adequate competition in contracts; defining contract requirements; overseeing contract performance; obtaining fair and reasonable prices; and maintaining contract documentation for contract payments.

Service contracts represent more than 50 percent of the Department's contract spending. The Department faces several challenges in contract oversight and administration of services contracts. Without proper oversight, which DoD IG audits continue to identify, the Department cannot be certain that contractors are performing in accordance with contract requirements, may have overpaid for increases in contract costs, and cannot ensure that services are performed. This leaves the Department vulnerable to increased fraud, waste, and abuse.

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 in the late 1990s, 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) arrangements, which have added a new challenge to obtaining fair and reasonable prices for parts since the Services now are procuring parts from the weapons systems contractors instead of other sources, such as the Defense Logistics Agency (DLA). These parts often are purchased unnecessarily and at higher prices rather than utilizing existing DLA inventory.

2-3B. Contract Management	IG Assessment of Progress

The Department continues to strengthen contracting and has issued policy, procedures, and guidance addressing current contracting challenges. The Department began the Better Buying Power (BBP) effort in 2010 and continued with the second phase of the initiative, BBP 2.0, in April 2013. The BBP 2.0 has seven areas of focus, and three of those help the Department address the following contract management challenges: promote effective competition; improve tradecraft in acquisition of services; and incentivize productivity and innovation in industry and Government.

To promote effective competition, BBP 2.0 emphasizes competition strategies, with initiatives to create and maintain competitive environments and increase small business roles and opportunities. When competition is applied effectively, it results in lower costs to the Government, greater innovation from industry, and added savings to the taxpayer.

Because service contracts make up the majority of the Department's purchases, the BBP 2.0 area of improving tradecraft in the acquisition of services is very important. For the acquisition of services, the Department is focusing on assigning senior managers, improving requirements definitions, preventing requirements creep, and strengthening contract management outside the normal acquisition chain, among other initiatives.

As part of its goal of incentivizing productivity and innovation in industry and government, BBP 2.0 will increase effective use of Performance Based Logistics (PBL) arrangements, by which the Department has achieved improved readiness at significant savings, when PBL arrangements are properly structured and executed. However, PBL success depends on the workforce having the expertise and support to properly develop and implement the PBL concept.

Even with the implementation of BBP 2.0, the Department continues to struggle with implementing Federal Acquisition Regulation revisions on the use of cost-reimbursement contracts. Contracting activities are still challenged in documenting:

1) The approval for a cost-reimbursement contract was at least one level above the Contracting Officer;
2) Cost-reimbursement contracts were justified;
3) How the requirements under the contract could transition to firm-fixed price in the future;
4) That Government resources were available to monitor the cost-reimbursement contract; and
5) That contractors had an adequate accounting system in place at contract award.

2-3C. Contract Management	**Department Response**

The Department agrees with the DoD IG's summary of challenges and assessment of progress and continues to work aggressively to resolve the long-standing material weaknesses in contract management. Key initiatives include:

Efforts to Improve Competition

The USD(AT&L) recently announced measures to boost competition in contracting at the field level for lower-dollar value services contracts, where there is more opportunity for improvement. The USD(AT&L) memorandum, entitled "*Actions to Improve Department of Defense Competition*," dated August 21, 2014, identifies actions to improve competition consistent with BBP 2.0 Initiatives to Promote Effective Competition. The memorandum encourages collaboration and sharing of best practices that have been successfully employed to increase competition, improve quality and performance, and lower cost for supplies and services. Specific actions include:

- Address competition on a quarterly basis at the Business Senior Integration Group meetings to track and manage progress in competition using expanded competition metrics to identify opportunities for improvement.
- Employ business intelligence tools to identify opportunities for improvement.
- Require contracting officers to obtain feedback on competitive solicitations in which more than one offer was expected based on market research, yet only one offer was received, and
- Require active market research using mandatory Request for Information notices on non-competitive acquisitions.

The August 21, 2014 memo announced publication of "*Guidelines for Creating and Maintaining a Competitive Environment for Supplies and Services in the Department of Defense*." The guidelines are intended to provoke thought about the various approaches that may be employed to competitively fulfill the Department's requirements.

Improve Tradecraft in Acquisition of Services

Services acquisition continues to play a critical role as the Department begins reducing the size of the force and appropriately balancing the mission requirements against the unique capabilities provided by the three types of labor in the Department's total workforce: uniformed military, DoD civilians, and contractors.

As stated in the DoD IG progress assessment, the USD(AT&L) recognized the need to develop more guidance, metrics, and oversight for services acquisition and focused these efforts through the BBP Initiatives. The Principal Deputy USD(AT&L) has been appointed as the DoD Senior Services Manager leading the contracted services initiatives, with the Deputy Director, Defense Procurement and Acquisition Policy (DPAP), Services Acquisition (SA), focused on day-to-day leadership and oversight of the Department's efforts, as detailed below.

The USD(AT&L) appointed DoD Functional Domain Experts (FDEs) to serve as the DoD-level lead for his or her respective Portfolio Group or Portfolio Category. The FDEs will actively oversee the life-cycle process for the contracted services within their portfolio, including forecasting and budgeting, requirements definition and validation, procurement, active management, and oversight of contracted services.

The USD(AT&L) also directed the development of a new DoD Instruction on Defense Acquisition of Services, which will:

- Establish policy, assign responsibilities, and provide procedures for identifying, assessing, reviewing, and validating requirements for the acquisition of services;
- Establish a simplified and flexible management framework for translating approved services requirements into stable, affordable, and well-managed programs;
- Authorize decision authorities, consistent with statutory and regulatory requirements for the acquisitions of services, to tailor the procedures to best achieve cost, schedule, and performance objectives; and
- Provide additional capability and oversight of services contracts.

The Department also is engaged in developing data capabilities to help stakeholders (including resource sponsors, Military Departments, and FDEs) understand and actively manage the services we are buying. The DPAP developed a Business Intelligence tool to provide visibility into our spending and allow greater management and oversight.

The Services Acquisition Functional Integrated Product Team (SA FIPT) is leading new and leveraging ongoing initiatives, to include development/deployment of formal Service Acquisition training for SA stakeholders, both Defense Acquisition Workforce Improvement Act (DAWIA) and non-DAWIA populations, in the lifecycle management of services contracts. The SA FIPT has identified competencies for services stakeholders and identified/endorsed five on-line modules (CLCs 011, 222, 007, 004, & 017), two classroom classes (ACQ101 and ACQ265), and one mission-assistance capability (Services Acquisition Workshop) related to improving services acquisitions for use within and outside of the DAWIA workforce. Work continues on completing both competency and full curriculum development.

Better Buying Power 2.0 Initiatives

The Better Buying Power (BBP) 2.0 Implementation Guidance of April 24, 2013, included specific direction to "Increase effective use of Performance-Based Logistics." The following recent policies and guidance address use of Performance Based Logistics (PBL) and assist the defense acquisition workforce in developing effective PBL product support arrangements.

- On November 23, 2013, Acting Assistant Secretary of Defense for Logistics & Materiel Readiness (ASD[L&MR]) issued a memorandum, entitled "Performance Based Logistics Comprehensive Guidance."
- On May 27, 2014, the ASD (L&MR) (Acting) issued the DoD PBL Guidebook. The Guidebook is designed to serve as both a reference manual for experienced PBL practitioners as well as a practical "how-to" guide for "new-to-PBL" logisticians. The guidebook provides PBL best practices and practical examples (tenets, analytics, metrics, and draft RFP information) for developing performance-based arrangements.

- Additionally, the Defense Acquisition University (DAU) has incorporated PBL learning assets into the Life Cycle Logistics curriculum and is working to incorporate performance-based learning assets into Program Management, Contracting, Systems Engineering, and Business/Financial Management curriculum.

An initiative implemented in *BBP 2.0* is "Continue to increase the cost consciousness of the Acquisition Workforce – change the culture" under the "Improve the Professionalism of the Total Acquisition Workforce" focus area. The Director, DPAP, continues to focus on improving the capability of the contracting workforce to include quality-focused initiatives to strengthen the capability and readiness. In FYs 2013 and 2014, DPAP prepared to reassess the proficiencies of the contracting workforce to determine if progress has been made to address competency gaps identified from the 2009 competency assessment and to determine if new training gaps exist. In the third quarter of FY 2014, the competency reassessment was deployed to the 30,000 member contracting workforce. The results of the competency assessment will be used for the basis of human capital actions/workforce planning; updated/initiating training, increasing/improving leadership developmental opportunities, and the results allow the Department to make informed and sustained investments in the workforce.

The DPAP continues to collaborate with DAU on the curriculum for the contracting, purchasing, and industrial property career fields. The new curriculum incorporates more pricing, competition, contract administration, services acquisition, small business, and the BBP initiatives. Efforts to improve acquisition workforce staffing and training continued in FYs 2013 and 2014. Courses CLC 106, COR With a Mission Focus, and CLC 222, Contracting Officer Representative, are ranked number one and number three amongst the "most taken" DAU online learning assets.

As recent as June 9-13, 2014, the Director of Defense Pricing and the Director of DPAP hosted a collaborative event for pricing subject matter experts from across the Department. Representatives from the Air Force, Army, Navy, Defense Logistics Agency (DLA), Missile Defense Agency (MDA), Defense Contract Audit Agency (DCAA), and Defense Contract Management Agency (DCMA) participated. The event included advanced training on topics such as contract incentives, subcontractor pricing, the Truth in Negotiations Act, and commercial pricing, and also included time devoted to each Component sharing best practices, examples of overcoming pricing challenges, and pricing success stories. Sessions on subcontract analysis/subcontracting issues, commercial item pricing, and effective incentive contracting, as well as vigorous discussions on these topics, enabled the participants to share experiences with strategies which have proven successful, and to brainstorm about possible further evolutions of these strategies. The Senior Leader Question and Answer session on competition/source selection allowed the participants to not only get the DPAP perspective on the process, but to engage in dialogue about some of the issues currently being experienced across the Department. Going forward, it is expected that the participants will avail themselves of these connections with other pricing experts across the Department to develop robust approaches to address the most complex pricing issues facing the DoD Components.

The Department developed the Contracting Officer Representative Tracking (CORT) tool to track and maintain COR assignment. The web-based tool, hosted on the Wide Area Workflow portal, enables Military Departments and Defense Agencies to manage nomination, training and tracking of their respective cadres of CORs and the contract(s) assigned to each COR. As of September 4, 2014, there were 50,288 registered CORs. Of the number registered, the Army has 31,578 users.

In addition to the BBP and BBP 2.0 initiatives, DCMA continued to both establish new and to refine existing capabilities to assist the Acquisition Workforce in making better business decisions. The DCMA stood up a commercial pricing cell to assist Procuring Contracting Officers in making commercial item determinations and to facilitate the cost reasonableness of commercial items. Calendar year 2014 marks the first full year DCMA had fully-staffed and operational Integrated Cost Analysis Teams (ICATs), comprised of dedicated business and technical pricing personnel located at 11 major contractor divisions. Expectations are for the

ICATs to more aggressively pursue opportunities to reduce costs in the supply chain in their proposal pricing efforts, including targeted engagements at second and third tier suppliers. The DCMA initiated a formalized process for coordinating and selecting locations for the conduct of overhead should-cost reviews to maximize benefit for the Department.

A Seaman signals to pilots in an MH-60S Seahawk helicopter as it picks up supplies from the flight deck during a vertical replenishment aboard the guided-missile destroyer USS Arleigh Burke in the Persian Gulf. The Arleigh Burke is deployed in the U.S. 5th Fleet area of responsibility supporting maritime security operations and theater security cooperation efforts. The Seahawk is assigned to Helicopter Sea Combat Squadron 26.

Photo by Petty Officer 2nd Class Carlos M. Vazquez II

3. IG-Identified Challenge: Joint Warfighting and Readiness

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

The United States removed its combat troops from Iraq and is drawing down its presence in Afghanistan. The lead for security responsibility in Afghanistan has transitioned to the Afghan government. The drawdown of forces from Afghanistan will continue to challenge the Services as they deal with retrograde and reset equipment, with much of the equipment being returned after exceeding utilization rates in many of their design operating parameters. The Department will be challenged to maintain the readiness of the forces as equipment is repaired or replaced.

The Services are engaged in a strategic rebalance to the Asia-Pacific region while continuing to maintain the global presence needed to protect national interests. While undergoing this rebalance, the Department will need to address a wide spectrum of challenges, ranging from increased reliance on uncertain host nation infrastructure to vast areas of responsibility – both requiring pre-positioning and the need for enhanced knowledge of various languages and cultural, ethnic, and religious sensitivities. The Department also continues to address emerging terrorism and instability challenges in AFRICOM's area of operation. Growth in AFRICOM's operational partnering mission raises the issue of sufficiency of its resources to address the terrorist threat. The Department returned some facilities in Europe and continues to move toward the completion of the Strategic Alliance in Korea. Global conflict and crises will continue to impact the Department's rebalancing and resetting. It is critical that the Department address these challenges to ensure our military is agile, flexible, and ready for the full range of contingencies during this time.

Meanwhile, the new budget reality is being sensed across the Department, especially in areas such as maintenance of existing equipment and systems, fielding and implementation of new systems, and the frequency and extent of training and exercises. The impact of sequestration was felt almost immediately as the Navy adjusted repair and overhaul schedules for ships and the Air Force began restricting flying hours for squadrons. The Services and the combatant commands need to ensure that the impact of the current sequestration, as well as future budget reductions, has minimal impact on the ability to respond to future threats. The Services will be challenged to review their existing force structures and make necessary changes or adjustments, especially when those changes or adjustments involve paradigm shifts in how we view future scenarios.

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

The Department must assess warfighter capabilities and readiness across the full range of strategic, operational, and tactical considerations. This assessment includes large questions, such as whether the joint force is capable of achieving the strategic objectives set forth in the *National Security Strategy*, to the tactical focus on individual unit readiness. The Department is making progress in addressing the many difficulties in the drawdown in Afghanistan, resetting equipment, and ensuring the long-term viability of the all-volunteer force. However, the Department must also be ready to address fiscal challenges; if not addressed, those fiscal challenges will overtake any improvements or enhancements the Department intends to make in the near term.

The National Security Strategy released in January 2012 placed increased emphasis on the Pacific theater. The realignment of forces from Okinawa, Japan, to Guam still faces formidable challenges, which have increased projected costs and schedules.

The Services will have to train to fight in conventional and unconventional scenarios, and they will be challenged to do so with diminishing resources while maintaining their readiness.

The Department must also provide the necessary levels of oversight to ensure that forces returning from Afghanistan, and their families, continue to receive the medical and other support they need.

As the drawdown continues in Afghanistan, the Department must ensure that adequate oversight of equipment being returned and the equipment reset process is properly managed so that only unusable equipment is disposed and that which is new is fielded to intended users. The DoD IG recently reported on concerns with the security of equipment staged for retrograde in Afghanistan. We also identified concerns with the contract oversight of the multimodal contract used to facilitate the transporting of equipment to the United States for reset.

Efforts to redeploy military units around the globe will enable the Services to better shape and focus their force structure to provide greater flexibility in responding to threats.

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

Turmoil around the world continues, ranging from the threat presented by ISIL in Iraq to the potential of an Ebola pandemic. Despite our continued 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, or training to full spectrum readiness hedging against the need to execute other potential contingencies.

The ongoing reduction of forces from Afghanistan has reduced the stress on forces in the near term; however, fiscal constraints will result in tough decisions on materiel, manpower, and infrastructure that 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 for the foreseeable future.

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 and their families. During these times of fiscal austerity, particularly the potential to return to Budget Control Act funding levels, finding the proper balance between maintaining readiness, force structure sizing, modernization, and future threats remains the highest priority of the Department's leadership.

4. IG-Identified Challenge: Cyber Security

4-1A. Cyber Security	IG Summary of Challenge

Although the Department has operated in the information and cyberspace environment for years, making "cyber" a new domain of warfare in the 2010 Quadrennial Defense Review (QDR) brought it into the forefront of warfighter planning. However, bringing the cyber domain into parity with the more easily distinguished and widely developed air, land, and sea domains will remain a challenging task for the near future.

As described in the National Military Strategy for Cyberspace Operations, cyberspace threats generally fall within six categories: traditional, irregular, catastrophic, disruptive, natural, and accidental. Addressing the rapidly increasing threats in the cyber domain is a priority. As such, developing offensive as well as defensive operations within the domain takes specialized equipment along with uniquely trained personnel.

In the relatively short life of the newly described cyber domain, the Department has developed strategies for both offensive and defensive operations. In a June 12, 2013, statement before the Senate Committee on Appropriations, the Commander, United States Cyber Command stated, "We are improving our tactics, techniques, and procedures, as well as our policies and organizations. This means building cyber capabilities into doctrine, plans, and training – and building them in a way that senior leaders can plan and integrate such capabilities as they would capabilities in the air, land, and sea domains." As stated by the Department's past Chief Information Officer, "There will never be a time that we can assume a comfort posture." As such, the Department must be ever vigilant to continuously invent and reinvent how it operates in the cyber domain.

4-1B. Cyber Security	IG Assessment of Progress

The Department has made strides in developing strategies for operating in the cyber domain, developing frameworks for evaluating risks, and building its cyber workforce strategy for the future. The Department is establishing cyber support elements at several geographic combatant commands to provide both technical capability and expertise for the combatant commander. The Department continues to develop, refine, and implement programs and processes for the five initiatives identified in the Department of Defense Strategy for Operating in Cyberspace. The Department continues to invest in cybersecurity capabilities by expanding the cyber forces that will defend the networks, degrade adversary cyber capabilities, and support defense of National infrastructure.

In March 2014, the Department issued instructions for the Risk Management Framework (RMF) for DoD Information Technology (IT). The instructions describe how cybersecurity requirements for DoD information technologies will be managed through RMF, consistent with the principles established by the National Institute of Standards and Technology. Also in March 2014, a new instruction on cybersecurity was issued to establish a cybersecurity program to protect and defend DoD information and information technology. The *Quadrennial Defense Review 2014* commits the Department to dedicate additional resources to cybersecurity. Lastly, the Department continues to increase the number of high-level positions with a cyber leadership role. However, unlike in the air, land, and sea domains, accomplishments can be quickly overcome by the stream of threats, and the Department must continue to challenge all military, civilian, and contractor employees to successfully implement cyber security while operating in the cyber domain.

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

The Department continues to make progress in ensuring the strategic goals of the cyber environment are met. To ensure cyber security for the nation, the Cyber Mission Force was created. The Cyber Mission Force continues to mature to respond to cyber security demands of the nation. Several programs have been put in place to ensure the Cyber Mission Force is properly manned, trained, and equipped.

The Assistant Secretary of Defense for Global Strategic Affairs has been assigned the role of Principal Cyber Advisor to inform the Secretary of Defense on policy related to the Cyber Mission Force. The Department is examining the role of the National Guard and Reserve Component for the Cyber Mission Force. The department is leveraging cyber National Guard forces to coordinate train, advise, and assist the Cyber Mission Force. Using the National Guard in this capacity allows the Department to take advantage of the knowledge and training of both the military and private sectors. In addition, the Department is ensuring a right sized, properly trained and equipped civilian cyber force by ensuring the proper hiring policy and authority is in place to recruit the talent needed. Lastly, the Department is taking action to create a persistent training environment is available to certify the Cyber Mission Force is properly trained.

Per the National Defense Authorization Act for FY 2014, the Department recently submitted a report to Congress which made recommendations across a range of issues in support of cyberspace, including the manpower, recruitment, retention, roles, mission requirements, training, infrastructure and structure for the Reserve Components (RC). This report also addressed how the Military Services supply personnel to the Cyber Mission Force.

4-2A. Cyber Workforce	**IG Summary of Challenge**

According to the National Initiative for Cyber Security Education, as the world grows more connected through cyberspace, a highly skilled cyber security workforce is required to secure, protect, and defend our nation’s information systems. While the demand for cyber security professionals is high, the supply is relatively insufficient. For example, according to one leading research director, “Top-notch cyber-threat hunters and tool builders are in short supply. There are probably fewer than 800 of them in the entire country.”

In the current environment of economic uncertainty and fiscal constraints, the Department faces a significant challenge in filling the multitude of cyber positions it needs to operate, defend, and protect its networks. The Center for Strategic and International Studies issued a report, “A Human Capital Crisis in Cybersecurity,” April 2010, identifying a national shortage of skilled cyberspace personnel that could potentially impact DoD’s operational readiness and put national security at risk. Additionally, the most recent Government Accountability Office report, *High Risk Series, An Update*, February 2013, includes strategic human capital management and identifies information technology management/cybersecurity as a Government-wide mission critical occupation. As of 2014, DoD is in the process of building its cyber mission force to provide effective defense of the nation, support combatant command military operations, and defense of DoD Information Networks. However, it is still imperative that the Department continue focused efforts to recruit, train, and retain a cyber workforce in the competitive national environment to meet the threat.

4-2B. Cyber Workforce	**IG Assessment of Progress**

Training and retaining a skilled cyber force is one of the biggest gaps in the cyberspace domain. The Department has taken steps recently to build its cyber workforce. On November 21, 2013, the Deputy Secretary of Defense issued the “Department of Defense

Cyberspace Workforce Strategy," identifying six strategic focus areas for building and maintaining a competent and resilient cyber workforce. For example, the Army developed a new military occupational specialty and graduated its first class of cyber network defenders in November 2013 as a means to building a cyber workforce. Also, the Deputy Secretary of Defense included funding in FYs 2014 and 2015 to field the approximately 6,000 personnel cyber mission force. In addition, the Department will add additional military and civilians to perform other cyberspace functions for U.S. Cyber Command, the combatant commands, and the Services related to defending networks, degrading adversary cyber capabilities, and supporting defense of national infrastructure. In addition, the 2014 budget adds resources to increase the quality and throughput of DoD's training pipeline. Although the Department has made progress in beginning to build a cyber workforce, it must maintain momentum through implementation to ensure the resourcing initiatives allow DoD to recruit, train, and retain a competent cyber workforce.

4-2C. Cyber Workforce	**Department Response**

The Department has set a goal of 6,000 personnel trained, equipped, and working as the Cyber Mission Force by the end of fiscal year 2016. To facilitate success, the Department is ensuring the proper policy and authorities are in place to hire the right personnel to meet this goal. While personnel with cyber security skills remain in high demand, the Department has put incentives in place to attract world class talent.

The Department also is conducting the Civilian Cyber Workforce Challenges study, which will examine the current human resources systems and practices in place at the National Security Agency and United States Cyber Command to ensure that human resources and funding systems are flexible for a dynamic community.

Lastly, the Services are creating occupational series specifically for cyber missions. These new career fields will replace the existing model of taking personnel from disparate career fields to become part of the Cyber Mission Force. Instead, the new career fields will be used to supply personnel to the Cyber Mission Force.

To ensure the Cyber Mission Force is properly trained, the Department continues to mature the United States Cyber Command Training and Readiness Manual. This document details individual training requirements for the Cyber Mission Force. It has seen wide distribution and coordination throughout the Department throughout the creation process.

The Department continues to prioritize cyber workforce and has developed a strategy for providing a phased cyber workforce development that is large enough and strategically structured to secure, protect, and defend Department networks. Budget constraints, including indiscriminate cuts, put that strategy at risk.

5. IG-Identified Challenge: Health Care

5-1A. Health Care	IG Summary of Challenge

The Military Health System (MHS) must provide quality care for 9.6 million beneficiaries within fiscal constraints while facing increased user demand, legislative imperatives, and inflation. These factors make cost control difficult in the public and private sectors. Over the last decade, health care costs continued to grow substantially, and MHS costs have been no exception. The DoD FY 2014 appropriations for health care were $32.7 billion, which is an increase of about 80 percent since FY 2005, and which has almost tripled since FY 2001 appropriations of $12.1 billion. However, the Department's appropriations slightly decreased by $16 million from FY 2013. The Department reported that growing health care costs will limit its ability to fund medical readiness requirements.

Health care fraud is another challenge in containing health care costs. Health care fraud is among the top five categories of criminal investigations of the DoD IG's Defense Criminal Investigative Service (DCIS). Specifically, as of March 31, 2014, DCIS had 322 health care cases representing 19.8 percent of the 1,725 open cases. The Defense Health Agency reported that during calendar year 2013, its program integrity unit managed 388 active investigations, opened 212 new cases, and responded to 931 leads or requests for assistance.

As the Military Health System continues to adapt to budgetary and force transformation constraints, the Department must maintain the medical readiness of the force. Challenges will include public health, suicide prevention, access to care, pre- and post-deployment health care, medication management, and Reserve Component health care. The Department continues to enable the recovery and transition of wounded, ill, and injured Service Members by using Wounded Warriors programs and the Integrated Disability Evaluation System. Due to the drawdown in Iraq and Afghanistan, the Military Services will be challenged with "right-sizing" their medical transition programs.

5-1B. Health Care	IG Assessment of Progress

The Department's efforts in controlling health care costs, while still ensuring our service men and women and their families receive the care they need and deserve, will continue to be a challenge. The MHS is focusing on many areas to manage health care costs per capita. Three managed-care support contracts are in effect; however, award protests resulted in staggered implementation of the new-generation TRICARE contracts. These contracts provide incentives for customer satisfaction and contractors for managed care support as partners in support of medical readiness. The Department continues to examine how the MHS purchases health care from the private sector.

The Department identified areas that assist in managing costs, including the use of the TRICARE Mail Order Pharmacy program. The DoD IG reported in July 2013 that the TRICARE Mail Order Pharmacy Program was more cost efficient than the retail program due to the difference in the cost of the pharmaceuticals. The Defense Health Agency Pharmacy Operations Directorate implemented an aggressive communication plan to encourage the increased use of receiving prescription drugs through the mail to reduce costs.

Also, through the authority provided in Section 703 of the FY 2008 National Defense Authorization Act, DoD obtains federal pricing discounts in the TRICARE retail network pharmacies in the form of refunds from pharmaceutical manufacturers. According to the Defense Health Agency, as of May 2014, DoD achieved savings to the Defense Health Plan of $493 million through the program. Finally, according to the Defense Health Agency, DoD achieved savings through DoD and VA joint pharmaceutical purchase contracts totaling $30 million in 2014, with further potential contracts pending totaling $129 million.

However, the Department continues to struggle with containing costs in the TRICARE Overseas Program. DoD IG reported in April 2014 that the Defense Health Agency and its overseas contractor officials did not negotiate rates in any of the 163 overseas locations, which represented $238 million in health care payments in FY 2012. TRICARE payments increased from $21.1 million in FY 2009 to $63.8 million in FY 2012, or about 203 percent, in six, high-dollar volume locations without negotiated rates or other cost containment measures. The Department did not agree to implement cost containment measures for these locations, but did agree to implement cost containment measures, similar to rates established by the Centers for Medicare and Medicaid Services, in the U.S. territories.

Since 2011, the IG has extensively assessed the efficiency and effectiveness of medical care and transition programs for wounded, ill, and injured Service Members. The Services have refined and improved these transition programs and have implemented plans to continually assess ongoing requirements.

The MHS Quadruple Aim Concept focuses on four factors in providing quality health care to DoD beneficiaries: readiness, population health, experience of care, and cost. Continuing to implement the MHS Quadruple Aim Concept should improve quality and reduce costs by focusing on improved care coordination and delivering care in the 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 aim to increase the quality of health care while reducing its cost.

5-1C. Health Care	**Department Response**

The Department acknowledges the summary of the DoD IG's challenges and assessment of the Department's progress regarding health care.

An Airman positions a Service Member for a CT scan at the Craig Joint Theater Hospital on Bagram Airfield, Afghanistan.

Photo by Staff Sgt. Evelyn Chavez

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

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

Between now and the end of CY 2014, the Department will continue to develop the Afghan National Security Force's (ANSF) capability to take ultimate responsibility for Afghanistan's security. Challenges include:

- Developing ministerial capability to plan and manage resources and human capital;
- Ensuring enabling-force capabilities (combat support and combat service support elements) are fielded prior to withdrawal of Coalition capabilities;
- Measuring and reporting ANSF operational readiness and effectiveness;
- Professionalizing the ANSF;
- Ensuring the ANSF logistical system can support an independent and sustainable security force; and
- Preparing for post-2014 operations.

Coalition force drawdown and retrograde have added significant challenges as ANSF completes the transition to full Afghan government responsibility for security.

Security Ministries. The Department must continue its focus on advising and assisting the development of the resource management capabilities of the Ministry of Interior and Ministry of Defense. Budget planning and execution, training and development of human resources, increasing the ranks of civilian professionals, and leader emphasis on command and control of logistics are key areas for continued emphasis. Ensuring the capacity of the ANSF and U.S./NATO command to maintain accountability and control over direct funding and equipment provided via the U.S. Afghan Security Forces Fund remains a key challenge. Additionally, coordination between the Afghan National Army (ANA), Afghan National Police (ANP), Afghan Air Force (AAF), and Special Operations Forces will be important to ensuring a multi-layered, long-term defense against insurgents and criminals.

Enabling Force Capabilities. Completing the fielding of "enablers," or military capabilities essential to building ANSF's capacity to accomplish its missions, is increasingly important. Fielding and integration of combat and support capabilities in the ANA and ANP will remain a priority. As Coalition advisors and trainers are withdrawn, the Department must take steps to mitigate the impact of the withdrawal of coalition provided enabler capability. Additionally, the Department must continue to identify, assess, and address the training, advice, and assistance requirements for fielding enabling capabilities beyond 2014.

Assessment of ANSF Progress. Assessing capabilities and identifying capability gaps will become more difficult during Coalition force withdrawal. The Department's visibility of the operational readiness and effectiveness of ANSF units is diminishing as the number of partner units and advisors continue to decrease. The challenge is to ensure sufficient skilled and qualified advisors are in key positions to continue assessing and developing ANSF leadership, command and control, and critical units.

Professionalization. The Department must continue to support ANSF's current efforts to professionalize the force. Command reports show recruitment and management of initial training at the enlisted and officer levels are becoming ANSF strengths. Developing quality leadership, managing effective training at all army and police levels, providing career development opportunities, and maintaining accurate personnel records have all been identified as areas requiring a sustained effort to build a professional army and police force.

Post-2014 Operations. Although no decision has been made on when the transition of DoD's security cooperation and assistance activities to the Department of State will occur, the Department should begin planning for an eventual transition. With the recent announcement by the President of a ceiling of 9,800 U.S. troops in 2015 in Afghanistan, reducing that presence to a Kabul-based presence, with a strong security assistance component by the end of 2016, careful deliberate planning is required to ensure timely progress in the development of a future DoD Office of Security Cooperation to provide ongoing security cooperation and support for the ANSF.

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

Despite the current challenges in Afghanistan, much progress has been made. Most of the challenges above are recognized in Command reports as Coalition and ANSF priorities.

Since force levels are at over 95 percent of personnel end strength objective in both the ANA and ANP, and are approaching 90 percent of personnel end-strength objectives in the AAF, the emphasis on ANSF development has shifted from force quantity, or growing the force, to force quality – sustaining and professionalizing the force.

Ministerial development is a primary emphasis, and the Coalition is increasing resource management training for security ministry personnel. Ministerial advisors are delivering assessments of the security ministry departments, reporting departmental setbacks as well as successes, and planning and revising training milestones and objectives as necessary. However, lack of sufficient experienced and trained advisors remains a challenge that the Command is trying to address.

With Coalition support, ANSF is committed to fielding a wide array of combat and combat support enablers that will provide ANSF the capability to operate independently and sustainably. Although ANSF logistics and force sustainment is still a primary concern as a force enabler, recent DoD IG assessments have noted some increased understanding and appreciation of the ANSF logistics system at the unit level.

Additionally, the shortage of qualified volunteers with sufficient education remains a challenge for ANSF; nevertheless, ANSF continues to support human capital development and training, particularly literacy training. The literacy program is on course to fully transition to ANSF ownership in January 2015. Literacy training is now mandatory for all ANA and ANP recruits.

The ANSF has taken responsibility for its own training. Coalition reports confirm that the number of Afghan trainers has increased steadily over time, easing the burden on the Coalition Forces to provide military and civilian trainers between now and December 2014. Reportedly, ANSF is also managing its non-commissioned officer (NCO) and officer ranks more aggressively, for example, taking action to meet ANP and ANA non-commissioned officer (NCO) shortages by training and promoting qualified and experienced enlisted soldiers and junior NCOs.

Importantly, operational readiness and effectiveness of the ANA and ANP continues to show improvement. The Regional Command (RC) ANSF Status Report (RASR) in March 2014 assessed 62 of 85 key headquarters and units as either fully capable or capable, the two highest definition levels. With the decrease in advisor teams and advisor resources at the Corps and Police Headquarter level, Coalition forces are shifting to using Afghan reporting to understand ANSF capabilities. Challenges remain in getting reliable data with this newly developed ANSF self-assessment tool.

The ANSF assumed the lead for security nationwide on June 18, 2013 and remains on target to assume full responsibility for Afghanistan security by the end of 2014. Coalition forces have assumed a Train, Advise, and Assist role rather than a combat role, except for force protection and certain counter-terrorism operations conducted with ANSF. As a consequence, Coalition casualties have been significantly reduced, but ANSF casualties have commensurately increased. The Coalition is providing equipment to mitigate this trend to the extent possible, especially with respect to Improvised Explosive Device (IED) attacks, which account for many of the ANSF wounded or killed.

The Coalition is monitoring the performance of ANSF in the current fighting season to determine its strengths and weaknesses. According to the "Report on Progress Toward Security and Stability in Afghanistan," issued in April 2014 by the Secretary of Defense, the Ministry of Defense (MOD) and the Ministry of Interior (MOI) continued to make progress in both budget execution and accountability, and critical support functions, but still required coalition assistance and are expected to require support for the near future, particularly with logistics and facilities. There were ministerial developmental shortfalls in acquisition and financial management; strategic plans and policy; and human resource management. The ANSF capability development shortfalls were in command and control (C2), leadership, combined arms integration, training, and logistical sustainment. Developmental shortfalls consisted of counter-IED, medical, fire support coordination, special operations capabilities, including counterterrorism (CT), and air power. The Afghan Security Institutions and ANSF both continued to rely on support from ISAF to mitigate these shortfalls and gaps.

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

The Department concurs with the DoD IG's assessment.

A Soldier assigned to 16th Combat Aviation Brigade flies the American flag from the back of a CH-47 Chinook helicopter over southern Kandahar province, Afghanistan. The pilots and crew chiefs fly American flags to present--with certificates--to Service Members as part of aviation tradition.

Photo by Staff Sgt. Bryan Lewis

7. IG-Identified Challenge: The Nuclear Enterprise

7-1A. Redefining the Importance of the Nuclear Enterprise and Overcoming Past Neglect	IG Summary of Challenge

Following the Soviet Union's collapse in 1991, the United States began to shift from a nuclear weapon-centric Cold War posture to a more dynamic and flexible force structure. Two Strategic Arms Reduction Treaties (START) and the 2010 Nuclear Posture Review (NPR) culminated in further steps to reduce the role of nuclear weapons in U.S. security strategy. Moreover, the NPR directs the Department to strengthen non-nuclear capabilities and reduce the role of nuclear weapons in deterring non-nuclear attacks. The shift in strategic priorities caused a cultural crisis throughout the nation's nuclear forces, particularly in the Air Force.

In June 2013, President Obama affirmed that the United States will maintain a credible deterrent, capable of convincing potential adversaries that the adverse consequences of attacking the United States, or its allies and partners, far outweigh any potential benefit they may seek to gain through an attack. The President reaffirmed that as long as nuclear weapons exist, the United States will maintain a safe, secure, and effective arsenal that guarantees the nation's defense and that of U.S. allies and partners.

The President has supported significant investments to modernize the nuclear enterprise and maintain a safe, secure, and effective arsenal. However, mishaps in the DoD nuclear enterprise, ranging from cheating scandals to fundamental errors in sustainment and acquisition, have tarnished the reputation of those providing the nation's nuclear deterrent, while budgetary constraints have hampered modernization.

Just as both the inadvertent transfer of nuclear warheads and the discovery of Intercontinental Ballistic Missile (ICBM) fuses accidentally shipped to Taiwan eroded the confidence in the bomber and logistics communities, several other high-profile incidents struck at the core of trust and reliability of the ICBM community in 2013 and 2014.

7-1B. Redefining the Importance of the Nuclear Enterprise and Overcoming Past Neglect	IG Assessment of Progress

This past year witnessed a setback in public perception of the integrity and professionalism of the nuclear force, primarily in the ICBM leg of the nuclear triad. A probe into cheating was launched in 2013 after a drug trafficking investigation involving missile launch officers revealed information on classified tests stored on cell phones. The investigation into the cheating resulted in the firing of nine commanders and the disciplining of 79 nuclear officers. This incident followed on the heels of failed inspections and disciplinary action for missile launch officers who had fallen asleep at their post. Finally, two Flag Officers were relieved of their nuclear duties due to off-duty incidents. The incidents throughout 2013 and 2014 resulted in both the Secretary of Defense and the Secretary of the Air Force acknowledging that systemic problems exist in the ICBM community.

In January 2014, Secretary of Defense Hagel initiated an internal DoD review and an independent review of the entire nuclear enterprise in response to the cheating scandal and other failures in the ICBM community. The charter for the internal review directed an examination of the nuclear mission of both the Air Force and the Navy, to include personnel, training, testing, command oversight, mission performance, and investment.

In addition, the Secretary of the Air Force, the Chief of Staff of the Air Force, and the Chief Master Sergeant of the Air Force visited all three ICBM wings in January 2014 to gather feedback from the Force and to reinforce Air Force standards and expectations. The Secretary of the Air Force developed a seven-point action plan to address systemic problems in the nuclear community and delivered the action plan to Secretary Hagel in March 2014.

Air Force Global Strike Command developed the Force Improvement Program, which pulled input directly from airmen at the organizational level on the most pressing issues. The command is pressing forward with a series of initiatives under the Force Improvement Program to change and improve the culture of the airmen who perform the nuclear mission. Building on the success of the Force Improvement Program's results from the ICBM wings, Air Force Global Strike Command initiated a similar effort for the B-52 wings at Minot Air Force Base (AFB) and Barksdale AFB, as well as the B-2 wing at Whiteman AFB.

Assessing the impact of these initiatives is premature, but this massive commitment of resources by senior leadership likely will improve morale and reinforce standards and expectations. As part of our FY 2015 project planning process, we are looking at potential projects that would follow up on these issues and corresponding Air Force actions.

7-1C. Redefining the Importance of the Nuclear Enterprise and Overcoming Past Neglect	**Department Response**

The Department concurs with the DoD IG's assessment.

An unarmed AGM-86B Air-Launched Cruise Missile is released from a B-52H Stratofortress over the Utah Test and Training Range during a Nuclear Weapons System Evaluation Program sortie. Conducted by Airmen from the 2nd Bomb Wing, Barksdale Air Force Base, La., the launch was part of an end-to-end operational evaluation of 8th Air Force and Task Force 204's ability to pull an ALCM from storage, load it aboard an aircraft, execute a simulated combat mission tasking, and successfully deliver the weapon from the aircraft to its final target.

Photo by Staff Sgt. Roidan Carlson

7-2A. Modernizing the Nuclear Force in the Face of Declining Resources	IG Summary of Challenge

The U.S. nuclear triad of land-based Intercontinental Ballistic Missiles (ICBMs), submarine-launched ballistic missiles (SLBMs), and heavy bombers has served for decades in providing a survivable and capable deterrent force. In essence, the triad has only been modernized twice – once in the early 1960s and once in the 1980s. Every one of the systems, to include the Nuclear Command, Control, and Communications (NC3) system, will require significant modernization or replacement in the next two decades. Both the Senate and House Armed Service Committees are concerned with sustainment and replacement efforts in the DoD nuclear enterprise. Similarly, the Defense Science Board Standing Task Force on Nuclear Weapons Surety states that failures continue in fundamental areas, negatively affecting the fielded forces and the replacing or upgrading of old equipment.

7-2B. Modernizing the Nuclear Force in the Face of Declining Resources	IG Assessment of Progress

The Services have initiated several programs to transform the aging nuclear force into a modern, nuclear-deterrent arm capable of operating into the latter part of the 21st century. Renovating the nuclear enterprise entails sustaining nuclear assets and developing replacement systems that integrate the latest technologies. When completed in 2030, almost every component of the strategic nuclear force will be replaced or updated.

Air Force

Long Range Strike Bomber (LRS-B): The LRS-B is funded and in the acquisition cycle. The Air Force released a request for proposal and anticipates vendor selection in FY 2015. However, Air Force leaders have issued contradictory statements regarding whether the first bomber variant will be nuclear capable. This ambiguity raises questions about the Air Force’s strategic message that the nuclear mission is its number one priority, and is strikingly similar to the Air Force’s acquisition strategy to procure conventional F-35s first before producing a nuclear variant. Additionally, the Air Force has not announced a commitment to require the LRS-B to be hardened against Electro-Magnetic Pulse (EMP). Any plans for future nuclear weapon platforms must consider the existing threat environment.

Sustaining current bombers: While the LRS-B is in development and production, the current fleet of bombers still needs sustainment, both for conventional and nuclear missions. Some of the systems and particular parts are showing aging issues that affect the fleet’s readiness and reliability. Similar to other nuclear platforms, as these systems age, more parts fail for the first time, many with old or obsolete technologies. The cost to create a manufacturing base for parts that are no longer available is prohibitively expensive

Air Launched Cruise Missile/Long Range Stand-Off (ALCM/LRSO): The LRSO effort will develop a weapon system to replace the Air Force's ALCM, operational since 1986. The LRSO weapon system will be capable of penetrating and surviving advanced Integrated Air Defense Systems from significant stand-off ranges to prosecute strategic targets. The ALCM is well past its expected operational lifetime, but the LRSO missile will not begin development in fiscal year 2015, as was scheduled; instead, development will slip by three years, deferring almost $1 billion in spending beyond FY 2018.

B61-12: The B61 family of nuclear gravity bombs, which include components dating to the 1960s, is going through a life extension process to preserve capabilities while consolidating the variants currently fielded. This process is a joint venture with the Department of Energy (DOE), which requires that the Air Force synchronize its schedules with DOE to field life extension programs without further delay. The weapon’s planned modernization is required for integration with the anticipated nuclear variant of the F-35, when it is nuclear capable, and the LRS-B.

Minuteman III/Ground Based Strategic Deterrent: The National Defense Authorization Act of 2007 directed the Air Force to sustain the Minuteman III (MMIII) ICBM until 2030. The MMIII has received several generations of sustainment and modernization, most recently focusing on propulsion replacement, guidance replacement, and Mk21 fuse refurbishment. At the same time, the Air Force must balance investment between the legacy system and the new Ground Based Strategic Deterrent (GBSD). The GBSD refers to the yet-to-be-determined follow-on to the MMIII. The requirement for the new GBSD was expressed in the April 2010 Nuclear Posture Review (NPR), which stated the "…U.S. Nuclear Triad of ICBMs, SLBMs, and nuclear capable heavy bombers will be maintained…" Thus, DoD began an initial study of alternatives in fiscal years 2011 and 2012. The studies identified a range of possible deployment options, with the objective of defining a cost-effective approach that "supports continued reductions in U.S. nuclear weapons while promoting stable deterrence," and "Exploring new modes of ICBM basing that enhance survivability and further reduce any incentives for prompt launch." Federally-mandated budget cuts, coupled with parts obsolescence for the legacy MMIII, put both sustainment of the MMIII and acquisition of the new GBSD at risk.

Security Helicopter: Despite continued congressional urging and a decade of studies highlighting the inadequacy of the UH-1 helicopter as an ICBM missile field security platform, the Air Force is still using aircraft with combat time dating to the Vietnam war. The FY 2014 budget request did not include funds for replacing the previously terminated Common Vertical Lift Support Platform, raising concerns in the Senate Armed Services Committee that the Air Force's number one priority to sustain an effective nuclear deterrent is being insufficiently supported.

National Airborne Operations Center (NAOC) E-4B: Aircraft availability has not met mission needs over the last two and a half years. In FY 2013, the lack of aircraft negatively manifested itself through significantly reduced training sorties jeopardizing aircrew proficiency. Additionally, the E-4Bs existing Very Low Frequency/Low Frequency system is mechanically/electronically obsolete and unsustainable.

Integrated Tactical Warning and Attack Assessment (ITW/AA): The ITW/AA enterprise's mission is to provide timely, accurate and unambiguous warning of air, missile, and space attacks against North America to the U.S. President, the Prime Minister of Canada, the Chairman of the Joint Chiefs of Staff, Combatant Commands, and other forward users. The ITW/AA is composed of Air and Space Missile Warning Missions, with sensors and forward users located worldwide, and at correlation centers at Peterson AFB, Cheyenne Mountain AFS, Offutt AFB, and Vandenberg AFB. Portions of this legacy system are unsustainable, and plans for replacement systems have been delayed.

Navy

Ohio Class Submarine Replacement: The current Ohio class of ballistic missile submarines (SSBN) were commissioned between 1984 and 1997, and their lifetime has been extended from 30 to 42 years – unprecedented for a nuclear submarine. Additional Ohio life extensions are unrealistic, and these SSBNs will begin to be retired at a rate of one per year in 2027. Ohio replacement construction must begin in 2021 to commence its first Strategic Patrol in 2031. The FY 2013 budget delayed delivery of the first new SSBN by two years, which produced manageable risk for the future transition. Additional delays are not manageable and would create a gap in at-sea strategic requirements.

Fixed Submarine Broadcast System (FSBS): The existing Low Frequency/Very Low Frequency stations were designed and built in different periods from 1953 to 1983. Consequently, each station is unique, and all are suffering from varying degrees of component obsolescence. System efficiencies are relatively low, which results in excessive energy consumption and complicated logistics support. This past year, the DoD IG examined the FSBS and concluded that while the transmitter equipment was well maintained, the supporting infrastructure at the geographically-isolated sites is on the verge of failing.

Nuclear Command, Control, and Communications (NC3)

The NC3 system is a large and complex system-of-systems comprised of numerous land, airborne, and space-based components used to assure connectivity between the President and nuclear forces. The NC3 system remains a primary concern for Congress. The National Defense Authorization Act of 2012 directed the then Assistant Secretary of Defense for Networks, Information and Infrastructure, in coordination with the service secretaries, to submit a report on the NC3 architecture and long-term strategy. More recently, the Senate Armed Services Committee report accompanying a bill for the National Defense Authorization Act for Fiscal Year 2013 mandated GAO to assess DoD's efforts to sustain and improve the NC3 system. These concerns for NC3 stem from the multitude of aging and obsolete legacy systems that require modernization and replacement.

7-2C. Modernizing the Nuclear Force in the Face of Declining Resources	Department Response

The Department concurs with the DoD IG's assessment.

A convoy follows a payload transporter (PT) through the weapons storage area at Malmstrom Air Force Base, Montana. The PT returned after maintenance crews removed the last multiple independently targetable reentry vehicle in the Air Force intercontinental ballistic missile inventory from a Minuteman III, helping bring the Air Force towards compliance with the New Strategic Arms Reduction Treaty and comply with direction from the 2010 Nuclear Posture Review.

Photo by Senior Airman Katrina Heikkinen

7-3A. Lack of an Integrated End-to-End Governance Process	IG Summary of Challenge

No integrated, end-to-end governance process exists for the DoD nuclear weapon enterprise. Existing forums are generally effective, but are separate entities, either in substance or process, that are not viewed as part of an integrated, whole-DoD effort.

7-3B. Lack of an Integrated End-to-End Governance Process	IG Assessment of Progress

With isolated exception, coordinated senior-level leadership attention dedicated to nuclear issues in the Department is insufficient. The Congressional Budget Office estimates that the nation is faced with $296 billion of nuclear weapon-related decisions to be made over the next 10 years. Without centralized and integrated management, these decisions will be made with an eroded capability to properly analyze these issues.

No governance structure exists that empowers a single DoD organization to ensure that capabilities are planned, resourced, modernized, and sustained as an integrated program of record in all DoD Services and organizations. Multiple committees, including the Nuclear Weapons Council, the Senior Nuclear Oversight Council, and the National Leadership Command, Control, and Communication Executive Management Board, have overlapping memberships to address various issues in the nuclear enterprise. Most committees, however, are not full-time bodies and cannot be expected to delve deeply into the details of every programmatic decision. Additionally, many of these committees are merely advisory or coordination bodies, unable to commit resources. The absence of a DoD-wide nuclear enterprise governance structure has resulted in gaps, seams, and overlap among these committees.

Not having clear delineations of responsibility is a trend throughout most of the DoD IG's recent nuclear enterprise reports. This trend may be hard to overcome for NC3 systems with multiple organizations hosting portions of it, but in other instances we find examples where responsibility is shared or uncertain.

Notable exceptions have recently occurred. The Deputy's Management Action Group effectively provided some specific programmatic direction for the Services, and the DoD Chief Information Officer established organizations to oversee Nuclear Command, Control, and Communications.

7-3C. Lack of an Integrated End-to-End Governance Process	Department Response

The Department concurs with the DoD IG's assessment, but notes that the Department is leading a congressionally mandated council for NC3. The Council on Oversight of the National Leadership C3 System, which was established in the FY 2014 National Defense Authorization Act, comprises DoD stakeholders to address declining resources for NC3 modernization. The Council members include the USD(AT&L), USD Policy, Vice Chairman of the Joint Chiefs of Staff, the Director of the National Security Agency, the DoD CIO, and the Commander of U.S. Strategic Command.

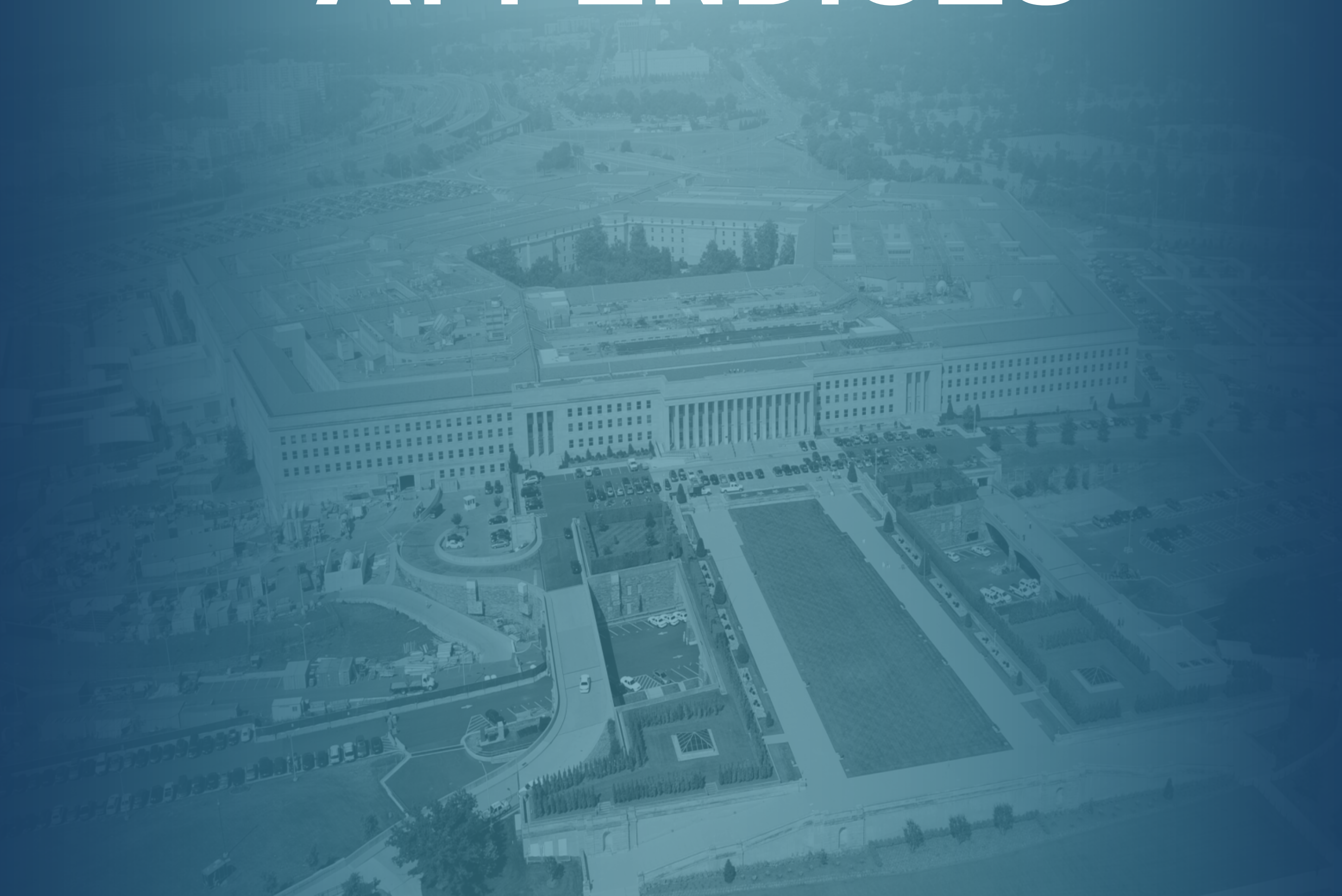
This Page Left Blank Intentionally

United States Department of Defense

Agency Financial Report

Fiscal Year 2014

Appendices



This Page Left Blank Intentionally

APPENDIX A: DEFENSE SECURITY COOPERATION AGENCY – SECURITY ASSISTANCE ACCOUNTS

The Defense Security Cooperation Agency (DSCA) is the Department of Defense (DoD) lead agency for the execution of security assistance functions, under Executive Order 11958. The financial statements and explanatory notes in this appendix pertain to the following accounts, generally referred to as "security assistance" provided by the Department of State: Foreign Military Sales (FMS) Trust Fund; the International Military Education and Training Account; Foreign Military Financing Program Account; Foreign Military Loan Liquidating Account; Foreign Military Financing Direct Loan Financing Account; Military Debt Reduction Financing Account; and the Special Defense Acquisition Fund, granted to the Executive Office of the President (EOP) pursuant to the Arms Export Control Act (AECA), as amended. The DSCA receives separate funding for the administration of the DoD Regional Centers for Security Studies reported in the DoD consolidated financial statements and separate from the security assistance functions, not reported in these financial statements.

Balance Sheet Defense Security Cooperation Agency – Security Assistance Accounts As of September 30, 2014 and 2013	*Dollars in Thousands* 2014 Consolidated	2013 Consolidated
ASSETS (Note 2)		
Intragovernmental		
Fund Balance with Treasury (Note 3)	$ 27,250,677	$ 24,420,154
Total Intragovernmental Assets	**$ 27,250,677**	**$ 24,420,154**
Cash and Other Monetary Assets (Note 6)	$ 20,539,802	$ 20,593,988
Accounts Receivable, Net (Note 4)	31,014	20,906
Loans Receivable (Note 7)	639,533	723,975
Other Assets (Note 5)	30,217,081	31,801,934
TOTAL ASSETS	**$ 78,678,107**	**$ 77,560,957**
LIABILITIES (Note 8)		
Intragovernmental		
Accounts Payable (Note 9)	$ 329,951	$ 266,922
Debt (Note 10)	37,469	116,604
Other Liabilities (Note 11 and 12)	647,550	652,851
Total Intragovernmental Liabilities	**$ 1,014,970**	**$ 1,036,377**
Accounts Payable (Note 9)	$ 355,870	$ 400,521
Federal Employment Benefits (Note 13)	648	595
Other Liabilities (Note 11 and 12)	68,078,173	67,102,699
TOTAL LIABILITIES	**$ 69,449,661**	**$ 68,540,192**
Commitments & Contingencies (Note 12)		
NET POSITION		
Unexpended Appropriations – Other Funds	$ 5,325,422	$ 5,130,896
Cumulative Results of Operations – Other Funds	3,903,024	3,889,869
TOTAL NET POSITION	**$ 9,228,446**	**$ 9,020,765**
TOTAL LIABILITIES AND NET POSITION	**$ 78,678,107**	**$ 77,560,957**

Statement of Net Cost Defense Security Cooperation Agency – Security Assistance Accounts For the Years Ended September 30, 2014 and 2013	*Dollars in Thousands* 2014 Consolidated	2013 Consolidated
Program Costs		
Gross Costs	$ 34,886,326	$ 30,906,145
(Less: Earned Revenue)	(5,890)	(14,556)
Net Cost before Losses (Gains) from Actuarial Assumption Changes for Military Retirement Benefits	$ 34,880,436	$ 30,891,589
Net Cost of Operations	**$ 34,880,436**	**$ 30,891,589**

Statement of Changes in Net Position Defense Security Cooperation Agency – Security Assistance Accounts For the Years Ended September 30, 2014 and 2013	*Dollars in Thousands* 2014 Consolidated	2013 Consolidated
Cumulative Results Of Operations		
Beginning balances	**$ 3,889,869**	**$ 3,528,023**
Budgetary Financing Sources		
Appropriations used	$ 5,625,649	$ 4,602,076
Nonexchange revenue	29,267,942	26,651,359
Total Financing Sources	**$ 34,893,591**	**$ 31,253,435**
Net Cost of Operations (+/-)	(34,880,436)	(30,891,589)
Net Change	**$ 13,155**	**$ 361,846**
Cumulative Results of Operations	**$ 3,903,024**	**$ 3,889,869**
Unexpended Appropriations		
Beginning Balances	**$ 5,130,896**	**$ 3,800,488**
Budgetary Financing Sources		
Appropriations received	$ 6,024,853	$ 6,418,005
Appropriations transferred (in/out)	(194,062)	(209,751)
Other adjustments (rescissions, etc.)	(10,616)	(275,770)
Appropriations used	(5,625,649)	(4,602,076)
Total Budgetary Financing Sources	**$ 194,526**	**$ 1,330,408**
Unexpended Appropriations	**$ 5,325,422**	**$ 5,130,896**
Net Position	**$ 9,228,446**	**$ 9,020,765**

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

Statement of Budgetary Resources Defense Security Cooperation Agency – Security Assistance Accounts For the Years Ended September 30, 2014 and 2013 *Dollars in Thousands*	Budgetary Financing Accounts 2014 Combined	Budgetary Financing Accounts 2013 Combined	Non-Budgetary Financing Accounts 2014 Combined	Non-Budgetary Financing Accounts 2013 Combined
Budgetary Resources				
Unobligated balance, brought forward, October 1	$ 141,901	$ 143,180	$ 27,139	$ 27,139
Recoveries of prior year unpaid obligations	938,532	339,303	0	0
Other changes in unobligated balance	(915,438)	(308,257)	0	0
Unobligated balance from prior year budget authority, net	164,995	174,226	27,139	27,139
Appropriation (discretionary and mandatory)	6,735,612	6,240,741	0	0
Borrowing Authority (discretionary and mandatory)	0	0	1,793	1,709
Contract authority (discretionary and mandatory)	35,145,412	15,313,617	0	0
Spending authority from offsetting collections (discretionary and mandatory)	57,196	49,346	0	0
Total Budgetary Resources	**$ 42,103,215**	**$ 21,777,930**	**$ 28,932**	**$ 28,848**
Status of Budgetary Resources				
Obligations incurred	$ 41,958,758	$ 21,636,029	$ 1,793	$ 1,709
Unobligated balance, end of year:				
Apportioned	29,767	112,118	0	0
Unapportioned	114,690	29,783	27,139	27,139
Total unobligated balance, end of year	**$ 144,457**	**$ 141,901**	**$ 27,139**	**$ 27,139**
Total Budgetary Resources	**$ 42,103,215**	**$ 21,777,930**	**$ 28,932**	**$ 28,848**
Change in Obligated Balance				
Unpaid obligations, brought forward, October 1	$ 129,002,355	$ 138,729,747	$ 2,462,224	$ 2,462,224
Obligations incurred	41,958,758	21,636,029	1,793	1,709
Outlays (Gross)	(32,314,788)	(31,024,118)	(1,793)	(1,709)
Recoveries of prior year unpaid obligations	(938,532)	(339,303)	0	0
Unpaid Obligations, end of year	137,707,793	129,002,355	2,462,224	2,462,224
Obligated balance, start of year	**$ 129,002,355**	**$ 138,729,747**	**$ 2,462,224**	**$ 2,462,224**
Obligated balance, end of year	**$ 137,707,793**	**$ 129,002,355**	**$ 2,462,224**	**$ 2,462,224**
Budgetary Authority and Outlays, Net				
Budget Authority, gross (discretionary and mandatory)	$ 41,938,220	$ 21,603,704	$ 1,793	$ 1,709
Actual offsetting collections (discretionary and mandatory)	(57,197)	(49,346)	(112,509)	(141,320)
Budget Authority, net (discretionary and mandatory)	**$ 41,881,023**	**$ 21,554,358**	**$ (110,716)**	**$ (139,611)**
Outlays, gross (discretionary and mandatory)	32,314,788	31,024,118	1,793	1,709
Actual offsetting collections (discretionary and mandatory)	(57,197)	(49,346)	(112,509)	(141,320)
Outlays, net (discretionary and mandatory)	32,257,591	30,974,772	(110,716)	(139,611)
Distributed offsetting receipts	(29,267,942)	(26,651,359)	0	0
Agency Outlays, net (discretionary and mandatory)	**$ 2,989,649**	**$ 4,323,413**	**$ (110,716)**	**$ (139,611)**

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

Table of Contents for Notes to the Financial Statements
DSCA-Security Assistance Accounts (SAA) 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 Defense Security Cooperation Agency (DSCA), consisting of the Foreign Military Sales (FMS) Trust Fund and several other accounts, identified in the President's Budget Request, as the Foreign Operations (International Affairs) appropriated accounts. The FMS Trust Fund includes accounts for U.S. government funds appropriated for security assistance and funds deposited by foreign countries and international organizations, or by others for their use. Refer to paragraph 1.C, Appropriations and Funds, for a list of these accounts.

The FMS Trust Fund and other accounts for funds appropriated for security assistance are managed by DSCA on behalf of the Department of Defense (DoD), in accordance with the authority of the Executive Office of the President (EOP), the requirements of the *Chief Financial Officers Act of 1990* (CFO Act), as expanded by the *Government Management Reform Act of 1994*, and other applicable laws and regulations. The FMS Trust Fund and the accounts for funds appropriated for security assistance hereafter will be referred to as the DSCA Security Assistance Accounts.

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 (FMR)*.

The accompanying financial statement information accounts for all DSCA Security Assistance Accounts 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 to not be discernible.

The accounting systems used by DSCA Security Assistance Accounts are unable to fully implement all elements of USGAAP and *OMB Circular No. A-136*, due to limitations of financial management processes, financial systems, and nonfinancial systems and processes supporting the financial statements. Many of the accounts derive their reported values and other information for major asset and liability categories largely from nonfinancial systems, such as the 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 Department currently has 13 auditor-identified material weaknesses related to the above limitations. Of these, DSCA Security Assistance Accounts contributes to: (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 promoting 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 (IMET) authorities.

1.C. Appropriations and Funds

The FMS Trust Fund is a U.S. Treasury account (Treasury Account Symbol (TAS) 8242) containing deposits from FMS foreign country and international organization customers, as well as funds transferred into the account from U.S. Government appropriations, for use in carrying out specific purposes or programs in accordance with the *Arms Export and Control Act*, 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 subsidiary accounts used by the Department through DSCA and DFAS to separately and individually account for each FMS customer's deposits, other collections or deposits, payments of bills, refunds, and adjustments. At the U.S. Treasury level, the corpus of the FMS Trust Fund represents the total aggregations of balances (receipts minus disbursements) for all activities and programs.

The Department uses 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 related to security assistance are allocation transfers from the EOP meeting the OMB exception and all related activity is reported separately from the consolidated DoD financial statements.

1.D. Basis of Accounting

The legacy financial management systems used by DSCA Security Assistance Accounts are unable to meet full accrual accounting requirements. 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 DSCA Security Assistance Accounts 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 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 DSCA Security Assistance Accounts 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 17, 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.

The DSCA collects payments from foreign customers in advance of delivery of goods or services and records unearned revenue accordingly. All FMS Trust Fund revenue is reclassified as nonexchange once customers confirm the receipt of goods and services, since the FMS Trust Fund does not provide any of the goods or services directly, but serves as an intermediary for the U.S. military services and contractors.

1.F. Recognition of Expenses

Department policy requires the recognition of operating expenses in the period incurred. Current financial and nonfinancial feeder systems used by DSCA Security Assistance Accounts 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 an entity eliminates intra-entity 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 Department is implementing replacement systems and a standard financial information structure incorporating the necessary elements to 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. 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.

Imputed Financing represents the costs paid on behalf of the FMS Trust Fund by the Office of Personnel Management for employee pension, post-retirement health, and life insurance benefits; and the Department of Labor post-employment benefits for terminated and inactive employees to include unemployment and workers compensation under the Federal Employees' Compensation Act.

The Department'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 Department'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, DSCA Security Assistance Accounts administers the sale of defense articles and services to foreign governments and international organizations under the provisions of the AECA. Under the provisions of the Act, the Department has authority to sell defense articles and services to foreign countries and international organizations generally at no profit or loss to the Federal Government. Payment in U.S. dollars is required in advance.

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

The FMS Trust Fund monies are held in U.S. Treasury accounts and the Federal Reserve Bank in individual accounts established by the U.S. for foreign countries. Funds held in the Federal Reserve Bank are transferred to the FMS Trust Fund account to be disbursed for FMS purposes.

For monetary financial resources maintained in U.S. Treasury accounts, the disbursing offices of DFAS, the Military Departments, the U.S. Army Corps of Engineers (USACE), and the DOS's financial service centers process the majority of DSCA Security Assistance Accounts cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports providing 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, the FBWT for the DSCA Security Assistance Accounts 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 including coin, paper currency, negotiable instruments 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 DSCA Manual 5105.38-M, 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 DSCA Security Assistance Accounts' accounts receivable from other federal entities or the public include: accounts receivable, claims receivable, and refunds receivable. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. The Department does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intragovernmental Business Rules published in the *Treasury Financial Manual*.

1.L. Direct Loans and Loan Guarantees

The DSCA administers the 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, 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 DSCA Security Assistance Accounts do not maintain inventory. The defense articles are provided to FMS customers from the U.S. Government or the contractor pursuant to a contract with the U.S. Government. Defense articles sold from the Department or the U.S. Coast Guard are assets of the providing component until title is transferred to foreign customer.

1.P. Advances and Prepayments

When advances are permitted by law, legislative action, or presidential authorization, the Department'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 Department's policy is to expense and/or properly classify assets when the related goods and services are received. Not all military services executing on behalf of DSCA have implemented this policy primarily due to system limitations.

1.Q. Leases

The FMS Trust Fund and the accounts for funds appropriated for security assistance do not have capital leases and currently is not able to reliably estimate the value of operating leases.

1.R. Other Assets

Other assets include civil service employee pay advances, travel advances, and certain contract financing payments not reported elsewhere on the DSCA Security Assistance Accounts Balance Sheet.

The DSCA Security Assistance Accounts conduct business with commercial contractors using two primary types of contracts: fixed price and cost reimbursable. Contract financing payments are defined in the *Federal Acquisition Regulations, Part 32*, as authorized disbursements to a contractor prior to acceptance of supplies or services by the Government. These payments are designed to alleviate the potential financial burden on contractors performing on certain long-term contracts and facilitate competition for defense contracts. Contract financing payment 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

Statement of Federal Financial Accounting Standard (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 involving 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 DSCA Security Assistance Accounts 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 DSCA Security Assistance Accounts' 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.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. As a result, misstatements of reported Accounts Payable and Receivables are likely included in the DSCA 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 nonfederal 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 to allocate supported undistributed disbursements and collections between federal and nonfederal categories based on the percentage of distributed federal and nonfederal accounts payable and accounts receivable. Unsupported undistributed disbursements and collections are also applied to reduce accounts payable and receivable accordingly.

NOTE 2. NONENTITY ASSETS

Nonentity Assets *As of September 30*	*Dollars in Thousands* 2014		2013	
Intragovernmental Assets				
Fund Balance with Treasury	$	11,010,018	$	7,799,844
Total Intragovernmental Assets	**$**	**11,010,018**	**$**	**7,799,844**
Nonfederal Assets				
Cash and Other Monetary Assets	$	20,539,802	$	20,593,988
Accounts Receivable		678,418		673,617
Other Assets		30,212,208		31,777,541
Total Nonfederal Assets	**$**	**51,430,428**	**$**	**53,045,146**
Total Nonentity Assets	**$**	**62,440,446**	**$**	**60,844,990**
Total Entity Assets	**$**	**16,237,661**	**$**	**16,715,967**
Total Assets	**$**	**78,678,107**	**$**	**77,560,957**

Nonentity Assets are assets for which the DSCA Security Assistance Accounts maintain stewardship accountability and reporting responsibility, but are not available for the agency's operations.

Fund Balance with Treasury and Cash and Other Monetary Assets consist of advance deposits from friendly countries and international organizations to facilitate the purchase of U.S. defense articles and services based on future requirement forecasts.

Accounts Receivable consist of amounts for interest, fines, and penalties due on debt from loans and nonfederal funds owed to the FMS Trust Fund country accounts in litigation at Department of Justice or collection status at Defense Finance and Accounting Service. Some portion of these uncollected funds may be payable to the FMS Administrative Surcharge account, but are not discernible prior to collection.

Nonfederal Other Assets consist primarily of advances paid for undelivered defense articles and services intended for future delivery to the FMS customer.

NOTE 3. FUND BALANCE WITH TREASURY

Fund Balance with Treasury *As of September 30*	*Dollars in Thousands* 2014		2013	
Fund Balance				
Appropriated Funds	$	5,522,643	$	5,318,823
Trust Funds		21,728,034		19,101,331
Total Fund Balance	**$**	**27,250,677**	**$**	**24,420,154**
Fund Balance Per Treasury Versus Agency				
Fund Balance per Treasury	$	27,250,677	$	24,420,154
Fund Balance per Agency		27,250,677		24,420,154
Reconciling Amount	$	0	$	0

Status of Fund Balance with Treasury *As of September 30*	*Dollars in Thousands* 2014	2013
Unobligated Balances		
Available	$ 29,767	$ 112,117
Unavailable	141,829	56,921
Total Unobligated Balance	**171,596**	**169,038**
Obligated Balance not yet Disbursed	**140,170,016**	**131,464,580**
Non-Budgetary FBWT	**0**	**26,651,365**
Non-FBWT Budgetary Accounts	**(113,090,935)**	**(133,864,829)**
Total Fund Balance	**$ 27,250,677**	**$ 24,420,154**

The Status of 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 not set aside to cover outstanding obligations. The unavailable balance consists primarily of funds invested in U.S. Treasury securities 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 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 without budgetary authority, such as deposit funds, unavailable receipt accounts, clearing accounts and nonentity FBWT. The 2013 balance in Non-budgetary FBWT consisted of Contingency Operations provided to Department of Defense in supplemental appropriations, and Contingency Operations funding transferred from Department of State (DOS), which DOS received in supplemental appropriations. Obligations are incurred using contract authority and liquidated with these appropriations.

Non-FBWT Budgetary Accounts reduces the Status of FBWT. The Non-FBWT Budgetary Accounts primarily consists of nonentity cash deposited in the Federal Reserve Bank and contract authority.

NOTE 4. ACCOUNTS RECEIVABLE

Accounts Receivable *As of September 30*	2014 Gross Amount Due	 Allowance for Estimated Uncollectibles	*Dollars in Thousands* Accounts Receivable, Net
Intragovernmental Receivables	$ 0	N/A	$ 0
Nonfederal Receivables (From the Public)	31,082	(68)	31,014
Total Accounts Receivable	**$ 31,082**	**$ (68)**	**$ 31,014**

Accounts Receivable As of September 30	2013 Gross Amount Due		2013 Allowance for Estimated Uncollectibles	2013 Accounts Receivable, Net	
Intragovernmental Receivables	$	0	N/A	$	0
Nonfederal Receivables (From the Public)		20,913	(7)		20,906
Total Accounts Receivable	**$**	**20,913**	**$ (7)**	**$**	**20,906**

Dollars in Thousands

Other Disclosures

The accounts receivable represent the FMS Trust Fund claim for payment from contractors and individuals for refunds and overpayments. 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 5. Other Assets

Other Assets As of September 30	2014		2013	
Nonfederal Other Assets				
Outstanding Contract Financing Payments	$	3,595,335	$	3,497,621
Advances and Prepayments		26,621,746		28,304,313
Total Nonfederal Other Assets	$	30,217,081	$	31,801,934
Total Other Assets	**$**	**30,217,081**	**$**	**31,801,934**

Dollars in Thousands

Contract terms and conditions for certain types of contract financing payments convey certain rights to the FMS Trust Fund protecting 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 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 $1.5 billion in estimated future payments to contractors upon delivery and government acceptance of a satisfactory product. See additional discussion in Note 11, Other Liabilities.

NOTE 6. CASH AND OTHER MONETARY ASSETS

Cash and Other Monetary Assets *As of September 30*	*Dollars in Thousands* 2014	2013
Cash	$ 20,539,802	$ 20,593,988
Total Cash, Foreign Currency, and Other Monetary Assets	**$ 20,539,802**	**$ 20,593,988**

Restricted cash of $20.5 billion includes advance deposits from foreign nations in the Federal Reserve Bank which have not been transferred to the Foreign Military Sales Trust Fund and are not available for agency use (nonentity cash).

NOTE 7. DIRECT LOAN AND LOAN GUARANTEE PROGRAMS

Direct Loan and Loan Guarantee Programs

The Defense Security Cooperation Agency (DSCA) operates the following direct loans and/or loan guarantee programs:

The *Arms Export Control Act*, as amended, authorizes funds to be appropriated to the President for financing the sales of defense articles and defense services to eligible foreign countries. Each loan is reviewed in the light of the purchasing country's financial condition, its need for credit, U.S. economic or military assistance programs in the country and region, and other proposed arms purchases by the country. The President delegates 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:

- Foreign Military Loan Liquidating Account (FMLLA)), for pre-1992 loans
- Foreign Military Direct Loan Program, for post-1991 loans
- Financing Accounts for post-1991 loans, for post-1991 loans
- Military Debt Reduction Financing Account (MDRFA) for reducing loan receivables for eligible countries.

The FMLLA is a liquidating account including 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 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 Foreign Military Direct Loan Program is still active with one outstanding loan with

Poland. Poland's loan works as a line of credit but has not been used since 2010. The FMFDLFA is a financing account 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 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 corresponding to the length of an International Monetary Fund (IMF) supported economic reform program. Reduction then is staged, with each successive stage contingent upon debtor country compliance with its IMF-support program. Under Naples Terms, stock of debt reduction is provided after three years of good performance with respect to IMF reform programs and payments to Paris Club creditors. The United States incurs the budget cost of the eventual stock of debt reduction when it agrees to the initial “maturities” reduction of payments coming due, since bilateral agreements commit us to stock reduction once the Paris Club agrees to provide them.

The FCRA governs all amended direct loan obligations and loan guarantee commitments made after FY 1991 resulting in direct loans or loan guarantees.

Direct loans are reported at the net present value of the following projected cash flows: (1) loan disbursements, (2) repayments of principal, and (3) payments of interest and other payments over the life of the loan after adjusting for estimated defaults, prepayments, fees, penalties, and other recoveries.

Summary of Direct Loans and Loan Guarantees	*Dollars in Thousands*	
As of September 30	**2014**	**2013**
Loans Receivable		
Direct Loans		
Foreign Military Loan Liquidating Account	$ 647,404	$ 733,641
Foreign Military Financing Account	0	(27,111)
Military Debt Reduction Financing Account	(7,871)	17,445
Total Loans Receivable	**$ 639,533**	**$ 723,975**

Direct Loans Obligated *As of September 30*	*Dollars in Thousands* 2014	2013
Direct Loans Obligated After FY 1992 (Allowance for Loss Method)		
Foreign Military Loan Liquidating Account		
Loans Receivable Gross	$ 377,627	$ 480,672
Interest Receivable	1,835,074	1,744,628
Allowance for Loan Losses	(1,565,297)	(1,491,659)
Value of Assets Related to Direct Loans, Net	**$ 647,404**	**$ 733,641**
Direct Loans Obligated After FY 1991 (Present Value Method)		
Foreign Military Financing Account		
Allowance for Subsidy Cost (Present Value)	$ 0	$ (27,111)
Value of Assets Related to Direct Loans	**$ 0**	**$ (27,111)**
Military Debt Reduction Financing Account		
Allowance for Subsidy Cost (Present Value)	$ (7,871)	17,445
Value of Assets Related to Direct Loans, Net	**$ (7,871)**	**$ 17,445**
Total Direct Loans Receivable	**$ 639,533**	**$ 723,975**

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.

Schedule for Reconciling Subsidy Cost Allowance Balances For Post-FY 1991 Direct Loans *As of September 30*	*Dollars in Thousands* 2014	2013
Beginning Balance, Changes, and Ending Balance		
Beginning Balance of the Subsidy Cost Allowance	**$ 9,666**	**$ 11,374**
Adjustments		
Subsidy Allowance Amortization	(1,795)	(1,708)
Total of the above Adjustment Components	**$ (1,795)**	**$ (1,708)**
Ending Balance of the Subsidy Cost Allowance before Reestimate	**$ 7,871**	**$ 9,666**
Ending Balance of the Subsidy Cost Allowance	**$ 7,871**	**$ 9,666**

Administrative Expenses

Administrative expenses for loans are not funded in the loan program account. The Office of Management and Budget directed the administration of loans be funded by the Foreign Military Financing Program (11*1082).

Note 8. Liabilities Not Covered by Budgetary Resources

Liabilities Not Covered by Budgetary Resources *As of September 30*	*Dollars in Thousands* 2014	2013
Intragovernmental Liabilities		
Other	$ 145	$ 139
Total Intragovernmental Liabilities	**$ 145**	**$ 139**
Nonfederal Liabilities		
Military Retirement and Other Federal Employment Benefits	648	595
Total Nonfederal Liabilities	**648**	**595**
Total Liabilities Not Covered by Budgetary Resources	**793**	**734**
Total Liabilities Covered by Budgetary Resources	**$ 69,448,868**	**$ 68,539,458**
Total Liabilities	**$ 69,449,661**	**$ 68,540,192**

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 to pay them.

Military Retirement and Other Federal Employment Benefits consists of Federal Employee Compensation Act (FECA) actuarial liabilities of $647.7 thousand not due and payable during the current fiscal year. Refer to Note 13, Federal Employment Benefits, for additional details and disclosures.

Intragovernmental Liabilities Other represents the amount payable to Department of Labor for FECA liabilities.

Note 9. Accounts Payable

Accounts Payable			*Dollars in Thousands*
	2014		
As of September 30	Accounts Payable	Interest, Penalties, and Administrative Fees	Total
Intragovernmental Payables	$ 329,951	N/A	$ 329,950
Nonfederal Payables (To the Public)	355,870	0	355,870
Total Accounts Payable	**$ 685,821**	**$ 0**	**$ 685,820**

Accounts Payable As of September 30	2013 Accounts Payable		2013 Interest, Penalties, and Administrative Fees		2013 Total	
Dollars in Thousands						
Intragovernmental Payables	$	266,922		N/A	$	266,922
Nonfederal Payables (To the Public)		400,521		0		400,521
Total Accounts Payable	**$**	**667,443**	**$**	**0**	**$**	**667,443**

Accounts Payable includes amounts owed to federal and nonfederal entities for goods and services received by DSCA Security Assistance Accounts.

The systems used by the DSCA Security Assistance Accounts do not track intragovernmental transactions by customer at the transaction level. The DSCA therefore cannot reconcile accounts payable with other federal entities. Buyer-side accounts payable are adjusted to agree with interagency seller-side accounts receivable.

NOTE 10. DEBT

Debt As of September 30	2014 Beginning Balance		2014 Net Borrowing		2014 Ending Balance	
Dollars in Thousands						
Agency Debt (Intragovernmental)						
Debt to the Treasury	$	35,674	$	1,795	$	37,469
Debt to the Federal Financing Bank		80,930		(80,930)		0
Total Debt	**$**	**116,604**	**$**	**(79,135)**	**$**	**37,469**

Debt As of September 30	2013 Beginning Balance		2013 Net Borrowing		2013 Ending Balance	
Dollars in Thousands						
Agency Debt (Intragovernmental)						
Debt to the Treasury	$	33,967	$	1,708	$	35,675
Debt to the Federal Financing Bank		190,191		(109,262)		80,929
Total Debt	**$**	**224,158**	**$**	**(107,554)**	**$**	**116,604**

The *Federal Credit Reform Act (FCRA) of 1990* provides financing accounts with indefinite authority to borrow from the U.S. Treasury to fund disbursements of loans made to sovereign nations for security assistance. This debt to the U.S. Treasury is reflected in the Foreign Military Financing Direct Loan Financing Account and the Military Debt Reduction Account.

Beginning in January 1975, the DSCA and the Federal Financing Bank (FFB), acting under section 24 of the Arms Export Control Act, as amended, entered into an agreement whereby the FFB would make loan agreements with friendly nations and acquire promissory notes guaranteed by DSCA. The promissory notes with FFB were liquidated during 2014.

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 principal amounts guaranteed.

NOTE 11. OTHER LIABILITIES

Other Liabilities			Dollars in Thousands
	2014		
As of September 30	Current Liability	Noncurrent Liability	Total
Intragovernmental			
FECA Reimbursement to the Department of Labor	$ 68	$ 78	$ 146
Custodial Liabilities	0	647,404	647,404
Total Intragovernmental Other Liabilities	**$ 68**	**$ 647,482**	**$ 647,550**
Nonfederal			
Accrued Funded Payroll and Benefits	$ 7	$ 0	$ 7
Advances from Others	64,151,890	3,594,897	67,746,787
Contract Holdbacks	331,379	0	331,379
Total Nonfederal Other Liabilities	**$ 64,483,276**	**$ 3,594,897**	**$ 68,078,173**
Total Other Liabilities	**$ 64,483,344**	**$ 4,242,379**	**$ 68,725,723**

Other Liabilities			Dollars in Thousands
	2013		
As of September 30	Current Liability	Noncurrent Liability	Total
Intragovernmental			
FECA Reimbursement to the Department of Labor	$ 59	$ 81	$ 140
Custodial Liabilities	0	652,711	652,711
Total Intragovernmental Other Liabilities	**$ 59**	**$ 652,792**	**$ 652,851**
Nonfederal			
Accrued Funded Payroll and Benefits	$ 44	$ 0	$ 44
Advances from Others	63,474,620	3,477,539	66,952,159
Contract Holdbacks	150,496	0	150,496
Total Nonfederal Other Liabilities	**$ 63,625,160**	**$ 3,477,539**	**$ 67,102,699**
Total Other Liabilities	**$ 63,625,219**	**$ 4,130,331**	**$ 67,755,550**

Advances from Others represent liabilities for collections received to cover future expenses or acquisition of assets.

Custodial Liabilities represents liabilities for collections reported as non-exchange revenues where the Department is acting on behalf of another Federal entity.

Contract Holdbacks are amounts earned by contractors or suppliers during the production period but not yet paid to the contractor/supplier to ensure future performance.

Other Liabilities

Nonfederal Advances from Others, Noncurrent includes $3.6 billion related to contracts authorizing progress payments based on cost as defined in the Federal Acquisition Regulation (FAR). In accordance with contract terms, specific rights to the contractors' work vest with the Federal Government when a specific type of contract financing payment is made. This action protects taxpayer funds in the event of contract nonperformance. These rights should not be misconstrued as rights of ownership. The Department is under no obligation to pay contractors for amounts greater than the amounts authorized in contracts until delivery and government acceptance. Due to the probability the contractors will complete their efforts and deliver satisfactory products, and because the amount of potential future payments are estimable, the Department has recognized a contingent liability for estimated future payments which are conditional pending delivery and government acceptance.

Total 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 12. COMMITMENTS AND CONTINGENCIES

The U.S. Government may be a party in various administrative proceedings or court litigations, but it is highly unlikely any will implicate the FMS Trust Fund. The U.S. funds appropriated for security assistance generally are not legally available for paying claims.

NOTE 13. FEDERAL EMPLOYMENT BENEFITS

Federal Employment Benefits			*Dollars in Thousands*
	2014		
As of September 30	**Liabilities**	**(Less: Assets Available to Pay Benefits)**	**Unfunded Liabilities**
Pension and Health Actuarial Benefits			
FECA	$ 648	$ 0	$ 648
Total Military Retirement and Other Federal Employment Benefits	**$ 648**	**$ 0**	**$ 648**

Federal Employment Benefits	2013		Dollars in Thousands
As of September 30	Liabilities	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Pension and Health Actuarial Benefits			
FECA	$ 595	$ 0	$ 595
Total Military Retirement and Other Federal Employment Benefits	**$** 595	**$ 0**	**$** 595

Federal Employees' Compensation Act (FECA)

Actuarial Cost Method Used and Assumptions

The Defense Security Cooperation Agency 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 utilizing 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 Office of Management and Budget's economic assumptions for 10-year Treasury notes and bonds. Interest rate assumptions utilized for discounting were as follows:

Discount Rates

3.455% in Year 1

3.455% 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) 2014 were also used to adjust the methodology's historical payments to current year constant dollars.

The compensation COLAs and CPIMs used in the projections for various CBYs were as follows:

Federal Employees Compensation Act (FECA)		
CBY	COLA	CPIM
2015	1.73%	2.93%
2016	2.17%	3.76%
2017	2.13%	3.86%
2018	2.23%	3.90%
2019+	2.30%	3.90%

The model's resulting projections were analyzed to ensure that the estimates were reliable. The analysis was based on four tests: (1) a sensitive analysis of the model to economic assumptions, (2) a comparison of the percentage change in the liability amount by agency 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 2014 to the average pattern observed during the most current three CBYs, and (4) a comparison of the estimated liability per case in the CBY 2014 projection to the average pattern for the projections of the most recent three years.

NOTE 14. GENERAL DISCLOSURES RELATED TO THE STATEMENT OF NET COST

Costs and Exchange Revenue *As of September 30*	*Dollars in Thousands* 2014	2013
Operations, Readiness & Support		
Gross Cost		
Intragovernmental Cost	$ 8,555,546	$ 7,424,481
Nonfederal Cost	$ 26,330,780	$ 23,481,664
Total Cost	**$ 34,886,326**	**$ 30,906,145**
Earned Revenue		
Intragovernmental Revenue	$ (32)	$ 0
Nonfederal Revenue	$ (5,858)	$ (14,556)
Total Revenue	**$ (5,890)**	**$ (14,556)**
Total Net Cost	**$ 34,880,436**	**$ 30,891,589**

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the Department as 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. Intragovernmental costs and revenue represent transactions between two reporting entities within the Federal Government. Public costs and exchange revenues are transactions made between the reporting entity and a nonfederal entity.

The systems utilized by Defense Security Cooperation Agency for the FMS Trust Fund and the accounts for funds appropriated for security assistance do not fully 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. The Department's current processes and systems do not capture and report accumulated costs for major programs based upon the performance measures as required by the *Government Performance and Results Act*. The Department is in the process of reviewing available data and developing a cost reporting methodology as required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as amended by SFFAS No. 30, *Inter-entity Cost Implementation*.

Additionally, these systems do not track intragovernmental transactions by a customer at the transaction level. The FMS Trust Fund adjusts expenses by reclassifying amounts between federal and nonfederal expenses and accruing additional payables and expenses. Intradepartmental revenues and expenses are then eliminated.

NOTE 15. DISCLOSURES RELATED TO THE STATEMENT OF CHANGES IN NET POSITION

The Appropriations on the SBR does not agree with the Appropriations Received on the Statement of Changes in Net Position. The difference of $710.8 million is primarily attributable to the period of availability extension within the Foreign Military Financing Program account.

Year Ended September 30, 2014 **Reconciliation of Appropriations on the Statement of Budgetary Resources to Appropriations Received on the Statement of Changes in Net Position**	*Dollars in Thousands* **Total**
Appropriations, Statement of Budgetary Resources	$ 6,735,612
Less: Appropriations Received, Statement of Changes in Net Position	(6,024,853)
Total Reconciling Amount	**$ 710,759**
Items Reported as Increases to Appropriations, Statement of Budgetary Resources	
Allocation Transfers	$ 710,759
Items Reported in Net Cost of Operations, Statement of Changes in Net Position	
Total Reconciling Items	**$ 710,759**

NOTE 16. DISCLOSURES RELATED TO THE STATEMENT OF BUDGETARY RESOURCES

Disclosures Related to the Statement of Budgetary Resources *As of September 30*	*Dollars in Thousands* **2014**	**2013**
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period.	$ 159,932,064	$ 153,849,411

On the Statement of Budgetary Resources (SBR), obligations incurred of $41.9 billion are direct and exempt from apportionment.

The SBR includes intra-entity transactions because the statements are presented combined.

Borrowings from the U.S. Treasury are required to be repaid once a year at the end of the fiscal year. The financing sources for the repayments on borrowings are loan repayments from the countries or permanent indefinite appropriations through subsidy reestimates.

The portions of the FMS Trust Fund receipts collected in the current fiscal year that exceed current outlays are temporarily precluded from obligation by law. These receipts, however, are available for obligation as needed in the future.

The *Federal Credit Reform Act of 1990* (FCRA) provides permanent indefinite appropriations to fund upward subsidy reestimates that fund repayments of principal and interest of U.S. Treasury borrowings with the Foreign Military Financing Direct Loan Program and the Military Debt Reduction Financing Account. The *FCRA* also provides permanent indefinite appropriations to fund loan defaults with the Federal Financing Bank in the Foreign Military

Loan Liquidating Account.

The Appropriations on the SBR does not agree with the Appropriations Received on the Statement of Changes in Net Position. Refer to Note 15, Disclosures Related to the Statement of Changes in Net Position for additional details.

Legal limitations and time restriction on the use of unobligated appropriation balances are provided under Public Law.

NOTE 17. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

Reconciliation of Net Cost of Operations to Budget *As of September 30*	*Dollars in Thousands* **2014**	**2013**
Resources Used to Finance Activities		
Budgetary Resources Obligated		
Obligations incurred	$ 41,960,551	$ 21,637,738
Less: Spending authority from offsetting collections and recoveries	(1,108,237)	(529,970)
Obligations net of offsetting collections and recoveries	**$ 40,852,314**	**$ 21,107,768**
Less: Offsetting receipts	(29,267,942)	(26,651,359)
Net Budgetary Resources Obligated	**$ 11,584,372**	**$ (5,543,591)**
Total resources used to finance activities	**$ 11,584,372**	**$ (5,543,591)**
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	$ (6,082,652)	$ 9,644,116
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	29,380,451	26,792,680
Resources that finance the acquisition of assets	(1,794)	(1,709)
Total resources used to finance items not part of the Net Cost of Operations	**$ 23,296,005**	**$ 36,435,087**
Total resources used to finance the Net Cost of Operations	**$ 34,880,377**	**$ 30,891,496**
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	$ 59	$ 93
Total components of Net Cost of Operations that will Require or Generate Resources in future periods	**$ 59**	**$ 93**
Components not Requiring or Generating Resources		
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	**$ 59**	**$ 93**
Net Cost of Operations	**$ 34,880,436**	**$ 30,891,589**

The Reconciliation of Net Cost of Operations to Budget reconciles the cost reflected on the Statement of Net Cost to the budgetary information reflected on the Statement of Budgetary Resources. This is accomplished by means of a reconciliation of budgetary obligations and non-budgetary resources available to the reporting entity with its net cost of operations.

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 Foreign Military Sales Trust Fund system limitations, budgetary data is not in agreement with proprietary expenses and assets capitalized. The difference between budgetary and proprietary data is a previously identified deficiency.

Components Requiring or Generating Resources in Future Period, Other is attributable to Federal Employee Compensation Act actuarial expense.

APPENDIX B: LIST OF ACRONYMS AND ABBREVIATIONS

Acronym	Definition
AF-IPPS	Air Force Integrated Personnel and Pay System ERP
AFR	Agency Financial Report
AFRICOM	Africa Combatant Command
ANSF	Afghan National Security Force
APP	Annual Performance Plan
APR	Annual Performance Report
ASD	Assistant Secretary of Defense
BAM	Business Activity Monitoring tool
BBP	Better Buying Power
BCA	Budget Control Act 2011
CEFMS	Corps of Engineers Financial Management System
CFO	Chief Financial Officer
CIO	Chief Information Officer
CMO	Chief Management Officer
COCOM	Combatant Command
COLA	Cost of Living Adjustment
COR	Contracting Officer Representative
COTS	Commercial off-the-shelf
CPIM	Consumer Price Index, Medical
CRS	Career Readiness Standards
DAI	Defense Agency Initiative ERP
DAU	Defense Acquisition University
DAWIA	Defense Acquisition Workforce Improvement Act
DBC	Defense Business Council
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DCMO	Deputy Chief Management Officer
DCPS	Defense Civilian Pay System
DEAMS	Defense Enterprise Accounting and Management System
DFAS	Defense Finance and Accounting Service
DHA	Defense Health Agency
DHP	Defense Health Program
DJMS	Defense Joint Military Pay System
DLA	Defense Logistics Agency
DMDC	Defense Manpower Data Center
DoD	Department of Defense
DoDI	Department of Defense Instruction
DSCA	Defense Security Cooperation Agency
DTMO	Defense Travel Management Office

Acronym	Definition
DTS	Defense Travel System
EBS	Enterprise Business System ERP
EIC	External Independent Contractor
ERP	Enterprise Resource Planning
FBWT	Fund Balance With Treasury
FFMIA	Federal Financial Management Improvement Act of 1996
FIAR	Financial Improvement and Audit Readiness
FM	Financial Management
FMFIA	Federal Managers' Financial Integrity Act of 1982
FMR	Financial Management Regulation
FMS	Foreign Military Sales
FPSR	FIAR Plan Status Report
FY	Fiscal Year
GAO	Government Accountability Office
GCSS-A	Global Combat Support System - Army
GCSS-MC	Global Combat Support System - MC
GFEBS	General Fund Enterprise Business System
GPF	General Purpose Force
HUMINT	Human intelligence
ICBM	Intercontinental Ballistic Missile
IDES	Integrated Disability Evaluation System
IG	Inspector General
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPERIA	Improper Payments Elimination and Recovery Improvement Act of 2012
IPIA	Improper Payment Information Act of 2002
IPPS-A	Integrated Personnel Pay System - Army
IRB	Investment Review Board
ISAF	International Security Assistance Force
ISR	Intelligence, Surveillance and Reconnaissance
ISIL	Islamic State of Iraq and the Levant
IT	Information Technology
LMP	Logistics Modernization Program
MDA	Missile Defense Agency
MDAP	Major Defense Acquisition Programs
MERHCF	Medicare-Eligible Retiree Health Care Fund
MHS	Military Health System
MICP	Managers' Internal Control Program
MILDEP	Military Department
MOCAS	Mechanization of Contract Administrative Services
MRF	Military Retirement Fund

Acronym	Definition
MRHB	Military Retirement Health Benefits
NATO	North Atlantic Treaty Organization
NDAA	National Defense Authorization Act
NDS	National Defense Stockpile
O&M	Operations and Maintenance
OCO	Overseas Contingency Operations
ODO	Other Defense organizations
OEF	Operation Enduring Freedom
OIF	Operation Iraqi Freedom
OIG	Office of the Inspector General
OM&S	Operating Material and Supplies
OMB	Office of Management and Budget
OPSEC	Operations Security
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
PCS	Permanent Change of Station
PFPA	Pentagon Force Protection Agency
PP&E	Property, Plant, and Equipment
PSA	Principal Staff Assistants
QDR	Quadrennial Defense Review
R&D	Research and Development
RAA	Rapid Acquisition Authority
RDT&E	Research, Development, Test, and Evaluation
SBA	Schedule of Budgetary Activity
SBR	Statement of Budgetary Resources
SCMR	Strategic Choices and Management Review
SCNP	Statement of Changes in Net Position
SFA	Security force assistance
SFFAS	Statement of Federal Financial Accounting Standards
SFIS	Standard Financial Information Structure
SIG	Senior Integration Group
SLOA	Standard Line of Accounting
SNC	Statement of Net Cost
SSAE	Statement on Standards for Attestation Engagement
TAP	Transition Assistance Program
TDY	Temporary Duty
UFC	USACE Finance Center
U.S.	United States
USACE	United States Army Corps of Engineers

Acronym	Definition
USD	Under Secretary of Defense
USD(AT&L)	Under Secretary of Defense for Acquisition, Technology and Logistics
USGAAP	United States Generally Accepted Accounting Principles
USMC	United States Marine Corps
USSGL	United States Standard General Ledger
USSOCOM	United States Special Operations Command
USSTRATCOM	United States Strategic Command
USTRANSCOM	United States Transportation Command
VA	Department of Veterans Affairs
WCF	Working Capital Fund
WII	Wounded, Ill, or Injured

APPENDIX C: USEFUL WEBSITES

Link	URL
Budget Control Act of 2011	http://www.gpo.gov/fdsys/pkg/PLAW-112publ25/pdf/PLAW-112publ25.pdf
Defense Advanced Research Projects Agency	http://www.darpa.mil
Defense Business Council	http://dcmo.defense.gov/governance/dbc-irb.html
Defense Commissary Agency	http://www.commissaries.com
Defense Contract Audit Agency	http://www.dcaa.mil
Defense Contract Management Agency	http://www.dcma.mil
Defense Finance & Accounting Service	http://www.dfas.mil
Defense Health Agency	http://tricare.mil/tma/
Defense Intelligence Agency	http://www.dia.mil
Defense Information Systems Agency	http://www.disa.mil
Defense Logistics Agency	http://www.dla.mil
Defense Media Activity	http://www.dma.mil
Defense POW/Missing Personnel Office	http://www.dtic.mil/dpmo/
Defense Security Cooperation Agency	http://www.dsca.mil
Defense Security Service	http://www.dss.mil
Defense Strategic Guidance 2012	http://www.defense.gov/news/Defense_Strategic_Guidance.pdf
Defense Technical Information Center	http://www.dtic.mil
Defense Technology Security Administration	http://www.dtsa.mil
Defense Threat Reduction Agency	http://www.dtra.mil
Department of the Air Force	http://www.af.mil
Department of the Army	http://www.army.mil
Department of Defense (DoD)	http://www.defense.gov/
Department of the Navy	http://www.navy.mil
DoD Education Activity	http://www.dodea.edu/
DoD Enterprise Transition Plan	http://dcmo.defense.gov/publications/enterprise-transition-plan.html
DoD Financial Improvement and Audit Readiness	http://comptroller.defense.gov/fiar
DoD Financial Management Certification Program	http://comptroller.defense.gov/externalLinks/FMCert.aspx
DoD Financial Management Regulation	http://comptroller.defense.gov/fmr
DoD Human Resources Activity	http://www.dhra.mil
DoD Joint Chiefs of Staff	http://www.jcs.mil/
DoD Managers' Internal Control Program	http://comptroller.defense.gov/fiar/micp.aspx
DoD, Office of the Inspector General	http://www.dodig.mil/

Link	URL
DoD Strategic Management Plan	http://dcmo.defense.gov/publications/strategic-management-plan.html
Federal Accounting Standards Advisory Board	http://fasab.gov/accounting-standards/authoritative-source-of-gaap/
Federal Financial Management Improvement Act	http://www.gpo.gov/fdsys/pkg/PLAW-104publ208/pdf/PLAW-104publ208.pdf
Federal Managers' Financial Integrity Act	http://www.gpo.gov/fdsys/pkg/STATUTE-96/pdf/STATUTE-96-Pg814.pdf
Missile Defense Agency	http://www.mda.mil
National Geospatial-Intelligence Agency	https://www.nga.mil/Pages/default.aspx
National Guard	http://www.nationalguard.mil
National Reconnaissance Office	http://www.nro.gov
National Security Agency/Central Security Service	https://www.nsa.gov/
Office of Economic Adjustment	http://www.oea.gov
Office of Management and Budget Circulars	http://www.whitehouse.gov/omb/circulars_default/
Pentagon Force Protection Agency	http://www.pfpa.mil
Quadrennial Defense Review 2014	http://www.defense.gov/qdr
U.S. Africa Command	http://www.africom.mil
U.S. Central Command	http://www.centcom.mil
U.S. European Command	http://www.eucom.mil
U.S. Marine Corps	http://www.marines.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
Washington Headquarters Services	http://www.whs.mil

APPENDIX D: INDEX OF FIGURES AND TABLES

FIGURES

TABLES

This Page Left Blank Intentionally

WELCOME TO THE DEPARTMENT OF DEFENSE

We are interested in your feedback regarding the content of this report.

Comments can be e-mailed to
osd.pentagon.ousd-c.mbx.dod-agency-financial-report@mail.mil

Comments can be mailed to
United States Department of Defense
Office of the Under Secretary of Defense (Comptroller)
1100 Defense Pentagon, Room 3D150
Washington, DC 20301-1100

This document can be viewed at
http://comptroller.defense.gov/FinancialManagement/Reports/afr2014.aspx/

FINANCIAL IMPROVEMENT AND AUDIT READINESS
KNOW YOUR BUSINESS
CONTROL YOUR FUTURE