DEPARTMENT OF DEFENSE

AGENCY FINANCIAL REPORT

NOVEMBER 15, 2007

FISCAL YEAR 2007

Table of Contents

Message from the Deputy Secretary of Defense

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

November 15, 2007

Enclosed is the fiscal year 2007 Agency Financial Report for the Department of Defense. This report has become the annual centerpiece for reporting on the Department's financial execution, plans and accomplishments. While the Department's focus during the past year has been the war against terror, much progress has also been made to improve the financial management of the public assets that are entrusted to the Department.

The men and women of the Department of Defense are committed to success in the war effort. These Soldiers, Sailors, Airmen and Marines are heavily engaged throughout the world:

- In Afghanistan, U.S. forces are working with local and coalition forces to strengthen governmental structures train indigenous forces and apply the rule of law.
- In Iraq, our forces are working to restore stability, provide security for economic development, defeat extremists, and deny extremists places to plan, train, and operate.
- In the Horn of Africa, the Philippines, and a host of other places, our forces are working to ameliorate the conditions that foster extremism.
- At home, service members are securing our borders, responding to natural disasters, and guarding against – and preparing for – terrorist attacks.

The Department has a responsibility to provide accurate and timely accounting of the financial resources that we manage. We take this responsibility seriously. While the challenge is large and much work remains to be done, progress continues and the enclosed report provides a status of improvement efforts and a summary of our financial position.

The report describes the challenges and presents the financial management and business transformation accomplishments of the Department of Defense during fiscal year 2007. The report supports the Defense Department's participation in the Office of Management and Budget pilot financial reporting initiative for all federal agencies and contains the most complete financial information available.

Gordon England

Overview

The Department of Defense (DoD) Fiscal Year (FY) 2007 Agency Financial Report (AFR) provides the President, the Congress, other Federal departments and agencies, and the American public an overview of the Department's financial condition. The AFR is similar to the private sector's annual report to stockholders.

The AFR covers the 12-month period ending September 30, 2007 in the following sections:

Section 1: Management's Discussion and Analysis is a high-level summary of the Department's financial information for FY 2007. It describes the Department's mission and organizational structure; includes financial highlights and a statement of limitations on the financial statements; and provides management assurances over internal control.

Section 2: Financial Information includes a message from the Chief Financial Officer, the DoD Inspector General Auditor's Report and opinion, and the Department's principal financial statements and notes, required supplementary stewardship information and required supplementary information.

Section 3: Other Accompanying Information includes the Inspector General's Summary of Management and Performance Challenges and Management's Responses, Summary of the Financial Statement Audit and Management Assurances, and Improper Payment Information Act Reporting Details.

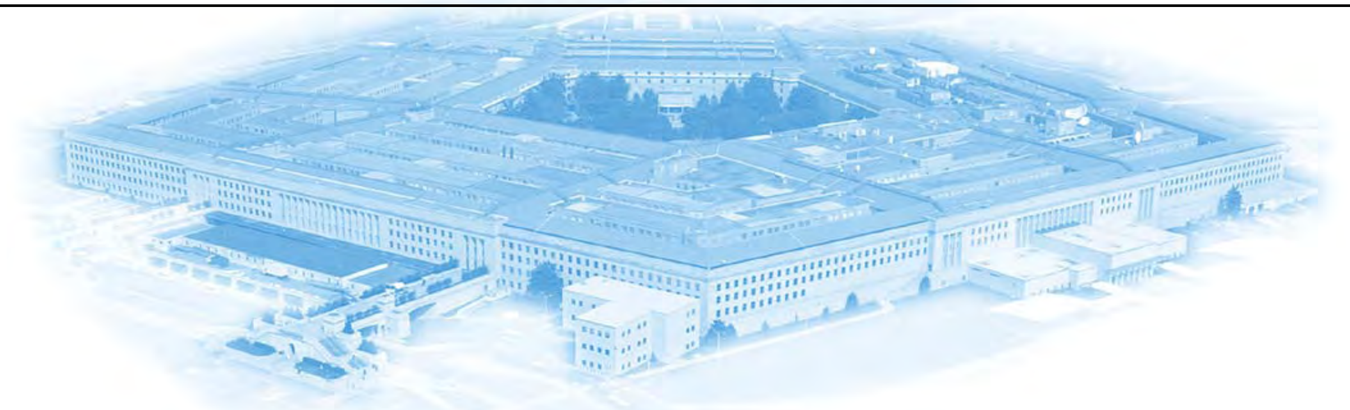
Appendix includes a glossary and a list of internet links for more detailed information about topics discussed in this report.

We welcome your feedback regarding the content of this report. To comment or to request copies of the report, please email us at DoDAFR@osd.mil, or write to:

U.S. Department of Defense
Office of the Under Secretary of Defense (Comptroller)
1100 Defense Pentagon
Washington, DC 20301-1100

This document also is available at http://www.defenselink.mil/comptroller/afr.

Year in Review



From the mountains of South America to the deserts of the Middle East to the tropical forests of the Pacific Rim, members of the Department of Defense continue their work to safeguard the American people. Wars in Iraq and Afghanistan garner the most attention, but the United States pursues violent extremists wherever they hide. And while heavily engaged in countering today's threats, the Department also looks to future risks and challenges, to ensure U.S. dominance over any threat that may arise. Humanitarian assistance and the building of partnerships with other nations have become mainstream endeavors. The Year in Review provides a sampling of just some of the Department's activities around the world in the past year.

On January 10, 2007, President Bush announced a new strategy in Iraq – what became known as the "surge." By the end of June, the last of five brigades arrived in Baghdad to help U.S. and Iraqi forces progress beyond the clearing of extremists. Results in Iraq, particularly in the political realm, are mixed, but Coalition forces, including significant numbers of Iraqi forces, are beginning to make progress toward the strategy's goal of holding territory and building environments adverse to extremism.

U.S. and Iraqi Army Soldiers unload humanitarian relief supplies in Abd al Hasan, Iraq, during a combat operation June 16, 2007. During the operation, U.S. and Iraqi Army soldiers deliver relief supplies and search houses to clear the area for future operations. The soldiers are from 2nd Battalion, 27th Infantry Regiment, 3rd Brigade Combat Team, 25th Infantry Division. (U.S. Air Force photo by SSgt Dallas Edwards)

In Afghanistan, the anticipated spring offensive by Taliban members turned into an offensive on the part of Coalition forces. The Taliban's top military commander was killed during an operation in May, while Coalition troops made advances against Taliban strongholds throughout southern and eastern Afghanistan.

In both Iraq and Afghanistan, military forces are working closer with members of other U.S. Departments than ever before. Provincial Reconstruction Teams, staffed by partners from the State and Justice Departments, United States Agency for International Development and others, are working closely with Coalition forces to rebuild infrastructure and give local citizens a chance to free themselves from destitute conditions.

In the Horn of Africa, the Philippines and elsewhere, American forces are working with foreign militaries like never before. Navies from over a dozen nations not only steam together in the Gulf of Arabia, they share intelligence and plan operations together to fight as one force against enemies ranging from terrorists to pirates. In September 2007, a bilateral exercise between the United States and India, called Malabar, grew into a major combined exercise that also included the navies of Australia, Japan and Singapore. The UNITAS exercise between the United States and South American nations is in its 48th year, and continues to be a foundation of cooperation between Western Hemisphere democracies.

Efforts to strengthen national partnerships during such exercises have been matched by efforts to build friendships at the local level. Through much of the history of our military, humanitarian efforts have been relegated to a tertiary role. Forces filled the role mostly in response to disasters such as a tsunami or hurricane. Today, members of the military are providing humanitarian services with

U.S. Navy Lt. John Shuler, a submarine exercise planner primary action officer for Exercise Malabar 07-01, discusses plans with Indian Navy Lt. Cmdr. Vivek Madhwal, an anti-submarine warfare officer with Indian navy destroyer INS Rana (D 52), in the ward room aboard Indian navy destroyer INS Mysore (D 60) while under way in the Philippine Sea April 6, 2007. The meeting is part of exercise Malabar 07-01, a U.S. and Indian naval exercise held off the coast of Okinawa, Japan. (U.S. Navy photo by Mass Communication Specialist 1st Class John L. Beeman)

increased frequency and effectiveness. Air Force physicians have performed surgeries and cared for citizens in Vietnam. Soldiers built a school complex in Uganda. The Navy dispatched *USS Peleliu* to the South Pacific and *USNS Comfort* to Latin America and the Caribbean to extend America's goodwill through humanitarian services.

While the Department is focused on today's challenges, we cannot overlook threats that may arise in the future. The government of Iran continues to cause concern as its members promote violence and instability throughout the Mideast region. The United States has increased cooperation with countries like Russia and China. But a lack of transparency, combined with aggressive statements from government leaders, calls into question the direction of our associations. And the United States, along with many nations, continues to guard against the threat of nuclear proliferation from North Korea.

The Department is developing a host of platforms and shifting mindsets to meet whatever challenges may arise. The Army continues to shift away from a static posture to modular systems capable of deploying rapidly. The Brigade Combat Team structure will also increase the Army's ability to build any force to meet any threat. The Navy's investment in littoral combat ships and riverine forces will give the Navy a similar ability to undertake a range of missions in blue, green and brown waters. The Air Force is shifting from mass to precision maneuver as the driving combat doctrine. The Marine Corps is focused on new technology to maximize their combat power.

The "peace dividend" many hoped for during the 1990s is giving way to the reality of today's world with its numerous centers of instability and crisis. In January 2007, Secretary of Defense Gates announced his recommendation to increase the size of the Army and Marine Corps by a combined 92,000 men and women to help meet our nation's many commitments throughout the world. The Department has also adjusted mobilization regiments for the Guard and Reserve. These efforts are meant to relieve strain on military members by decreasing the length and frequency of deployments.

The Department's mission is to protect the citizens of our nation. But the Department also serves those undertaking that mission. Men and women in uniform are more than our nation's sons and daughters. They are parents. They are brothers, sisters, and children. They are our neighbors and fellow Americans and should be looked after with the same passion that they give in service to us. As we saw with the problems at Walter Reed and other military health facilities, some of our patriots have been let down. The Department has renewed efforts to ensure that every person in uniform is cared for not only on the battlefield, but at home as well. The Department has updated policies to ensure that its civilians, wounded while participating in a contingency operation, are provided care on the battlefield and at home.

The Department has also renewed efforts to get the latest technologies to better protect forces in combat. For example, Mine Resistant Ambush Protected vehicles are arriving in Iraq.

As always, the remarkable achievements of the Department of Defense could not be possible without the heroic efforts of those in uniform. Each has sworn an oath to serve and protect us. They do so with the utmost professionalism and skill. We thank them for their service.

U.S. Marines from Task Force Military Police (1/12 TFMP) drive through the Mine Resistant Ambush Protected vehicle (MRAP) course at the 1/12 TFMP motor pool in Al Asad, Iraq, July 24, 2007. Marines from 1/12 TFMP maneuver through different road courses to obtain their MRAP license. (U.S. Marine Corps photo by Lance Cpl. Ashley S. Hoffman)

Section 1

Management's Discussion and Analysis

Significance of the DoD Seal

Heraldry, a system of identification using visual symbols, became a useful art in the Middle Ages, when warriors on the battlefield displayed an emblem on their shields and the tunics they wore over their armor. In America, heraldry symbols have been used by military forces as well as other organizational elements of the government since the beginning of the Revolution.

The Great Seal of the United States is a symbol familiar to Americans. In addition, each department and agency of the government has its own seal which appears on documents and publications issued by the organization. The seal of the Department of Defense, shown above, was designed to visually depict the mission of the Department.

The American bald eagle, long associated with symbolism representing the United States of America and its military establishment, is an emblem of strength. In facing to the right, the field of honor is indicated. The eagle is defending the United States, represented by the shield of thirteen pieces. The thirteen pieces are joined together by the blue chief, representing the Congress. The rays and stars above the eagle signify glory, while the three arrows are collectively symbolic of the three component parts of the Department of Defense (Army, Navy, and Air Force). The laurel stands for honors received in combat defending the peace represented by the olive branch.

Section 1: Management's Discussion and Analysis

The Department of Defense has chosen to produce an alternative to the consolidated Performance and Accountability Report called the Agency Financial Report (AFR). The Department decided to participate in the FY 2007 pilot pursuant to Office of Management and Budget (OMB) Circular A-136, "Financial Reporting Requirements." We will include our FY 2007 Annual Performance Report and FY 2009 Annual Performance Plan with the FY 2009 Congressional Budget Justification (CBJ) that will be submitted to the Congress and OMB in February 2008. As a supplement to this report, we will issue a "Highlights" document to be published on our website. The Highlights document will contain budget, performance, and financial information in a brief, user-friendly format.

Links to the Department's Performance and Financial Documents

"Highlights FY 2007" summary of financial and performance information will be available February 2008, at http://www.defenselink.mil/comptroller/afr

FY 2009 Congressional Budget Justification (including the Annual Performance Report for FY 2007 and Annual Performance Plan for FY 2009) will be available February 2008, at http://www.defenselink.mil/comptroller/defbudget/FY2009/

Using this approach the Department projects several significant improvements:

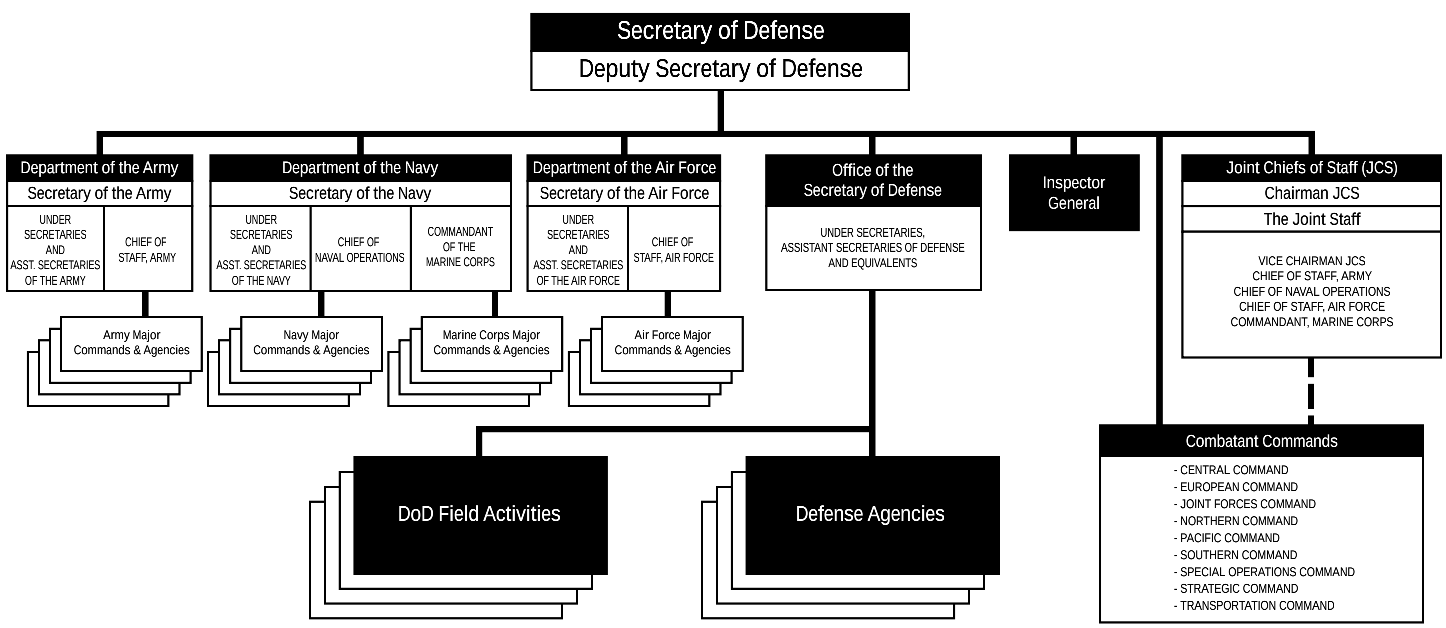
- Enhanced readability by reducing the length of the report.
- Reduced duplicative information in the content of this report.
- Improved performance information by submitting it with our FY 2009 CBJ submission to Congress and OMB. The performance information will be based upon a full year of actual data instead of estimating fourth quarter as we have in the previous years.
- Enhanced transparency using website links.
- Reduced production costs.

To further streamline and consolidate its reports, the Department will use website links and references to provide some of the performance and financial information associated with agency missions, functions, and strategic plans.

Mission and Organizational Structure

The mission of the United States Armed Forces is to provide the military forces needed to deter war and to protect the security of our country. Since the creation of America's first army in 1775, the Department has evolved to become a global presence with individuals stationed in more than 140 countries dedicated to defending the United States and its interests around the world. The Department embraces the core values of leadership, professionalism, and technical knowledge. Its employees are dedicated to duty, integrity, ethics, honor, courage and commitment.

The chart below shows how the Department is structured.



The Secretary and the Office of the Secretary

The Secretary of Defense and the Office of the Secretary of Defense are responsible for the formulation and oversight of defense strategy and policy. The Office of the Secretary of Defense supports the Secretary in policy development, strategy formulation, planning, resource management, and fiscal and program evaluation.

Military Departments

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

Personnel in the Military Departments are assigned to Active Duty, Reserve, and National Guard forces. Active Duty forces are full-time military service members. Reserve forces and National Guard forces, when ordered to active duty, augment active forces. Reserve and National Guard forces are an extension of Active Duty forces. The National Guard has a unique dual mission with both federal and state responsibilities. In peacetime the Guard is commanded by the governor of each respective state or territory. Under applicable state laws, their authority includes the ability to call the Guard into action during local or statewide emergencies, such as storms, drought, or civil disturbances. When ordered to active duty for mobilization or called into federal service for emergencies, units of the Guard are placed under operational control of the appropriate Military Department. Guard and Reserve forces are recognized as an indispensable and integral part of the nation's defense from the earliest days of a conflict.

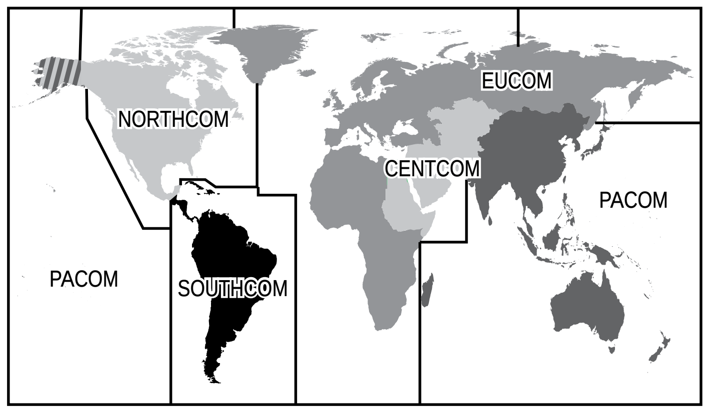
Chairman of the Joint Chiefs of Staff

The Chairman of the Joint Chiefs of Staff, who is the principal military advisor to the President, the National Security Council, and the Secretary of Defense, assists the President and Secretary in providing for the strategic direction of the Armed Forces, including operations conducted by the Commanders of the Combatant Commands. As part of this responsibility, the Chairman also assists in the preparation of strategic plans and helps to ensure that plans conform to the resource levels the Secretary of Defense projects will be available.

Combatant Commands

The nine Combatant Commands have responsibility for missions around the world. For example, U.S. Central Command is primarily responsible for conducting Operation Enduring Freedom in Afghanistan and Operation Iraqi Freedom in Iraq. The Army, Navy, Air Force, and Marine Corps supply forces to these Commands.

Five of these Commands have specific mission objectives for their geographic areas of responsibility, as shown in the map below:



- U.S. European Command (USEUCOM) is responsible for activities in Europe, Greenland, Russia, and most of Africa.
- U.S. Central Command (USCENTCOM) is responsible for the Middle East, eastern Africa, and several of the former Soviet republics.
- U.S. Pacific Command (USPACOM) is responsible for Northeast, South and Southeast Asia, as well as Oceania.
- U.S. Southern Command (USSOUTHCOM) is responsible for Central and South America, and the Caribbean.
- U.S. Northern Command (USNORTHCOM) is responsible for North America including Canada and Mexico.

This structure undergoes periodic reviews. In 2007 the President ordered the establishment of the U.S. Africa Command, drawing territory from USEUCOM and USCENTCOM. The headquarters will be functional in the coming year.

The remaining four Commands have worldwide mission responsibilities, each focused on a particular function:

- U.S. Strategic Command is responsible for providing global deterrence capabilities and synchronizing the Department's efforts to combat weapons of mass destruction.

- U.S. Special Operations Command is responsible for leading, planning, synchronizing and, as directed, executing global operations against terrorist networks.
- U.S. Transportation Command is responsible for moving military equipment, supplies, and personnel around the world in support of operations.
- U.S. Joint Forces Command is responsible for developing future concepts for joint warfighting and training.

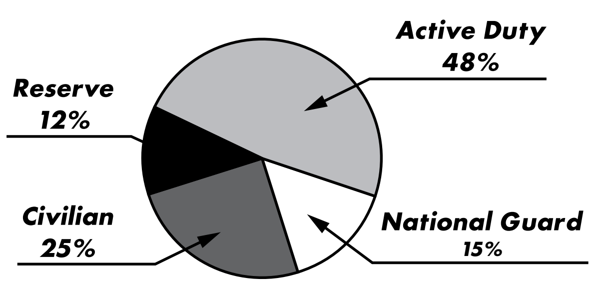
Defense Agencies and Defense Field Activities

These organizations provide support Department-wide. Defense Agencies provide a variety of support services commonly used throughout the Department. For example, the Defense Finance and Accounting Service (DFAS) provides accounting services, contractor and vendor payments, and payroll services. Defense Field Activities perform missions more limited in scope, such as the American Forces Information Service that serves as the focal point for all Armed Forces information programs.

Resources

Nearly half of the Department's workforce are men and women on Active Duty. To provide Americans with the highest level of national security, the Department employs more than 1.4 million men and women on Active Duty, approximately 828,000 in the Reserve and National Guard, and about 729,000 thousand civilians. The chart below shows the employee breakdown.

Staffing for FY 2007*



*The percentages reflect data as of September 30, 2007, subject to rounding differences.

The Department's worldwide infrastructure includes nearly 580,000 facilities (buildings, structures, and utilities) located at more than 5,300 sites around the world, and more than 32 million acres. To protect the security of the United States, the Department uses approximately 250,000 vehicles, 11,000 aircraft, and 500 vessels.

Analysis of Financial Statements

The Agency Financial Report affords the Department an opportunity to provide its "investors" (e.g., stakeholders, oversight, and the American people) with critical information to assess current financial performance as well as its future outlook. Though not a commercial entity, the DoD has numerous stakeholders with interests similar to those of public companies.

For external reporting purposes, the Department reports its financial information in four principal financial statements, including a consolidated Balance Sheet along with statements of Net Cost; Changes in Net Position, and Budgetary Resources. These statements reflect the Department's financial position and changes in both proprietary and budgetary activities. Comparatively, the statements are similar to a corporate Balance Sheet, Income Statement, Stockholders' Equity, and Statement of Cash Flow. The number of principal financial statements has been reduced from six in the previous year to four this year by presenting their information in the Notes to the financial statements (see Notes 21 and 22).

The Department's financial management environment is complex and diverse. Comparatively, the Department's assets exceed the combined assets of the top six Fortune 500 companies, while gross costs exceed only those of the top two. Current assets exceed current liabilities. Alternatively, long-term liabilities exceed long-term assets. However, 83% of the long-term liabilities are covered by existing assets or will be funded with resources outside of normal DoD appropriations.

Structurally, the Department consists of 33 reporting entities. The Department submits nine separate financial statements to OMB. These include the Department-wide financial statements, the Military Retirement Fund, the U.S. Army Corps of Engineers, and the general funds and working capital funds for the Army, Air Force, and Navy. Overall, the Department received a disclaimer of opinion from its auditors for FY 2007, and the auditors have determined information in the financial statements may not be reliable.

To date, four of the 33 reporting entities within the Department are projected to achieve unqualified audit opinions in FY 2007: the Defense Finance and Accounting Service, the Defense Contract Audit Agency, the Defense Commissary Agency, and the Office of the Inspector General. At the Department-wide level, the Department received favorable reviews for the fourth consecutive year on two financial statement line items in FY 2007:
(1) Federal Employees' Compensation Act Liabilities, and
(2) Appropriations Received.

Over the past year, the Department has refined the audit approach from one that focuses solely on line-items to one that focuses on "segments." This aligns end-to-end business processes with financial management initiatives that focus on improving the quality, accuracy, and reliability of the Department's financial information. The department has not yet undergone segmented audits. Refer to section 1-9 for additional details.

The Department's financial statements for FY 2007 are presented in their entirety in Section 2, Financial Information. A summary analysis of the statements is provided in the following section.

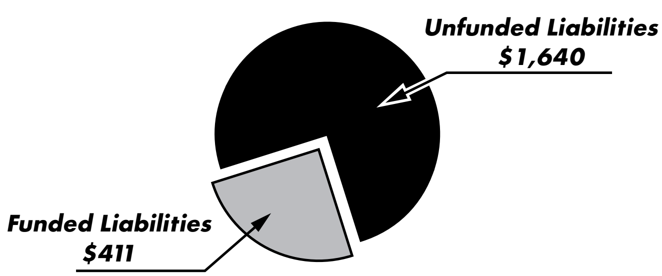
Financial Analysis

In general, the financial statements for the Department reflect short-term solvency. The Department's current assets exceed current liabilities by approximately $337.6 billion indicating DoD's ability to satisfy immediate requirements. However, long-term liabilities exceed long-term assets by approximately $882.0 billion as the future cost of military retirement, health, and other employee benefits significantly influence the long-term financial outlook.

The Department's unfunded liabilities consist primarily of military retirement, health, and other employee benefits, which comprise $1.5 trillion of DoD's total liabilities. Of this amount, $1.2 trillion of unfunded actuarial liabilities related to estimated future year costs for the Military Retirement Fund and the Medicare-eligible Retiree Health Care Fund are covered by appropriations that are not part of the Department's budget.

Unfunded vs. Funded Liabilities*

(amounts in billions)

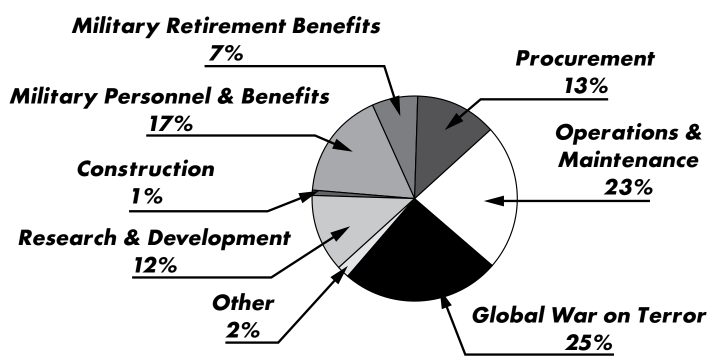


*The amounts reflect data as of September 30, 2007, subject to rounding differences.

With the exception of the "concurrent receipt" benefits granted to military retirees, the Department receives resources for all normal costs of retirement and Medicare-eligible Retiree Health care through regular appropriations. Approximately $317.3 billion in unfunded liabilities for retiree health programs remain to be funded from the Department's future appropriations. Once actuarial liabilities to be covered by annual appropriations outside the Department's budget are factored out, the Department's assets exceed its remaining liabilities by approximately $678.1 billion. This amount consists primarily of fixed assets and inventory, therefore, they are not necessarily available to cover liabilities. Additionally, significant portions of the Department's assets are earmarked for specific purposes.

During FY 2007, the Department received $658.6 billion in appropriations from the Congress and invested these resources in the key areas shown on the chart below. The Department, the Federal Government's single largest agency, receives more than half of the discretionary federal budget.

FY 2007 Resource Allocation*



*The percentages reflect data as of September 30, 2007, subject to rounding differences.

By making investments in Departmental assets such as people, infrastructure, operations and technologies, DoD continues to defend national interests. Through August 2007, the Department spent approximately $118.2 billion for the global war on terror. Over the past year, $5.6 billion was spent on infrastructure, $31.2 billion on military equipment, and $102.7 billion on military personnel costs. The complete picture of the Department's financial information shows several trends and insights into the financial health of the organization.

- Total assets of the Department have grown 10% over the past year, resulting from an increase in funds available, as well as investments for long-term assets and military equipment.
- Liabilities have increased nearly 4% primarily due to the long-term liability increases for military retirement benefits.
- Costs increased 5% over the past year mainly due to military retirement benefit costs.

Long-Term Liabilities Related to Military Retirement Benefits

The Military Retirement Fund was established in 1984 and certain costs were carried forward from pre-existing liabilities. A Board of Actuaries appointed by the President is responsible for approving actuarial assumptions for the fund and setting the payment schedule. Historically, interest costs have mounted because annual payments were less than total cost of interest. The Board has determined that a revised payment plan is necessary to pay the full cost of interest and the unfunded liability which will be reduced over time assuming no significant changes occur in benefits, assumptions, and actuarial experience.

Military Equipment

The actual change in military equipment for FY 2007 was $9.6 billion. Of that amount, $8.2 billion in training equipment was reclassified to General Property, Plant and Equipment in accordance with a DoD policy change refining the definition of military equipment. Effective FY 2007, the definition of military equipment specifically excludes training equipment. As a result, the net increase in military equipment was $1.4 billion.

Real Property

Ongoing efforts to accurately identify and report real property resulted in an increase of $4.9 billion to real property during FY 2007. In general, the DoD occupies more than 60% of the total property that federal agencies own or lease. Managing federal assets differs from the management of private sector assets. Primarily, the proceeds from the sale of fixed assets are not available for use by the agency, but are returned to the Department of the Treasury. In the private sector, those same proceeds are typically used to support or liquidate long-term debt.

Summary

In summary, the Department is improving financial decision-making processes and progressing toward better financial management. Great strides have been made toward improving the long-term financial condition. The short-term outlook is trending in a positive direction as the value of current assets exceeds that of current of liabilities. In addition, equity is trending in a positive direction after not factoring actuarial liabilities to be covered from non-DoD resources. While resources are limited and there are vast requirements that go unfunded each year, the Department's core missions are being satisfied by prioritizing and funding the most critical requirements. For its longer-term outlook, the Department has been assured of a continuing source of appropriated funds to cover a significant portion of long-term obligations, (primarily related to health care and retirement benefit costs).

Financial Improvement and Audit Readiness Plan

The Financial Improvement and Audit Readiness (FIAR) Plan is the Department's guide for comprehensively improving financial management and preparing for audit. As evidence that progress is being made, DoD is maintaining a green score for progress in Improving Financial Performance under the President's Management Agenda.

The September 2007 FIAR Plan is the fifth submission of the Plan to the Congress and OMB. The plan demonstrates an incremental approach that builds on the accomplishments of previous efforts, incorporates lessons learned, and adapts as necessary to sustain and advance progress already achieved. While the U.S. Army Corps of Engineers awaits the results of their first financial statement audit for FY 2006, they are simultaneously undergoing their FY 2007 audit. The Defense Logistics Agency's contingent legal liabilities have been examined and verified as audit ready by the Inspector General, and the Defense Information Systems Agency is ready to assert that its Balance Sheet is ready for audit. Additionally, several large business process segments are undergoing an independent examination to confirm audit readiness. They are:

- The Navy's nuclear and conventional ships environmental liability, and

- The Air Force's appropriations received, net transfers, and fund balance with Treasury.

The Department's overall goal is sustainable financial management improvement. DoD believes receiving an unqualified opinion on DoD's consolidated financial statements will demonstrate that the goal has been achieved. While the Department remains committed to making incremental improvements, many of the supporting details of that strategy have been refined. The Department's refined audit strategy:

- Limits audits to entire financial statements rather than audits on financial statement lines.
- Implements alternative methods of verifying incremental progress or audit readiness.
- Incorporates a model to sustain progress once audit readiness of a segment has been verified.
- Focuses on the business processes, or segments, that underlie the amounts reported on the financial statements rather than exclusively on balance sheet lines.

- Recognizes that financial statement auditability, and the correction of deficiencies for many business processes, must be tied to the implementation of Enterprise Resource Planning systems.

The refined audit readiness strategy transitions its approach from one that focuses solely on a line-item to one that focuses on segments. Segments are formed by either bringing together closely related areas of financial management or breaking apart areas into more manageable portions. Segments more closely align financial improvement initiatives to end-to-end business processes. The Navy has already transitioned to a segment approach, and the Defense Logistics Agency has made significant progress toward completing the transition.

To improve financial management and internal control, the FIAR Plan organizes and integrates the Department's previously independent activities and aligns them with business systems modernization. Integration of the FIAR Plan, the Enterprise Transition Plan (ETP), the Component Financial Improvement Plans (FIPs), the Enterprise Resource Planning deployment plans, and system modernization plans has set a comprehensive path for complying with requirements, improving financial visibility into business processes and information, and achieving audit readiness.

Enterprise Transition Plan

The Enterprise Transition Plan (ETP) serves as the Department's roadmap for business transformation and describes its strategy for achieving the Department's Enterprise and Component Priorities. One of the six Business Enterprise Priorities described in the ETP is financial visibility. The goal for financial visibility is more efficient and effective decision-making throughout the Department and assistance in achieving the Department-wide effort to achieve financial auditability. Financial visibility means having immediate access to accurate and reliable financial information (planning, programming, budgeting, accounting, and cost information) in support of financial accountability and efficient and effective decision-making throughout the Department in support of the warfighters and their missions. The Department has established a broad strategy to accomplish the goals of financial visibility. This strategy relies on concurrent efforts in four areas that involve:

- Defining and implementing the Standard Financial Information Structure (SFIS), a common language that provides standard definitions, lengths, values, and business rules that enable transparency and interoperability of financial information across the Department.

- Implementing financial systems that comply with federal financial management requirements. The Defense Agencies Initiative, for example, represents the Department's effort to extend its solution set for streamlining financial management capabilities, reducing material weaknesses, improving internal controls, and achieving financial statement auditability to 28 Defense Agencies and Field Activities. The objective is to achieve an auditable business environment with accurate, timely, and authoritative financial data.

- Implementing the Business Enterprise Information Service (BEIS) to aggregate financial information and provide Department-wide financial reporting. The BEIS provides services for financial reporting, cash reporting and reconciliation, general ledger, reference data, and enterprise business intelligence. The BEIS will yield timely, accurate, and reliable financial information and enable comparison of financial data across the Department. It works with other financial management initiatives such as the SFIS to provide information for more informed financial decision-making.

- Implementing audit-ready financial processes and practices (This effort includes activities tied to the FIAR Plan).

Limitations of the Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the Department of Defense, pursuant to the requirements of 31 U.S.C. 3515(b). The statements are prepared from accounting records of the Department in accordance with OMB Circular A-136 and, to the extent possible, generally accepted accounting principles. 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.

Performance Goals, Objectives, and Results

The OMB approved the Department's participation in the AFR pilot for FY 2007. As part of that pilot, the Department will include its Annual Performance Report in its FY 2009 Congressional Budget Justification (CBJ). The CBJ will be submitted to the Congress in February 2008. The links below take you to the Department's performance information, including plans and reports, and scores on the President's Management Agenda.

Where and When the Department's Performance Information Is Available

The Department of Defense Strategic Plan
http://www.defenselink.mil/qdr/report/Report20060203.pdf (Available now)

FY 2007/2008 Performance Budget/Plan
http://www.defenselink.mil/comptroller/defbudget/fy2008/fy2008_Performance_Budget.pdf
(Available now)

FY 2009 Secretary's Summary Justification (FY 2009 Performance Plan and FY 2007 Performance Report) http://www/defenselink.mil/comptroller/defbudget/FY2009 (Available February 2008)

The Department's Scores on the President's Management Agenda
http://www.whitehouse.gov/results/agenda/scorecard.html (Available now for the latest quarter)

The Department's performance budget recognizes that every level of the Department is accountable for measuring performance and delivering results at multiple tiers of the organization that support the Department's strategic objectives. The performance measures and targets, identified in the Department's FY 2007/2008 Performance Budget/Plan, are presented at the Department's enterprise level. However, some measures and targets will undergo reevaluation for FY 2009 to ensure that they are of a cross-cutting and strategic nature. Such efforts reflect the evolutionary nature of the performance budget and the Department's continuing efforts to ensure that performance assessment is linked to identifiable and measurable strategic outcomes.

The Department's FY 2007/2008 Performance Budget/Plan identifies a select number of performance targets for gauging success among a limited number of high priority strategic objectives. The FY 2007 framework includes five overarching general strategic goals, 17 strategic objectives, and 42 performance targets. In addition, the Department also will monitor five classified performance targets that are not identified in the document that is available on our public website. This plan constitutes the basis against which performance results for FY 2007 will be assessed in the Department's CBJ.

Analysis of Systems, Controls, and Legal Compliance

Annual Assurance Statement

Using assessments according to the OMB Circular A-123, Management's Responsibility for Internal Control as the basis, the Department prepared the FY 2007 Annual Statement of Assurance, presented on the next page. The Department asserts that all Components have reported to the Secretary of Defense their individual statements of assurance over internal controls. The tables referenced in the statement appear in Section 3: Other Accompanying Information.

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

November 15, 2007

The Department of Defense (DoD) leadership team is committed to accomplishing its mission within a culture of integrity, accountability, and forthright reporting. DoD's management accepts responsibility for establishing and maintaining effective internal management control and financial systems that meet the objectives and requirements of the Federal Managers' Financial Integrity Act (FMFIA).

The Department conducted its annual assessment according to the requirement of the Office of Management and Budget Circular A-123 (OMB A-123) entitled, Management's Responsibility for Internal Control. DoD can provide a qualified level of assurance that its control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations as of September 30, 2007, was operating effectively except for material weaknesses listed in Section 3 of this report at Table 2b, Summary of Management Assurances.

DoD conducted limited assessments of internal control effectiveness over financial reporting according to the OMB A-123, Appendix A, for the following:

- Fund Balance with Treasury
- Investments
- Accounts Receivable
- Inventory and Operating Materials and Supplies
- Real Property
- Military Equipment
- Accounts Payable
- Federal Employees' Compensation Act Liabilities
- Environmental Liabilities
- Medicare-Eligible Retiree Health Care Liabilities, and
- Appropriations Received

This limited assessment determined that, while measurable progress is being made, there are still pervasive material weaknesses in the Department's internal control systems. As such, DoD is unable to provide complete assurance that it conforms to the system requirements of FMFIA Section 4.

The Department recognizes these current problems with its financial reporting and systems and has initiated Department-wide corrective action plans. Descriptions of the outstanding FMFIA material weaknesses with summaries of corrective actions for financial reporting and systems are listed in Section 3 of this report at Tables 2a and 2c, Summary of Management Assurances.

Systems

The Federal Financial Management Improvement Act (FFMIA) of 1996 requires federal agencies to:

- Conform to the U.S. Government Standard General Ledger at the transaction level
- Comply with all applicable federal accounting standards
- Establish financial management systems that meet Government-wide standards requirements
- Support full disclosure of federal financial data, including the costs of federal programs and activities

The Department's Inspector General and the audit agencies within the Military Services have reported on the Department's noncompliance with the Act's requirements. Many of the Department's legacy systems do not comply with the wide range of requirements for systems compliance and, therefore, do not provide the necessary assurances to rely on information contained in either the legacy (source) system or those systems that were fed information from the legacy systems.

To resolve these challenges, the Department's FIAR Plan and the ETP, discussed previously, document our strategies for improving processes and ultimately achieving FFMIA compliance.

Improper Payments Information Act Reporting

The Improper Payments Information Act (IPIA) of 2002, as implemented by OMB, requires federal agencies to review all programs and activities annually and identify those that may be susceptible to significant erroneous payments. For FY 2007 IPIA reporting results, see Section 3: Other Accompanying Information.

Other Management Information, Initiatives, and Issues

Looking Forward: Challenges for 2008 and Beyond

The "Defense Strategy and Strategic Planning" section described in the 2006 Quadrennial Defense Review (QDR) incorporates the National Defense, National Military, and National Security Strategies. Past QDRs focused on the proper "size" of the force. The 2006 QDR shapes the Department's future with a 20-year outlook by linking strategy to defense resources and encompassing four areas that drive capabilities development and force planning:

- Defeating terrorist networks
- Defending the homeland in-depth
- Shaping the choices of countries at strategic crossroads
- Preventing hostile state or non-state actors from acquiring or using weapons of mass destruction

These interrelated areas illustrate the types of capabilities and forces needed to address the challenges described in the National Defense Strategy. They have helped the Department shift its portfolio of capabilities to address irregular, catastrophic, and disruptive challenges while sustaining capabilities to address traditional challenges.

Although these focus areas do not encompass the full range of military activities that the Department may have to conduct, senior leaders have identified them as among the most pressing issues. Improving capabilities and forces to meet these challenges also will increase the overall adaptability and versatility of our warfighters in responding to other threats and contingencies.

Based on their evaluation of the four QDR focus areas, the Department's senior leaders decided to refine the capstone force planning construct that translates the Department's strategy into guidance to shape and size military forces. This construct recognizes that the United States is a nation at war. The Department is using lessons learned from recent and ongoing operations in Iraq and Afghanistan and making adjustments to capture the realities of a long war by:

- Better defining the Department's responsibilities for homeland defense within a broader national framework.

- Giving greater emphasis to the war on terror and irregular warfare activities, including long-duration unconventional warfare, counterterrorism, counterinsurgency, and military support for stabilization and reconstruction efforts.

- Accounting for, and drawing a distinction between, steady-state force demands and surge activities over multi-year periods.

At the same time, this wartime construct requires the capability to conduct multiple, overlapping wars. In addition, it calls for the forces and capabilities needed for deterrence, reflecting a shift from "one-size-fits-all" deterrence toward more tailorable capabilities to deter advanced military powers, regional weapons of mass destruction states, or non-state terrorists.

The 2006 QDR provided new direction for accelerating the transformation of the Department to focus more on the needs of Combatant Commanders and to develop portfolios of joint capabilities rather than individual stove-piped programs. The essence of capabilities-based planning is to identify capabilities that adversaries could employ and capabilities that could be available to the United States. Once identified, the potential intersections are evaluated which helps prevent over-optimization of the joint forces for a limited set of threat scenarios.

This paradigm shift continues emphasis on the needs of the Combatant Commanders as the basis for programs and budgetary priorities. The goal is to improve the Department's ability to meet the needs of the President and the Combatant Commanders through the use of joint capability portfolios. Moving toward a more "demand-driven" approach should reduce unnecessary program redundancy, improve joint interoperability, and streamline acquisition and budgeting processes.

This environment also places new demands on the Department's Total Force concept. Although the all-volunteer force has been a key to successful U.S. military operations over the past several decades, its continued success is not preordained. The Total Force of Active and Reserve military, civilian, and contractor personnel must continue to develop the best mix of people equipped with the right skills needed by the Combatant Commanders. To this end, the QDR updates the Department's workforce management policies to guide investments in the force and improve the workforce's ability to adapt to new challenges.

The 2006 QDR was designed to serve as a means to spur the Department's continuing adaptation and reorientation to produce a truly integrated joint force that is more agile, more rapidly deployable, and more capable against a wider range of threats. Through continuous improvement, constant reassessment, and application of lessons learned, changes based on this review will continue to meet the increasingly dangerous security challenges of the 21st century.

Summary

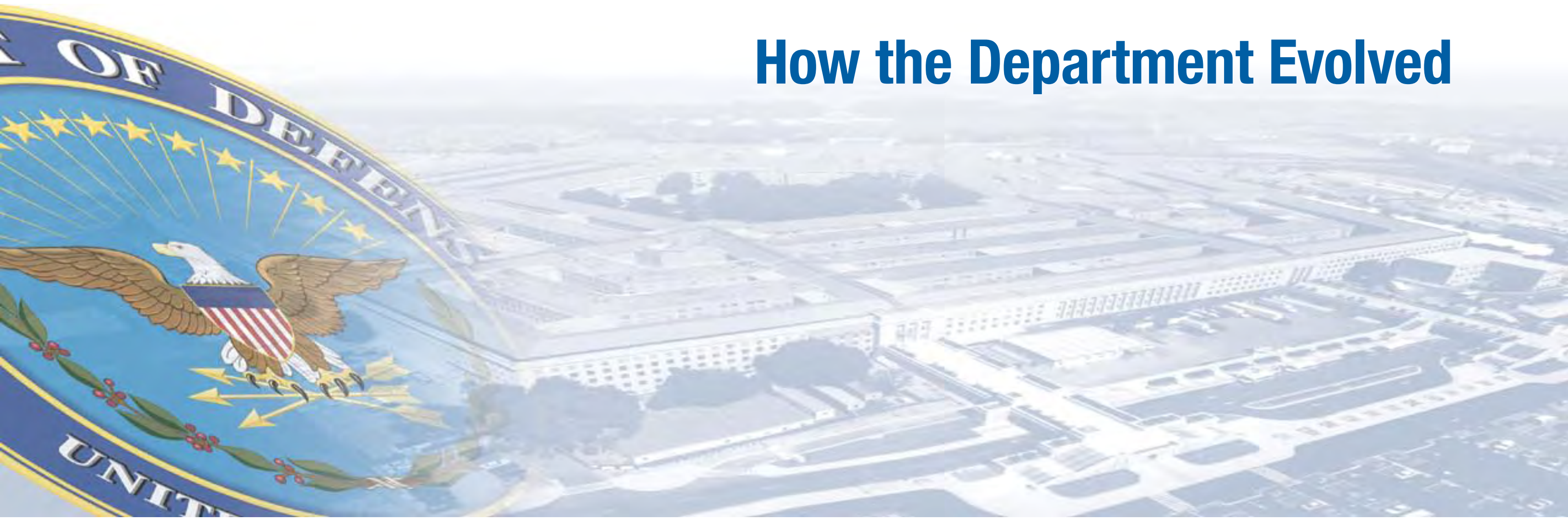
Without doubt, reshaping the defense enterprise is difficult. The structures and processes developed over the past half-century were forged in the Cold War and strengthened over time through our successes. However, the strategic landscape of the 21st century demands excellence across a much broader set of national security challenges.

Military means alone will not win the global war on terror or achieve other crucial national security objectives as discussed in the 2006 QDR. Instead, the application of diplomacy, at the national level and in concert with allies and international partners, is critical. In addition to coalition and partner-supported combat and preventive operations, interaction with civilian populations will be essential. To achieve the desired vision requires determination and perseverance within the Department and the Administration, and cooperation with the Congress.

Section 2

Financial Information

How the Department Evolved



1775 *The Army, Navy, and Marine Corps were established in concurrence with the American Revolution.*

1789 *The War Department was established and was the precursor to what is now the Department of Defense.*

1798 *The Department of the Navy, and the U.S. Coast Guard, were founded.*

1947 *Congress established a civilian, Cabinet-level Secretary of Defense. The Department of the Air Force was created, the War Department was converted to the Department of the Army, and the three military departments of the Army, Navy and Air Force were placed under the direct control of the first Secretary of Defense.*

1949 *The national defense structure was consolidated further, creating what we now know as the Department of Defense, and withdrawing cabinet-level status for the three Military Department Secretaries.*

Message from the Chief Financial Officer

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

November 15, 2007

We are pleased to present the fiscal year (FY) 2007 Agency Financial Report of the Department of Defense. The Department's leadership considers its financial stewardship responsibility to be an integral part of its mission to defend our Nation.

The Department's financial management professionals have worked hard to improve the quality, accuracy and reliability of our financial information. As of FY 2006, roughly one-third of the Department's $3.3 trillion in combined assets and liabilities have achieved an unqualified audit opinion. By following the roadmap we have laid out, the Department expects to increase its overall audit readiness to two-thirds by the end of FY 2009.

During FY 2007, efficiency gains in financial management operations allowed us to return savings to the warfighter of almost $100 million in projected overhead costs. We also reduced the amount of outstanding debt owed to the Department by $1.2 billion over the last two years through better monitoring and collection efforts.

Our monitoring of costs in the procurement contract area led to over $2.4 billion in savings. In addition, the Department investigated and collected over $225 million in fraudulently billed costs. These efforts have stretched the warfighter dollar and increased the Department's purchasing power.

We continue to improve our financial stewardship by strengthening internal controls. A recently concluded audit of the Department's civilian payroll system, which pays over 795,000 federal employees, found no weaknesses in the design of the system internal controls. This year, the Department's Management Internal Control Program, which identifies reports and corrects material internal control weaknesses, reduced the number of uncorrected weaknesses from 35 to 19.

We acknowledge that the journey before us is challenging, but supporting our warfighters and prudent stewardship of taxpayer resources demands nothing less. We are all deeply grateful to our soldiers, sailors, airmen and marines who defend our freedom each and every day. Those of us in the financial community are proud to do our part to support them.

Tina W. Jonas

Independent Auditor's Report

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

November 12, 2007

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

SUBJECT: Independent Auditor's Report on the Department of Defense FY 2007 Financial Statements (Report No. D-2008-023)

We are providing the subject report to be published in the DoD FY 2007 Agency Financial Report in conjunction with the DoD Agency-Wide FY 2007 Basic Statements provided to us in draft on November 1, 2007. The report includes our disclaimer of opinion on the basic financial statements, as well as our required report on internal control and compliance with laws and regulations. Because our disclaimer of opinion is being issued to accompany the DoD Agency-Wide FY 2007 Basic Financial Statements, this audit report should not be disseminated separately from those statements.

We appreciate the courtesies extended to the audit staff. Please contact Mr. Daniel R. Blair (703) 325-6120 or Mr. Charles O. Egu at (703) 325-5961 if you have any questions.

Paul J. Granetto, CPA
Assistant Inspector General and Director
Defense Financial Auditing
Service

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

November 12, 2007

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

SUBJECT: Independent Auditor's Report on the FY 2007 DoD Financial Statements (Report No. D-2008-023)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2007 and 2006, and the Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, and the Combined Statement of Budgetary Resources, and related notes for the FYs then ended.[1] The basic financial statements are the responsibility of DoD management. DoD is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to express an opinion on the DoD Agency-Wide FY 2007 Financial Statements because of limitations on the scope of our work. Thus, the basic financial statements may be unreliable. In addition to our disclaimer of opinion on the basic financial statements, we are including the required Report on Internal Control and Compliance with Laws and Regulations. The Report on Internal Control and Compliance with Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of our work.

Disclaimer of Opinion on the Financial Statements

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that the DoD Agency-Wide FY 2007 Financial Statements would not substantially conform to accounting principles generally accepted in the United States of America (GAAP), and that DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2007. Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to performing only those audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. Therefore, we did not perform auditing procedures required by U.S. Government auditing standards and Office of Management and Budget (OMB) Bulletin No. 07-04 to determine whether material amounts on the financial statements were fairly presented. Prior audits have identified, and DoD has also acknowledged, the long-standing material internal control weaknesses identified in the Summary of Internal Control. These pervasive material weaknesses may affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the basic financial statements.[2] Therefore, we are unable to express, and we do not express, an opinion on the basic financial statements. Further, the purpose of the audit was not to express an opinion on Management Discussion and Analysis, Required Supplementary Stewardship

[1] Beginning in FY 2007, OMB Circular A-136 requires entities to present the Statement of Financing as a note. It is no longer considered a basic statement. In addition, DoD no longer prepares a Statement of Custodial Activity. DoD asserted that its Custodial Collections are immaterial and incidental to the agency's primary mission.

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

Information, Required Supplementary Information, Other Accompanying Information, and Performance Measures accompanying the basic financial statements. Accordingly, we express no opinion on that information.

As discussed in Note 25 to the financial statements, DoD has restated the FY 2006 basic financial statements. DoD made the restatements in order to account for changes in the reporting requirements for Allocation Transfers and to correct errors in the computation of the Distributed Offsetting Receipts reported on the Statement of Budgetary Resources. These restatements are material to the DoD Agency-Wide financial statements. Further, there has been no change to the previously issued disclaimer of audit opinion on the FY 06 basic financial statements.

As discussed in Notes 1.H, 1.Z, and 25 to the basic financial statements, DoD reported the programs it administers on behalf of the Executive Office of the President, including the Foreign Military Sales Program, in its FY 2007 basic financial statements. Previously, DoD recorded these programs as "Other Accompanying Information." DoD made this change to comply with new requirements in OMB Circular A-136 pertaining to allocation transfers. Because the impact of this change in accounting principle is material and pervasive, DoD, in coordination with OMB and the Treasury, restated the FY 2006 comparative columns on the financial statements and accompanying notes, rather than accounting for it as a change in accounting principle, as required by OMB Circular A-136.

As discussed in Notes 1.Z and 21 to the financial statements, effective FY 2007 DoD no longer prepares a Statement of Financing, and has presented the information formerly included in this Statement in Note 21, "Reconciliation of Net Cost of Operations to Budget" in accordance with the requirements contained in the revised OMB Circular A-136.

As discussed in Note 1.Z to the financial statements, effective FY 2007 DoD no longer prepares a Statement of Custodial Activity. DoD previously used the Statement of Custodial Activity to record collections and disbursements for three custodial accounts, including Foreign Military Sales. Because the Foreign Military Sales activity is no longer reported in the Statement of Custodial Activity, and the remaining DoD custodial activity is immaterial and incidental to DoD's primary mission, DoD has elected to disclose the remaining activity in Note 22, "Incidental Custodial Collections."

Summary of Internal Control

In planning our work, we considered DoD internal controls over financial reporting and compliance with applicable laws and regulations. We did this to determine our procedures for auditing the financial statements and to comply with OMB guidance, but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance with applicable laws and regulations. In addition, the Under Secretary of Defense (Comptroller)/Chief Financial Officer has acknowledged that she can offer no assurance on internal control over financial reporting. Previously identified control weaknesses, all of which are material, continued to exist in the following areas:

- **Financial Management Systems**
- **Fund Balance with Treasury**
- **Inventory**

- **Operating Materials and Supplies**
- **General Property, Plant, and Equipment**
- **Government-Furnished Material and Contractor-Acquired Material**
- **Environmental Liabilities**
- **Intragovernmental Eliminations**
- **Other Accounting Entries**
- **Statement of Net Cost**
- **Reconciliation of Net Cost of Operations to Budget**[3]
- **Accounts Payable**

We identified the following additional material weakness in FY 2007:

- **Accounts Receivable**

A material weakness is a significant deficiency, or a combination of significant deficiencies, resulting in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.[4]

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 control deficiency, or a combination of control deficiencies, adversely affecting the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP.

Significant deficiencies result in more than a remote likelihood that a misstatement of an entity's financial statements that is more than inconsequential will not be prevented or detected. The following significant deficiency continued to exist:

- **Contingent Legal Liabilities**

We identified the following significant deficiency during FY 2007:

- **Cash and Other Monetary Assets**

[3] This material weakness originally was presented as the Statement of Financing. Because OMB Circular A-136 requires entities to present the Statement of Financing as a note to the financial statements and the condition that caused the material weakness continued to exist, we renamed the material weakness to reflect the title of the new note.

[4] The term "remote" is defined as "the chance of the future event or events occurring is slight." Therefore, the likelihood of an event is "more than remote" when it is at least reasonably possible.

Our internal control work (conducted as part of prior audits) would not necessarily disclose all significant deficiencies. The Attachment offers additional details on significant deficiencies, most of which we consider to be material internal control weaknesses.

Summary of Compliance with Laws and Regulations

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

Management's Responsibilities

Management is responsible for:

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

We provided a draft of this report to the Under Secretary of Defense (Comptroller)/Chief Financial Officer who then provided us technical comments, which we incorporated as appropriate. DoD officials expressed their continuing commitment to address the problems this report outlines.

Paul J. Granetto, CPA
Assistant Inspector General and Director
Defense Financial Auditing
Service

Attachment:
As stated

Report on Internal Control and Compliance with Laws and Regulations

Internal Control

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

Previously Identified Material Weaknesses

Management acknowledged that previously identified control weaknesses, all of which are material, continued to exist in the following areas:

Financial Management Systems. Statement of Federal Financial Accounting Concepts 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. Statement of Federal Financial Accounting Concepts 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 is adequately supported. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged that DoD financial management and feeder systems do not substantially comply with Federal financial management system requirements. DoD financial management and feeder systems were not designed to adequately support various material amounts on the financial statements. These systemic deficiencies in financial management and feeder systems, and inadequate DoD business processes, result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.

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

Inventory. Statement of Federal Financial Accounting Standards 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 is not reported in accordance with GAAP, and the Department's legacy systems do not maintain the historical cost data necessary to comply with Statement of Federal Financial Accounting Standards No. 3. Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by Statement of Federal Financial Accounting Standards No. 3.

Attachment

Operating Materials and Supplies. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," states that Operating Materials and Supplies must be expensed when the items are consumed. DoD has acknowledged that significant amounts of Operating Materials and Supplies were expensed when purchased instead of when consumed. In addition, DoD cannot accurately report the value of operating materials and supplies, which causes the potential for a misstatement in financial reporting. For example, the Navy did not accurately report Sponsor-Owned Material in its FY 2006 Financial Statements. More than $2.5 billion of Sponsor-Owned Material was improperly classified and reported as Operating Materials and Supplies, including $1.9 billion of special tooling and test equipment, $481.6 million of aviation support equipment held for Foreign Military Sales, and $113.7 million of general support equipment. Those items should have been reported in the Inventory or General Property, Plant, and Equipment accounts.

General Property, Plant, and Equipment. Statement of Federal Financial Accounting Standards No. 6, "Accounting for Property, Plant, and Equipment," requires DoD to record General Property, Plant, and Equipment at acquisition cost, capitalize improvement costs, and recognize depreciation expense. However, the cost and depreciation of the DoD General Property, Plant, and Equipment is not reliably reported because of: (1) an accounting requirement that classified military equipment as General Property, Plant, and Equipment (such costs were previously expensed); (2) a lack of supporting documentation for General Property, Plant, and Equipment items, which were purchased many years ago; and (3) a failure to integrate most legacy property and logistics systems with acquisition and financial systems. Also, DoD property and logistics systems were not designed to capture acquisition cost and the cost of modifications and upgrades, or to calculate depreciation. DoD has acknowledged that it does not currently meet GAAP for the financial reporting of personal property, and documentation for personal property is neither accurate nor reliable. In addition, DoD does not have adequate internal controls in place to provide reasonable assurance that real property assets are identified and properly reported in its financial reports. DoD has also acknowledged that its inability to accurately report the value of military equipment supports the probability that the financial statements are materially misstated.

Government-Furnished Material and Contractor-Acquired Material. Statement of Federal Financial Accounting Standards No. 11, "Amendments to Accounting for Property, Plant, and Equipment," requires that property and equipment in the possession of a contractor, for use in accomplishing a contract, be considered Government property. Such property should be accounted for based on the nature of the item, regardless of who has possession. DoD has acknowledged that it is unable to comply with these requirements for Government-Furnished Materials and Contractor-Acquired Materials. As a result, the value of DoD property and material in the possession of contractors is not reliably reported.

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

Intragovernmental Eliminations. DoD disclosed that it cannot accurately identify most of its intragovernmental transactions by customer because the Department's systems do not track buyer and seller data needed to match related transactions. In addition, the Department is unable to fully reconcile intragovernmental transactions with all Federal partners. DoD acknowledged that its inability to reconcile most intragovernmental transactions results in adjustments that cannot be fully supported. For example, Defense Finance and Accounting Service (DFAS), Indianapolis Operations made $35.5 billion in unsupported adjustments to intragovernmental accounts to force the accounts to agree with the records of Army's trading partners.

Other Accounting Entries. DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, DFAS, Indianapolis Operations recorded $258.2 billion in unsupported accounting entries to prepare the FY 2006 Army General Fund Financial Statements.

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

Reconciliation of Net Cost of Operations to Budget. Statement of Federal Financial Accounting Standards 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. During FY 2007, OMB rescinded the requirement to report this reconciliation as a Statement of Financing and now requires the disclosure of the information as a note to the financial statements. DoD acknowledged that it is unable to reconcile budgetary obligations to net costs without making unsupported adjustments. Specifically, budgetary data do not agree with proprietary expenses and capitalized assets. DoD made unsupported adjustments of $2 billion (absolute value) to reconcile obligations to the Statement of Net Cost. In addition, the Army General Fund is unable to accurately represent the relationship between budgetary obligations incurred and its Statement of Net Costs without preparing $22.9 billion in unsupported adjustments to the general ledger accounts to force costs to match obligation information.

Accounts Payable. According to Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," "… a liability is recognized 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 does 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. DoD identified Accounts Payable as a material weakness based on its FY 2007 assessment of internal control over financial reporting as required by OMB A-123 Appendix A. Additionally, our Independent

Auditor's reports on Internal Control for the FY 2007 Army General and Working Capital Funds, Navy General and Working Capital Funds, and the U.S. Army Corps of Engineers, Civil Works, identified Accounts Payable as a material weakness. These Components accounts payable balances comprised more than 54 percent of the DoD-Wide combined Accounts Payable balance as of September 30, 2007.

Material Weakness Identified During FY 2007. As a result of our financial-related audit work during FY 2007, we identified the following material internal control weakness:

Accounts Receivable. According to Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," a receivable should be recognized when a Federal entity establishes a claim to cash or other assets against other entities, either based on legal provisions, or goods and services provided. DoD acknowledged that it is unable to accurately record, report, collect, and reconcile intragovernmental accounts receivable as well as accounts receivable due from the public. DoD identified Accounts Receivable as a material weakness based on its FY 2007 assessment of internal control over financial reporting as required by OMB Circular No. A-123 Appendix A. Also, our independent auditor's reports on internal control for the FY 2007 Navy General and Working Capital Funds, Army General Fund, and the U.S. Army Corps of Engineers, Civil Works, showed accounts receivable to be a material weakness. These Components' accounts receivable balances comprised approximately 60 percent of the DoD-Wide combined accounts receivable balance as of September 30, 2007. For example,

- In the Army General Fund, there was a lack of controls to ensure that all entitlement system receivables (vendor pay, civilian pay, and interest) were recorded in the accounting systems and to ensure that accounts receivable balances were supported at the transaction level. As a result, DFAS, Indianapolis Operations made $1.1 billion in unsupported adjustments for FY 2007 that decreased the accounts receivable balances by $845.1 million.

- In the Navy General Fund, audit trails for accounts receivable were inadequate, and accounts receivable subledgers did not reconcile with the general ledger.

Previously Identified Significant Deficiency. As part of our financial-related audits, we noted the following significant deficiency, which continued to exist:

Contingent Legal Liabilities. Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," as amended by Statement of Federal Financial Accounting Standards No. 12, requires contingent legal liabilities to be disclosed if there is at least a reasonable possibility that a loss may be incurred. We noted that significant deficiencies continued to exist relating to the DoD process for reporting contingent legal liabilities. For example:

- DoD excluded from its legal representation letters at least 74 pending cases, with a total claim amount of $3.7 billion, that individually did not exceed the DoD Agency-Wide individual reporting threshold, but in aggregate exceeded this threshold.

- The legal representation letters from the DoD Office of General Counsel showed that DoD General Counsel was unable to express an opinion on the likely outcome of 55 of the 65 pending legal actions, totaling $1.57 trillion.

- The Army legal representation process did not provide meaningful assessments of potential liabilities and was not linked to the Army process for reporting and disclosing contingent legal liabilities on the financial statements. The legal representation letter from the Army Office of General Counsel and its attached management schedule did not corroborate either the $443.2 million reported on the Balance Sheet as part of Non-Federal Other Liabilities or the $446.8 million disclosed as contingent legal liabilities on Note 16 in the FY 2007 Army General Fund Financial Statements.

Significant Deficiency Identified During FY 2007. During FY 2007, we noted a significant deficiency related to Cash and Other Monetary Assets.

Cash and Other Monetary Assets. In the Army General Fund, internal and physical controls over Army Cash and Other Monetary Assets were inadequate, and cash in custody of agents reported on the Monthly Accountability Form (Standard Form 1219) was unreliable and unauditable. DFAS, Indianapolis Operations used its monthly Consolidated Statement of Accountability to make a $2.18 billion adjustment to the accounting records. Because Army and DFAS were not in compliance with reporting and control requirements mandated by OMB and DoD, there was no assurance that cash transactions were recorded, accumulated, and reported properly and that cash was adequately safeguarded. In addition, Army may have materially overstated the $2.18 billion of Cash and Other Monetary Assets reported on the Army General Fund Balance Sheet.

These financial management deficiencies may cause inaccurate management information and the DoD basic financial statements may also contain misstatements resulting from these deficiencies. As a result, DoD management and other users' decisions based in whole or in part on this information may be adversely affected.

Attachment

Compliance with Laws and Regulations

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

Federal Financial Management Improvement Act of 1996. The Federal Financial Management Improvement Act of 1996 requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management system requirements, applicable GAAP, and the U.S. Government Standard General Ledger at the transaction level. The Federal Financial Management Improvement Act also requires DoD to develop a remediation plan when its financial management systems do not comply with Federal financial management system requirements. The remediation plan is to include remedies, resources, and milestones. For FY 2007, DoD did not comply with the Federal Financial Management Improvement Act. DoD acknowledged that many of its financial management and feeder systems did not substantially comply with Federal financial management system requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2007.

Government Performance and Results Act. Congress enacted the Government Performance and Results Act of 1993 (GPRA) to establish strategic planning and performance measurement in the Federal Government. Strategic plans, annual performance plans, and annual program performance reports comprise the main elements of GPRA. DoD did not fully comply with the requirements of GPRA and subsequent implementation guidance in OMB Circular A-11, "Preparation, Submission, and Execution of the Budget." Specifically, DoD did not have a compliant strategic plan for FY 2007 because DoD designated the Quadrennial Defense Review report, (which was prepared to fulfill the specific legislative requirements for a Quadrennial Defense Review) as its strategic plan without considering other requirements specified in GPRA. As a result, DoD performance budget and performance report for FY 2007 did not comply with the requirements of GPRA and OMB Circular A-11.

Antideficiency Act. Section 1341, Title 31, United States Code limits DoD and its agents to make or authorize only expenditures or obligations that do not exceed the amount available in the appropriations or funds for the expenditures or obligations. Also, DoD, and 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. During FY 2007, DoD reported 17 cases where actual violations of the Antideficiency Act occurred.

Section 1341, Title 31, United States Code states that if an officer or employee of an executive agency violates the Antideficiency Act, the head of the agency must report immediately to the President and Congress all relevant facts and a statement of the actions taken. DoD internal guidance limits the time between identification and reporting violations of the Antideficiency Act to 12 months. Our review of DoD Antideficiency Act investigations of potential violations shows that DoD did not report Antideficiency Act violation cases within the 12-month time limit.

Prompt Payment Act. The Prompt Payment Act requires the payment date for an invoice to be the date payment is due under the contract or 30 days after a proper invoice is received (if a specific payment date is not established by the contract). The Prompt Payment Act also states that an agency must make payments no more than 7 days prior to the payment due date unless the agency head or designee has determined that earlier payment is necessary. The Act requires DoD to maintain an internal control environment in accordance with OMB Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004. In prior audit reports, we identified internal control weaknesses in the DFAS Columbus contractor payment system, "Mechanization of Contract Administration Service," that resulted in incorrect payments of interest to contractors. If controls governing compliance with the Prompt Payment Act are not corrected, DFAS Columbus could continue to pay a significant number of interest payments incorrectly and violate the provisions of the Prompt Payment Act.

Improper Payments Information Act. DoD does not fully comply with the requirements of the Improper Payments Information Act of 2002, Public Law 107-300, and subsequent OMB guidance. Specifically, DoD was still in the process of developing procedures to implement OMB's August 2006 guidance that requires additional documentation related to the identification of improper payments. The new OMB guidance requires that when an agency is unable to discern whether a payment was proper because of insufficient or lack of documentation, the payment must be considered an error. In addition, DoD efforts to manage recovery audit contracts have been largely unsuccessful. Further, in the FY 2006 Performance and Accountability Report, DoD overstated the amount identified through recovery audits by $64 million. The Department needs to disseminate guidance to improve contracting for recovery audits and adhere to that guidance in reporting recovered funds.

In November 2006, to facilitate DoD compliance with OMB guidance, the Office of the Under Secretary of Defense(Comptroller)/Chief Financial Officer established a DoD Project Officer for Improper Payments and Recovery Auditing. The Project Officer reviews DoD statistical methodologies and processes to verify that its reporting is accurate, complete, and meets or exceeds OMB requirements. In May 2007, DoD held its first Defense Improper Payment Act Conference to facilitate identification and reporting of improper payments in the Department.

Audit Disclosures

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us on September 17, 2007, that the DoD financial management and feeder systems cannot provide adequate evidence supporting various material amounts on the financial statements, and previously identified material weaknesses continue to exist. Therefore, we did not perform detailed testing related to previously identified material weaknesses. In addition, we did not perform audit work related to the following selected provisions of laws and regulations: Provisions Governing Claims of the United States Government (including provisions of the Debt Collection Improvement Act), Federal Credit Reform Act, and the Pay and Allowance System for Civilian Employees.

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

Attachment

Principal Financial Statements And Notes

The principal financial statements included in this report have been prepared in accordance with the requirements of the Chief Financial Officers Act of 1990, the Government Management Reform Act of 1994, and the Office of Management and Budget's Circular A-136, "Financial Reporting Requirements." The responsibility for the integrity of the financial information included in these statements rests with the management of DoD. The Department's fiscal years 2007 and 2006 principal financial statements were audited by the Office of Inspector General. The auditor's report accompanies the principal statements.

The Department's principal financial statements for fiscal years 2007 and 2006 consisted of the following:

The Balance Sheet

The Balance Sheet, which presents as of September 30, 2007 and 2006 those resources owned or managed by the Department which are available to provide future economic benefits (assets); amounts owed by the Department that will require payments from those resources or future resources (liabilities); and residual amounts retained by the Department, comprising the difference (net position).

The Statement of Net Cost

The Statement of Net Cost, which presents the net cost of the Department's operations for the years ended September 30, 2007 and 2006. The Department's net cost of operations includes the gross costs incurred by the Department less any exchange revenue earned from Department activities.

The Statement of Changes in Net Position

The Statement of Changes in Net Position, which presents the change in the Department's net position resulting from the net cost of the Department's operations, budgetary financing sources other than exchange revenues, and other financing sources for the years ended September 30, 2007 and 2006.

The Statement of Budgetary Resources

The Statement of Budgetary Resources, which presents the budgetary resources available to the Department during FY 2007 and 2006, the status of these resources at September 30, 2007 and 2006, and the outlay of budgetary resources for the years ended September 30, 2007 and 2006.

CONSOLIDATED BALANCE SHEET

Department of Defense

As of September 30, 2007 and 2006

($ in millions)

	2007	2006 Restated
Assets (Note 2)		
Intragovernmental		
Fund Balance with Treasury (Note 3)	$ 407,167.0	$ 329,045.1
Investments and Related Interest (Note 4)	333,711.0	299,261.2
Accounts Receivable, Net (Note 5)	1,412.9	2,941.8
Other Assets (Note 6)	1,212.5	1,189.6
Total Intragovernmental Assets	743,503.4	632,437.7
Cash and Other Monetary Assets (Note 7)	15,028.0	2,199.8
Accounts Receivable, Net (Note 5)	7,469.4	7,864.1
Loans Receivable (Note 8)	3,207.1	3,855.1
Inventory and Related Property, Net (Note 9)	224,948.7	231,823.2
General Property, Plant and Equipment, Net (Note 10)	474,530.5	465,439.5
Investments and Related Interest (Note 4)	1,412.3	1,089.8
Other Assets (Note 6)	36,246.1	27,928.7
Total Assets	**$ 1,506,345.5**	**$ 1,372,637.9**
Liabilities (Note 11)		
Intragovernmental		
Accounts Payable (Note 12)	$ 1,911.5	$ 1,549.8
Debt (Note 13)	3,242.3	3,697.8
Other Liabilities (Notes 15 and 16)	11,501.0	13,199.7
Total Intragovernmental Liabilities	16,654.8	18,447.3
Accounts Payable (Note 12)	29,674.0	27,388.4
Military Retirement and Other Federal Employment Benefits (Note 17)	1,874,679.5	1,815,769.5
Environmental and Disposal Liabilities (Note 14)	72,489.9	69,985.1
Loan Guarantee Liability (Note 8)	25.0	36.8
Other Liabilities (Notes 15 and 16)	57,203.7	31,566.1
Total Liabilities	**2,050,726.9**	**1,963,193.2**
Net Position		
Unexpended Appropriations - Earmarked Funds (Note 23)	8.1	11.4
Unexpended Appropriations - Other Funds	380,510.0	309,521.1
Cumulative Results of Operations - Earmarked Funds	(1,280,107.2)	(1,271,684.5)
Cumulative Results of Operations - Other Funds	355,207.7	371,596.7
Total Net Position	(544,381.4)	(590,555.3)
Total Liabilities and Net Position	**$ 1,506,345.5**	**$ 1,372,637.9**

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

CONSOLIDATED STATEMENT OF NET COST

Department of Defense

For the years ended September 30, 2007 and 2006

($ in millions)

	2007	2006 Restated
Program Costs		
Gross Costs	$ 668,138.4	$ 634,544.0
Less: Earned Revenue	(45,686.4)	(48,495.7)
Net Program Costs	$ 622,452.0	$ 586,048.3
Cost Not Assigned to Programs	-	-
Less: Earned Revenue Not Attributable to Programs	-	-
Net Cost of Operations	**$ 622,452.0**	**$ 586,048.3**

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

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

Department of Defense

As of September 30, 2007 and 2006

($ in millions)

	FY 2007		
	Earmarked Funds	**All Other Funds**	**Eliminations**
Cumulative Results of Operations			
Beginning Balances	$ (1,206,769.4)	$ 306,681.6	$ -
Prior Period Adjustments:			
Changes in Accounting Principles	-	(4,230.9)	-
Correction of Errors	-	-	-
Beginning Balances, as adjusted	(1,206,769.4)	302,450.7	-
Budgetary Financing Sources			
Appropriations used	3.3	585,691.3	-
Nonexchange revenue	3,076.9	16,665.2	-
Donations and forfeitures of cash and cash equivalents	63.8	-	-
Transfers in(out) without reimbursement	200.2	(78.4)	-
Other budgetary financing sources	-	-	-
Other Financing Sources (Non-Exchange)			
Donations and forfeitures of property	-	13.8	-
Transfers in(out) without reimbursement	243.3	(330.2)	-
Imputed financing from costs absorbed by others	-	14,813.4	10,392.1
Other	(21.8)	(8,077.5)	-
Total Financing Sources	3,565.7	608,697.6	10,392.1
Net Cost of Operations	8,617.5	624,226.6	10,392.1
Net Change	(5,051.8)	(15,529.0)	-
Cumulative Results of Operations	$ (1,211,821.2)	$ 286,921.7	$ -
Unexpended Appropriations			
Beginning Balances	$ 11.4	$ 309,521.1	$ -
Prior Period Adjustments:			
Changes in accounting principles	-	3,745.5	-
Corrections of errors	-	-	-
Beginning balances, as adjusted	11.4	313,266.6	-
Budgetary Financing Sources			
Appropriations received	-	658,617.9	-
Appropriations transferred in(out)	-	(197.4)	-
Other adjustments (rescissions, etc)	-	(5,485.8)	-
Appropriations used	(3.3)	(585,691.3)	-
Total Budgetary Financing Sources	(3.3)	67,243.4	-
Total Unexpended Appropriations	**8.1**	380,510.0	-
Net Position	**$ (1,211,813.1)**	**$ 667,431.7**	**$ -**

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

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

Department of Defense

As of September 30, 2007 and 2006

($ in millions)

	2007 Consolidated Total	2006 Consolidated Total Restated
Cumulative Results of Operations		
Beginning Balances	$ (900,087.8)	$ (870,674.3)
Prior Period Adjustments:		
Changes in Accounting Principles	(4,230.9)	-
Correction of Errors	-	(8,034.3)
Beginning Balances, as adjusted	(904,318.7)	(878,708.6)
Budgetary Financing Sources		
Appropriations used	585,694.6	552,838.4
Nonexchange revenue	19,742.1	3,057.1
Donations and forfeitures of cash and cash equivalents	63.8	25.4
Transfers in(out) without reimbursement	121.8	958.5
Other budgetary financing sources	-	0.6
Other Financing Sources (Non-Exchange)		
Donations and forfeitures of property	13.8	47.3
Transfers in(out) without reimbursement	(86.9)	(83.7)
Imputed financing from costs absorbed by others	4,421.3	4,409.6
Other	(8,099.3)	3,415.9
Total Financing Sources	601,871.2	564,669.1
Net Cost of Operations	622,452.0	586,048.3
Net Change	(20,580.8)	(21,379.2)
Cumulative Results of Operations	**$ (924,899.5)**	**$ (900,087.8)**
Unexpended Appropriations		
Beginning Balances	$ 309,532.5	$ 273,460.3
Prior Period Adjustments:		
Changes in accounting principles	3,745.5	-
Corrections of errors	-	(0.5)
Beginning balances, as adjusted	313,278.0	273,459.8
Budgetary Financing Sources		
Appropriations received	658,617.9	559,255.2
Appropriations transferred in(out)	(197.4)	(120.7)
Other adjustments (rescissions, etc)	(5,485.8)	(10,223.4)
Appropriations used	(585,694.6)	(552,838.4)
Total Budgetary Financing Sources	67,240.1	36,072.7
Total Unexpended Appropriations	**380,518.1**	**309,532.5**
Net Position	**$ (544,381.4)**	**$ (590,555.3)**

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

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2007 and 2006

($ in millions)

	2007	
	Budgetary Financing Accounts	**Non-Budgetary Credit Reform Financing Accounts**
Budgetary Resources		
Unobligated balance, brought forward, October 1	$ 85,793.1	$ 46.8
Recoveries of prior year unpaid obligations	44,879.2	-
Budget Authority:		
Appropriations received	762,641.4	13.1
Borrowing authority	-	381.8
Contract authority	116,690.2	-
Spending authority from offsetting collections:		
Earned:		
Collected	164,627.8	867.5
Receivable from federal sources	(1,277.6)	-
Change in unfilled customer orders:		
Advanced received	448.9	-
Without advance from federal sources	5,994.0	53.5
Subtotal	1,049,124.7	1,315.9
Nonexpenditure transfers, net, anticipated and actual	(118.4)	-
Temporarily not available pursuant to Public Law	(33,819.5)	-
Permanently not available	(90,598.2)	(791.1)
Total Budgetary Resources	**$ 1,055,260.9**	**$ 571.6**
Status of Budgetary Resources		
Obligations Incurred:		
Direct	$ 772,419.6	$ 512.4
Reimbursable	170,850.3	-
Subtotal	943,269.9	512.4
Unobligated balance:		
Apportioned	98,585.7	23.2
Exempt from apportionment	1,050.5	-
Subtotal	99,636.2	23.2
Unobligated balances not available	12,354.8	36.0
Total Status of Budgetary Resources	**$ 1,055,260.9**	**$ 571.6**

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

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2007 and 2006

($ in millions)

	2007	
	Budgetary Financing Accounts	**Non-Budgetary Credit Reform Financing Accounts**
Change in Obligated Balance		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	$ 349,774.5	$ 3,417.8
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(55,414.9)	(76.9)
Total unpaid obligated balance	294,359.6	3,340.9
Obligations incurred net	943,269.9	512.4
Less: Gross outlays	(814,588.1)	(421.8)
Obligated balance transferred, net:		
Actual transfers, unpaid obligations	-	-
Actual transfers, uncollected customer payments from federal sources	-	-
Total unpaid obligated balance transferred, net	-	-
Less: Recoveries of prior year unpaid obligations, actual	(44,879.2)	-
Change in uncollected customer payments from federal sources	(4,716.4)	(53.5)
Obligated balance, net, end of period:		
Unpaid obligations	433,577.1	3,508.4
Less: Uncollected customer payments from federal sources	(60,131.3)	(130.4)
Total, unpaid obligated balance, net, end of period	**$ 373,445.8**	**$ 3,378.0**
Net Outlays		
Net Outlays:		
Gross outlays	$ 814,588.1	$ 421.8
Less: Offsetting collections	(165,077.2)	(867.7)
Less: Distributed offsetting receipts	(64,105.0)	-
Net Outlays	**$ 585,405.9**	**$ (445.9)**

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

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2007 and 2006

($ in millions)

	2006	
	Budgetary Financing Accounts (Restated)	**Non-Budgetary Credit Reform Financing Accounts**
Budgetary Resources		
Unobligated balance, brought forward, October 1	$ 68,608.6	$ 83.0
Recoveries of prior year unpaid obligations	30,252.3	-
Budget Authority:		
Appropriations received	686,284.4	16.0
Borrowing authority	-	119.4
Contract authority	59,451.7	-
Spending authority from offsetting collections:		
Earned:		
Collected	164,718.1	1,169.6
Receivable from federal sources	649.0	-
Change in unfilled customer orders:		
Advanced received	313.9	-
Without advance from federal sources	179.1	(46.8)
Subtotal	911,596.2	1,258.2
Nonexpenditure transfers, net, anticipated and actual	(156.2)	-
Temporarily not available pursuant to Public Law	(35,746.3)	-
Permanently not available	(71,908.9)	(1,083.2)
Total Budgetary Resources	**$ 902,645.7**	**$ 258.0**
Status of Budgetary Resources		
Obligations Incurred:		
Direct	$ 651,019.8	$ 211.3
Reimbursable	165,521.3	-
Subtotal	816,541.1	211.3
Unobligated balance:		
Apportioned	74,623.8	1.2
Exempt from apportionment	1,220.4	-
Subtotal	75,844.2	1.2
Unobligated balances not available	10,260.4	45.5
Total Status of Budgetary Resources	**$ 902,645.7**	**$ 258.0**

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

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2007 and 2006

($ in millions)

	2006	
	Budgetary Financing Accounts (Restated)	**Non-Budgetary Credit Reform Financing Accounts**
Change in Obligated Balance		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	$ 302,427.0	$ 3,863.8
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(54,586.9)	(123.7)
Total unpaid obligated balance	247,840.1	3,740.1
Obligations incurred net	816,541.1	211.3
Less: Gross outlays	(768,310.0)	(657.3)
Obligated balance transferred, net:		
Actual transfers, unpaid obligations	-	-
Actual transfers, uncollected customer payments from federal sources	-	-
Total unpaid obligated balance transferred, net	-	-
Less: Recoveries of prior year unpaid obligations, actual	(30,252.3)	-
Change in uncollected customer payments from federal sources	(827.8)	46.8
Obligated balance, net, end of period:		
Unpaid obligations	320,405.8	3,417.8
Less: Uncollected customer payments from federal sources	(55,414.7)	(76.9)
Total, unpaid obligated balance, net, end of period	**$ 264,991.1**	**$ 3,340.9**
Net Outlays		
Net Outlays:		
Gross outlays	$ 768,310.0	$ 657.3
Less: Offsetting collections	(165,031.7)	(1,169.4)
Less: Distributed Offsetting receipts	(48,222.1)	-
Net Outlays	**$ 555,056.2**	**$ (512.1)**

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

Note 1. Significant Accounting Policies

1.A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations of the Department of Defense (DoD), as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the Department in accordance with the "DoD Financial Management Regulation," the Office of Management and Budget (OMB) Circular No. A-136, "Financial Reporting Requirements," and to the extent possible, generally accepted accounting principles (GAAP). Effective 4th Quarter, fiscal year (FY) 2006, the Department no longer publishes consolidating/combining financial statements. The accompanying financial statements account for all resources for which the Department is responsible unless otherwise noted. Information relative to classified assets, programs, and operations is excluded from the statements or otherwise aggregated and reported in such a manner that it is not discernable.

The Department is unable to fully implement all elements of GAAP and OMB Circular No. A-136 due to limitations of its financial and nonfinancial management processes and systems that support the financial statements. The Department derives its 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 GAAP. The Department continues to implement process and system improvements addressing these limitations.

Auditors are required to audit the financial statements of the following Department reporting activities: Army General Fund, Army Working Capital Fund, Navy General Fund, Navy Working Capital Fund, Air Force General Fund, Air Force Working Capital Fund, Military Retirement Fund, Medicare-Eligible Retiree Health Care Fund, and U.S. Army Corps of Engineers (Civil Works).

In addition, the Department requires the Marine Corps General and Working Capital Funds and the following Defense Agencies to prepare internal stand-alone auditable financial statements: Defense Logistics Agency, Defense Finance and Accounting Service, Defense Information Systems Agency, Defense Contract Audit Agency, Defense Commissary Agency, Defense Security Service, Defense Threat Reduction Agency, Defense Advanced Research Projects Agency, Chemical and Biological Defense Program, Missile Defense Agency, Services Medical Activity, TRICARE Management Activity, U.S. Special Operations Command, and Defense Security Cooperative Agency.

The Department currently has 13 auditor-identified material weaknesses: (1) Accounts Payable, (2) Accounting Entries, (3) Environmental Liabilities, (4) Government Property and Materiel in Possession of Contractors, (5) Intragovernmental Eliminations, (6) Operating Materiels and Supplies, (7) Reconciliation of Net Cost of Operations to Budget (formerly Statement of Financing), (8) Statement of Net Cost, (9) Financial Management Systems, (10) Fund Balance with Treasury, (11) General Property, Plant and Equipment, (12) Inventory, and (13) Accounts Receivable.

1.B. Mission of the Reporting Entity

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

1.C. Appropriations of Funds

The Department receives its 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 accounts.

Working capital funds (WCF) received funding to establish an initial corpus through an appropriation or a transfer of resources from existing appropriations or funds. The corpus finances operations and transactions that flow through the fund. The WCF resources the goods and services sold to customers on a reimbursable basis and maintains the corpus. Reimbursable receipts fund future operations and generally are available in their entirety for use without further congressional action. At various times, the 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. Certain trust and special funds may be designated as earmarked funds. Earmarked funds are financed by specifically identified revenues, required by statute to be used for designated activities, benefits or purposes, and remain available over time. The Department is required to separately account for and report on the receipt, use and retention of revenues and other financing sources for earmarked funds.

Special fund accounts are used to record government receipts reserved for a specific purpose.

Deposit funds are used to record amounts held temporarily until paid to the appropriate government or public entity. 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) or receiving (child) entity. Allocation transfers are an agency's legal delegation of its authority to obligate budget authority and outlay funds to another agency. Generally, all financial activity related to these 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 is a receiving (child) party to allocation transfers for the following agencies: Departments of Agriculture, Interior, Energy, and Transportation; the Appalachian Regional Commission; and the Federal Highway Administration.

Additionally, the Department is a party to other allocation transfers as the child for certain funds meeting the OMB exception and all related activity is thus included in the Department's financial statements. The exceptions reported by the Department include South Dakota Terrestrial Wildlife Habitat Restoration, Inland Waterways and Harbor Maintenance, and the EOP.

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

1.D. Basis of Accounting

For FY 2007, the Department's financial management systems are unable to meet all of the requirements for full accrual accounting. Many of the Department's financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of GAAP for federal agencies. These systems were not designed to collect and record financial information on the full accrual accounting basis as required by GAAP. Most of the Department's financial and nonfinancial legacy systems were designed to record information on a budgetary basis.

The Department has undertaken efforts to determine the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with GAAP. One such action is the current revision of its 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 updated to collect and report financial information as required by GAAP, the Department's financial data will be 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.

In addition, the Department identifies program costs based upon the major appropriation groups provided by the Congress. 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 working toward a cost reporting methodology that will satisfy the requirement for cost information as mandated in the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government."

1.E. Revenues and Other Financing Sources

The Department receives congressional appropriations as financing sources for general funds that expire annually, on a multiyear 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 A-25, "User Charges." The Department recognizes revenue when earned within the constraints of 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 other countries. Examples include countries where there is a mutual or reciprocal defense agreement, where U.S. troops are stationed, or where the U.S. Fleet is in a port.

1.F. Recognition of Expenses

For financial reporting purposes, the Department's policy requires the recognition of operating expenses in the period incurred. However, because the Department's 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, and environmental liabilities. In addition, expenditures for capital and other long-term assets are recognized as operating expenses. Expenses for operating materials and supplies are currently recognized when the items are purchased.

1.G. Accounting for Intragovernmental Transactions

Preparation of reliable financial statements requires the elimination of transactions occurring among entities within the Department or between two or more federal agencies. However, the Department cannot accurately eliminate 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 Department accounting offices. In most cases, the buyer-side records are adjusted to agree with the Department's seller-side balances. Intra-Department governmental balances are then eliminated. The volume of intragovernmental transactions is so large that after-the-fact reconciliations cannot be accomplished effectively. The Department is developing long-term system improvements to ensure accurate intragovernmental information, to include sufficient up-front edits and controls, eliminating the need for after-the-fact reconciliations.

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

The Department's proportionate share of public debt and related expenses of the Federal Government is not included. The Federal Government does not apportion debt and its related costs to federal agencies. The Department's financial statements, therefore, do not report any portion of the public debt or interest thereon, nor do the statements report the 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 U.S. Government. Payment in U.S. dollars is required in advance.

The Department additionally reports foreign military sales transactions on behalf of the Executive Office of the President.

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

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

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

1.J. Foreign Currency

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

The majority of cash and all foreign currency is classified as nonentity and is restricted. Amounts reported consist primarily of cash and foreign currency held by disbursing officers to carry out their paying, collecting, and foreign currency accommodation exchange missions. Cash seized during Operation Iraqi Freedom is restricted to assist the Iraqi people and support the restoration of Iraq.

The Department conducts a significant portion of its operations overseas. The Congress established a special account to handle the gains and losses from foreign currency transactions for five general fund appropriations: operation and maintenance, military personnel, military construction, family housing operation and maintenance, and 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

The Balance Sheet reports accounts receivable in three categories: accounts receivable, claims receivable, and refunds receivable from other federal entities or from the public. Allowances for uncollectible accounts due from the public are based upon an 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 at http://www.fms.treas.gov/tfm/vol1/07-03.pdf.

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, P.L. 104-106, Section 2801. The Act includes a series of authorities that allow the Department to work with the private sector to renovate military housing. The Department's goals are to obtain private capital to leverage government dollars, make efficient use of limited resources, and use a variety of private sector approaches to build and renovate military housing faster and at a lower cost to the American taxpayers.

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

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

The Department operates a loan guarantee program 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 EOP. This program is authorized by sections 23 and 24 of the Arms Export Control Act of 1976, as amended, P.L. 90-629, as amended, and section 503(a). This program provides loans to help countries purchase U.S.-produced weapons, defense equipment, services, or military training. The direct loans and loan guarantees related to Foreign Military Sales are included in the basic financial statements.

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

1.M. Inventories and Related Property

The Department values approximately 63% of its resale inventory using the moving average cost method. An additional 9% (fuel inventory) is reported using the first-in-first-out method. The Department reports the remaining 28% 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 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, P.L. 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. However, since the on-hand balances which were transitioned were not, for the most part, baselined to auditable historical cost, the reported values remain noncompliant with SFFAS No. 3 and GAAP.

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. Real property, installations, and utilities that are necessary to equip, operate, maintain, and support military activities without distinction as to application for administrative or combat purposes are excluded. Items commonly used in and available from the commercial sector are not managed in the Department's materiel management activities. Operational cycles are irregular and the military risks associated with stock-out positions have no commercial parallel. The Department holds materiel based on military need and support for contingencies. The Department does not attempt to account separately for "inventory held for sale" and "inventory held in reserve for future sale" based on SFFAS No. 3 definitions, unless otherwise noted.

Related property includes OM&S and stockpile materiels. 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, materiels and supplies are expensed when purchased. During FY 2007, the Department expensed significant amounts using the purchase method because the systems could not support the consumption method or management deemed that the item was in the hands of the end user. This is a material weakness for the Department and long-term system corrections are in process. Once the proper systems are in place, these items will be accounted for under the consumption method of accounting.

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

The Department recognizes condemned materiel as "excess, obsolete, and unserviceable." The cost of disposal is greater than the potential scrap value; therefore, the net value of condemned materiel is zero. Potentially redistributed materiel, classified in previous years as "excess, obsolete, and unserviceable," is included in the "held for use" or "held for repair" categories according to its condition.

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

1.N. Investments

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 investment using the effective interest rate method or another method obtaining similar results. The Department's intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

The Department invests in nonmarketable securities. The two types of nonmarketable securities are par value and market-based intragovernmental securities. The Bureau of the Public Debt issues nonmarketable par value intragovernmental securities. Nonmarketable, market-based intragovernmental securities emulate marketable securities, but are not publicly traded.

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

Other investments represent limited partnerships entered into on behalf of the U.S. Government in support of the MHPI authorized by P.L. 104-106, Section 2801. These investments do not require market value disclosure.

1.O. General Property, Plant and Equipment

The SFFAS No. 23, "Eliminating the Category National Defense Property, Plant, and Equipment," established GAAP for valuing and reporting military equipment (e.g., ships, aircraft, combat vehicles, weapons) in federal financial statements. The Standard provided for the use of estimated historical cost for valuing military equipment if obtaining actual historical cost information is not practical. The Department used the Bureau of Economic Analysis (BEA) estimation methodology to calculate the value of the military equipment for reporting periods from October 1, 2002, through March 31, 2006.

Effective 3rd Quarter, FY 2006, the Department replaced the BEA estimation methodology with one based on departmental internal records for military equipment. The Department identified the universe of military equipment by accumulating information relating to program funding and associated military equipment, equipment useful life, program acquisitions, and disposals to create a baseline. The military equipment baseline is updated using expenditure information and information related to acquisitions and disposals.

In FY 2006, the Department revised the real property capitalization threshold from $100 thousand to $20 thousand. The current $100 thousand capitalization threshold remains unchanged for the remaining General Property, Plant and Equipment (PP&E) categories. Not all Military Departments have implemented this revised policy due to system and process limitations. General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of two or more years and the acquisition cost equals or exceeds the Department's capitalization threshold. The Department also requires capitalization of improvement costs over the Department's capitalization threshold. The Department depreciates all General PP&E, other than land, on a straight-line basis.

Prior to FY 1996, General PP&E was capitalized if it had an acquisition cost of $15 thousand, $25 thousand, and $50 thousand for FYs 1993, 1994, and 1995 respectively, and an estimated useful life of two or more years. General PP&E previously capitalized at amounts below $100 thousand was written off General Fund financial statements in FY 1998. No adjustment was made for WCF assets that remain capitalized and reported on WCF financial statements.

The USACE Civil Works General PP&E is capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of two or more years and the acquisition cost exceeds $25 thousand. One exception is that all buildings and structures related to hydropower projects are capitalized regardless of cost. Prior to FY 2004, the USACE capitalized all buildings and structures regardless of cost. In FY 2003, the USACE increased the threshold (effective FY 2004) for buildings and structures to $25 thousand for all Civil Works appropriations with the exception of Revolving Fund and Power Marketing Agency assets and expensed all previously acquired assets that did not meet the new $25 thousand threshold.

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 exceeds the Department's capitalization threshold, federal accounting standards require that it be reported on the Department's Balance Sheet.

The Department is developing new policies and a contractor reporting process for Government furnished equipment that will provide appropriate General PP&E information for future financial statement reporting purposes. Accordingly, the Department reports only government property in the possession of contractors that is maintained in the Department's property systems. The Department has issued new property accountability and reporting requirements for Department entities to maintain, in their property systems, information on all property furnished to contractors. This action and other proposed actions are structured to capture and report the information necessary for compliance with federal accounting standards.

1.P. Advances and Prepayments

The Department's policy is to record advances and prepayments in accordance with GAAP. As such, payments made in advance of the receipt of goods and services are reported as assets on the Balance Sheet. The Department's policy is to expense or capitalize assets when the related goods and services are received. Not all Department entities have 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 and liability. The Department records the amounts as 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 risk of ownership. Payments for operating leases are charged to expense over the lease term as they become payable.

Office space and leases entered into by the Department are the largest component of operating leases. These costs were gathered from existing leases, General Services Administration (GSA) bills, and interservice support agreements. Future year projections use the consumer price index (CPI) rather than the Department's inflation factor.

1.R. Other Assets

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

The Department conducts business with commercial contractors under two primary types of contracts: fixed price and cost reimbursable. To alleviate the potential financial burden on the contractor that long-term contracts can cause, the Department may provide financing payments. Contract financing payments are defined in the Federal Acquisition Regulation, Part 32, as authorized disbursements of monies 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.

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 for real property and ships are reported as construction in progress. It is the Department's policy to record certain contract financing payments as other asset.

1.S. Contingencies and Other Liabilities

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

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. Examples of loss contingencies include the collectibility of receivables, pending or threatened litigation, and possible claims and assessments. 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 arise as a result of anticipated disposal costs for the Department's assets. This type of liability has two components: nonenvironmental and environmental. Consistent with SFFAS No. 6, "Accounting for Property, Plant and Equipment," recognition of an anticipated environmental disposal liability begins when the asset is placed into service. Based on the Department's policy, which is consistent with SFFAS No. 5 "Accounting for Liabilities of the Federal Government," nonenvironmental disposal liabilities are recognized for assets when management decides to dispose of an asset. The Department recognizes nonenvironmental disposal liabilities for military equipment nuclear-powered assets when placed into service. Such amounts are developed in conjunction with, and not easily identifiable from, environmental disposal costs.

1.T. Accrued Leave

The Department reports liabilities for military leave and accrued annual leave for DoD civilians. Sick leave for DoD civilians is expensed when taken. The liability reported at the end of the accounting period reflects the current pay rates.

1.U. Net Position

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

Unexpended appropriations represents amounts of 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 represents the net difference between expenses and losses, and financing sources (including appropriations, revenue, and gains), since inception. Beginning with FY 1998, cumulative results of operations also includes donations and transfers in and out of assets that were not reimbursed.

1.V. Treaties for Use of Foreign Bases

The Department has the use of land, buildings, and other overseas facilities that are obtained through various international treaties and agreements negotiated by the Department of State. The Department purchases capital assets overseas with appropriated funds; however, the host country retains title to the land and capital improvements. Generally, treaty terms allow the Department continued use of these properties until the treaties expire. In the event treaties or other agreements are terminated, whereby use of the foreign bases is prohibited, 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. Comparative Data

The Department's financial statements and notes are presented on a comparative basis.

1.X. Unexpended Obligations

The Department obligates funds to provide goods and services for outstanding orders not yet delivered. Unless title has passed, the financial statements do not reflect a liability for payment for goods and services not yet delivered. Unexpended obligations includes both obligations for which goods and services have been delivered (title passed) and a liability recognized, and obligations for which no delivery has occurred and no liability recognized. The balance of unexpended obligations appears immediately before net outlays in the Statement of Budgetary Resources, and is referred to as "Total, unpaid obligated balances, net, end of period."

1.Y. Undistributed Disbursements and Collection

Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to a specific obligation, payable, or receivable in the activity field records as opposed to those reported by the U.S. Treasury. These amounts should agree with the undistributed amounts reported on the departmental accounting reports. In-transit payments are those payments that have been made, but have not been recorded in the fund holder's accounting records. These payments are applied to the outstanding accounts payable balance. In-transit collections are those collections from other agencies or entities that have not been recorded in the accounting records. These collections are applied to the accounts receivable balance.

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 are recorded in accounts payable. Unsupported undistributed collections are recorded in other liabilities.

1.Z. Significant Events

In FY 2007 the Department made several modifications to its financial reports and notes that had significant and pervasive effects. These changes are summarized below:

In response to updated reporting requirements from OMB, the Department began reporting in its basic financial statements all activity for the programs it administers on behalf of the Executive Office of the President including the Foreign Military Sales Program (FMS). Previously, the Department reported these programs as "Other Accompanying Information" in its Performance and Accountability Report.

Prior to FY 2007, the Department had reported the current year changes only in undelivered orders, contract authority, collections, and disbursements for FMS. Based on changes to accounting and reporting methodologies, the Department now correctly reflects undelivered orders, contract authority, and Fund Balance with Treasury (FBWT) for FMS in its financial statements and notes with cumulative-from-inception balances.

In addition, the Department no longer reports FMS undelivered orders and FBWT in the Statement of Custodial Activity (SCA). The Department's remaining custodial activity is immaterial and incidental to its primary mission. Therefore, the Department is no longer producing a SCA. Note 22 has been renamed and revised to report "Incidental Custodial Collections."

In accordance with updated reporting requirements in OMB Circular A-136, the Department eliminated the Statement of Financing and began presenting the information formerly contained in the Statement in Note 21 "Reconciliation of Net Cost of Operations to Budget."

Note 2. Nonentity Assets

As of September 30	2007	2006 Restated
(amounts in millions)		
Intragovernmental Assets		
Fund Balance with Treasury	$ 9,926.3	$ 2,896.6
Accounts Receivable	0.9	11.6
Total Intragovernmental Assets	9,927.2	2,908.2
Nonfederal Assets		
Cash and Other Monetary Assets	14,879.6	2,085.2
Accounts Receivable	5,162.9	5,486.7
Other Assets	9,386.9	196.8
Total Nonfederal Assets	29,429.4	7,768.7
Total Nonentity Assets	39,356.6	10,676.9
Total Entity Assets	1,466,988.9	1,361,961.0
Total Assets	$ 1,506,345.5	$ 1,372,637.9

Nonentity assets are assets for which the Department maintains stewardship accountability and responsibility to report, but are not available for the Department's operations.

Nonentity Fund Balance with Treasury is comprised of deposit funds, seized Iraqi cash, the Development Fund for Iraq (DFI), and advances from foreign governments for Foreign Military Sales Trust Funds (FMSTF) for the purchase of defense articles and services. Deposit funds are generally used to record amounts held temporarily until paid to the appropriate party. Seized Iraqi cash is former Iraqi regime monies confiscated by coalition forces and restricted for support of the Iraqi people. The DFI consists of proceeds from Iraqi oil sales, repatriated assets from the United States and other nations, and deposits from unencumbered oil-for-food proceeds. The DFI funds are restricted for Iraqi infrastructure and other Iraqi support needs.

Intragovernmental Accounts Receivable consists of amounts due from cancelled appropriations.

Nonfederal Cash and Other Monetary Assets consists of cash received from foreign governments deposited in the Federal Reserve Bank, U.S. commercial banks and foreign banks; and cash held by Disbursing Officers to carry out payment, collection, and foreign currency accommodation exchange missions.

Nonfederal Accounts Receivable consists of amounts due for cancelled year appropriations; and interest, fines and penalties due on debt. The Department generally cannot use the collections and must distribute them to the U.S. Treasury. The Department has specific statutory authority to retain collections from certain cancelled year accounts receivable as entity assets.

Nonfederal Other Assets primarily consists of advances paid to contractors for undelivered defense articles and services owed to foreign governments.

The Department is reporting nonentity balances of Fund Balance with Treasury of $8.5 billion, Cash and Other Monetary Assets of $12.4 billion, and Other Assets of $9.2 billion on behalf of the Executive Office of the President. The Department holds these amounts as stewards on the behalf of others and are therefore, not available for use by the Department.

Note 3. Fund Balance with Treasury

As of September 30	2007	2006 Restated
(amounts in millions)		
Fund Balances		
Appropriated Funds	$ 383,074.3	$ 313,962.4
Revolving Funds	11,021.1	9,619.6
Trust Funds	9,703.5	2,212.2
Special Funds	396.5	328.1
Other Fund Types	2,971.6	2,922.8
Total Fund Balances	407,167.0	329,045.1
Fund Balances Per Treasury Versus Agency		
Fund Balance per Treasury	399,862.9	329,921.4
Fund Balance per Agency	407,167.0	329,045.1
Reconciling Amount	$ (7,304.1)	$ 876.3

Fund Balance with Treasury includes immaterial nonentity balances the Department holds on behalf of others, and entity balances which represent funds with Treasury for which the Department is authorized to make expenditures and pay liabilities. It reflects the balance of all fund types held by the Department.

Other Fund Types primarily consists of deposit funds, receipt accounts, clearing accounts, seized Iraqi cash, Development Fund for Iraq, and Foreign Military Sales Trust Funds (FMSTF) advance deposits.

The Department shows a reconciling net difference of ($7.3) billion with the U.S. Treasury. This includes ($11.9) billion differences due to the U.S. Treasury treatment of allocation transfers, offset by $3.2 billion in cancelled appropriations and $1.4 billion in unavailable receipt accounts.

The balance in Fund Balance with Treasury includes $11.9 billion ($3.4 billion entity and $8.5 billion nonentity) that the Department is executing on behalf of the Executive Office of the President. The Department holds these amounts as stewards on the behalf of others and are therefore, not available for use by the Department.

Status of Fund Balance with Treasury		
As of September 30	2007	2006 Restated
(amounts in millions)		
Unobligated Balance		
Available	$ 99,188.4	$ 75,403.0
Unavailable	338,343.1	302,061.5
Obligated Balance not yet Disbursed	437,085.6	323,823.5
Nonbudgetary FBWT	4,755.7	7,640.4
NonFBWT Budgetary Accounts	(472,205.8)	(379,883.3)
Total	$ 407,167.0	$ 329,045.1

The Status of Fund Balance with Treasury is the reconciliation between budgetary and proprietary accounts at Treasury. It consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current or future obligations.

Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. The unavailable balance consists primarily of funds invested in U.S. Treasury securities that are temporarily precluded from obligation by law.

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

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

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

Certain unobligated balances are restricted for future use and are not apportioned for current use. Unobligated balances for trust fund accounts are restricted for use by the Public Law that established the funds.

Disclosures Related to Suspense/Budget Clearing Accounts				
As of September 30	2005	2006	2007	(Decrease)/ Increase FY 2006-2007
(amounts in millions)				
Account				
F3845 – Personal Property Proceeds	$ 0.9	$ 0.7	$ 0.8	$ 0.1
F3875 – Budget Clearing Account Suspense	263.5	903.9	20.0	(883.9)
F3880 – Lost or Cancelled Treasury Checks	11.9	26.4	5.8	(20.6)
F3882 – Uniformed Services Thrift Savings Plan Suspense	83.5	108.5	115.8	7.3
F3885 – Interfund/IPAC Suspense	(211.6)	(114.9)	(100.2)	14.7
F3886 – Thrift Savings Plan Suspense	(4.9)	(6.4)	(10.1)	(3.7)
Total	$ 143.3	$ 918.2	$ 32.1	$ (886.1)

Abnormal Balances

The ($10.1) million balance for F3886 suspense account reflects the timing differences due to the additional processing time for negative adjustments, lost earnings, forfeitures, and loan repayments.

Other Disclosures

The F3845 suspense account represents the balance of proceeds from the sale of personal property.

The F3875 and F3885 suspense accounts temporarily hold collections or disbursements until identified and applied to a valid appropriation.

The F3880 suspense account represents the balance of U.S. Treasury checks that: (1) have either been lost by the payee and need to be reissued, (2) have never been cashed by the payee, or (3) have been cancelled by the U.S. Treasury and need to be transferred to the original appropriation.

The F3882 and F3886 suspense accounts represent the difference between retirement funds withheld from members of the uniformed services and civilians employed by the Department and amounts transferred to the Federal Retirement Thrift Investment Board, who administers the Thrift Savings Plan.

Disclosures Related to Problem Disbursements and In-Transit Disbursements				
As of September 30	2005	2006 Restated	2007	(Decrease)/ Increase from FY 2006 – 2007
(amounts in millions)				
Total Problem Disbursements, Absolute Value				
Unmatched Disbursements (UMDs)	$ 2,225.3	$ 1,353.4	$ 1,414.1	$ 60.7
Negative Unliquidated Obligations (NULO)	95.5	78.6	107.9	29.3
In-Transit Disbursements	6,869.4	6,994.3	7,534.3	540.0
Total	$ 9,190.2	$ 8,426.3	$ 9,056.3	$ 630.0

The Department reports Problem Disbursements as an absolute value, which is the sum of the debit and credit transactions without regard to the sign.

An Unmatched Disbursement occurs when a payment does not match an obligation in the accounting system.

A Negative Unliquidated Obligation occurs when a payment matches, but exceeds a valid obligation in the accounting system.

In-Transit Disbursements represents disbursements and collections made by a disbursing activity on behalf of an accountable activity and not posted to the accounting system.

The amounts reported in FY 2005 and FY 2006 were changed to correct balances and to change reporting methodology from net to absolute for In-Transit Disbursements.

Note 4. Investments and Related Interest

As of September 30	2007				
(amounts in millions)	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities					
Nonmarketable, Market- Based					
Military Retirement Fund	$ 222,030.5	See Below	$ (6,666.2)	$ 215,364.3	$ 212,242.6
Medicare Eligible Retiree Health Care Fund	110,206.3	See Below	(1,762.9)	108,443.4	106,692.8
US Army Corps of Engineers	4,058.5	See Below	(44.1)	4,014.4	4,043.1
Other Funds	2,039.0	See Below	(11.5)	2,027.5	2,040.2
Total Nonmarketable, Market-Based	338,334.3		(8,484.7)	329,849.6	325,018.7
Accrued Interest	3,861.4			3,861.4	3,861.4
Total Intragovernmental Securities	342,195.7		(8,484.7)	333,711.0	328,880.1
Other Investments					
Total Other Investments	$ 1,412.3		$ 0.0	$ 1,412.3	$ N/A

As of September 30	2006				
(amounts in millions)	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities					
Nonmarketable, Market-Based					
Military Retirement Fund	$ 213,248.6	See Below	$ (7,889.9)	$ 205,358.7	$ 202,876.7
Medicare Eligible Retiree Health Care Fund	85,730.6	See Below	(1,123.3)	84,607.3	82,962.7
US Army Corps of Engineers	3,632.9	See Below	(81.3)	3,551.6	3,519.5
Other Funds	1,911.1	See Below	(11.1)	1,900.0	1,900.6
Total Nonmarketable, Market-Based	304,523.2		(9,105.6)	295,417.6	291,259.5
Accrued Interest	3,843.6			3,843.6	3,843.6
Total Intragovernmental Securities	308,366.8		(9,105.6)	299,261.2	295,103.1
Other Investments					
Total Other Investments	$ 1,089.8		$ 0.0	$ 1,089.8	$ N/A

Amortization Method Used: Effective Interest

The market value of the non-marketable securities held by the Department fluctuates in tandem with the current selling price of the equivalent marketable security on the open bond market. It is the intent of the Department to hold the investments to maturity to prevent losses on the securities.

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

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

Other Funds are primarily comprised of DoD Education Benefits Fund and Voluntary Separation Incentive investments.

Note 5. Accounts Receivable

As of September 30	2007			2006 Restated
(amounts in millions)	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
Intragovernmental Receivables	$ 1,412.9	$ N/A	$ 1,412.9	$ 2,941.8
Nonfederal Receivables (From the Public)	7,702.1	(232.7)	7,469.4	7,864.1
Total Accounts Receivable	$ 9,115.0	$ (232.7)	$ 8,882.3	$ 10,805.9

Aged Accounts Receivable				
As of September 30	2007		2006	
	Intragovernmental	Nonfederal	Intragovernmental	Nonfederal
(amounts in millions)				
Category				
Nondelinquent				
Current	$ 8,299.6	$ 1,771.0	$ 7,735.6	$ 1,840.8
Noncurrent	233.9	1,607.4	232.1	1,740.9
Delinquent				
1 to 30 days	132.3	167.4	321.1	159.9
31 to 60 days	50.0	136.7	345.7	53.4
61 to 90 days	54.3	98.0	57.2	117.8
91 to 180 days	68.1	184.5	716.5	130.0
181 days to 1 year	49.8	201.9	908.7	207.2
Greater than 1 year and less than or equal to 2 years	65.4	205.4	44.4	192.2
Greater than 2 years and less than or equal to 6 years	25.1	169.2	55.0	896.2
Greater than 6 years and less than or equal to 10 years	0.7	588.9	1.2	676.0
Greater than 10 years	0.0	2,714.4	0.0	2,640.5
Subtotal	8,979.2	7,844.8	10,417.5	8,654.9
Less Supported Undistributed Collections	(76.8)	(162.1)	(492.7)	(478.9)
Less Eliminations	(7,166.8)	0.0	(6,986.3)	0.0
Less Other	(322.7)	19.4	(11.1)	38.5
Total	$ 1,412.9	$ 7,702.1	$ 2,927.4	$ 8,214.5

The prior year Intragovernmental accounts receivable on the aging schedule does not agree with the accounts receivable reported on the Balance Sheet. The FY 2006 aging schedule does not include $14.4 million for the Foreign Military Account Program.

Nondelinquent noncurrent accounts receivable consists of nonfederal receivables of $1.6 billion on repayment schedules primarily for long term water storage contracts with state and local municipalities. The balance represents intragovernmental accounts receivable collected but not posted to accounting systems.

The Intragovernmental Other consists of pending customer returns.

The Nonfederal Other reflects reconciling differences between the general and subsidiary ledgers.

The Department generates debt letters and pursues all debts over 30 days delinquent. For debts over 180 days delinquent, the Department utilizes various offset programs and collection agencies to pursue collections. In certain instances, the status of litigation affects the Department's ability to pursue collection actions.

Note 6. Other Assets

As of September 30	2007	2006
(amounts in millions)		
Intragovernmental Other Assets		
Advances and Prepayments	$ 1,087.6	$ 1,064.7
Other Assets	124.9	124.9
Total Intragovernmental Other Assets	1,212.5	1,189.6
Nonfederal Other Assets		
Outstanding Contract Financing Payments	25,030.3	25,630.4
Advances and Prepayments From Foreign Governments	8,015.3	0.0
Advances and Prepayments From the Public	1,549.6	1,176.2
Other Assets (With the Public)	1,650.9	1,122.1
Total Nonfederal Other Assets	36,246.1	27,928.7
Total Other Assets	$ 37,458.6	$ 29,118.3

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

Advances and Prepayments From Foreign Governments is comprised of advances paid to contractors for undelivered defense articles and services owed to foreign governments under the Foreign Military Sales Program.

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

Outstanding Contract Financing Payments balance of $25.0 billion is comprised of $23.4 billion in contract financing payments and an additional $1.7 billion in estimated future payments to the contractor upon delivery and Government acceptance of a satisfactory product. (See additional discussion in Note 15, Other Liabilities.)

Nonfederal Other Assets consists primarily of undelivered assets.

The balance in Other Assets includes $9.4 billion that the Department is executing on behalf of the Executive Office of the President. The Department holds these amounts as stewards on the behalf of others and the assets are therefore, not available for use by the Department.

Note 7. Cash and Other Monetary Assets

As of September 30	2007		2006	
(amounts in millions)				
Cash	$	13,907.0	$	1,389.0
Foreign Currency		1,121.0		810.8
Total Cash, Foreign Currency, & Other Monetary Assets	$	15,028.0	$	2,199.8

The Department began reporting the accrued assets, liabilities, and expenses of the Foreign Military Sales Trust Fund during FY 2007, resulting in the recognition of an additional $12.4 billion in cash. Nonentity assets of $15.0 billion, consisting of $13.7 billion in cash and $1.1 billion in foreign currency which are restricted and unavailable for use in the Department's mission.

The balance in Cash includes $12.4 billion that the Department is executing on behalf of the Executive Office of the President. The Department holds these amounts as stewards on the behalf of others and are therefore, not available for use by the Department.

Note 8. Direct Loan and/or Loan Guarantee Programs

Direct Loan and/or Loan Guarantee Programs

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

- Foreign Military Account Program (FMA)
- Military Housing Privatization Initiative (MHPI)
- Armament Retooling and Manufacturing Support Initiative (ARMS)

The Federal Credit Reform Act of 1990 governs all amended direct loan obligations and loan guarantee commitments made after FY 1991 and the resulting direct loans or loan guarantees. The OMB Circular A-11, section 185, "Federal Credit" and OMB Circular A-129 provide additional guidance for direct loan and loan guarantee programs.

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

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

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

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

Foreign Military Account Program

The FMA is a military assistance program that includes both direct loan and loan guarantee programs. The Department is authorized by the U.S. Congress to execute the authorities of the Foreign Assistance Act of 1961, as amended, section 503(a) and the Arms Export Control Act of 1976, as amended, section 23. The Defense Security Cooperation Agency, under the auspices of the Executive Office of the President (EOP), administers the FMA program. The FMA program is comprised of: (1) the pre 1992 Foreign Military Loan Liquidating Account, (2) the post 1991 Foreign Military Financing Account, and (3) the post 1991 Military Debt Reduction Financing Account.

Military Housing Privatization Initiative

The MHPI includes both direct loan and loan guarantee programs. The loan guarantee program is authorized by the National Defense Authorization Act for FY 1996, Public Law 104-106, Statute 186, Section 2801, and includes a series of authorities that allow the Department to work with the private sector to renovate and build military family housing. The MHPI accelerates the construction of new housing, builds to market standards, and leverages private sector capital with government dollars. The Department provides protection to the private sector partner against specific risks, such as base closure or member deployment.

Armament Retooling and Manufacturing Support Initiative

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

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

Summary of Direct Loans and Loan Guarantees		
As of September 30	2007	2006 Restated
(amounts in millions)		
Loans Receivable		
Direct Loans		
Foreign Military Loan Liquidating Account	$ 2,683.2	$ 2,865.6
Military Housing Privatization Initiative	212.1	191.7
Foreign Military Financing Account	92.7	573.5
Military Debt Reduction Financing Account	219.0	224.3
Total Direct Loans	3,207.0	3,855.1
Defaulted Loan Guarantees		
Armament Retooling & Manufacturing Support Initiative	0.1	0.0
Total Default Loan Guarantees	0.1	0.0
Total Loans Receivable	3,207.1	3,855.1
Loan Guarantee Liability		
Military Housing Privatization Initiative	24.7	23.8
Armament Retooling & Manufacturing Support Initiative	0.3	13.0
Total Loan Guarantee Liability	$ 25.0	$ 36.8

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

Direct Loans Obligated		
As of September 30	2007	2006 Restated
(amounts in millions)		
Direct Loans Obligated Prior to FY 1992		
(Allowance for Loss Method):		
Foreign Military Loan Liquidating Account		
Loans Receivable Gross	$ 1,364.2	$ 1,629.3
Interest Receivable	1,319.0	1,236.3
Value of Assets Related to Direct Loans, Net	2,683.2	2,865.6
Direct Loans Obligated After FY 1991		
(Present Value Method):		
Military Housing Privatization Initiative		
Loans Receivable Gross	308.0	296.3
Allowance for Subsidy Cost (Present Value)	(95.9)	(104.6)
Value of Assets Related to Direct Loans	212.1	191.7
Foreign Military Financing Account		
Loans Receivable Gross	0.0	214.4
Interest Receivable	0.0	3.1
Allowance for Subsidy Cost (Present Value)	92.7	356.0
Value of Assets Related to Direct Loans	92.7	573.5
Military Debt Reduction Financing Account		
Loans Receivable Gross	512.1	511.3
Interest Receivable	25.3	14.1
Allowance for Subsidy Cost (Present Value)	(318.4)	(301.1)
Value of Assets Related to Direct Loans	219.0	224.3
Total Direct Loans Receivable	$ 3,207.0	$ 3,855.1

Abnormal Balances

The abnormal balance in the Allowance for Subsidy Cost for the Foreign Military Financing Account reflects loans prepaid in FY 2006 and FY 2007. The allowance for subsidy cost was adjusted to reflect the balance due to the U.S. Treasury.

Total Amount of Direct Loans Disbursed		
As of September 30	2007	2006 Restated
(amounts in millions)		
Direct Loan Programs		
Military Housing Privatization Initiative	$ 11.9	$ 155.0
Foreign Military Financing Account	299.0	274.9
Total	$ 310.9	$ 429.9

Subsidy Expense for Post FY 1991 Direct Loan					
As of September 30					
(amounts in millions)					
2007	Interest Differential	Defaults	Fees	Other	Total
New Direct Loans Disbursed:					
Military Housing Privatization Initiative	$ 2.1	$ 1.3	$ 0.0	$ 0.0	$ 3.4
2006	Interest Differential	Defaults	Fees	Other	Total
New Direct Loans Disbursed:					
Military Housing Privatization Initiative	$ 27.9	$ 20.7	$ 0.0	$ 0.0	$ 48.6
2007	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Direct Loan Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ (7.3)	$ (8.2)	$ (15.5)	$ (15.5)
Foreign Military Financing Account	0.0	62.6	0.0	62.6	62.6
Total	$ 0.0	$ 55.3	$ (8.2)	$ 47.1	$ 47.1
2006 Restated	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Direct Loan Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ (0.3)	$ (7.8)	$ (8.1)	$ (8.1)
Foreign Military Financing Account	0.0	0.0	(17.7)	(17.7)	(17.7)
Total	$ 0.0	$ (0.3)	$ (25.5)	$ (25.8)	$ (25.8)

	2007	2006 Restated
Total Direct Loan Subsidy Expense:		
Military Housing Privatization Initiative	$ (12.1)	$ 40.5
Foreign Military Financing Account	62.6	(17.7)
Total	$ 50.5	$ 22.8

Subsidy Rate for Direct Loans by Program					
As of September 30	Interest Differential	Defaults	Fees and Other Collections	Other	Total
Budget Subsidy for Direct Loans:					
Military Housing Privatization Initiative	16.07%	10.31%	0.00%	0.00%	26.38%

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

Schedule for Reconciling Subsidy Cost Allowance Balances for Post 1991 Direct Loans		
As of September 30	2007	2006 Restated
(amounts in millions)		
Beginning Balance of the Subsidy Cost Allowance	$ 49.7	$ 63.1
Add: Subsidy Expense for Direct Loans Disbursed during the Reporting Years by Component		
Interest Rate Differential Costs	2.1	27.9
Default Costs (Net of Recoveries)	1.3	20.7
Total of the above Subsidy Expense Components	3.4	48.6
Adjustments		
Loans Written Off	(5.0)	(24.2)
Subsidy Allowance Amortization	219.4	(12.0)
Other	7.0	0.0
Total of the above Adjustment Components	221.4	(36.2)
Ending Balance of the Subsidy Cost Allowance before Reestimates	274.5	75.5
Add or Subtract Reestimates by Component		
Interest Rate Reestimate	55.3	(0.3)
Technical/Default Reestimate	(8.2)	(25.5)
Total of the above Reestimate Components	47.1	(25.8)
Ending Balance of the Subsidy Cost Allowance	$ 321.6	$ 49.7

Three Foreign Military Financing Account loans were prepaid in FY 2006 and FY 2007. The allowance for subsidy cost was adjusted to reflect the balance due to the U.S. Treasury.

Defaulted Guaranteed Loans		
As of September 30	2007	2006
(amounts in millions)		
Defaulted Guaranteed Loans from Post-FY 1991 Guarantees		
(Present Value Method):		
Armament Retooling & Manufacturing Support Initiative		
Defaulted Guaranteed Loans Receivable, Gross	$ 14.4	$ 0.0
Allowance for Subsidy Cost (Present Value)	(14.3)	0.0
Total Value of Assets Related to Defaulted Guaranteed Loans Receivable	$ 0.1	$ 0.0

The value of assets related to defaulted guaranteed loans totaling $0.1 million represents the net recovery from a defaulted loan.

Guaranteed Loans Outstanding		
As of September 30	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
(amounts in millions)		
Guaranteed Loans Outstanding		
Military Housing Privatization Initiative	$ 499.1	$ 499.1
Armament Retooling & Manufacturing Support Initiative	4.1	3.5
Total	503.2	502.6
2007 New Guaranteed Loans Disbursed	0.0	0.0
2006 New Guaranteed Loans Disbursed		
Armament Retooling & Manufacturing Support Initiative	2.7	2.3
Total	$ 2.7	$ 2.3

In FY 2006, an incremental disbursement of $2.7 million was made on a loan guaranteed previous to the 2004 moratorium on new ARMS Initiative loans.

Liabilities for Post FY 1991 Loan Guarantees, Present Value		
As of September 30	2007	2006
(amounts in millions)		
Military Housing Privatization Initiative	$ 24.7	$ 23.8
Armament Retooling & Manufacturing Support Initiative	0.3	13.0
Total Loan Guarantee Liability	$ 25.0	$ 36.8

Pre-1992 loan guarantee liabilities are to be calculated based on the allowance method. Currently no allowances are reported.

Subsidy Expense for Loan Guarantees by Program					
As of September 30					
(amounts in millions)					
	Interest Differential	Defaults	Fees	Other	Total
2007 New Loan Guarantees Disbursed:					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	0.0	0.0	0.0
2006 New Loan Guarantees Disbursed:					
Military Housing Privatization Initiative	0.0	0.0	0.0	0.0	0.0
Armament Retooling & Manufacturing Support Initiative	0.0	0.0	0.0	0.0	0.0
	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
2007 Modifications and Reestimates:					
Military Housing Privatization Initiative	0.0	0.0	(0.2)	(0.2)	(0.2)
Armament Retooling & Manufacturing Support Initiative	0.0	2.1	(1.1)	1.0	1.0
Total	$ 0.0	$ 2.1	$ (1.3)	$ 0.8	$ 0.8

	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
2006 Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ (6.4)	$ (6.4)	$ (6.4)
Armament Retooling & Manufacturing Support Initiative	0.0	0.2	11.6	11.8	11.8
Total	$ 0.0	$ 0.2	$ 5.2	$ 5.4	$ 5.4

	2007	2006
Total Loan Guarantee:		
Military Housing Privatization Initiative	$ (0.2)	$ (6.4)
Armament Retooling & Manufacturing Support Initiative	1.0	11.8
Total	$ 0.8	$ 5.4

Subsidy Rates for Loan Guarantees

There are no subsidy rates to report because the Department did not have any new loan guarantees in FY 2007.

Schedule for Reconciling Loan Guarantee Liability Balances for Post FY 1991 Loan Guarantees		
As of September 30	2007	2006
(amounts in millions)		
Beginning Balance of the Loan Guarantee Liability	$ 36.8	$ 41.1
Add: Subsidy Expense for Guaranteed Loans Disbursed during the Reporting Years	0.0	0.0
Adjustments		
Foreclosed Property and Loans Acquired	2.3	0.0
Claim Payments to Lenders	(15.3)	(11.4)
Interest Accumulation on the Liability Balance	0.6	1.7
Other	(0.2)	0.0
Total of the above Adjustments	(12.6)	(9.7)
Ending Balance of the Loan Guarantee Liability before Reestimates	24.2	31.4
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimate	2.1	0.2
Technical/default Reestimate	(1.3)	5.2
Total of the above Reestimate Components	0.8	5.4
Ending Balance of the Loan Guarantee Liability	$ 25.0	$ 36.8

Administrative Expenses

Administrative Expenses are limited to separately identified expenses for administrating direct loans and loan guarantee programs. The Department does not maintain a separate program to capture the expenses related to direct loans and loan guarantees for MHPI and the FMA. Administrative expenses for ARMS represent a fee paid to U.S. Department of Agriculture, Rural Business Cooperative.

Note 9. Inventory and Related Property

As of September 30	2007	2006
(amounts in millions)		
Inventory, Net	$ 84,191.0	$ 83,861.1
Operating Materials & Supplies, Net	139,871.2	146,883.3
Stockpile Materials, Net	886.5	1,078.8
Total	$ 224,948.7	$ 231,823.2

Inventory, Net					
As of September 30	2007			2006	
(amounts in millions)	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	Inventory, Net	Valuation Method
Inventory Categories					
Available and Purchased for Resale	$ 86,546.5	$ (25,465.8)	$ 61,080.7	$ 56,674.9	LAC,MAC
Held for Repair	31,477.7	(9,003.8)	22,473.9	26,349.0	LAC,MAC
Excess, Obsolete, and Unserviceable	7,324.0	(7,324.0)	0.0	0.0	NRV
Raw Materials	100.1	0.0	100.1	43.1	LAC,SP,MAC
Work in Process	536.3	0.0	536.3	794.1	AC
Total	$ 125,984.6	$ (41,793.6)	$ 84,191.0	$ 83,861.1	

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

Restrictions

Generally, there are no restrictions on the use, sale, or disposition of inventory. However, some restrictions currently do exist, and they include the following:

- War reserve materiel valued at $2.1 billion;
- Commissary items valued at $341.9 million for purchase by authorized patrons;
- Dispositions pending litigation or negotiation valued at $1.5 million; or
- Identified safety stocks restricted from sale outside the federal government.

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

General Composition of Inventory

Inventory includes spare and repair parts, clothing and textiles, and fuels held for sale by the Defense Working Capital Funds. Inventory is tangible personal property that is:

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

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

Operating Materials and Supplies, Net					
As of September 30	2007			2006	
(amounts in millions)	OM&S Gross Value	Revaluation Allowance	OM&S, Net	OM&S, Net	Valuation Method
OM&S Categories					
Held for Use	$ 123,958.8	$ (0.8)	$ 123,958.0	$ 130,617.2	SP, LAC,MAC
Held for Repair	17,021.7	(1,108.5)	15,913.2	16,266.1	SP, LAC,MAC
Excess, Obsolete, and Unserviceable	2,387.3	(2,387.3)	0	0	NRV
Total	$ 143,367.8	$ (3,496.6)	$ 139,871.2	$ 146,883.3	

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

Restrictions

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

General Composition of Operating Materials and Supplies

The OM&S includes spare and repair parts, ammunition, tactical missiles, aircraft configuration pods, and centrally managed aircraft engines held for consumption.

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

Stockpile Materials, Net					
As of September 30	2007			2006	
(amounts in millions)	Stockpile Materials Amount	Allowance for Gains (Losses)	Stockpile Materials, Net	Stockpile Materials, Net	Valuation Method
Stockpile Materials Categories					
Held for Sale	$ 857.2	$ 0.0	$ 857.2	$ 984.7	AC, LCM
Held in Reserve for Future Sale	29.3	0.0	29.3	94.1	AC, LCM
Total	$ 886.5	$ 0.0	$ 886.5	$ 1,078.8	

Legend for Valuation Methods:
AC = Actual Cost
LCM = Lower of Cost or Market

Restrictions

Stockpile materiels held by the National Defense Stockpile (NDS) are restricted until relieved by congressional action and made available for sale on the open market. Stockpile materiels 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) as authorized by law.

In 1994, the NDS voluntarily suspended mercury sales. The suspension was in response to concerns raised by the U.S. Environmental Protection Agency regarding the accumulation of mercury in the global environment.

The Requirements Report to Congress proposes additional restrictions on the use of beryllium metal, mica block, and quartz.

General Composition of Stockpile Materiels

The Department holds strategic and critical stockpile materiels due to statutory requirements for use in national defense, conservation, or national emergencies.

Before any materiels are sold, Congress must enact specific enabling legislation (e.g., the National Defense Authorization Act). When authorized to offer materiels for sale, NDS removes the materiels from Materiel Held in Reserve and reclassifies them as Materiels Held for Sale. The estimated market price of the stockpile materiels held for sale is $1.2 billion.

Note 10. General PP&E, Net

As of September 30	2007					2006
(amounts in millions)	Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value	Prior FY Net Book Value
Land	N/A	N/A	$ 10,509.6	$ N/A	$ 10,509.6	$ 10,533.4
Buildings, Structure, and Facilities	S/L	20 or 40	173,311.1	(101,467.1)	71,844.0	69,455.2
Leasehold Improvements	S/L	Lease term	569.2	(340.8)	228.4	167.2
Software	S/L	2-5 or 10	9,313.8	(5,801.5)	3,512.3	3,391.0
General Equipment	S/L	5 or 10	71,015.8	(48,921.5)	22,094.3	16,718.1
Military Equipment	S/L	Various	657,100.3	(310,779.1)	346,321.2	344,945.0
Assets Under Capital Lease[1]	S/L	lease term	982.7	(501.4)	481.3	149.7
Construction-in-Progress	N/A	N/A	19,480.5	N/A	19,480.5	20,019.5
Other			60.3	(1.4)	58.9	60.4
Total General PP&E			$ 942,343.3	$ (467,812.8)	$ 474,530.5	$ 465,439.5
[1]Note 15 for additional information on Capital Leases						
Legend for Valuation Methods: S/L = Straight Line N/A = Not Applicable						

Military Equipment

In accordance with the Statement of Federal Financial Accounting Standards (SFFAS) No. 23, "Eliminating the Category National Defense Property, Plant, and Equipment," beginning in FY 2003, the Department capitalized military equipment into General Property, Plant, and Equipment (PP&E) at estimated historical cost using information obtained from the Bureau of Economic Analysis (BEA). During FY 2006, the Department replaced the BEA estimates with one based on departmental internal records for military equipment.

Heritage Assets and Stewardship Land

The Federal Accounting Standards Advisory Board, SFFAS No. 29, “Heritage Assets and Stewardship Land,” requires note disclosures for these types of assets. The Department’s policy is to preserve and account for its heritage assets’ historical, cultural, educational, or artistic importance. Additionally, the Department possesses and maintains land not acquired in connection with General PP&E, land donated to the Federal Government, and land previously recorded as public domain.

Heritage Assets within the Department consist of buildings and structures, archeological sites, museums, and monuments and memorials. Stewardship Land consists mainly of mission essential (donated, public domain, executive order) land. The Department, with minor exceptions, uses most of the buildings and structures as part of its everyday activities and includes them on the Balance Sheet as multi-use heritage assets (capitalized and depreciated).

Other Disclosures

The Department has the use of land, buildings, and other overseas facilities that are obtained through international treaties and agreements negotiated by the Department of State. The Department is restricted by treaty covenants regarding the use and disposal of real property (land and buildings) located outside the continental United States.

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

Other primarily consists of assets awaiting disposal and the projected value of forest product sales.

Assets Under Capital Lease		
As of September 30	2007	2006
(amounts in millions)		
Entity as Lessee, Assets Under Capital Lease		
Land and Buildings	$ 719.5	$ 619.6
Equipment	263.2	8.2
Accumulated Amortization	(501.4)	(478.1)
Total Capital Leases	$ 481.3	$ 149.7

Note 11. Liabilities Not Covered by Budgetary Resources

As of September 30	2007	2006 Restated
(amounts in millions)		
Intragovernmental Liabilities		
Accounts Payable	$ 3.3	$ 1.0
Debt	1,850.0	1,842.3
Other	6,986.1	7,780.8
Total Intragovernmental Liabilities	8,839.4	9,624.1
Nonfederal Liabilities		
Accounts Payable	461.8	371.9
Military Retirement and Other Federal Employment Benefits	1,547,796.2	1,524,140.2
Environmental Liabilities	68,718.8	65,343.7
Other Liabilities	13,904.4	14,664.4
Total Nonfederal Liabilities	1,630,881.2	1,604,520.2
Total Liabilities Not Covered by Budgetary Resources	1,639,720.6	1,614,144.3
Total Liabilities Covered by Budgetary Resources	411,006.3	349,048.9
Total Liabilities	$ 2,050,726.9	$ 1,963,193.2

Liabilities Not Covered by Budgetary Resources represents liabilities for which congressional action is generally needed to provide resources. The Department expects to receive the necessary budgetary resources to cover these liabilities in future budget years.

Intragovernmental Accounts Payable and Nonfederal Accounts Payable represent liabilities in cancelled appropriations that, if paid, will be disbursed using funds current in the year of disbursement.

Debt consists primarily of borrowing from the U.S. Treasury for loans made to foreign governments.

Intragovernmental Liabilities Other is comprised of custodial liabilities for non-entity assets. The amounts collected cannot be used by the Department and must be returned to the U.S. Treasury. Intragovernmental Liabilities Other also includes unfunded Federal Employees Compensation Act liabilities that were not due during FY 2007.

Military Retirement and Other Federal Employment Benefits is comprised of employee actuarial liabilities not due and payable during the current fiscal year. These liabilities are primarily comprised of $813.5 billion in pension liabilities and $726.3 billion in health benefit liabilities. (Refer to Note 17, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.)

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

Note 12. Accounts Payable

As of September 30	2007			2006 Restated
(amounts in millions)	Accounts Payable	Interest, Penalties, and Administrative Fees	Total	Total
Intragovernmental Payables	$ 1,911.5	$ N/A	$ 1,911.5	$ 1,549.8
Nonfederal Payables (to the Public)	29,671.7	2.3	29,674.0	27,388.4
Total	$ 31,583.2	$ 2.3	$ 31,585.5	$ 28,938.2

Accounts payable are amounts owed to federal and nonfederal entities for goods and services received by the Department that have not been paid. The Department's systems do not track intragovernmental transactions by customer at the transaction level. Therefore, buyer-side balances are adjusted to agree with seller-side balances for revenue, accounts receivable, and unearned revenue. Accounts payable were adjusted by reclassifying amounts between federal and nonfederal accounts payable.

Note 13. Debt

As of September 30	2007			2006 Restated	
(amounts in millions)	Beginning Balance	Net Borrowing	Ending Balance	Net Borrowing	Ending Balance
Agency Debt (Intragovernmental)					
Debt to the Treasury	$ 659.0	$ (170.5)	$ 488.5	$ 123.3	$ 659.0
Debt to the Federal Financing Bank	3,038.8	(285.0)	2,753.8	(208.3)	3,038.8
Total Agency Debt	3,697.8	(455.5)	3,242.3	(85.0)	3,697.8
Total Debt	$ 3,697.8	$ (455.5)	$ 3,242.3	$ (85.0)	$ 3,697.8

The Department's debt consists of interest and principal payments due to the U.S. Treasury and the Federal Financing Bank. The Department borrows funds for the Foreign Military Financing Program, the Washington Aqueduct Project, the U.S. Navy Afloat Prepositioning Force Program, the Military Housing Privatization Initiative, and the Armanment Retooling and Manufacturing Support.

The majority of the debt represents direct and guaranteed loans to foreign governments. Before 1992, funds were borrowed from the Federal Financing Bank to either directly loan the funds to foreign governments or to reimburse defaulted guaranteed loans. Beginning in 1992, the Department began borrowing funds for the Foreign Military Account Program from the U.S. Treasury, in accordance with the Federal Credit Reform Act of 1990, which governs all direct loan obligations and loan guarantee commitments made after FY 1991.

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

Note 14. Environmental and Disposal Liabilities

As of September 30	2007			2006
(amounts in millions)	Current Liability	Noncurrent Liability	Total	Total
Environmental Liabilities—Nonfederal				
Accrued Environmental Restoration Liabilities				
Active Installations—Installation Restoration Program (IRP) and Building Demolition and Debris Removal (BD/DR)	$ 1,179.5	$ 7,958.3	$ 9,137.8	$ 9,084.8
Active Installations—Military Munitions Response Program (MMRP)	130.2	5,274.5	5,404.7	5,396.5
Formerly Used Defense Sites—IRP and BD/DR	151.5	3,662.5	3,814.0	4,169.5
Formerly Used Defense Sites–MMRP	89.2	14,607.6	14,696.8	14,797.3
Other Accrued Environmental Liabilities—Active Installations				
Environmental Corrective Action	50.3	868.1	918.4	727.4
Environmental Closure Requirements	7.1	1,017.7	1,024.8	409.4
Environmental Response at Operational Ranges	35.1	174.5	209.6	305.0
Other	149.2	593.7	742.9	781.4
Base Realignment and Closure (BRAC)				
Installation Restoration Program	673.0	3,279.2	3,952.2	2,882.5
Military Munitions Response Program	35.6	993.1	1,028.7	913.2
Environmental Corrective Action / Closure Requirements	38.0	125.3	163.3	181.2
Other	0.0	0.0	0.0	149.2
Environmental Disposal for Weapons Systems Programs				
Nuclear Powered Aircraft Carriers	0.0	5,665.8	5,665.8	5,604.3
Nuclear Powered Submarines	484.0	3,202.4	3,686.4	3,377.7
Other Nuclear Powered Ships	226.9	66.5	293.4	277.2
Other National Defense Weapons Systems	0.8	204.3	205.1	233.8
Chemical Weapons Disposal Program	1,458.4	16,850.2	18,308.6	17,457.3
Other	0.0	3,237.4	3,237.4	3,237.4
Total Environmental Liabilities	$ 4,708.8	$ 67,781.1	$ 72,489.9	$ 69,985.1

Others Category Disclosure Comparative Table		
As of September 30	2007	2006
(amounts in millions)		
Other Accrued Environmental Liabilities—Active Installations—Other		
U.S. Army Corps of Engineers (USACE) remediation of the Formerly Utilized Sites Remedial Action Program (FUSRAP)	$ 622.4	$ 653.4
USACE environmental liabilities not related to FUSRAP	4.4	0.0
Army Low Level Radioactive Waste Program	46.4	35.8
National Defense Stockpile (NDS) Transaction Fund	27.8	52.2
Defense Commissary Agency—asbestos and/or lead-based paint	40.7	29.0
TRICARE Management Activity Uniformed Services University of Health Sciences—disposal liability for research laboratories	0.0	11.0
Under Secretary of Defense—Operations and Maintenance—Other Defense Organizations	0.2	0.0
Navy estimate for disposal of polychlorinated biphenyls transformers	1.0	0.0
Total	742.9	781.4
Base Realignment and Closure (BRAC)—Other		
Army unliquidated obligations associated with cleanup contracts at BRAC installations	0.0	149.2
Total	0.0	149.2
Environmental Disposal for Weapons Systems Program—Other		
Navy Spent Nuclear Fuel	3,237.4	3,237.4
Total	$ 3,237.4	$ 3,237.4

Other Accrued Environmental Liabilities, Active Installations, Other primarily consists of remediation related to FUSRAP. The USACE is responsible for FUSRAP, which remediates radiological contamination from the Department of Energy's U.S. Atomic Energy and Weapons Program.

Environmental Disposal for Weapons Systems Programs, Other represents spent nuclear fuel, which is used fuel removed from the nuclear reactors of nuclear-powered ships and submarines. The estimate includes shipping, processing, and storing spent nuclear fuel.

Environmental Disclosures		
As of September 30	2007	2006
(amounts in millions)		
A. The unrecognized portion of the estimated total cleanup costs associated with General Property, Plant, and Equipment.	$ 1,589.1	$ 1,527.4
B. Changes in total cleanup costs due to changes in laws, regulations, and/or technology.	(12.7)	(44.9)
C. Portion of the changes in estimated costs due to changes in laws and technology that is related to prior periods.	$ (4.4)	$ 0.0

Environmental Disclosures – Line A represents the unrecognized costs associated with General Property, Plant, and Equipment (PP&E). The unrecognized portion of the estimated total cleanup costs is primarily associated with Non-Defense Environmental Restoration Program (DERP), such as nuclear-powered carriers and submarines, conventional ships, spent nuclear fuel, and landfills. Not all components of the Department disclose the unrecognized portion of the estimated cleanup costs associated with General PP&E. The Department is implementing procedures to address this deficiency.

Environmental Disclosures – Line B represents the amount of changes in total cleanup costs due to changes in laws, regulations, and/or technology. Not all components of the Department disclose changes in total cleanup costs due to changes in laws, regulations, and/or technology. The Department is implementing procedures to address this deficiency.

Environmental Disclosures – Line C represents the portion of changes in estimated costs due to changes in laws and technology that is related to prior periods. Not all components of the Department disclose the amount of change in estimates for costs due to changes in laws and technology relating to prior periods. The Department is implementing procedures to address this deficiency.

Other Disclosures

Types of Environmental Liabilities and Disposal Liabilities Identified

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

Applicable Laws and Regulations for Cleanup Requirements

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

The Department follows the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Superfund Amendment and Reauthorization Act to clean up DERP-eligible contamination. Contamination clean up that is not eligible for DERP is performed in accordance with the Resource Conservation and Recovery Act (RCRA) or other applicable federal or state laws. The CERCLA and RCRA require the Department to clean up contamination in coordination with regulatory agencies, current owners of property damaged by the Department, and third parties that have a partial responsibility for the environmental restoration. Failure to comply with agreements and legal mandates will put the Department at risk of incurring fines and penalties.

The cleanup requirements for nuclear-powered aircraft carriers, submarines, and other nuclear ships are based on laws that affect the Department's conduct of environmental policy and regulations. The Atomic Energy Act of 1954, as amended, assures the proper management of source, special nuclear, and byproduct materiel. As in all cases with nuclear power, the Department coordinates actions with the Department of Energy. The Nuclear Waste Policy Act of 1982 requires all owners and generators of high-level nuclear waste and spent nuclear fuel to pay their respective shares of the full cost of the program. Finally, the Low Level Radioactive Waste Policy Amendments Act of 1986 provides for the safe and efficient management of low-level radioactive waste.

The Chemical Weapons Disposal Program is based on FY 1986 National Defense Authorization Act (PL 99-145, as amended by subsequent acts) that directed the Department to destroy the unitary chemical stockpile by April 29, 2004. The current guidelines for destruction are based on the Chemical Weapons Convention Treaty. The United States ratified the Treaty in April 1997, requiring the stockpile of chemical weapons to be destroyed by April 2007, according to the terms outlined. The Army, as Executive Agent within the Department, provides policy, direction, and oversight for both the Chemical Stockpile Program and the Nonstockpile Chemical Materiel Project. As such, the Army is responsible for the safe and economical disposal of the U.S. stockpile of lethal and incapacitating chemical warfare agents and munitions.

Methods for Assigning Total Cleanup Costs to Current Operating Periods

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

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

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

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

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

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

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

The Army has a liability to take environmental restoration/corrective action for buried chemical munitions and agents, which they are unable to estimate at this time because the extent of the buried chemical munitions and agents is not known. The USACE is also unable to provide a complete estimate for the FUSRAP. The USACE 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 is in the process of determining the extent of the liabilities at installations that are realigning or closing as a result of recent BRAC requirements, in particular those liabilities associated with unexploded ordnance on training ranges. In addition, the Department has the potential to incur costs for restoration initiatives in conjunction with returning overseas Defense facilities to host nations. The Department is unable to provide a reasonable estimate at this time because the extent of required restoration is not known.

Note 15. Other Liabilities

As of September 30	2007			2006 Restated
(amounts in millions)	Current Liability	Noncurrent Liability	Total	Total
Intragovernmental				
Advances from Others	$ 308.9	$ 0.0	$ 308.9	$ 448.8
Deposit Funds and Suspense Account Liabilities	1,181.6	0.0	1,181.6	2,009.3
Disbursing Officer Cash	2,620.0	0.0	2,620.0	2,273.2
Judgment Fund Liabilities	167.5	0.0	167.5	164.2
FECA Reimbursement to the Department of Labor	601.8	785.8	1,387.6	1,404.7
Custodial Liabilities	3,718.2	1,518.3	5,236.5	5,960.0
Employer Contribution & Payroll Taxes Payable	281.8	0.0	281.8	290.5
Other Liabilities	317.1	0.0	317.1	649.0
Total Intragovernmental Other Liabilities	9,196.9	2,304.1	11,501.0	13,199.7
Nonfederal				
Accrued Funded Payroll and Benefits	6,197.3	0.0	6,197.3	4,497.8
Advances from Others	31,423.4	0.0	31,423.4	2,074.3
Deposit Funds and Suspense Accounts	59.9	0.0	59.9	205.6
Temporary Early Retirement Authority	0.0	0.0	0.0	0.1
Nonenvironmental Disposal Liabilities				
Military Equipment (Nonnuclear)	8.2	263.0	271.2	285.2
Excess/Obsolete Structures	76.0	587.0	663.0	685.6
Conventional Munitions Disposal	0.0	1,284.1	1,284.1	1,217.8
Accrued Unfunded Annual Leave	8,708.2	0.0	8,708.2	9,403.9
Capital Lease Liability	17.8	165.7	183.5	226.1
Contract Holdbacks	827.6	0.0	827.6	747.0
Employer Contribution & Payroll Taxes Payable	1,565.9	0.0	1,565.9	1,226.8
Contingent Liabilities	2,984.2	2,250.1	5,234.3	5,204.1
Other Liabilities	781.3	4.0	785.3	5,791.8
Total Nonfederal Other Liabilities	52,649.8	4,553.9	57,203.7	31,566.1
Total Other Liabilities	$ 61,846.7	$ 6,858.0	$ 68,704.7	$ 44,765.8

Intragovernmental Custodial Liabilities is primarily comprised of accounts receivable for cancelled appropriations and interest, penalties, fines, and administrative fees from the public. The Department generally cannot use the collections and must distribute them to the U.S. Treasury. The Department has specific statutory authority to retain collections from certain cancelled year accounts receivable as entity assets.

Intragovernmental Other Liabilities is primarily comprised of other unfunded employment related liabilities.

Contingent Liabilities includes $1.7 billion in estimated future contract financing payments. In accordance with contract terms, specific rights to the contractors' work vests with the 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 deliver and Government acceptance.

Nonfederal Other Liabilities consists primarily of estimated accruals for work in process by contractors in support of depot maintenance activities.

The balance in Nonfederal Other Liabilities includes $29.2 billion that the Department is executing on behalf of the Executive Office of the President. These amounts do not represent liabilities of the Department.

Capital Lease Liability					
As of September 30	2007				2006
	Asset Category				
(amounts in millions)	Land and Buildings	Equipment	Other	Total	Total
Future Payments Due					
2007	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 63.0
2008	47.1	3.8	0.0	50.9	47.3
2009	43.9	1.5	0.0	45.4	43.9
2010	43.9	0.0	0.0	43.9	43.9
2011	41.3	0.0	0.0	41.3	36.8
2012	15.5	0.0	0.0	15.5	0.0
After 5 Years	28.6	0.0	0.0	28.6	52.1
Total Future Lease Payments Due	220.3	5.3	0.0	225.6	287.0
Less: Inputed Interest Executory Costs	42.0	0.1	0.0	42.1	60.9
Net Capital Lease Liability	$ 178.3	$ 5.2	$ 0.0	$ 183.5	$ 226.1
Capital Lease Liabilities Covered by Budgetary Resources				150.8	181.2
Capital Lease Liabilities Not Covered by Budgetary Resources				$ 32.7	$ 44.9

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 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 Judgment Fund liabilities in Note 12, "Accounts Payable," and Note 15, "Other Liabilities."

The OGC reported 63 legal actions with individual claims greater than the Department's FY 2007 materiality threshold of $110.5 million. The total of these 63 actions is approximately $1.6 trillion. Of this amount, the OGC determined that claims totaling approximately $15.4 billion are reasonably possible, $12.9 billion are remote, and $1.57 trillion unable to determine the probability of loss. The Department also had a number of potential claims that individually did not meet the Department's materiality threshold, but did meet the individual Components' thresholds. These claims are disclosed in the Components' financial statements.

Other Commitments and Contingencies

Undelivered orders for open (unfilled or unreconciled) contracts citing cancelled appropriations, for which the Department may incur a contractual commitment for payment, total $1.2 billion.

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 funds if contract terms are satisfied. Currently, the Department has limited automated system processes by which it captures or assesses these potential contingent liabilities.

Note 17. Military Retirement and Other Federal Employment Benefits

As of September 30	2007				2006
(amounts in millions)	Present Value of Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liability	Present Value of Benefits
Pension and Health Actuarial Benefits					
Military Retirement Pensions	$ 1,025,320.6	6.0	$ (211,854.6)	$ 813,466.0	$ 963,696.1
Military Retirement Health Benefits	317,332.8	6.0	0.0	317,332.8	299,203.8
Military Medicare-Eligible Retiree Benefits	516,479.2	6.0	(107,454.2)	409,025.0	538,032.5
Total Pension and Health Actuarial Benefits	1,859,132.6		(319,308.8)	1,539,823.8	1,800,932.4
Other Actuarial Benefits					
FECA	6,830.1	5.2	0.0	6,830.1	6,856.0
Voluntary Separation Incentive Programs	1,250.5	4.0	(548.6)	701.9	1,391.2
Department Education Benefits Fund	1,858.2	5.0	(1,417.8)	440.4	1,785.3
Total Other Actuarial Benefits	9,938.8		(1,966.4)	7,972.4	10,032.5
Other Federal Employment Benefits	5,608.1		(5,608.1)	0.0	4,804.6
Total Military Retirement and Other Federal Employment Benefits	$ 1,874,679.5		$ (326,883.3)	$ 1,547,796.2	$ 1,815,769.5

Actuarial Cost Method Used: Aggregate entry-age normal method
Assumptions: See below
Market Value of Investments in Market-based and Marketable Securities: $324.8 billion

Military Retirement Pensions

The Military Retirement Fund (MRF) is a defined benefit plan authorized by Public Law (P.L.) 98-94 to provide funds used to pay annuities and pensions to retired military personnel and their survivors. The Board 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 Department used the following assumptions in calculating the FY 2007 roll-forward amount.

	Inflation	Salary	Interest
Fiscal Year 2007	3.3% (actual)	2.2% (actual)	6.0%
Fiscal Year 2008	2.3% (estimated)	3.5% (estimated)	6.0%
Long-Term	3.0%	3.75%	6.0%

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

Change in MRF Actuarial Liability	(Amounts in billions)
Actuarial Liability as of 9/30/06	$963.7
Expected Normal Cost for FY 2007	17.7
Plan Amendment Liability	1.5
Assumption Change Liability	26.5
Expected Benefit Payments for FY 2007	(43.5)
Interest Cost for FY 2007	57.1
Actuarial (gains)/losses due to changes in trend assumptions	2.2
Actuarial Liability as of 09/30/07	$1,025.3
Change in Actuarial Liability	**$61.6**

Actuarial Cost Method Used: Aggregate entry-age normal method.
Market Value of Investments in Market-Based and Marketable Securities: $215.0 billion
Assumed Interest Rate: 6.0%

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 Department Medical Treatment Facilities. The Department used the following assumptions in calculating the FY 2007 actuarial liability.

Medical Trend	FY 2006 – FY 2007	Ultimate Rate FY 2031
Medicare Inpatient	6.74%	6.25%
Medicare Outpatient	6.54%	6.25%
Medicare Prescriptions (Direct Care)	6.25%	6.25%
Medicare Prescriptions (Purchased Care)	6.25%	6.25%
Non-Medicare Inpatient (Direct Care)	6.25%	6.25%
Non-Medicare Outpatient (Direct Care)	6.25%	6.25%
Non-Medicare Prescriptions (Direct Care)	6.25%	6.25%
Non-Medicare Inpatient (Purchased Care)	6.25%	6.25%
Non-Medicare Outpatient (Purchased Care)	9.48%	6.25%
Non-Medicare Prescriptions (Purchased Care)	9.84%	6.25%

Change in MRHB Actuarial Liability	(Amounts in billions)
Actuarial Liability as of 09/30/06 (Department preMedicare + all Uniformed services Medicare cost-basis effect)	$299.2
Expected Normal Cost for FY 2007	$10.0
Expected Benefit Payments for FY 2007	($10.4)
Interest Cost for FY 2007	$19.0
Actuarial (gains)/losses due to other factors	($11.9)
Actuarial (gains)/losses due to changes in trend assumptions	$11.9
Actuarial Liability as of 09/30/07 (Department preMedicare + all Uniformed Services Medicare cost-basis effect)	$317.3
Change in Actuarial Liability	**$18.1**

Actuarial Cost Method Used: Aggregate Entry-Age Normal Method
Assumed Interest Rate: 6.0%

Medicare-Eligible Retiree Health Care Fund (MERHCF) Benefits

In accordance with P.L. 106-398, the 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 Board 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 Department used the following assumptions in calculating the FY 2007 roll-forward amount.

Medical Trend	FY 2006 – FY 2007	Ultimate Rate FY 2031
Medicare Inpatient	6.74%	6.25%
Medicare Outpatient	6.54%	6.25%
Medicare Prescriptions (Direct Care)	6.25%	6.25%
Medicare Prescriptions (Purchased Care)	10.95%	6.25%

Changes in MERHCF Actuarial Liability	(Amounts in billions)
Actuarial Liability as of 09/30/06 (all Uniformed Services Medicare)	$538.0
Expected Normal Cost for FY 2007	10.8
Expected Benefit Payments for FY 2007	(8.5)
Interest Cost for FY 2007	34.0
Actuarial (gains)/losses due to other factors	(4.8)
Actuarial (gains)/losses due to changes in trend assumptions	(53.1)
Actuarial Liability as of 09/30/07 (all Uniformed Services Medicare)	$516.5
Change in Actuarial Liability	**($21.5)**

Actuarial Cost Method Used for MERHCF Liability: Aggregate Entry-Age Normal
Market Value of Investments in Market-Based and Marketable Securities: $107.8 billion
Assumed Interest Rate: 6.0%

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The $516.5 billion liability includes $505.1 billion for the Department, $10.2 billion for the Coast Guard, $1.1 billion for the Public Health Service and $72.8 million for National Oceanic and Atmospheric Association (NOAA). The FY 2007 contributions from each of the services were: $11.2 billion by the Department, $278.7 million by the Coast Guard, $36.3 million by the Public Health Service, and $1.8 million by NOAA.

Federal Employees Compensation Act (FECA)

The Department of Labor (DOL) 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 annually using historical benefit payment patterns related to a specific incurred period to predict the final payment related to that period. Consistent with past practice, these projected annual benefit payments have been discounted to present value using the Office of Management and Budget's economic assumptions for 10-year U.S. Treasury notes and bonds. A 4.93% interest rate was assumed for year one and 5.08% was assumed for year two and thereafter.

The DOL calculates this liability using wage inflation factors (cost of living adjustments or COLA) and medical inflation factors (consumer price index medical or CPIM). The actual rates for these factors for charge back year (CBY) 2007 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.

CBY	COLA	CPIM
2007	2.63%	3.74%
2008	2.90%	4.04%
2009	2.47%	4.00%
2010	2.37%	3.94%
2011+	2.30%	3.94%

The model's resulting projections were analyzed 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 by agency to the percentage change in the actual incremental payments, (3) a comparison of the incremental paid losses (the medical component in particular) in CBY 2007 (by injury cohort) to the average pattern observed during the prior three charge back years, and (4) a comparison of the estimated liability per case in the 2007 projection to the average pattern for the projections for the most recent three years.

Voluntary Separation Incentive (VSI) Program

The P.L. 102-190 established the VSI program to reduce the number of military personnel on active duty. The VSI Board of Actuaries approved the assumed annual interest rate of 4.5% used to calculate the actuarial liability. Since the VSI program is no longer offered, the actuarial liability is expected to continue to decrease with benefit outlays and increase with interest cost. The liability is calculated annually at the present value of all remaining payments.

Market Value of Investments in Market-based and Marketable Securities: $573.1 million

DoD Education Benefits Fund (EBF)

The P.L. 98-525 established the EBF program to recruit and retain military members and aid in the readjustment of military members to civilian life. The EBF Board of Actuaries approved the assumed interest rate of 5% used to calculate the actuarial liability.

Market Value of Investments in Market-based and Marketable Securities: $1.4 billion

Other Federal Employment Benefits

Other Federal Employment Benefits primarily consists of accrued pensions and annuities and an estimated liability for Incurred But Not Reported medical claims not processed prior to fiscal year end.

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

Intragovernmental Costs and Exchange Revenue		
As of September 30	2007	2006 Restated
(amounts in millions)		
Intragovernmental Costs	$ 27,266.6	$ 31,990.6
Public Costs	640,871.8	602,553.4
Total Costs	668,138.4	634,544.0
Intragovernmental Earned Revenue	(20,465.9)	(24,327.1)
Public Earned Revenue	(25,220.5)	(24,168.6)
Total Earned Revenue	(45,686.4)	(48,495.7)
Net Cost of Operations	$ 622,452.0	$ 586,048.3

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the Federal Government supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity. The Department's current processes and systems do not capture and report accumulated costs for major programs based upon the performance measures as required by the Government Performance and Results Act. The Department is in the process of reviewing available data and developing a cost reporting methodology as required by the Statement of Federal Financial Accounting Standard No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government."

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

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

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

The majority of the Department's accounting systems do not capture information relative to heritage assets separately and distinctly from normal operations. Where it was able to identify the cost of acquiring, constructing, improving, reconstructing or renovating heritage assets, the Department has identified $2.0 million for the fiscal year.

Note 19. Disclosures Related to the Statement of Changes in Net Position

As of September 30	2007		2006 Restated	
(amounts in millions)	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Prior Period Adjustments Increases (Decreases) to Net Position Beginning Balance				
Changes in Accounting Standards	$ (4,230.9)	$ 3,745.5	$ 0.0	$ 0.0
Errors and Omissions in Prior Year Accounting Reports	0.0	0.0	(8,034.3)	(0.5)
Total Prior Period Adjustments	(4,230.9)	3,745.5	(8,034.3)	(0.5)
Imputed Financing				
Civilian CSRS/FERS Retirement	1,429.4	0.0	1,553.8	0.0
Civilian Health	2,784.7	0.0	2,646.5	0.0
Civilian Life Insurance	8.4	0.0	26.1	0.0
Judgment Fund	198.8	0.0	183.2	0.0
Total Imputed Financing	$ 4,421.3	$ 0.0	$ 4,409.6	$ 0.0

The Department recognized a net prior period adjustment of ($485.4) million in FY 2007 and restated cumulative results of operations by ($4.2) billion and unexpended appropriations by $3.7 billion. The adjustment relates to a change in reporting parent/child allocation transfers, and is presented as a change in accounting principle. The change affects the Balance Sheet and the Statement of Changes in Net Position. Parent/child reporting is intended to consolidate the complete financial reporting of delegated activities and funds within the parent's financial statements for overall performance reporting. In accordance with Office of Management and Budget (OMB) Circular A-136, "Financial Reporting Requirements," the Department, as the parent agency, reports the financial activity carried out by the child agencies who received transfer appropriations from the Department. When the Department performs as the child, it does not report any information relating to transfer appropriations received from other agencies except for Treasury-Managed Trust funds and funds for which the Executive Office of the President (EOP) is the parent. The OMB Circular A-136 makes exceptions for these transfer appropriations. The Department includes transfer appropriations received from the EOP whereby the EOP is the parent. The EOP delegates authority to the Department for foreign military sales, and the Department reports the related activity in its financial statements on behalf of the EOP.

Contributions to the Office of Personnel Management (OPM) do not fully cover the Government's cost to provide benefits for employees covered by the Civil Service Retirement System, the Federal Employees' Retirement System, the Federal Employees' Health Benefits program, and the Federal Employees' Group Life Insurance program. An imputed cost is recognized as the difference between the Government's cost of providing these benefits to employees and the Department's contributions. The OPM provides cost factors for the computation of imputed financing costs, and these estimates are included in the Department's financial statements.

Other Financing Sources, Other consists primarily of adjustments to reconcile budgetary and proprietary trial balances. Due to financial system limitations, the Department adjusts for these unreconciled differences.

Unexpended Appropriations, Budgetary Financing Sources, Other Adjustments is comprised of rescissions, capital transfers, and canceling appropriations.

In the Statement of Changes in Net Position (SCNP), offsetting balances for intraDepartmental activity between Earmarked Funds and All Other Funds is reported on the same lines. The Eliminations column contains all appropriate elimination entries, which net to zero within each respective line, except for intraentity imputed financing costs.

Earmarked Cumulative Results of Operations ending balance on the SCNP does not agree with the Earmarked Cumulative Results reported on the Balance Sheet because the cumulative results on the Balance Sheet are presented net of eliminations.

Appropriations on the Statement of Budgetary Resources (SBR) exceed Appropriations Received on the SCNP by $104.1 billion. The SCNP recognizes appropriations received by the Military Departments and Defense Agencies totaling $70.4 billion which are additionally recognized on the SBR as appropriated receipts in trust and special funds. Investments in trust and special funds accumulate interest earnings; the interest earnings comprise most of the remaining difference of $33.7 billion, which is recognized only on the SBR.

Note 20. Disclosures Related to the Statement of Budgetary Resources

As of September 30	2007	2006 Restated
(amounts in millions)		
Net Amount Budgetary Resources Obligated for Undelivered Orders at the End of the Period	$ 350,761.4	$ 297,272.1
Available Borrowing and Contract Authority at the End of the Period	$ 0.0	$ 29,488.9

Reconciliation Differences

The Department modified this note to more accurately report the remaining available balance of borrowing and contract authority. Previously, the Department reported the amount of borrowing and contract authority used, but not the amount replaced by reimbursement or appropriation.

Appropriations Received on the Statement of Budgetary Resources (SBR) exceed Appropriations Received on the Statement of Changes in Net Position by $104.1 billion. In accordance with Office of Management and Budget (OMB) guidance, appropriations received by the Military Departments and Defense Agencies totaling $70.4 billion are subsequently recognized a second time on the SBR as appropriations transferred into trust and special funds. Actual and anticipated earnings in trust and special funds comprise the balance of the difference.

Permanent Indefinite Appropriations

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

- Department of the Army General Gift Fund (10 USC 2601(b)(1))
- Department of the Navy General Gift Fund (10 USC 2601(b)(2))
- Department of the Air Force General Gift Fund (10 USC 2601(b)(3))

- 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)
- Midshipmen's Store (10 USC 6971B)
- Burdensharing Contributions Account (10 USC 2350(j))
- Forest Program (10 USC 2665)
- Department of Defense Base Closure Account (10 USC 2687)
- Medicare Eligible Retiree Health Care Fund (MERHCF) (10 USC 1111)
- Military Retirement Fund (MRF) (10 USC 1461)
- Education Benefits Fund (10 USC 2006)
- Reserve Mobilization Income Insurance Fund (10 USC 12528)
- Host Nation Support for U.S. Relocation Activities (10 USC 2350(k))
- National Defense Sealift Fund (10 USC 2218)
- Environmental Restoration, Navy (10 USC 2702)
- 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)
- Department of Defense Family Housing Improvement Fund (10 USC 2883 (a))
- Department of Defense Military Unaccompanied Housing Improvement Fund (10 USC 2883 (a))

The above permanent indefinite appropriations cover a wide variety of purposes to help the Department accomplish its missions. These purposes include: (1) military retirees health care benefits, retirement and survivor pay, and education benefits for veterans; (2) environmental, coastal, and wildlife habitat restoration, and water resources maintenance; (3) costs associated with the closure or realignment of military installations; (4) relocation of armed forces to a host nation; (5) separation payments for foreign nationals; (6) the construction, purchase, alteration, and conversion of sealift vessels; and (7) upkeep of libraries and museums. (See Note 23 for additional information on earmarked funds.)

In addition to the above, the Executive Office of the President has given the Department authority to execute the funds listed below on its behalf:

- Special Defense Acquisition Fund (22 USC 2795)
- Foreign Military Loans Liquidating Account (22 USC 2764)
- Foreign Military Financing, Direct Loan Financing Account (2 USC 661 (d))
- Military Debt Reduction Financing Account (2 USC 661 (d))
- Advances, Foreign Military Sales (22 USC 2761-2762)

Apportionment Categories for Obligations

The Department reported the following amounts of direct obligations: (1) $516.3 billion in category A; (2) $159.9 billion in category B; and (3) $96.7 billion in exempt from apportionment. The Department reported the following amounts of reimbursable obligations: (1) $93.0 billion in category A; (2) $77.9 billion in category B; and (3) $14.0 million in exempt from apportionment. Category A relates to appropriations for a specific period of time (e.g., Military Personnel appropriation), and category B relates to appropriations for a specific project (e.g., Military Construction appropriation).

Other Disclosures

The President's budget for FY 2009 has not yet been published. The budget is expected to be published on February 4, 2008, and will be available at: http://www.defenselink.mil/comptroller/defbudget.

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

The Department utilizes borrowing authority for the Military Housing Privatization Initiative, the Armament Retooling and Manufacturing Support Initiative, and the Foreign Military Account Program. Borrowing authority is used in accordance with OMB Circular A-129, "Managing Federal Credit Programs."

The Department operates within the constraints of fiscal law and has no additional legal arrangements affecting the use of unobligated balances.

The Department received additional funding of $70.0 billion to replenish expenses incurred outside of normal operating expenses. The Department also received an additional $99.4 billion primarily for U.S. Troop Readiness, Veterans Care, and Hurricane Katrina recovery.

The Department reported a change in obligated balances brought forward of $29.2 billion, and unobligated balances brought forward of $1.0 billion, due to stipulations of OMB Circular A-136, "Financial Reporting Requirements." (See Note 1, "Significant Accounting Policies", and Note 25, "Restatements" for details.)

The Department is executing balances of Contract Authority of $48.0 billion, Permanently not Available of ($16.6) billion, and Distributed Offsetting Receipts of $15.8 billion, on behalf of the Executive Office of the President. These amounts do not represent budgetary resources or obligations of the Department.

Note 21. Reconciliation of Net Cost of Operations to Budget

As of September 30	2007	2006 Restated
(amounts in millions)		
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations Incurred	$ 943,782.3	$ 816,752.4
Less: Spending Authority from Offsetting Collections and Recoveries (-)	(215,593.3)	(197,235.2)
Obligations Net of Offsetting Collections and Recoveries	728,189.0	619,517.2
Less: Offsetting Receipts (-)	(64,105.0)	(48,222.1)
Net Obligations	664,084.0	571,295.1
Other Resources:		
Donations and Forfeitures of Property	13.8	47.3
Transfers in/out Without Reimbursement (+/-)	(86.9)	(83.7)
Inputed Financing from Costs Absorbed by Others	4,421.3	4,409.6
Other (+/-)	(8,099.3)	3,415.9
Net Other Resources Used to Finance Activities	(3,751.1)	7,789.1
Total Resources Used to Finance Activities	660,332.9	579,084.2
Resources Used to Finance Items not Part of the Net Cost of Operations:		
Change In Budgetary Resources Obligated for Goods, Services, and Benefits Ordered but Not Yet Provided:		
Undelivered Orders (-)	(82,882.9)	(19,138.7)
Unfilled Customer Orders	6,496.4	446.2
Resources that Fund Expenses Recognized in Prior Periods (-)	(34,595.5)	(6,392.3)
Budgetary Offsetting Collections and Receipts that do not Affect Net Cost of Operations	18,663.2	6,202.7
Resources that Finance the Acquisition of Assets (-)	(92,704.7)	(132,348.5)
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 (-)	(10.0)	(10.0)
Other (+/-)	$ 8,172.3	$ (3,379.2)

Total resources used to finance items not part of the Net Cost of Operations	$ (176,861.2)	$ (154,619.8)
Total resources used to finance the Net Cost of Operations	483,471.7	424,464.4
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	1,866.1	7,401.2
Increase in Environmental and Disposal Liability	2,615.0	5,632.5
Upward/Downward Reestimates of Credit Subsidy Expense (+/-)	(103.6)	(35.6)
Increase in Exchange Revenue Receivable from the Public (-)	(23.3)	(47.7)
Other (+/-)	91,873.1	73,776.0
Total Components of Net Cost of Operations that Will Require or Generate Resources in Future Periods	96,227.3	86,726.4
Components not Requiring or Generating Resources:		
Depreciation and Amortization	27,287.0	65,116.2
Revaluation of Assets or Liabilities (+/-)	6,073.3	5,174.4
Other (+/-)		
Trust Fund Exchange Revenue	(39,246.6)	(40,583.4)
Cost of Goods Sold	56,125.0	47,718.4
Operating Material and Supplies Used	30,590.5	10,062.5
Other	(38,076.2)	(12,630.6)
Total Components of Net Cost of Operations that will not Require or Generate Resources	42,753.0	74,857.5
Total Components of Net Cost of Operations that will not Require or Generate Resources in the current period	138,980.3	161,583.9
Net Cost of Operations	$ 622,452.0	$ 586,048.3

Beginning 4th Quarter, FY 2007, the Department began presenting the Statement of Financing (SOF) as a note in accordance with OMB Circular A-136. The SOF is no longer considered a basic statement and is now referred to as Reconciliation of Net Cost of Operations to Budget. The reconciliation of the former SOF is now incorporated into Note 21.

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

Resources That Finance the Acquisition of Assets	$1,862.0
Other - Other Components Not Requiring or Generating Resources	55.5
Revaluation of Assets or Liabilities	14.3
Total Amount	$1,931.8

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 and Other Resources or Adjustments to Net Obligated Resources that Do Not Affect Net Cost of Operations – Other primarily consists of nonexchange gains and losses necessary to reconcile the proprietary and budgetary accounts.

Components Requiring or Generating Resources in Future Period - Other primarily consists of future funded expenses for the current year change in actuarial liabilities.

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

Liabilities not covered by budgetary resources on the Balance Sheet total $1.6 trillion. The amount reported as Components Requiring or Generating Resources in Future Periods in Note 21, the Reconciliation of Net Cost of Operations to Budget, totals $96.2 billion. The difference of $1.5 trillion is primarily due to the differing perspectives between the two reports. Liabilities not covered by budgetary resources report the cumulative balance for Balance Sheet liabilities not yet funded whereas as Components Requiring or Generating Resources in Future Periods in Note 21 reflects only the current period changes for all unfunded liabilities.

Note 22. Disclosures Related to Incidental Custodial Collections

Incidental custodial collections represent miscellaneous receipts, such as collections of fines and penalties, which are deposited directly into the General Fund of the U.S. Treasury. These funds are not available for use by the Department. At the end of each fiscal year the accounts are closed and the balances absorbed by the U.S. Treasury. The Department collected and distributed to the U.S. Treasury $92.4 million of incidental custodial revenues generated primarily from the collection of fines and penalties.

Note 23. Earmarked Funds

BALANCE SHEET As of September 30, 2007 (amounts in millions)	Military Retirement Fund	Medicare Eligible Retiree Health Care Fund	Other Earmarked Funds	Eliminations	Total
ASSETS					
Fund balance with Treasury	$ 20.4	$ 5.0	$ 1,961.4	$ 0.0	$ 1,986.8
Investments	218,085.0	109,549.1	6,075.9	0.0	333,710.0
Accounts and Interest Receivable	143.1	10.3	515.2	(151.8)	516.8
Other Assets	0.0	0.0	2,215.7	0.0	2,215.7
Total Assets	$ 218,248.5	$ 109,564.4	$ 10,768.2	$ (151.8)	$ 338,429.3
LIABILITIES and NET POSITION					
Military Retirement Benefits and Other Federal Employment Benefits	$ 1,028,850.7	$ 517,104.6	$ 3,108.7	$ 0.0	$ 1,549,064.0
Other Liabilities	1.0	256.6	1,072.6	(133.8)	1,196.4
Total Liabilities	1,028,851.7	517,361.2	4,181.3	(133.8)	1,550,260.4
Unexpended Appropriations	0.0	0.0	8.1	0.0	8.1
Cumulative Results of Operations	(810,603.2)	(407,796.8)	6,578.8	(68,286.0)	(1,280,107.2)
Total Liabilities and Net Position	$ 218,248.5	$ 109,564.4	$ 10,768.2	$ (68,419.8)	$ 270,161.3

BALANCE SHEET As of September 30, 2007 (amounts in millions)	Military Retirement Fund	Medicare Eligible Retiree Health Care Fund	Other Earmarked Funds	Eliminations	Total
STATEMENT OF NET COST For the Year Ended September 30, 2007					
Program Costs	$ 105,253.0	$ (13,945.8)	$ 3,242.8	$ (2,542.8)	$ 92,007.2
Less Earned Revenue	(53,311.2)	(31,539.3)	(1,082.0)	70,427.7	(15,504.8)
Net Program Costs	51,941.8	(45,485.1)	2,160.8	67,884.9	76,502.4
Net Cost of Operations	$ 51,941.8	$ (45,485.1)	$ 2,160.8	$ 67,884.9	$ 76,502.4
STATEMENT OF CHANGES IN NET POSITION For the period ended September 30, 2007					
Net Position Beginning of the Period	$ (758,661.4)	$ (453,467.9)	$ 5,371.4	$ 0.0	$ (1,206,757.9)
Net Cost of Operations	51,941.8	(45,485.1)	2,160.8	67,884.9	76,502.4
Budgetary Financing Sources	0.0	186.0	3,154.8	(414.2)	2,926.6
Other Financing Sources	0.0	0.0	221.5	13.1	234.6
Change in Net Position	(51,941.8)	45,671.1	1,215.5	(68,286.0)	(73,341.2)
Net Position End of Period	$ (810,603.2)	$ (407,796.8)	$ 6,586.9	$ (68,286.0)	$ (1,280,099.1)

Other Disclosures

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

The Total column is shown as consolidated and relates only to Earmarked Funds. The Eliminations column includes eliminations associated with Earmarked Funds and excludes the offsetting eliminations from All Other Funds. This exclusion causes assets to not equal liabilities and net position in the note. However, the amounts in the Total column equal the amounts reported for Earmarked Funds on the Balance Sheet. The SFFAS No. 27 requires the presentation of gross amounts of Earmarked Funds separate from All Other (nonearmarked) Funds. Cumulative Results of Operations ending balances for Earmarked Funds on the Statement of Changes in Net Position do not agree with the Cumulative Results of Operations for Earmarked Funds reported on the Balance Sheet because the Cumulative Results of Operations on the Balance Sheet are presented net of eliminations. The summation for Military Retirement Fund (MRF), Medicare-Eligible Retiree Health Care Fund (MERHCF), and Other Earmarked Funds is equivalent to the gross amount presented on the Statement of Changes in Net Position.

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

Medicare-Eligible Retiree Health Care Fund, 10 USC 1111. The MERHCF accumulates funds to finance, on an actuarially sound basis, liabilities of the Department and the uniformed services health care programs for qualified Medicare-eligible beneficiaries. Financing sources for MERHCF are provided primarily through an annual actuarial liability payment from the U.S. Treasury, annual contributions from the Military Services and other Uniformed Services (the U.S. Coast Guard, the

National Oceanic and Atmospheric Administration, and the U.S. Public Health Service), and interest earned from the Fund's investments.

Other Earmarked Funds

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

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

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

Maintenance and Operation of Dams and Other Improvements of Navigable Waters, 16 USC 803(f) and 810. The USC states, "All proceeds from any Indian reservation shall be placed to the credit of the Indians of such reservation." However, the USC also states, "…all other charges arising from licenses…" except those charges established by the Federal Power Commission, now known as the Federal Energy Regulatory Commission, for purpose of administrative reimbursement shall be paid to the U.S. Treasury from which specific allocations will be made. From the specific allocations, 50% of charges from "all other licenses" is reserved and appropriated as a special fund in the U.S. Treasury to be expended under the direction of the Secretary of the Army in the maintenance, operation, and improvement of dams and other navigation structures that are owned by the United States or in construction, maintenance, or operation of headwater or other improvements of navigable waters of the United States.

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

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

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

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

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

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

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

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

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

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

Military Housing Privatization Initiative, Public Law 104-106, Statute 186, Section 2801. The Military Housing Privatization Initiative (MHPI) includes both direct loan and loan guarantee programs, is authorized by the National Defense Authorization Act for FY 1996, and includes a series of authorities that allow the Department to work with the private sector to renovate and build military family housing. The MHPI accelerates the construction of new housing, builds to market standards, and leverages private sector capital with government dollars. The Department provides protection to the private sector partner against specific risks, such as base closure or member deployment.

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

Note 24. Other Disclosures

As of September 30	2007 Asset Category			
(amounts in millions)	Land and Buildings	Equipment	Other	Total
Entity as Lessee—Operating Leases				
Future Payments Due				
Fiscal Year				
FY 2008	$ 384.1	$ 15.7	$ 113.2	$ 513.0
FY 2009	366.2	15.1	117.7	499.0
FY 2010	317.7	15.1	122.4	455.2
FY 2011	299.1	15.2	127.3	441.6
FY 2012	279.5	15.2	132.4	427.1
After 5 years	530.2	1.2	137.7	669.1
Total Future Lease Payments Due	$ 2,176.8	$ 77.5	$ 750.7	$ 3,005.0

Note 25. Restatements

During the reporting period, material errors were identified or accounting principle changes deemed necessary. As a result, prior year changes have been made retrospectively in accordance with generally accepted accounting principles (GAAP).

Correction Due to Change in Allocation Transfer Reporting

Effective FY 2007, the Office of Management and Budget (OMB) Circular A-136 "Financial Reporting Requirements" changed the reporting of allocation transfers. Due to this change, the Department reports in its basic financial statements the programs it administers on behalf of the Executive Office of the President (EOP) including the Foreign Military Sales (FMS) Program. Previously, the Department recorded the majority of FMS programs as "Other Accompanying Information," rather than as part of the basic financial statements. The FMS Trust Fund was not part of this change, as it was formerly included in the Department's financial statements.

Per OMB Circular A-136 Section I.14.2, the cumulative effect of the change on prior periods should be reported as a change in accounting principle, consistent with Statement of Federal Financial Accounting Standards No. 21, "Reporting Corrections of Errors and Changes in Accounting Principles." Although this is not considered an error, due to the material and pervasive impact, the Department, in coordination with OMB and the U.S. Treasury, restated prior year comparative columns as outlined below:

FY 2006 Balance Sheet
(amounts in billions)

Fund Balance with Treasury	$1.9
Loans Receivable	3.7
Total Assets	$5.6
Debt	$3.3
Other Liabilities	0.4
Total Liabilities	$3.7
Net Position	$1.9

FY 2006 Statement of Net Cost
(amounts in billions)

Gross Costs	$4.8
Less: Earned Revenue	(0.2)
Net Cost of Operations	$4.6

Statement of Budgetary Resources
(amounts in billions)

Beginning Balance Change for FY 2007:	
Unobligated Balance, Brought Forward	($1.0)
Obligated Balance, Brought Forward	$29.2
Comparative Year Effect for FY 2006:	
Appropriation	$4.7
Spending Authority from Offsetting Collections	
Earned	
Collected	1.1
Permanently Not Available	(1.1)
Total Budgetary Resources	$4.7
Obligations	$4.7
Total Status of Budgetary Resources	$4.7
Gross Outlays	$5.2
Less: Offsetting Collections	(1.1)
Distributed Offsetting Receipts	13.8
Net Outlays	$17.9

Beginning balances were changed to accommodate the proper reporting of the EOP balances in the Department's Statement of Budgetary Resources. The Unobligated Balance, Brought Forward decrease of $1.0 billion was the result of a decrease of $1.4 billion for FMS offset by an increase of $385.2 million in the Army General Fund Iraqi Reconstruction Fund. The Obligated Balance, Brought Forward increase of $29.2 billion included an increase from FMS of $25.9 billion and an increase of $3.5 billion in the Iraqi Reconstruction Fund. The amounts reported as Comparative Year Effect were restatements of prior years.

Correction of Error

Following the current reporting period, the Department discovered an error in the computation of the Distributed Offsetting Receipts reported on the Statement of Budgetary Resources. The Department previously included all of the annual contribution from Treasury for the Military Retirement Fund and should have excluded the concurrent receipts of the normal cost contribution as Distributed Offsetting Receipts. The Department had also included the Military Departments' contributions, the non-DoD employing agency contributions, and the interest receivable for the DoD Medicare-Eligible Retiree Health Care Fund as Distributed Offsetting Receipts. The Department confirmed with OMB and the U.S. Treasury that only specific receipt accounts, and no accrued interest, should be reported as Distributed Offsetting Receipts. Due to the size of the misstatement in FY 2006, the Department restated lines on the Statement of Budgetary Resources and Note 21, "Reconciliation of Net Cost of Operations to Budget," formerly the Statement of Financing. The restatement has no impact on the Department's overall net position. The Department restated the prior year comparative column decreasing Distributed Offsetting Receipts by $13.8 billion in the Statement of Budgetary Resources. The Reconciliation of Net Cost of Operations to Budget was adjusted by like amount in the Distributed Offsetting Receipts and Trust Fund Exchange Revenue lines, resulting in no change in Net Cost of Operations.

Required Supplementary Stewardship Information

Nonfederal Physical Property

Department of Defense Consolidated Nonfederal Physical Property Yearly Investments in State and Local Governments For Fiscal Years 2007 through 2003 (In Millions of Dollars)					
Categories	FY 2007	FY 2006	FY 2005	FY 2004	FY 2003
Transferred Assets:					
National Defense Mission Related	$ 23.0	$ 66.5	$ 70.7	$ 54.7	$ 85.0
Federal Mission Related	1,028.0	1,229.0	1,324.0	4,429.0	NR
Funded Assets:					
National Defense Mission Related	2.8	8.5	8.3	18.3	11.3
Total	$ 1,053.8	$ 1,304.0	$ 1403.0	$ 4,502.0	$ 96.3

NR = Not Reported

The Department incurs investments in Nonfederal Physical Property for the purchase, construction, or major renovation of physical property owned by state and local governments, including major additions, alterations, and replacements, the purchase of major equipment, and the purchase or improvement of other physical assets. In addition, Nonfederal Physical Property Investments include federally-owned physical property transferred to state and local governments.

The Department changed its methodology for reporting Nonfederal Physical Property during FY 2007. Investment values included in this report are based on Nonfederal Physical Property outlays (expenditures). Outlays are used because current Department accounting systems are unable to capture and summarize costs in accordance with federal accounting standards.

Investments in Research and Development

Department of Defense Consolidated Yearly Investments in Research and Development For the Current and Four Preceding Fiscal Years (In Millions of Dollars)					
Categories	FY 2007	FY 2006	FY 2005	FY 2004	FY 2003
Basic Research	$ 71.1	$ 157.1	$ 199.5	$ 194.6	$ 516.8
Applied Research	430.2	1,442.5	1,713.1	1,711.2	1,775.7
Development					
Advanced Technology Development	1,052.3	2,308.6	3,096.1	2,761.4	2,445.4
Advanced Component Development and Prototypes	5,217.7	7,232.7	8,745.3	7,278.0	5,569.6
System Development and Demonstration	236.3	515.7	461.7	345.7	1,380.9
Research, Development, Test and Evaluation Management Support	465.2	963.1	1,035.8	997.0	960.2
Operational System Development	340.8	713.4	876.8	1,213.2	1,099.9
Total	$ 7,813.6	$ 13,333.1	$ 16,128.4	$ 14,501.1	$ 13,748.5

The Department changed its methodology for reporting Yearly Investments in Research and Development during FY 2007. Investment values included in this report are based on Research and Development (R &D) outlays (expenditures). Outlays are used because current Department accounting systems are unable to capture and summarize costs in accordance with Federal accounting standards. The R&D programs are classified in three categories: Basic Research, Applied Research and Development. The definition for each type of R&D Category and the Development 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 gathering 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, and limited construction of, or part of, a weapon system to include nonsystem-specific development efforts.

- Development takes what has been discovered or learned from basic and applied research and uses it to establish technological feasibility and to assess operability, and production capability. Development is comprised of five stages defined below:

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

- Advanced Component Development and Prototypes evaluates integrated technologies in as realistic an operating environment as possible to assess the performance or cost reduction potential of advanced technology. Programs in this phase are generally system specific. Major outputs of hardware and software components, or 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 is support for 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 in support of the R&D program.

- Operational Systems Development is concerned with development projects in support of programs or upgrades still in engineering and manufacturing development, which have received approval for production, for which production funds have been budgeted in subsequent fiscal years.

Required Supplementary Information

Heritage Assets

Department of Defense Consolidated Heritage Assets For Fiscal Year Ended September 30, 2007					
Categories	Measure Quantity	As of 10/01/06	Additions	Deletions	As of 9/30/07
Buildings and Structures	Each	23,444	1,304	7,631	17,117
Archeological Sites	Site	97,911	992	70,948	27,955
Museums	Each	103	5	5	103
Monuments and Memorials	Each	2,022	47	54	2,015

Heritage Assets are real and personal property with significance in American history due to their architectural, archeological, and cultural value. In FY 2007, the archeological sites reflect those sites identified, evaluated, and determined eligible for or listed on the National Register of Historic Places. The FY 2007 categories are defined as follows:

Buildings and Structures. Buildings and structures that are listed on, or eligible for listing on, the National Register of Historic Places, including Multi-Use Heritage Assets.

Archeological Sites. Sites that have been identified, evaluated, and determined to be eligible for or are listed on the National Register of Historic Places in accordance with Section 110 of the National Historic Preservation Act.

Museums. Buildings, places, or institutions devoted to the acquisition, conservation, study, exhibition, and educational interpretation of objects having scientific, historical, or artistic value.

Monuments and Memorials. Sites and structures built to honor and preserve the memory of significant individuals or events in history.

Stewardship Land

Department of Defense Consolidated Stewardship Land For Fiscal Year Ended September 30, 2007 (Acres in Thousands)				
Land Use	As of 10/01/06	Additions	Deletions	As of 9/30/07
Mission	16,015	1,387	15	17,387
Parks and Historic Sites	1			1
Totals	16,016	1,387	15	17,388

Stewardship Land is land and land rights owned by the Department of Defense but not acquired for, or in connection with, items of General Property, Plant and Equipment. All land provided to the Department from the public domain, or at no cost, regardless of its use is classified as Stewardship Land. Stewardship Land is reported in acres rather than at cost or fair value. The FY 2007 categories are defined as follows:

Mission. Stewardship Land is land used for military bases, test and training ranges, or other military mission related functions.

Parks and Historic Sites. This category includes battlefields, cemeteries, and parks.

Real Property Deferred Maintenance

Department of Defense Real Property Deferred Maintenance For Fiscal Year Ended September 30, 2007 (In Millions of Dollars)			
Property Type	Current Fiscal Year (CFY)		
	Plant Replacement Value	Required Work (deferred maintenance)	Percentage
Category 1	$514,304.5	$61,634.5	12%
Category 2	$42,154.0	$8,881.6	21%
Category 3	$14,411.3	$1,503.1	10%

This year, the Department changed its methodology for reporting deferred maintenance. In previous reports, the amount was based upon the Department's Facilities Sustainment Model and represented the annual deferred sustainment (maintenance). This year, the amount is based upon facility Q-ratings found in the Department's real property inventory that represent the cumulative deferred amount for facility restoration and modernization, and thus are significantly larger than previous years. While restoration and modernization is not precisely equivalent to deferred maintenance, the values are generally representative of the magnitude of the deferred maintenance requirements. Over the next year, the Department will be transitioning the Q-ratings to more precisely represent deferred maintenance requirements.

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, representing the acceptable operating condition. Acceptable operating condition levels vary by Component within the Department. The low value is the mid-point of the Q-2 rating band, representing deferred work valued at 15% of the facility replacement value. This point equates to the Department minimum goal for average facility condition. The high value is fully serviceable condition, representing a facility with no deferred requirements. The reported deferred maintenance for the Department reflects the mixture of acceptable operating condition values.

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

Deferred Maintenance of Military Equipment

Depot maintenance requirements for military equipment are developed during the annual budget process. The table below displays the deferred unfunded requirements for the depot maintenance program. The Department Components' FY 2008 Budget Estimates, contain detailed information on each program.

FY 2007	
Military Equipment Type	Unfunded Deferred Requirement (In Millions of Dollars)
Ship	$136
Aircraft	$1,225
Combat Vehicles	$358
Other	$1,048
Total	$2,767

Statement of Disaggregated Budgetary Resources

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
For the Years Ended September 30, 2007 and 2006
($ in Millions)

	Military Retirement Fund	Medicare-Eligible Retiree Health Care Fund	Research, Development, Test & Evaluation
BUDGETARY FINANCING ACCOUNTS			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 0.0	$ 0.0	$ 12,249.8
Recoveries of prior year unpaid obligations	0.0	0.0	3,094.8
Budget authority			
Appropriation	53,452.7	31,200.6	73,593.5
Borrowing authority	0.0	0.0	0.0
Contract authority	0.0	0.0	0.0
Spending authority from offsetting collections			
Earned			
Collected	0.0	0.0	9,339.6
Change in receivables from Federal sources	0.0	0.0	72.1
Change in unfilled customer orders			
Advance received	0.0	0.0	224.1
Without advance from Federal sources	0.0	0.0	(201.6)
Subtotal	53,452.7	31,200.6	83,027.7
Nonexpenditure transfers, net, anticipated and actual	0.0	186.0	1,086.9
Temporarily not available pursuant to Public Law	(9,822.6)	(23,810.9)	0.0
Permanently not available	0.0	0.0	(848.6)
Total Budgetary Resources	$ 43,630.1	$ 7,575.7	$ 98,610.6
Status of Budgetary Resources			
Obligations incurred:			
Direct	$ 43,630.1	$ 7,575.7	$ 74,880.1
Reimbursable	0.0	0.0	9,906.7
Subtotal	43,630.1	7,575.7	84,786.8
Unobligated balance:			
Apportioned	0.0	0.0	12,740.5
Exempt from apportionment	0.0	0.0	0.0
Subtotal	0.0	0.0	12,740.5
Unobligated balance not available	0.0	0.0	1,083.3
Total Status of Budgetary Resources	$ 43,630.1	$ 7,575.7	$ 98,610.6
Change in Obligated Balance			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 3,409.8	$ 397.2	$ 36,267.7
Less: Uncollected customer payments from Federal sources, brought forward, October 1	0.0	0.0	(5,766.6)
Total unpaid obligated balance	3,409.8	397.2	30,501.1
Obligations incurred net	43,630.1	7,575.7	84,786.8
Less: Gross outlays	(43,509.7)	(7,604.1)	(78,922.2)
Obligated balance transferred, net:			
Actual transfers, unpaid obligations	0.0	0.0	0.0
Actual transfers, uncollected customer payments from Federal sources	0.0	0.0	0.0
Total Unpaid obligated balance transferred, net	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	0.0	0.0	(3,094.8)
Change in uncollected customer payments from Federal sources	0.0	0.0	129.6
Obligated balance, net, end of period:			
Unpaid obligations	3,530.2	368.8	39,037.5
Less: Uncollected customer payments from Federal sources	0.0	0.0	(5,637.0)
Total, unpaid obligated balance, net, end of period	3,530.2	368.8	33,400.5
Net Outlays:			
Gross outlays	$ 43,509.7	$ 7,604.1	$ 78,922.2
Less: Offsetting collections	0.0	0.0	(9,563.7)
Less: Distributed Offsetting receipts	(26,048.0)	(19,653.2)	0.0
Net Outlays	$ 17,461.7	$ (12,049.1)	$ 69,358.5

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
For the Years Ended September 30, 2007 and 2006
($ in Millions)

	Civil Works	Operation and Maintenance	Procurement
BUDGETARY FINANCING ACCOUNTS			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 9,368.3	$ 9,551.0	$ 32,821.6
Recoveries of prior year unpaid obligations	0.0	17,339.0	16,631.1
Budget authority			
Appropriation	7,503.6	230,456.3	127,235.9
Borrowing authority	0.0	0.0	0.0
Contract authority	0.0	0.0	0.0
Spending authority from offsetting collections			
Earned			
Collected	10,401.3	26,496.0	2,803.9
Change in receivables from Federal sources	(1,504.5)	(55.9)	(79.7)
Change in unfilled customer orders			
Advance received	(4.1)	125.1	138.7
Without advance from Federal sources	(780.4)	1,281.7	230.2
Subtotal	15,615.9	258,303.2	130,329.0
Nonexpenditure transfers, net, anticipated and actual	78.6	941.7	2,906.0
Temporarily not available pursuant to Public Law	(10.0)	0.0	0.0
Permanently not available	(0.8)	(2,555.3)	(1,547.0)
Total Budgetary Resources	$ 25,052.0	$ 283,579.6	$ 181,140.7
Status of Budgetary Resources			
Obligations incurred:			
Direct	$ 6,924.6	$ 245,220.3	$ 132,550.7
Reimbursable	8,479.2	28,475.6	2,222.2
Subtotal	15,403.8	273,695.9	134,772.9
Unobligated balance:			
Apportioned	8,742.9	2,812.3	45,241.5
Exempt from apportionment	895.1	0.0	0.0
Subtotal	9,638.0	2,812.3	45,241.5
Unobligated balance not available	10.2	7,071.4	1,126.3
Total Status of Budgetary Resources	$ 25,052.0	$ 283,579.6	$ 181,140.7
Change in Obligated Balance			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 5,478.1	$ 91,784.7	$ 104,210.1
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(6,421.1)	(10,646.6)	(2,602.8)
Total unpaid obligated balance	(943.0)	81,138.1	101,607.3
Obligations incurred net	15,403.8	273,695.9	134,772.9
Less: Gross outlays	(14,836.2)	(240,581.6)	(101,699.0)
Obligated balance transferred, net:			
Actual transfers, unpaid obligations	0.0	0.0	0.0
Actual transfers, uncollected customer payments from Federal sources	0.0	0.0	0.0
Total Unpaid obligated balance transferred, net	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	0.0	(17,339.0)	(16,631.1)
Change in uncollected customer payments from Federal sources	2,284.9	(1,225.7)	(150.5)
Obligated balance, net, end of period:			
Unpaid obligations	6,045.7	107,560.0	120,652.9
Less: Uncollected customer payments from Federal sources	(4,136.2)	(11,872.3)	(2,753.3)
Total, unpaid obligated balance, net, end of period	1,909.5	95,687.7	117,899.6
Net Outlays:			
Gross outlays	$ 14,836.2	$ 240,581.6	$ 101,699.0
Less: Offsetting collections	(10,397.2)	(26,621.1)	(2,942.6)
Less: Distributed Offsetting receipts	(521.9)	(1.8)	0.0
Net Outlays	$ 3,917.1	$ 213,958.7	$ 98,756.4

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
For the Years Ended September 30, 2007 and 2006
($ in Millions)

	Military Personnel	Military Construction/Family Housing	Working Capital Funds
BUDGETARY FINANCING ACCOUNTS			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 900.1	$ 7,007.9	$ 5,709.7
Recoveries of prior year unpaid obligations	4,020.1	849.7	1,695.9
Budget authority			
Appropriation	129,988.0	9,753.3	2,461.5
Borrowing authority	0.0	0.0	0.0
Contract authority	0.0	0.0	68,624.5
Spending authority from offsetting collections			
Earned			
Collected	1,030.2	4,505.9	108,366.2
Change in receivables from Federal sources	31.2	79.3	295.1
Change in unfilled customer orders			
Advance received	0.0	259.8	(307.4)
Without advance from Federal sources	14.1	1,337.8	4,120.3
Subtotal	131,063.5	15,936.1	183,560.2
Nonexpenditure transfers, net, anticipated and actual	267.5	(559.6)	(527.7)
Temporarily not available pursuant to Public Law	0.0	0.0	0.0
Permanently not available	(259.6)	(221.3)	(69,281.8)
Total Budgetary Resources	$ 135,991.6	$ 23,012.8	$ 121,156.3
Status of Budgetary Resources			
Obligations incurred:			
Direct	$ 133,986.4	$ 8,249.2	$ 1,177.3
Reimbursable	1,122.4	5,971.1	113,165.2
Subtotal	135,108.8	14,220.3	114,342.5
Unobligated balance:			
Apportioned	50.0	8,646.0	6,645.2
Exempt from apportionment	0.0	0.0	130.6
Subtotal	50.0	8,646.0	6,775.8
Unobligated balance not available	832.8	146.5	38.0
Total Status of Budgetary Resources	$ 135,991.6	$ 23,012.8	$ 121,156.3
Change in Obligated Balance			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 3,628.0	$ 15,046.7	$ 49,276.3
Less: Uncollected customer payments from Federal sources, brought forward, October 1	23.0	(5,596.6)	(24,259.9)
Total unpaid obligated balance	3,651.0	9,450.1	25,016.4
Obligations incurred net	135,108.8	14,220.3	114,342.5
Less: Gross outlays	(127,405.2)	(11,914.4)	(107,939.0)
Obligated balance transferred, net:			
Actual transfers, unpaid obligations	0.0	0.0	0.0
Actual transfers, uncollected customer payments from Federal sources	0.0	0.0	0.0
Total Unpaid obligated balance transferred, net	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	(4,020.1)	(849.7)	(1,695.9)
Change in uncollected customer payments from Federal sources	(45.4)	(1,417.1)	(4,415.4)
Obligated balance, net, end of period:			
Unpaid obligations	7,311.5	16,502.9	53,983.9
Less: Uncollected customer payments from Federal sources	(22.4)	(7,013.7)	(28,675.3)
Total, unpaid obligated balance, net, end of period	7,289.1	9,489.2	25,308.6
Net Outlays:			
Gross outlays	$ 127,405.2	$ 11,914.4	$ 107,939.0
Less: Offsetting collections	(1,030.2)	(4,765.6)	(108,058.9)
Less: Distributed Offsetting receipts	0.0	0.0	0.0
Net Outlays	$ 126,375.0	$ 7,148.8	$ (119.9)

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
For the Years Ended September 30, 2007 and 2006
($ in Millions)

		Other	2007 Combined		Restated 2006 Combined
BUDGETARY FINANCING ACCOUNTS					
Budgetary Resources					
Unobligated balance, brought forward, October 1	$	8,184.7	85,793.1	$	68,608.6
Recoveries of prior year unpaid obligations		1,248.6	44,879.2		30,252.3
Budget authority					
Appropriation		96,996.0	762,641.4		686,284.4
Borrowing authority		0.0	0.0		0.0
Contract authority		48,065.7	116,690.2		59,451.7
Spending authority from offsetting collections					
Earned					
Collected		1,684.7	164,627.8		164,718.1
Change in receivables from Federal sources		(115.2)	(1,227.6)		649.0
Change in unfilled customer orders					
Advance received		12.7	448.9		313.9
Without advance from Federal sources		(8.1)	5,994.0		179.1
Subtotal		146,635.8	1,049,124.7		911,596.2
Nonexpenditure transfers, net, anticipated and actual		(4,497.8)	(118.4)		(156.2)
Temporarily not available pursuant to Public Law		(176.0)	(33,819.5)		(35,746.3)
Permanently not available		(15,883.8)	(90,598.2)		(71,908.9)
Total Budgetary Resources	$	135,511.5	1,055,260.9	$	902,645.7
Status of Budgetary Resources					
Obligations incurred:					
Direct	$	118,225.2	772,419.6	$	651,019.8
Reimbursable		1,507.9	170,850.3		165,521.3
Subtotal		119,733.1	943,269.9		816,541.1
Unobligated balance:					
Apportioned		13,707.3	98,585.7		74,623.8
Exempt from apportionment		24.8	1,050.5		1,220.4
Subtotal		13,732.1	99,636.2		75,844.4
Unobligated balance not available		2,046.3	12,354.8		10,260.4
Total Status of Budgetary Resources	$	135,511.5	1,055,260.9	$	902,645.7
Change in Obligated Balance					
Obligated balance, net					
Unpaid obligations, brought forward, October 1	$	40,275.9	349,774.5	$	302,427.0
Less: Uncollected customer payments from Federal sources, brought forward, October 1		(144.3)	(55,414.9)		(54,586.9)
Total unpaid obligated balance		40,131.6	294,359.8		247,840.1
Obligations incurred net		119,733.1	943,269.9		816,541.1
Less: Gross outlays		(80,176.7)	(814,588.1)		(768,310.0)
Obligated balance transferred, net:					
Actual transfers, unpaid obligations		0.0	0.0		0.0
Actual transfers, uncollected customer payments from Federal sources		0.0	0.0		0.0
Total Unpaid obligated balance transferred, net		0.0	0.0		0.0
Less: Recoveries of prior year unpaid obligations, actual		(1,248.6)	(44,879.2)		(30,252.3)
Change in uncollected customer payments from Federal sources		123.2	(4,716.4)		(827.8)
Obligated balance, net, end of period:					
Unpaid obligations		78,583.7	433,577.1		320,405.8
Less: Uncollected customer payments from Federal sources		(21.1)	(60,131.3)		(55,414.7)
Total, unpaid obligated balance, net, end of period		78,562.6	373,445.8		264,991.1
Net Outlays:					
Gross outlays	$	80,176.7	814,588.1	$	768,310.0
Less: Offsetting collections		(1,697.9)	(165,077.2)		(165,031.7)
Less: Distributed Offsetting receipts		(17,880.1)	(64,105.0)		(48,222.1)
Net Outlays	$	60,598.7	585,405.9	$	555,056.2

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
For the Years Ended September 30, 2007 and 2006
($ in Millions)

	Other	2007 Combined	2006 Combined
NONBUDGETARY FINANCING ACCOUNTS			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 46.8	$ 46.8	$ 83.0
Recoveries of prior year unpaid obligations	0.0	0.0	0.0
Budget authority			
Appropriation	13.1	13.1	16.0
Borrowing authority	381.8	381.8	119.4
Contract authority	0.0	0.0	0.0
Spending authority from offsetting collections			
Earned			
Collected	867.5	867.5	1,169.6
Change in receivables from Federal sources	0.0	0.0	0.0
Change in unfilled customer orders			
Advance received	0.0	0.0	0.0
Without advance from Federal sources	53.5	53.5	(46.8)
Subtotal	1,315.9	1,315.9	1,258.2
Nonexpenditure transfers, net, anticipated and actual	0.0	0.0	0.0
Temporarily not available pursuant to Public Law	0.0	0.0	0.0
Permanently not available	(791.1)	(791.1)	(1,083.2)
Total Budgetary Resources	$ 571.6	$ 571.6	$ 258.0
Status of Budgetary Resources			
Obligations incurred:			
Direct	$ 512.4	$ 512.4	$ 211.3
Reimbursable	0.0	0.0	0.0
Subtotal	512.4	512.4	211.3
Unobligated balance:			
Apportioned	23.2	23.2	1.2
Exempt from apportionment	0.0	0.0	0.0
Subtotal	23.2	23.2	1.2
Unobligated balance not available	36.0	36.0	45.5
Total Status of Budgetary Resources	$ 571.6	$ 571.6	$ 258.0
Change in Obligated Balance			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 3,417.8	$ 3,417.8	$ 3,863.8
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(76.9)	(76.9)	(123.7)
Total unpaid obligated balance	3,340.9	3,340.9	3,740.1
Obligations incurred net	512.4	512.4	211.3
Less: Gross outlays	(421.8)	(421.8)	(657.3)
Obligated balance transferred, net:			
Actual transfers, unpaid obligations	0.0	0.0	0.0
Actual transfers, uncollected customer payments from Federal sources	0.0	0.0	0.0
Total Unpaid obligated balance transferred, net	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	0.0	0.0	0.0
Change in uncollected customer payments from Federal sources	(53.5)	(53.5)	(46.8)
Obligated balance, net, end of period:			
Unpaid obligations	3,508.4	3,508.4	3,417.8
Less: Uncollected customer payments from Federal sources	(130.4)	(130.4)	(76.9)
Total, unpaid obligated balance, net, end of period	3,378.0	3,378.0	3,340.9
Net Outlays:			
Gross outlays	$ 421.8	$ 421.8	$ 657.3
Less: Offsetting collections	(867.7)	(867.7)	(1,169.4)
Less: Distributed Offsetting receipts	0.0	0.0	0.0
Net Outlays	$ (445.9)	$ (445.9)	$ (512.1)

Section 3

Other Accompanying Information

The Pentagon Memorial

One hundred eighty four *lives were lost in a single moment at the Pentagon. One hundred eighty four individuals forever linked through the horrific events that unfolded on September 11, 2001.*

Thousands *of others lost their lives and suffered injury that day while millions wept. That day was simply incomprehensible. It jolted us into a different world, a tragic reality that just did not seem real.*

We claim this ground in rememberance of the events of September 11, 2001. To honor the 184 people whose lives were lost, their families, and all those who sacrifice that we may live in freedom.

We will never forget.

Section 3: Other Accompanying Information

Inspector General's Summary of Management and Performance Challenges and Management's Response to Auditor Challenges

The Inspector General (IG) has determined that five of the six management and performance challenges identified in FY 2006 continue to be challenges for FY 2007. Human capital has been removed as a separate challenge area and has been incorporated into the remaining challenge areas due to its fundamental relationship with virtually all other facets of management. The following are the five management and performance challenges identified by the IG for FY 2007:

1. Financial Management
2. Acquisition Processes and Contract Management
3. Joint Warfighting and Readiness
4. Information Assurance, Security and Privacy
5. Health Care

The table below outlines these challenges and includes both the IG's and Department of Defense (DoD) management's assessments of the Department's progress in addressing the issues. Columns A and B were prepared by the Inspector General; Column C was prepared by the Department.

1. Financial Management		
A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
The Department faces financial management challenges that are complex, long-standing, and pervade virtually all its business operations. The challenges affect DoD's ability to provide reliable, timely, and useful financial and managerial data needed to support operating, budgeting, and policy decisions. The DoD's financial management problems are so significant that they constitute the single largest and most challenging impediment to the U.S. Government's ability to obtain an opinion on its consolidated financial statements. The weaknesses that affect the auditability of the financial statements also impact other DoD programs and operations and contribute to waste, mismanagement, and inefficient use of DoD resources. The Government Accountability Office identified DoD financial management as a high-risk area in 1995, a designation that continues to date. This designation, together with the high-risk areas of business systems modernization (designated in 1995), and supply chain management (designated in 1990) directly affect the Department's ability to attain an unqualified audit opinion on its financial statements. In its June 30, 2007, Executive Branch Management Scorecard, the Office of Management and Budget assessed the status of the Department's financial performance as "Red," or "Unsatisfactory." The IG previously had identified and reported on several material control weaknesses that reflect some of the pervasive and long-standing financial management issues faced by DoD and which directly impact the Department's ability to obtain an unqualified opinion on its financial statements. These weaknesses, which also affect the safeguarding of assets and proper use of funds and impair the prevention and identification of fraud, waste, and abuse, include the following: • Fund balance with Treasury • Inventory • Operating materials and supplies	One significant measure of the ongoing progress in the area of financial management would be the Department's ability to obtain an unqualified audit opinion on its financial statements. The DoD is far from reaching this milestone as demonstrated by the audit opinions received by the Department and its Components on their FY 2006 financial statements. However, the Department's ongoing initiatives in the area of financial management improvement indicate that DoD management is responding to the significant and pervasive financial management issues and is positioning itself to leverage planned systems and business improvements to achieve sustainable and long-term solutions. The Financial Improvement and Audit Readiness (FIAR) Directorate is responsible for centrally coordinating the FIAR initiative; regularly updating a written plan with stated objectives and milestones; defining a process with protocols for making decisions; tracking progress; and providing guidance for the decision-making process through oversight groups consisting of participants from across DoD. The FIAR Plan categorizes the financial management challenges faced by the Department into three broad categories; those that depend on: 1. systems solutions, 2. process solutions, and 3. both systems and process solutions. The FIAR plan focuses on the process solutions that DoD financial managers identify, develop, and implement to correct financial reporting deficiencies or internal control weaknesses. The IG has focused its audit efforts primarily on the FIAR improvement initiative. The IG considers the following DoD financial management efforts to be limited successes: • Implementation of integrated organizational structures and processes to address financial management improvement. • Assignment of accountability to DoD managers. • DoD improvement initiatives at the entity and line-item level.	The Department is pleased to see the recognition on the part of the DoDIG regarding financial improvements being made across the DoD. We concur that the financial management area is a large challenge and we have comprehensive plans that highlight improvements on the path forward. Our financial management challenges are both pervasive and well documented. The Department's roadmap for financial improvements is its Financial Improvement and Audit Readiness (FIAR) initiative. The FIAR Plan is our guide for comprehensively improving financial management and preparing for audit. It identifies critical activities for improving internal controls, resolving auditor identified weaknesses, optimizing fiscal stewardship, and achieving audit readiness. The Plan addresses action taken to correct both auditor identified material weaknesses along with internal management control weaknesses. Milestones are established to monitor progress and to ensure that required actions are completed and the Department is on schedule to achieve auditability. We also concur that the Department has made substantive progress in "establishing a culture and ingrained structure" and will continue our commitment to the on-going evolution of the Department's business processes and organizational structure. Based on the efforts achieved with the FIAR Plan, the Office of Management and Budget continues to rate the Department "green" for progress in Improving Financial Performance under the President's Management Agenda. The FIAR Plan is closely integrated with the Department's Enterprise Transition Plan, which guides the Department's business transformation effort to modernize processes, systems, and information flows to support 21st century national security requirements. The links below connect to these plans and provide details about the Department's goals and accomplishments.

1. Financial Management

A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
• Property, plant, and equipment • Government-furnished material and contractor-acquired material • Environmental liabilities • Financial management systems • Intragovernmental eliminations • Other accounting entries • Statement of Net Cost • Statement of Financing (see note 21) • Accounts Payable • Accounts Receivable The following elements and actions are key to improving the Department's financial management: • Create an environment that fully supports clean financial reporting. The financial managers need buy-in from senior management and personnel in the field offices in order to successfully implement the corrective action plans. • Maintain a significant level of continued review to identify all of the material financial management and reporting deficiencies, internal control weaknesses, and quality of data issues. • Develop corrective action plans that will adequately correct the deficiencies and result in financial reporting in accordance with generally accepted accounting principles. • Implement the corrective action plans that address the system, control, reporting, or quality of data weakness. Additionally, an overall shortage of qualified auditors and accountants has hindered progress on the challenges outlined above. Continual turnover of qualified staff who conduct audits at DoD Agencies and independent public accounting firms, and also turnover of qualified accounting staff to support financial functions and audits, has surfaced as a formidable obstacle to the effective and efficient execution of those audits. The Department needs improved recruiting and retention practices as well as robust training and continuity of operations planning to alleviate the problem.	Although the IG anticipates that DoD will need to make refinements in these areas, the IG considers these to be the critical steps for establishing a culture and ingrained structure that will enable DoD managers to identify internal control weaknesses and plan effectively for resolution of those weaknesses. The culture and structure also will hold DoD managers accountable for improving internal controls over financial reporting. Further, these steps should result in a financial management structure that can provide accurate, relevant, and timely financial management information for decision making. We fully support the Department's goal to implement internal controls that will result in sustained improvements in its ability to produce timely, reliable, and complete financial management information. To that end, DoD needs to continue the development of comprehensive, integrated plans that will lead to improved systems and internal control. We recognize that there are many variables affecting the execution of DoD improvement initiatives, such as specific Components' ability to make corrective actions and meet the projected milestones. For example, the U.S. Army Corps of Engineers is making progress by working to fix the majority of the property, plant, and equipment beginning balances; and the Office of the Under Secretary of Defense (Comptroller) is tracking progress through weekly updates from the U.S. Army Corps of Engineers and DoD IG personnel. The IG will continue to provide input to the DoD managers on these initiatives as requested, or as part of the IG's advisory role on the DoD committees that support these initiatives. However, the qualified staffing shortage will remain a concern for the foreseeable future until it is more adequately addressed.	FIAR Plan - http//:www.defenselink.mil/comptroller/FIAR/documents/FIAR_Plan_Sept_2007.pdf Enterprise Transition Plan - http//:www.defenselink.mil/dbt/products/2007_BEA_ETP/etp/ETP.html

2. Acquisition Processes and Contract Management

A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
The Department continues to experience the management challenge to provide required materiel and services that are superior in performance, high in quality, sufficient in quantity, and within the timeframes needed by the warfighter while balancing the cost concerns for the taxpayer. With the war, the volume and complexity of purchases have increased to provide the additional support needed by the warfighter. The DoD spending in FY 2007 (with supplementals) will exceed $600 billion, which is more than double the spending from FY 2000. This, in turn, has led to efforts to increase the speed of the procurements to meet urgent warfighter needs. Some of these efforts have resulted in less than prudent contracting practices. Every acquisition dollar that is not prudently spent results in the unavailability of that dollar to fund other top priorities of the Secretary of Defense and wastes valuable taxpayer dollars.	The Department has made progress in improving acquisition processes. Despite this progress, the increasing volume of acquisitions, the decrease in the number of acquisition personnel, and the numerous types of contracting vehicles and methods for accomplishing acquisition make this a long-term challenge. The Department has worked closely with the IG and other agencies to develop solutions to make interagency contracting work better. The DoD also has demonstrated a strong commitment to hold contracting officers accountable for following the regulations and the law. However, the sheer number of contracting actions and the pressures on contracting officials to award procurements faster make the challenge of correcting the problem more difficult. These same issues are compounded when contracting for and in hostile environments such as Southwest Asia and the aftermath of tragedies such as Hurricane Katrina.	No Response

2. Acquisition Processes and Contract Management

A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
While the problems encountered in the contracting process are not unique to the wartime environment, the risk of critical gaps in the contracting process increases during contingency operations. The challenge in a wartime environment is to mitigate these gaps. Gaps occurred when: • user requirements were not met, • funds were not spent appropriately and unaccounted for, • goods and services were not properly accounted for, • delivery of goods and services were not made properly, • individuals involved in the acquisition process lacked integrity, and • adequate documentation was not retained or prepared. The DoD acquisition workforce has not kept pace with the increasing demand for technical expertise, compounding the risk of critical gaps. Ensuring the appropriate size and experience level of the acquisition workforce in light of changing acquisition strategies and vehicles, prior downsizing, and an aging workforce, is a challenge. A recent congressional proposal calls for the transfer of 600 General Services Administration contracting officers to assist the Department in meeting its contracting needs. Management also is challenged to make appropriate use of acquisition streamlining initiatives. Government quality assurance and pricing options are more limited under commercial contracts. Therefore, the procurement community must continue to closely monitor whether we are receiving the real benefits of the commercial marketplace including market-based pricing and products and services that meet warfighter requirements. The Department also continued to experience a variety of shortcomings in its approach to compliance with the DoD acquisition guidance and the Federal Acquisition Regulation in FY 2007. The IG identified instances where acquisition officials made decisions to proceed with key milestones without sufficient documentation to support those decisions. In other cases, warfighter requirements were not adequately justified. In one case, acquisition officials prematurely released the presolicitation notice for the competition of a 5.56-mm carbine before they performed other essential requirements to determine that a new competition was warranted or contacted the current contractor to determine whether the contractor would lower its unit prices. The Department continues to experience significant challenges regarding purchases made through other agencies for the Department. Last year, the Inspector General continued to find a variety of problems with interagency orders. One significant recurring issue was the failure to allow all contractors the fair opportunity to compete for awards on multiple award contracts. Also, Military Interdepartmental Purchase Requests did not comply with the appropriations law and the Federal Acquisition Regulation for making purchases through other agencies.	The Department needs to continue to be vigilant about allegations of corrupt acquisition, especially with the volume and speed of acquisitions in support of Operation Iraqi Freedom and Operation Enduring Freedom. In support of this mission, the Defense Criminal Investigative Service, as a member of the Department of Justice National Procurement Fraud Task Force Training Committee, assisted in the development of the Procurement Fraud Investigation Training Program, which has been made available to all Defense criminal investigative organizations through the Federal Law Enforcement Training Center. Furthermore, the National Defense Authorization Act of FY 2007 directed the Department of Defense to convene a panel of senior leaders representing a cross-section of the Department. The panel's mission is to conduct a Department-wide review of vulnerabilities to fraud, waste, and abuse in contracting integrity, to recommend corrective actions, and to report the panel's findings and actions to the Congress by December 31, 2007. The report will be the first of three annual reports issued by the panel. The panel has developed subcommittees that will evaluate issues related to the challenge areas noted above. The creation of this panel is a positive step toward addressing and managing these challenges.	No Response

2. Acquisition Processes and Contract Management

A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
With the war effort, it was sometimes quicker and easier for contracting officers to go to known sources without ensuring that Federal Acquisition Regulation guidelines on exceptions from competition were met before making these awards. We found instances where sole source actions were not properly justified. The challenge remains to ensure that adequate market research is performed before contracts are awarded, thereby allowing capable contractors to compete for the large volume of procurements. A final challenge with the decline in the acquisition workforce is to provide adequate surveillance over cost-type service contracts. These contracts provide no incentive for contractors to control costs so adequate surveillance by the Department is especially important to make sure that we get the quality of services that we should expect while also best serving the taxpayer.		No Response

3. Joint Warfighting and Readiness

A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
The challenge of Joint Warfighting and Readiness is to provide the right force, the right personnel, and the right equipment and supplies in the right place, at the right time, and in the right quantity, across the full range of military operations. This challenge is compounded by the strain on resources as a result of Operation Iraqi Freedom and Operation Enduring Freedom. Furthermore, this challenge encompasses the need for the Services and allies to be interoperable, communicate with each other effectively, share data when necessary, and train together when possible. To meet this challenge, the Department is continuously transforming. While U.S. forces continue to operate around the world, changes are underway to better align the resources of the Department to benefit the warfighters, wherever they are. Those changes have taken a variety of forms, not the least of which is the improvement of the tools used to fight the enemies of the United States. The fight against terrorism, as well as the ongoing Operations Enduring Freedom and Iraqi Freedom continue to test the limits of the Department and its ability to successfully defend the United States. But those have been shared battles, with each Service shouldering its portion of the load. For example, the IG's investigative component, the Defense Criminal Investigative Service, has worked effectively with the Army's Criminal Investigation Command, Federal Bureau of Investigation, and the Special Inspector General for Iraq Reconstruction, by assigning two special agents to Iraq and two special agents to Kuwait on 6-month rotating details. These agents specifically will address allegations related to bribery, kickbacks, contracting irregularities, and other matters that involve procurement fraud and public corruption that impact joint warfighting capabilities. In addition, in June 2007 the DoD IG established a field office in Afghanistan to conduct audits of contracts, funds management, and other accountability-related issues in support of Operation Enduring Freedom.	The Department is making progress on the issue of Joint Warfighting and Readiness, but that progress must be monitored to ensure that it continues. Changes in the location and numbers of bases in the European and Pacific theaters and the continued operations in Southwest Asia have brought to light numerous challenges facing commanders. The DoD has taken steps to align materials pre-positioned in the European theater with the new basing structure for that Command. Our review of the management of pre-positioned munitions in the European theater showed that DoD had taken positive steps to reduce the amount of munitions stored in the European theater while still meeting requirements. The ability to equip in-lieu-of forces, as well as those forces performing nontraditional missions was highlighted by our work in the U.S. Central Command area of responsibility. Our audit of force structure changes in the U.S. Pacific Command highlighted the need for continued vigilance as DoD realigns forces to meet commitments in that theater. Transformational changes in the Army structure and warfighting policies have had an effect on the ability to provide weapons for the entire Army. Transformation to a modular force also has had an effect on making sure small arms get out to the warfighter; however, the Army continues to be responsive in efforts to forecast requirements for small arms. During our review of the availability of small arms for meeting current operational requirements, we concluded that the Army equipped its deployed forces in support of Operation Iraqi Freedom with the small arms necessary to meet Combatant Commanders' requirements. However, before deployment, some units were not fully equipped with the types of small arms required to do their assigned mission, so they had to obtain those small arms from other sources, such as nondeployed units. This happened because the current mission requirements warrant different types of small arms not reflected in a unit's Modified Table of Organization and equipment.	Joint warfighting capabilities and readiness remains a major focus of the Department. At the strategic level, considerable effort is expended to ensure our current and emerging joint warfighting capabilities and basing strategy support our strategic and operational needs, and the changes in the European theater cited by the IG are one example of that effort. As the Department realigns forces to better respond to today's environment, forward positioned munitions are continuously evaluated to ensure requirements are met and excess munitions are retrograde to CONUS depots. However, current operations in OIF/OEF continue to be the major effort and place significant strain on the force. The Department is committed to ensuring forces deploying to OIF/OEF have the personnel, equipment and training necessary to meet operational needs. To do so, the non-deployed force has seen a decrease in readiness as some of their equipment and personnel are re-allocated to fully man/equip deploying units for their theater assigned missions. Additionally, these manning and equipment shortfalls can result in decreased training for non-deployed units. Moreover, some units are trained to new missions to relieve the stress on certain heavily demanded segments of the force (ex: military police). These in-lieu-of (ILO) units must be trained, and often receive new equipment, for this new mission before deploying to OIF/OEF. But to reiterate, great effort is expended to ensure all deploying units are manned, equipped and trained to meet the operational needs identified by the gaining combatant commander. As OIF/OEF operations continue, the Department is addressing the resources needed to reset and reconstitute the force. As the IG noted, considerable reset funds are expended today, and additional resources will be necessary in the coming years to repair or replace damaged or worn out equipment. Furthermore, as the Department works diligently to ensure success in OIF/OEF, we remain vigilant of other global areas

3. Joint Warfighting and Readiness		
A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
	The Army continues to address small arms sustainment and modernization that should close future shortage gaps. Ongoing reviews cover issues such as the Army's reset program for equipment to determine the effectiveness of the technical inspection process for those units that are completing their tour in support of Operation Iraqi Freedom. Since FY 2002, the Army has allocated approximately $38.6 billion for equipment reset, with the Army receiving $17.1 billion in FY 2007 Global War on Terror supplemental funding. Another ongoing review is addressing whether U.S. ground forces supporting Operation Iraqi Freedom are receiving training necessary to meet operational requirements. Specifically, we will determine whether requirements reflect the training necessary in the area of operation and verify whether the ground forces are receiving the required training, as well as evaluate whether the training is meeting the needs of ground forces supporting Operation Iraqi Freedom. Additionally, we have an ongoing review evaluating the transformation of the U.S. global defense posture in the U.S. European Command.	of concern, and regularly assess our preparedness to respond to contingencies/event elsewhere.
The Global War on Terror will continue to be a long and difficult war affecting the entire global community. It will require firm commitment and cooperation of U.S. allies and coalition partners, as well as international organizations, domestic state governments, and the private sector. The demands placed on the Armed Forces the past few years have been extensive, but our military is unwavering in its focus on, resolve, and dedication to peace and freedom. With the Congress' continued strong support, the military will continue to effectively combat terrorism, counter the proliferation of weapons of mass destruction, help Iraq and Afghanistan build a stable and secure future, improve joint warfighting capabilities, and transform the Armed Forces to meet future threats.	The Department has made great strides toward addressing the challenge of defending our homeland. The Department has taken positive steps toward enhancing its ability to promote a greater understanding and cooperation among all DoD Components that are combating weapons of mass destruction. Also, the Department has made significant improvements in its controls over transfers of militarily sensitive technology to countries of concern during the past 6 years. Further, the Department has developed numerous policies, plans, and procedures for deterring, intercepting, and defeating threats to the U.S. homeland. However, terrorists and countries of concern are relentless in their pursuit to strike our cities, our citizens, and our interests abroad. Therefore, the Department must maintain its vigilance, as the traditional vanguard of America's security, in addressing the dynamic and ever-changing challenges of defending our homeland.	While DoD has "taken positive steps toward enhancing its ability to promote a greater understanding and cooperation among all DoD Components that are Combating Weapons of Mass Destruction", there is still more to be done. The Department needs to ensure it is effectively organized and staffed to oversee CWMD programs; the lack of a single portfolio manager for CWMD programs significantly hampers the Department's ability to allocate investments across the eight WMD mission areas. Furthermore, to realize national goals in CWMD, DoD will need increased investment in WMD detection, WMD forensics and attribution, and WMD consequence management.
The Department's available resources are finite and require constant monitoring of our abilities and of the world situation to enable the Department to successfully operate on a global scale. The continued operations in Iraq and Afghanistan require a significant commitment of forces. Meanwhile, the advances by the People's Republic of China in modernizing its armed forces and the possibility of nuclear weapons in North Korea and Iran also require constant monitoring. The combination of these various factors continues to challenge the Department.		The Department regularly assesses readiness to meet the demands of the national military strategy. This includes an assessment of our ability to conduct current operations as well as other, simultaneous scenarios. While OIF/OEF does put significant stress on our forces, leadership is routinely advised of situations being monitored globally, and our readiness to respond elsewhere, if needed.

3. Joint Warfighting and Readiness		
A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
Additionally, the Department is being asked to take on other roles that require different tactics, techniques, and procedures than warfighting operations, often at the same time. In November 2005, the Deputy Secretary of Defense issued DoD Directive 3000.05, which established that stability operations are a core U.S. Military mission to be given priority comparable to combat operations and to be ". . . explicitly addressed and integrated across all DoD activities including doctrine, organizations, training, education, exercises, materiel, leadership, personnel, facilities, and planning." A National Security Presidential Directive and the National Defense Authorization Act for FY 2006 recognize DoD's role in reconstruction and stabilization efforts. In fact, some of the work being done in Southwest Asia can be considered part of these activities. These programs support Global War on Terror and other national interest areas. The DoD often takes on efforts in these areas, even though they might not be the agency or organization with primary responsibility – because they can. A number of challenges in this area exist. The doctrine must be developed and the difference between reconstruction and stability and warfighting missions must be clearly articulated while at the same time recognizing that the two might be conducted simultaneously. Building and rebuilding the DoD institutions and organizations and developing meaningful doctrine may require significant investment, including the need for the DoD training schools and educational system to address two different missions with different tactics, techniques, and procedures, that more than likely will be executed at the same time and place.		Since the issuance of DoD Directive 3000.5 and NSPD 44, the Department has either led, participated in or supported change initiatives required to conduct stability, security, transition and reconstruction operations. These initiatives have included seeking new Congressional Authorities, launching a new Combatant Command with inherently unique interagency command structure, participating in an interagency crisis planning initiative, assisting in publishing guidelines for military and Non-governmental Humanitarian Organizations (NGHO's) relationships, increasing billet sharing among the department and interagency and creating a department sponsored Consortium for Complex Operations (CCO). Undertaking these initiatives simultaneously has made analytical assessment of any one activity a challenge. That said, the broad front on which the department has engaged SSTR challenges illustrates the commitment to improving the department's capability and capacity to conduct SSTR. The following assessment is provided in the broader categories of SSTR improvements: Authorities. The department has sought and will continue to seek congressional support to build on our force's ability to assist and train partners in the War on Terror, build our interagency partner capacity through the development of a Civilian Response Corps (CRC), and expanding the capability of the Commander's Emergency Response Program (CERP). Planning. The department is experimenting with organizational structures in the Combatant Commands in effort to improve interagency communication and integration in campaign planning. These experiments include placing interagency officials in the command organization at the Africa Command headquarters and creating an interagency directorate at Southern Command. The department also participated in the first table top planning exercise using the Interagency Management System (IMS) sponsored by the Department of State. The IMS is designed to respond to complex crises and operations that have been identified as national priorities. Training and Education. The department is becoming more coordinated, integrated and standardized. Though not necessarily the model for all future SSTR missions, the Provincial Reconstruction Teams (PRTs) deployed to Iraq and Afghanistan are prepared in an integrated and coordinated enviroment. The Deparment's CCO when operational in the Spring 2008, will serve as a training and education hub to facilitate interagency education sharing. Doctrine. The department has issued a Joint Operational Concept (JOC) for SSTR operations. This is the first step in developing codified doctrine for force wide adaptation. Joint and Service exercises are incorporating SSTR into planning and execution to test and evaluate the JOC. Capabilities Based Assessments (CBAs) are under consideration which will inform force structure requirements in both the general purpose as well as the special operations forces. SSTR assessment will by the nature of the operations which occur during all phases of a campaign, including pre-hostilities, will be iterative and ongoing.

3. Joint Warfighting and Readiness		
A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
Transformation of logistics capabilities poses a significant challenge to the Department. The Department's transformed logistics capabilities must support future joint forces that are fully integrated, expeditionary, networked, decentralized, adaptable, capable of decision superiority, and increasingly lethal. Additionally, transformed logistics capabilities must support future joint force operations that are continuous and distributed across the full range of military operations. Supply chain management is a challenge for the Department. The Government Accountability Office identified supply chain management as a high-risk area because of weaknesses uncovered in key aspects, such as distribution, inventory management, and asset visibility. It has reported on numerous problems associated with supply chain management such as shortages of items caused by inaccurate or inadequately funded war reserve requirements and DoD's lack of visibility and control over the supplies and spare parts it owns.	The Department has made progress toward meeting its goal of transforming logistics through numerous initiatives. However, that progress is tempered by the sheer magnitude of logistics operations that will continue to make it a long-term challenge. To this goal, the Inspector General has evaluated such areas as inventory management, which remains a challenge within the Department. The Defense Logistics Agency successfully has managed selected items in its own inventory by providing a stable industrial base through a program entitled "Warstopper." These items, critical to the Services' mission, are needed to meet wartime surge requirements, but their peacetime requirements are not sufficient to maintain an industrial capability. Among the items included as warstopper items were nerve agent antidote auto-injectors; chemical protective over-garments and gloves; meals ready-to-eat; tray pack rations; combat boots, including cold weather boots; and barrier materials. The program provides an increased industrial capacity to provide surge and sustainment of selected warstopper items. However, the program also included items that did not fully meet its criteria, resulting in the use of scarce warstopper funds for non-program projects at the expense of higher priority projects. While DoD officials established business rules, defined goals for measuring customer wait time, and reported customer wait time metrics from 2001 to 2005, the metrics did not allow DoD officials to effectively measure the link between customer wait time and operational availability of equipment. Consequently, officials do not know how the customer wait time for high priority items will affect operational readiness.	The DoD supply chain is undergoing a significant transformation. Joint and Service logistics capabilities must support a joint force that is fully integrated, expeditionary, networked, decentralized, and adaptable. Without a coordinated and holistic approach, progress towards transforming the DoD Supply Chain will continue to be tempered by the sheer magnitude of logistics operations. Services must strive to fully integrate and synchronize the DoD Supply Chain by achieving unity of effort, JLE-wide visibility, and rapid/precise response to better generate and sustain joint readiness. The Services are engaged in numerous transformation efforts to enhance and better coordinate their efforts such as BRAC, Air Force eLog-21, Marine Corps MLI, USTRANSCOM Distribution Process Owner, OSD and Joint Staff's DoD Joint Supply Chain Architecture efforts.
The Department also faces a challenge in meeting its goal to reduce preventable accidents. Accidents not only reduce readiness through lost man-hours and the unavailability of personnel but are estimated to cost the Department approximately $25 billion a year, not to mention the human suffering that is the most regrettable consequence of accidents. In March 2004, the Secretary challenged Department managers to reduce accidents 75 percent by 2008. In May 2007, the Secretary recommitted to the 75 percent accident reduction target and stated a goal of zero preventable accidents. The challenge for the Department is to make safety an institutional value. Responsibility for environment, safety, and health policy is dispersed throughout the Department.	Reducing preventable accidents remains a challenge for the Department. Based on current trends, the Department is unlikely to achieve the Secretary's target of reducing accidents by 75 percent. The Defense Safety Oversight Council, established in June 2003 to facilitate oversight of the Department's efforts to achieve the Secretary's goal, has established eight task forces to address near-term issues and produce rapid results. The council is encouraging Service participation and partially funding Department-wide adoption of the Voluntary Protection Program, an Occupational Health and Safety Administration-developed program designed to stress prevention activities.	The Department continues to strive towards reducing accidents and meet the SecDef 75% mishap reduction goals from the baseline of 2002. The Defense Safety Oversight Council (DSOC) monitors mishap metrics on a regular basis with specific focus on: civilian lost day rates, private motor vehicle (PMV) accident fatality rates, military injury case rates and aviation Class A rates. To date, the Department has shown improvements in all areas with the exception of military injuries, which show a 20% increase. This increase may be attributable to improved reporting procedures and DSOC routinely re-validates the data. Civilian lost day rates have shown a 29% reduction, PMV 20%, and aviation Class A with a 25% reduction. The Department has seen these improvements in mishap rates despite the increased exposure to risk due to increased training, deployments, and OPTEMPO in inherently dangerous environments. Further improvements may be gained through continued leadership commitment, coordinated efforts between the DSOC and the functional organizations, and investments in safety technologies and safety training.

4. Information Assurance, Security and Privacy		
A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
Ensuring that a robust information assurance and security program is in place is still a challenge to the Department. Such a program includes periodic risk assessments; security awareness training; security policies, procedures, and practices, as well as tests of their effectiveness; procedures for addressing deficiencies and for detecting, reporting, and responding to security incidents and privacy data breaches; and ensuring the continuity of operations. The Department also faces the challenge of ensuring that privacy protections are not compromised by advances in technology. One of the major challenges identified last year was protection of DoD information in the hands of contractors and the appropriate response to data breaches involving both privacy protected data, such as personally-identifiable information, and sensitive but unclassified information, such as contractor proprietary information.	The Department made little improvement during the course of FY 2007 in its information assurance and security posture. Unresolved issues now are exacerbated by the recent losses of privacy and sensitive but unclassified data, and the lack of clear DoD policy regarding protection of such data and the reporting of incidents regarding its compromise. Of particular concern is protection of DoD information in the hands of contractors, to include all members of the Defense Industrial Base (DIB). The Department has recognized these challenges and initiated cooperative efforts with the Directors of National Intelligence and the National Institute of Standards and Technology. These efforts establish a common set of information security controls, risk management framework, and security certification and accreditation process that can meet the needs of federal agencies managing and operating both national security and non-national security systems. Additionally, it has initiated outreach efforts to members of the Defense Industrial Base to improve identification of and response to instances of data breaches pertaining to DoD information in the hands of contractors. These efforts should be expanded and accelerated.	The Department has moved aggressively to address DIB information assurance (IA) vulnerabilities. Beginning in April 2007, DoD working groups developed a strategy to address DIB IA that was presented to the Deputy Secretary of Defense (DSD) in July. At DSD direction, DoD reached out to industry under the DIB sector coordinating committee of the Critical Infrastructure Partnership Advisory Council (CIPAC) and has developed a concept of operations for threat information sharing, incident reporting and response and damage assessments. In addition, the CIPAC DIB working groups have developed an IA standard built on guidance published by the National Institute of Standards and Technology. This DoD/industry effort is working under an aggressive schedule to implement changes needed to address IA in the DIB. The Department also is publishing updated guidance that explicitly addresses certification and accreditation of information systems operated by contractors on behalf of the Department, as required by the Federal Information Security Management Act of 2002. Additionally, in July 2007 the Department issued a policy memorandum requiring that all unclassified DoD information not cleared for public release that is stored on mobile computing devices (e.g., laptops) or removable storage media (e.g., thumb drives) be encrypted. The policy applies to supporting contractors as well as DoD organizations. In May 2007, DoD revised and reissued the DoD Directive and Regulation, both entitled DoD Privacy Program. In those documents specific requirements were established to ensure the protection of personally identifiable information (PII) throughout the DoD including applicability to contractors. The regulation described specific reporting requirements to agency heads, the Defense Privacy Office and the US-Computer Emergency Response Team at the Department of Homeland Security. The requirement to notify individuals of the loss, theft or compromise previously directed by a DEPSECDEF Memo dated July 15, 2005 was incorporated into the regulation and included a sample notification letter. In May 2007, OMB issued a memorandum "Safeguarding Against and Responding to Breaches of Personally Identifiable Information" requiring establishment of new policies to address safety and security measures to instill safeguards to prevent a breach. While DoD has adopted policies in many of the areas addressed, new requirements were established to augment, and thereby strengthen current agency policies. The OMB Memo included new requirements to inform and train persons with access to PII. New training policies include specific focused training to managers as well as others in the workforce as a prerequisite to system/network access, and annual refresher training followed by signed certification of awareness by individuals. Agencies were directed to review and reduce the volume of PII. DoD components were required to establish plans for the systematic review of holdings of PII to determine that such holdings are accurate,

4. Information Assurance, Security and Privacy		
A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
		relevant, timely, and complete, and to reduce them Agencies were directed to review and reduce the volume of PII. DoD components were required to establish plans for the systematic review of holdings of PII to determine that such holdings are accurate, relevant, timely, and complete, and to reduce them to the minimum necessary. Also included was direction to reduce the use of the Social Security number when found to be unnecessary. Plans for addressing these reviews were incorporated in the annual reporting requirement of the Federal Information Security Management Act for 2007 and are ongoing. The DoD established and published new privacy policy for compliance by the DoD Components with the OMB Memo in a September 21, 2007 Memo signed by the Director of Administration and Management. The new policies are applicable to all DoD personnel including contractors and business partners. The DoD has taken constructive steps through the development of new policies and reporting requirements to safeguard PII in its possession to prevent loss, theft or compromise. With these new policy initiatives and increased individual and organization awareness, safeguarding and protection of PII and other sensitive information to prevent loss, theft or compromise will continue to improve.

5. Health Care		
A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
The DoD Military Health System must provide quality care for approximately 9.1 million eligible beneficiaries within fiscal parameters while facing growth pressures, legislative imperatives, and inflation that make cost control difficult in both the public and private sectors. The DoD challenge is magnified because the Military Health System's primary mission is to provide health care support for the full range of military operations. Part of the challenge in delivering health care is combating fraud. Health care fraud is among the top five categories of criminal investigations; currently representing approximately 8 percent of the open cases of the Defense Criminal Investigative Service. A major challenge to the Department is sufficient oversight of the growing cost of health care for its beneficiaries. The increased frequency and duration of military deployment further stresses the Military Health System in both the Active and Reserve Components. The DoD budget for health care costs was approximately $40 billion in 2007, including $21.9 billion in the Defense Health Program appropriation, $6.5 billion in the Military Departments' military personnel appropriations, $0.4 billion for military construction, and $11.2 billion for contributions to the DoD Medicare-Eligible Retiree Health Care Fund to cover future costs of health care for Medicare-eligible retirees, retiree family members, and survivors. Increasing health care benefits provides additional pressure to manage and contain costs. The Department is scheduled to transition to the next generation of TRICARE contracts during FY 2008.	The DoD Military Health System has been moving forward on improving health care while attempting to control costs. The Military Health System has made progress in implementing new TRICARE contracts. The current contracts provide incentives for customer satisfaction and include the managed care support contractors as partners in support of medical readiness. The Military Health System continues to work with the contractors to refine the contracts with the ultimate goal of improving readiness and the quality of care. Lessons learned are being used to implement the next set of contracts, with formal acquisition scheduled to commence this fall when the request for proposals will be issued. It appears unlikely that DoD will obtain authority on the use of federal ceiling prices for pharmaceuticals in the near future, a process that would allow the Military Health System to realize millions of dollars in savings annually in pharmacy costs. However, DoD is making headway in economizing on pharmacy costs by implementing use of generic drugs and promoting use of the TRICARE Mail Order Pharmacy system. The Medical Readiness Review has been completed. It was created to assess the baseline medical capabilities required to support the warfighter during peacetime and to assess the surge capabilities required for wartime. The Review evaluated medical personnel currently available, the cost of those personnel, and strategies necessary to supply those capabilities. It also reviewed wartime medical force requirements and compared those requirements to the current force structure, looking for gaps and redundancies. The Review recommended aligning medical support with the growing movement	

5. Health Care

A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
The Department's challenge is how to oversee the growing cost of health care for military members and to effectively transition to the next generation of TRICARE contracts. Maintaining medical readiness continues to be a challenge. Readiness of the medical staff and units includes ensuring that medical staff can perform at all echelons of operation and that the units have the right mix of skills, equipment sets, logistics support, and evacuation and support capabilities. The challenge of keeping reservists medically ready to deploy continues because of the frequency and duration of Reserve deployments. In addition, transitioning wounded, ill, or injured Service members to post-deployment care will continue to grow as a challenge while the Global War on Terror, Operation Iraqi Freedom, and Operation Enduring Freedom continue. As with most Department functions, the Military Health System continues to face the challenges of increased joint operations. For example, the number of wounded warriors associated with Southwest Asia and other such conflicts significantly impacts the health care resources within the Department and can result in such issues as the conditions that were raised at Walter Reed Army Medical Center. And another related challenge to medical readiness are the issues inherent in providing efficient processes for post-deployment health care and benefits to severely injured and ill Service members. The Department needs to improve the medical care and benefits transition program to achieve a streamlined, transparent process as wounded warriors move from the DoD system to the Department of Veterans Affairs' system. Information assurance relating to sensitive medical information continues to be a challenge in the health care community. Episodes of potential exposure of electronic patient information during the year demonstrate the challenge to maintain security and privacy. Also, expanding automation efforts, including the transition from paper to electronic patient records, increases the exposure of sensitive patient information to inadvertent or intentional compromise. Maintaining information operations that ensure the protection and privacy of data will continue to grow as a challenge.	toward joint capabilities and recommended improving the medical planning process. The policies, techniques, and tools developed during the Review are now being imbedded within the system to determine future optimal force structure in a constantly changing threat environment. The DoD continually will reassess the results of the Review against the ever changing and expanding medical missions facing the Department at war and in support of homeland security contingency planning. Disparities in the transition of health care and benefits are easily identified, yet actionable solutions are difficult to implement and streamline. On a positive note, DoD's response to Traumatic Brain Injury and mental disorders, such as Post Traumatic Stress Disorder, is improving significantly—but much effort still is required to help Traumatic Brain Injury patients. The Department established the Force Health Protection Quality Assurance Program to ensure that the health of Service members, as well as applicable DoD civilian and contractor personnel, is monitored, protected, sustained, and improved effectively across the full range of military activities and operations. Although the Military Health System has tools available for commanders to screen those pre-deployed, deployed, and post-deployed, and to assist the deployed reservists' and guardsmen's family members, the challenge of preparing reservists and guardsmen medically for deployment will go on as the Global War on Terror, Operation Iraqi Freedom, and Operation Enduring Freedom continue. Recent reports in the press on problems associated with post-deployment transition to care for wounded Service members has resulted in many reviews internal and external to the DoD including the President's Commission on Care for America's Returning Wounded Warriors. The President's Commission made several recommendations focusing on ways to better serve the multiple needs of injured service members and their families; better support the wounded warriors in their recovery and return to military duty or their communities; and simplify the delivery of medical care and disability programs. In addition, the Congress provided $300 million for research and $600 million for care of trauma and serious injuries, including traumatic and other brain injuries. Implementing the recommendations resulting from the reviews will be core to the Department's business this coming year. The DoD continues to progress in sharing electronic medical records with the Department of Veterans Affairs. Under the auspices of the American Health Information Community, the DoD and the Department of Veterans Affairs are partnering on building a Joint Inpatient Record to complement existing outpatient records systems.	
Implementing recommendations resulting from the 2005 Base Realignment and Closure process will continue to be a challenge for the near future. In addition to improving the readiness and cost efficiency associated with realigning base structure, a primary objective of the process was to examine and implement opportunities for greater joint activity among the Military Departments.	The Military Health System is facing a major challenge in overseeing the implementation of the 2005 Base Realignment and Closure recommendations and has begun the multi-year transition and acquisition process of improving capability and access to care in two major and several minor markets. Realignment recommendations for the National Capital Area and San Antonio regional markets are examples of DoD's efforts to exploit joint medical opportunities as they transition to new facilities. Additionally, the Military Health System is ready to	Consistent with BRAC law and the 2005 Quadrennial Defense Review (QDR) Medical Roadmap, DEPSECDEF has established a Joint Task Force to (1) ensure the effective and efficient delivery of world-class military healthcare within the NCR Tricare Sub-region (JOA) using all available military healthcare resources within this JOA, and (2) oversee the consolidation and realignment of military healthcare within the JOA in accordance with the BRAC.

5. Health Care		
A. IG Summary of the Challenge	B. IG Assessment of Progress	C. Management's Response
	embark on a change in governance. The Department completed various studies of a unified medical command. Using those studies and recommendations made by the Defense Business Board, the Department decided on an incremental approach to increasing joint governance. The Department is exploring the opportunities provided by the 2005 Base Realignment and Closure recommendations as well as establishing a joint medical education and training center. In addition, the Department also is looking into bringing support functions such as finance, logistics, information technology, facilities, human capital management, and medical research and development under joint governance in a combined headquarters. These functions would serve as corporate assets and the Military Health System could potentially enhance medical readiness while gaining efficiency and economy of scale.	

Summary of Financial Statement Audit and Management Assurances

The Federal Managers' Financial Integrity Act (FMFIA) requires Federal agencies to assess the effectiveness of internal management controls for program, operational, and administrative areas as well as accounting and financial management. Internal management controls are the organization, policies, and procedures that are considered the tools that help program and financial mangers achieve results and safeguard the integrity of their programs. The program strengthens integrity and accountability within programs and operations, and:

- Is critical for good government
- Demonstrates responsible stewardship over assets and resources
- Promotes high-quality, responsible leadership
- Enhances the sound delivery of services to customers
- Maximizes desired program outcomes.

The Department conducts its assessments of the internal management controls under a formalized program conducted throughout the Department to include forward-deployed units such as the Multi-National Forces - Iraq. Using assessments according to the Office of Management and Budget Circular A-123, "Management's Responsibility for Internal Control," as the basis, the Department prepared the FY 2007 Annual Statement of Assurance (presented in the Management's Discussion and Analysis section of this report). The Department asserts that all Components have reported to the Secretary their individual statements of assurance over internal control.

The Department's internal control program is divided into two main processes:

1. The overall statement of assurance that covers the effectiveness of internal management controls for all functions and processes except for the financial reporting.

2. The statement of assurance over financial reporting which covers the effectiveness of internal management controls as prescribed by Appendix A of Circular A-123.

The Department has 34 entities required to report including (3) Military Departments, (9) Combatant Commands, (1) Joint Staff, (1) Office of the Secretary of Defense, (1) Office of the Inspector General, (18) Defense Agencies, and and (1) Department Financial Reporting Senior Assessment Team. Components are required to conduct a robust programmatic approach to establishing and assessing internal management controls for the overall operations with the Component heads annually providing assurance to the Secretary of Defense. Only specified Components are also required to include financial reporting assurance. The Department uses these feeder statements as the basis for the Department's Statement of Assurance. The Department has dramatically reduced the number of outstanding material weaknesses since fiscal year 2001, by 84 percent from 116 material weaknesses to 19 in fiscal year 2007. The percentage of material weaknesses resolved rose from 21% in fiscal year 2006 to 34 percent in fiscal year 2007.

The Department reports several types of weaknesses. Table 1 shows the material weaknesses in financial statement reporting as identified by the Department of Defense Inspector General, who audits the annual financial statements. Table 2 shows management self-identified material weaknesses. Table 2a identifies financial reporting weaknesses, Table 2b identifies overall material weaknesses, and Table 2c identifies system nonconformances identified by the Department through its internal control process.

Details about each weakness are presented in expanded tables available at http://www.defenselink.mil/comptroller/afr/fy2007/fy07afrsection3fmfia.pdf. Table 2d summarizes the Department's compliance with the Federal Financial Management Improvement Act of 1996.

The Department-identified weaknesses fall into three categories:

- ***Section 2 Financial Reporting Material Weaknesses:*** Financial reporting material weaknesses are identified as materially affecting the Department's financial reporting identified under the oversight of the DoD Senior Assessment Team during the limited assessment of internal controls over financial reporting. The Department is using an incremental approach in complying with OMB Circular A-123, Appendix A. In fiscal year 2007, the assessments conducted include: fund balance with Treasury, investments, accounts receivable, inventory and operating materials and supplies, real property, military equipment, accounts payable, Federal Employees' Compensation Act Liabilities, environmental liabilities, Medicare-eligible Retiree Health Care Liabilities, and appropriations received.

- ***Section 2 Overall Operations Material Weaknesses:*** Overall operations material weaknesses materially affect internal management controls usually affecting multiple Department Components for all functions except financial reporting weaknesses unless those financial weaknesses were identified through assessments which were not under the oversight of the Department's Senior Assessment Team. At this time, only one material weakness, general personal property, is functionally part of the financial reporting, but it is included in the overall material weakness category because the assessment did not fall under the oversight of the Senior Assessment Team.

- ***Section 4 System Nonconformance Material Weaknesses:*** System nonconformance material weaknesses are identified as systems that nonconform with Government-wide requirements such as the Federal Financial Management Improvement Act as prescribed by OMB Circular A-127, "Financial Management Systems." The Department is reporting one weakness that covers the entire pervasive problems identified with system nonconformance.

DoD Reportable Conditions are weaknesses identified as materially affecting only one Department Component unless the weakness is so pervasive that it is deemed material to the Department as a whole. Reportable conditions, as prescribed in the OMB Circular A-123, are not reported in the Statement of Assurance, but are tracked internally for correction. The Department is reporting five material weaknesses in overall operations as being reassessed to reportable conditions in fiscal year 2007.

The tables below summarize the results of the fiscal year 2007 financial statement audit and the results of management's assessments of the Department's internal control process. Links in tables 2b, 2c, and 2d will take you to specific details on each weakness.

Table 1. Summary of Financial Statement Audit

Audit Opinion	Disclaimer					
Restatement	Yes					
Material Weakness		Beginning Balance	New	Resolved	Consolidated	Ending Balance
1	Accounts Payable	1				1
2	Accounting Entries	1				1
3	Environmental Liabilities	1				1
4	Government Property in Possession of Contractors	1				1
5	Intragovernmental Elimination	1				1
6	Operating Materials and Supplies	1				1
7	Statement of Financing	1				1
8	Statement of Net Cost	1				1
9	Financial Management Systems	1				1
10	Fund Balance with Treasury	1				1
11	General Property, Plant & Equipment	1				1
12	Inventory	1				1
13	Accounts Receivable		1			1
Total Material Weaknesses		12	1	0	0	13

[1] In accordance with OMB guidance, the Statement of Financing is a note to the financial statements, Reference Note 21.

Table 2. Summary of Management Assurances

Table 2a. Summary of Management Assurances							
Effectiveness of Internal Control over Financial Reporting (FMFIA Section 2)							
Statement of Assurance	No Assurance						
Material Weaknesses (information deemed necessary for clarification)	Ref Table 1	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
1) Valuation of Property Plant and Equipment -Military Equipment	11	1					1
2) Real Property Assets	11	1					1
3) Environmental Liabilities	3	1					1
4) Health Care		1					1
5) Fund Balance with Treasury (includes reported problems with unsupported accounting entries)	10 & 2	1					1
6) Accounts Receivable	13		1				1
7) Inventory Valuation	12		1				1
8) Operating Materials and Supplies	6		1				1
9) Accounts Payable (includes reported problems with eliminations)	1 & 5		1				1
Total Financial Reporting Material Weaknesses		5	4	0	0	0	9

Table 2b. Summary of Management Assurances							
Effectiveness of Internal Control over Overall Operations (FMFIA Section 2)							
Statement of Assurance	Qualified						
Overall Material Weaknesses (information deemed necessary for clarification)	Ref Table 1	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
1) Ending Balance Adjustments at Defense Finance and Accounting Service		1		1			0
2) Accounts Receivable Noncompliance at Defense Finance and Accounting Service		1		1			0
3) Foreign Military Sales Authority (consolidated into Overall Operations Material Weakness #19)		1			1		0
4) Unsupported Adjustments at Defense Logistics Agency (consolidated into Financial Reporting Material Weakness #9)		1			1		0
5) Joint Training Exercises		1		1			0
6) Pharmaceuticals		1		1			0
7) Engineering Plan		1		1			0
8) Civilian Premium Payment		1		1			0
9) Information Technology Capital Implementation		1		1			0
10) Systems Acquisition Program (consolidated into Overall Operations Material Weakness #27)		1			1		0
11) Status of Funds (reassessed as a DoD Reportable Condition)		1				1	0
12) Planning Program (reassessed as a DoD Reportable Condition)		1				1	0
13) Force Readiness		1		1			0
14) Program Inefficiencies		1		1			0
15) Inaccurate Accountability of Equity (reassessed as a DoD Reportable Condition)		1				1	0

Table 2b. Summary of Management Assurances							
Effectiveness of Internal Control over Overall Operations (FMFIA Section 2)							
Statement of Assurance	Qualified						
Overall Material Weaknesses (information deemed necessary for clarification)	Ref Table 1	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
16) Lack of Policy (reassessed as a DoD Reportable Condition)		1				1	0
17) Foreign Military Sales Export Controls		1		1			0
18) Foreign Language Inadequacies (reassessed as a DoD Reportable Condition)		1				1	0
19) Department of Defense Financial Management Systems and Processes (includes reported problems with unsupported accounting entries, reconciliation of net costs of operations to budget, and unauditable financial statements)	2,7,8, & 9	1					1
20) Management of Information Technology and Assurance		1					1
21) Personal Property (General Personal Property which includes reported problems with the cost of DoD property and material in the possession of contractors)	11 & 4	1					1
22) Personnel Security Investigations		1					1
23) Real Property Infrastructure		1					1
24) Government Card Program		1					1
25) Inventory Valuation (reassessed and moved to DoD Financial Reporting Material Weakness # 7)		1				1	0
26) Non-Department of Defense Contracts		1		1			0
27) Contracting		1					1
28) Procurement Reporting		1		1			0
29) Accounts Payable (reassessed and moved to DoD Financial Reporting Material Weakness # 9)		1				1	0
30) Procurement Data			1				1
31) Interagency Acquisition and Potential Anti-Deficiency Act Violations			1				1
Total Material Weaknesses for Overall Operations		29	2	12	3	7	9

Table 2c. Summary of Management Assurances							
Conformance with Financial Management System Requirements (FMFIA Section 4)							
Statement of Assurance	No Assurance						
Material Weaknesses (information deemed necessary for clarification)	Ref Table 1	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
1) Department of Defense Financial Management Systems and Processes (includes reported problems with unsupported ac counting entries, reconciliation of net costs of operations to budget, and unauditable financial statements)	2,7,8, & 9	1					1
Total System Conformance Material Weaknesses		1	0	0	0	0	1
Total FMFIA Weaknesses		35	6	12	3	7	19

Table 2d. Compliance with Federal Financial Management Improvement Act		
	Agency	Auditor
Overall Substantial Compliance	No	No
1. System Requirements	No	No
2. Accounting Standards	No	No
3. U.S. Standard General Ledger at Transaction Level	No	No

√CHECK IT

The Department of Defense leadership is keenly aware and actively involved in helping its managers and employees understand that effective internal management controls are important to getting the job done right. The Department reminds its personnel that the Defense mission cannot be accomplished by the warfighters alone; everyone has a job to do, and every job is important. Internal management controls help ensure that what should happen does happen on a daily basis, but first internal management controls must be in place, effective and used. To help draw the attention of the approximately 2.9 million employees in more than 140 countries, the Deputy Secretary of Defense kicked off an awareness campaign known as, the Check It Campaign. The slogan states, "Check It. What gets checked, gets done."

Details about the campaign may be found at *http://www.defenselink.mil/comptroller/micp/03_check_it_campaign/index.html*

Improper Payments Information Act Reporting

The Improper Payments Information Act (IPIA) of 2002, as implemented by the OMB Circular A-123, Appendix C, "Requirements for Effective Measurement and Remediation of Improper Payments," requires federal agencies to review all programs and activities annually and identify those that may be susceptible to significant erroneous payments. The Department's FY 2007 review did not identify any programs or activities at risk of significant erroneous payments in accordance with OMB criteria (programs with erroneous payments exceeding both $10 million and 2.5% of program payments). However, based on the large volume of transactions or high dollar amounts, the following five programs are reportable in FY 2007: (1) Military Health Benefits, (2) Military Pay, (3) Civilian Pay, (4) Military Retirement, and (5) Travel Pay. Improper payment estimates for these programs are presented in the table below. Additionally, Commercial Pay information is included in Section V, Recovery Audit.

FY 2007 Estimated Improper Payments
(dollars in millions)

Program	Estimated $	Estimated %
Military Health Benefits	$ 156	2.00 %
Military Pay	$ 370	0.51 %
Civilian Pay	$ 75	0.26 %
Military Retirement	$ 49	0.13 %
Travel Pay	$ 44	1.00 %

I. Risk Assessment

The Department's risk assessments for each of the programs identified above addressed the effectiveness of internal controls in place to prevent improper payments (such as prepayment reviews) as well system weaknesses identified internally or by outside audit activities. While the Department's improper payment percentages are extremely low, numerous pre- and post-payment controls further minimize and eliminate improper payments. The following paragraphs summarize the processes in place and the results of survey assessment reviews.

II. Statistical Sampling Process

The Department uses random sampling methods designed to meet or exceed the OMB requirement of annual estimates of improper payments with a 90% confidence interval (plus or minus 2.5%). Details on these sampling processes can be found at *http://www.defenselink.mil/comptroller/afr/fy2007/FY07AFRSection3IPIA.pdf*.

III. Corrective Action Plans

(1) Military Health Benefits. The Department's contracts have had payment performance standards for military health benefit claims processing in place for many years. Overpayments found in the audit process are projected to the audit universe, and the managed care support contractor is liable for the total amount. This contractual design, combined with numerous prepayment and post-payment controls which effectively minimize improper payments, helps to ensure the Government is not at risk for improper payments in military health benefit payments. Additional discussion of these controls can be found at *http://www.defenselink.mil/comptroller/afr/fy2007/FY07AFRSection3IPIA.pdf*.

(2) Military Pay. Reviews of military pay accounts for FY 2007 resulted in projected improper payments of an estimated $292 million (.4% of approximately $73 billion in total military net pay). The majority (approximately $271 million) are attributable to the Reserve and Guard Components, due to inaccurate and untimely reporting of entitlement data to the automated pay system. The two most significant reporting discrepancies involve leave accountability (Lump Sum Leave payments) and Basic Allowance for Housing. A special review and subsequent data extract of Active Duty in-service collections performed at the recommendation of the IG revealed approximately $78 million in additional improper payments. Therefore, the total improper payment estimate for military pay, including Active Duty collections and adjusting sample results to preclude over-estimation, is approximately $370 million (.51%) of net pay.

The Department has worked closely with the Active Duty Components to develop metrics and track timeliness and accuracy of pay entitlements. Senior leaders participate in regular Pay and Personnel Council meetings to discuss problem areas and seek solutions to mitigate discrepancies causing improper payments. This partnership with the Active Duty Components has improved pay entitlement timeliness and accuracy. The Department is developing Reserve and Guard performance metrics and goals to improve accuracy and timeliness, which should help to reduce improper payments.

(3) Civilian Pay. Reviews indicate improper payments have decreased in civilian pay over recent years; however, efforts to identify and reduce actions contributing to net pay errors continue. For FY 2007, civilian pay account reviews project an estimated $7.1 million (.02%) in annual improper payments out of approximately $29 billion in net pay to civilian employees. However, based on findings from the special review of military pay collections, a similar review was conducted for civilian pay accounts. This special review and subsequent data extract of civilian in-service collections revealed approximately $68 million in additional improper payments. Therefore, the total improper payment estimate for civilian pay, including collections and adjusting sample results as needed to prevent over-estimation, is approximately $75 million (.26%) of net pay. The improper payments that resulted in collection actions are primarily attributed to untimely and inaccurate reporting of time and attendance, personnel actions, and pay allowances. The Pay and Personnel Council serves as a forum to address civilian pay problem areas and seek methods to mitigate risks and reduce improper payments. Civilian pay metrics and corresponding accuracy and timeliness goals have been developed at the Component level and serve as a baseline for corrective action plans.

(4) Military Retirement. Payments to deceased retirees continue to be the highest risk for improper payments in military retired pay. Based on FY 2007 reviews, the Department projected approximately $49 million in improper payments for this program, with almost the entire amount paid to deceased retirees. This represents an overpayment rate of .13% of the estimated $37 billion in annual military retirement payments. In certain situations, payment to deceased retirees is unavoidable due to payment cycle dates and the fact that notifying a payroll activity is not likely to be the first action for next-of-kin at the time of a retiree's passing. A review of confirmed payments to deceased retirees in FY 2007 indicated that the Department recovered 93% of the overpayment amounts within 60 days, demonstrating the effectiveness of controls within the retired pay system once a retiree's death confirmation is received and processed for final disposition.

The Department's control processes to prevent, identify, and reduce overpayments to deceased retirees include a series of periodic eligibility notifications, early detection data mining efforts, and partnerships with other Federal and state entities. The Department routinely compares retired and annuity payroll master file databases to Social Security Administration "deceased" records and periodically compares records with the Office of Personnel Management deceased files. The file comparisons are also conducted with the Department of Veterans Affairs' cemetery database and with individual states with sizable retiree and annuitant populations (e.g., Texas, California, and Florida). Retirees identified as deceased in these comparisons must validate their continued eligibility, or the accounts are suspended.

(5) Travel Pay. The Department performs monthly random post-pay reviews of the Defense Travel System (DTS) and regularly reports the results to management. Reports address accuracy rate trends, over- and underpayment dollar amounts, reasons for errors, and recommendations for corrective actions to alleviate similar errors in the future. Results from reviews of trip records performed during FY 2007 revealed an estimated $22 million (.91%) in improper payments out of a travel settlement population value of $2.4 billion in DTS disbursements.

The Air Force's reviews of Reserve Travel System (RTS) vouchers for FY 2007 resulted in an estimate of $19 million (1.6%) in improper payments out of $1.2 billion in total payments for the year. Erroneous payments identified in RTS are sent to the appropriate Air Force bases for corrective actions (including collections or supplemental payments). The Air Force bases confirm corrections are completed. Also, a report of commonly identified errors is sent to all Air Force bases as a training tool. In the future, the Air Force plans to process all vouchers through DTS.

The other Active Duty Components (Army, Navy, and Marine Corps) primarily use the Integrated Automated Travel System (IATS) for travel payments not processed through DTS. Army payments are centrally processed through IATS with the exception of two offices that process a limited amount of travel payments. In FY 2007, Army IATS payments were reviewed against DTS payments to identify any duplicate payments between the two systems. The Department is implementing a sampling and review process for Army IATS in FY 2008 that meets the improper payment reporting requirements. Additionally, the Department is working with Navy and Marine Corps to ensure an adequate sampling and review process is developed and implemented in FY 2008 for their travel payments processed outside DTS. It is worth noting, however, that DTS implementation recently has been expanding exponentially throughout the Department. As DTS functionality expands, Components will continue transitioning away from the legacy systems.

Reviews of travel payment vouchers settled outside DTS for the U.S. Army Corps of Engineers (USACE) in FY 2007 resulted in approximately $770 thousand (.5%) in improper payments out of approximately $166 million in annual payments. The majority of these improper payments are due to traveler input errors and the failure of approving officials to properly review the voucher prior to payment. During FY 2007, all travel approving officials completed certification training. Additionally, the audit function will be consolidated at the USACE Finance Center in FY 2008. This should ensure greater consistency and accuracy in the audit of temporary duty travel vouchers.

IV. Program Improper Payment Reporting

The following table summarizes the Department's improper payment reduction outlook and total program outlays (payments) from FY 2006 through FY 2010.

Improper Payment Reduction Outlook

	FY 2006			FY 2007			FY 2008 Estimated			FY 2009 Estimated			FY 2010 Estimated		
Program	Outlays ($ B)	IP (%)	IP ($ M)	Outlays ($ B)	IP (%)	IP ($ M)	Outlays ($ B)	IP (%)	IP ($ M)	Outlays ($ B)	IP (%)	IP ($ M)	Outlays ($ B)	IP (%)	IP ($ M)
Military Health Benefits (Notes 1-4)	$8.7	0.96	$83.5	$7.8	2.0	$156.0	$8.9	2.0	$178.0	$9.4	2.0	$188.0	$8.9	2.0	$178.0
Military Pay (Notes 5)	$72.4	0.09	$65.9	$72.9	0.51	$370.0	$75.7	0.46	$349.6	$68.4	0.46	$314.6	$69.7	0.45	$313.4
Civilian Pay (Notes 6-7)	$33.2	0.05	$16.7	$29.2	0.26	$74.6	$29.7	0.25	$73.8	$30.8	0.24	$73.0	$31.8	0.23	$72.3
Military Retirement	$35.9	0.14	$49.4	$37.1	0.13	$48.7	$39.6	0.13	$51.2	$41.3	0.13	$51.9	$42.9	0.12	$52.3
Travel Pay (Notes 8-9)	$5.2	0.80	$29.4	$5.8	1.00	$43.6	$6.8	1.00	$68.0	$6.8	1.00	$68.0	$6.8	1.00	$68.0

IP – Improper Payments, B – Billions, M – Millions

Accompanying table notes can be found at http://www.defenselink.mil/comptroller/afr/fy2007/FY07AFRSection3IPIA.pdf.

V. Recovery Auditing Reporting

The Department utilizes a number of different mechanisms to prevent, identify, and collect improper payments, to include recovery and contract auditing.

Recovery Auditing. The Department maintains an extensive post-payment process for identifying improper payments. This process utilizes post-payment review techniques performed both internally and by recovery auditing contractors paid from the proceeds actually recovered. Agency-wide commercial payments result in a large volume of transactions and high dollar values, so DoD maintains vigilance to ensure payment accuracy, using various manual and automated prepayment initiatives to prevent over- and underpayments.

Commercial pay overpayments identified for recovery are attributable primarily to internal recovery audit efforts and other means (including contract reconciliation and statistical sampling). Selected high dollar value payments are reviewed manually, and periodic independent reviews of commercial payments improve improper payment detection, correction, and prevention efforts.

The Department's Mechanization of Contract Administration Services (MOCAS) system, used for contract payments, processed 59% of the $320 billion in DFAS commercial pay disbursements for FY 2007. Reviews of this system accounted for 69% ($232.8 million) of the total $338.4 million in improper commercial payments identified by DFAS for FY 2007. Over half of this total was underpayments. The Department disbursed approximately $174 million in FY 2007 and $210 million in FY 2006 to correct the identified underpayments. For FY 2006 and FY 2007, MOCAS system reviews identified $66.2 million in improper overpayments, of which $59.2 million has been recouped. The Department also recouped $18.6 million in commercial overpayments through contract recovery audits since 1996.

In addition to the amounts identified through recovery efforts, voluntary refunds received in FY 2006 and FY 2007 accounted for approximately $125 million in collections. The DFAS continues to work with the Defense Agencies to improve the unsolicited refund process through improved identification and classification of the root causes of improper payments and take appropriate preventative actions.

The Department also has utilized a recovery audit contractor to identify for recapture overpayments made to hospitals that failed to submit amended cost reports from calendar years 1992 through 1997. These reviews have helped to recoup almost $23 million in overpayments.

The Department has recovered $30 million (99.9%) of the overpayments identified by the USACE during FYs 2004 through 2007. These recoveries are a result of reviews of payments, as well as vendor voluntary refunds. The two programs with the most identified overpayments pertain to military leases and utility payments. The USACE manages the Military Lease Program for all military services. When leased property is sold or leases are terminated without timely notifications, extra payments may be made. The USACE helps correct the error and notifies the Military Service. The USACE also manages the utility payments for the Department. When there is a merger or acquisition of utility companies, payments may be made before USACE is aware of changes to the payee information. To reduce the likelihood of these errors, USACE monitors the news for pending/new acquisitions and mergers of utility companies.

Recovery Audit Activity (amounts in millions)	Departmental Recovery Audit Totals *(Note 1)*	DFAS Agency-wide Commercial Payments *(Note 2)*	Military Health Benefits Recovery Audit Contractor
Amount Subject to Review for FY 2007 Reporting	$189,300	$189,300	$0
Actual Amount Reviewed and Reported (FY 2007)	$189,300	$189,300	$0
Overpayment Amounts Identified for Recovery (FY 2007)	$24.6	$24.6	$0
Amounts Recovered (FY 2007)	$19.6	$18.9	$0.7
Overpayment Amounts Identified for Recovery (Prior Years)	$65.9	$41.6	$16.1
Amounts Recovered (Prior Years)	$69.6	$40.6	$20.8
Cumulative Amounts Identified for Recovery (FY 2007 and Prior)	$90.5	$66.2	$16.1
Cumulative Amounts Recovered (FY 2007 and Prior)	$89.2	$59.5	$21.5

Note 1: The Department recovery audit totals include $8.2 million in prior year recoveries ($6.3 million in FY 2004 and $1.9 million in FY 2005) from a recovery audit contract that concluded in FY 2005.

Note 2: The $189.3 billion represents the total dollar value of disbursements (payments) in the MOCAS system, which includes 59% of the dollars disbursed by DFAS for commercial pay. There were $59.1 million in overpayments and $173.7 million in underpayments reported for MOCAS. Underpayments are not subject to recovery action. In accordance with IG recommendations, the identified recoveries do not include voluntary repayments of overpayments from vendors (these amounts were included in reporting in prior years). Cumulative amounts reflect totals from FYs 2006 and 2007, since detailed information on collections by type (to exclude voluntary repayments) is not readily available for FY 2005 and prior.

Additionally, many major companies now notify the USACE and the customer directly. Queries of related USACE databases help ensure records are modified promptly upon receipt of change notifications.

The Department of the Navy, Office of the Chief Information Officer, conducted a pilot recovery audit in FY 2006 on a sample of Navy telecommunications invoices. The results of the pilot indicated that a full recovery audit initiative might deliver a number of benefits to the Navy and assist in the ongoing implementation of its Telecommunications Management and Action Plan. A recovery audit contractor began work in early calendar year 2007 to examine all local, long distance, and data-related telecommunications costs. The program currently remains in its initial stages and no funds yet have been recovered or identified as recoverable.

Contract Auditing. The Defense Contract Audit Agency (DCAA) routinely performs billing system audits at major contractors (e.g., contractors with a substantial amount of flexibly priced contracts and fixed price contracts) to determine the adequacy of the contractor's billing system internal controls and its compliance with those controls. This effort provides assurance to the Department that the contract payment billings are based on costs incurred and approved provisional billing rates. The DCAA also performs paid voucher reviews at major contractors and special purpose audits at contractor locations when an improper payment risk factor is identified and neither a billing system review nor a test of paid vouchers is planned.

VI. Accountability

Certifying officer legislation holds certifying and disbursing officers accountable for government funds. In accordance with Section 2773a of Title 10, United States Code, 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. Efforts to recover from a recipient must be undertaken in accordance with the debt collection procedures in Volume V, Chapters 29 and 30, of the DoD Financial Management Regulation.

VII. Infrastructure

The Department has the information and infrastructure needed to reduce improper payments in each of the improper payment program areas. The Department also is implementing a Business Activity Monitoring service which will employ the latest technology to increase the efficiency and effectiveness of improper payment detection efforts for commercial pay.

VIII. Barriers

The Department did not identify any program areas facing statutory or regulatory barriers limiting corrective actions.

IX. Additional Comments

The OMB requested the Department identify Iraq improper payment indicators. In support of this request, DFAS and the USACE have conducted additional reviews on payments for Iraq.

At the recommendation of the IG, DFAS initiated a review of in-service collections in FY 2007. Findings confirmed that these collections were related to initial improper payments. Therefore, special reviews of these populations are ongoing for military pay and civilian pay collections. Results of these new reviews are included in improper payments reporting.

Details about these special reviews can be found at *http://www.defenselink.mil/comptroller/afr/fy2007/FY07AFRSection3IPIA.pdf*.

Appendix

Glossary of Terms & Useful Internet Links

Glossary of Terms

Acronym	***Full Title***
BRAC	Base Realignment and Closure
CBJ	Congressional Budget Justification
DTS	Defense Travel System
ETP	Enterprise Transition Plan
FFMIA	Federal Financial Management Improvement Act
FMFIA	Federal Managers' Financial Integrity Act
FIAR	Financial Improvement and Audit Readiness
IATS	Integrated Automated Travel System
IG	Inspector General
IPIA	Improper Payment Information Act
RTS	Reserve Travel System
SFIS	Standard Financial Information Structure
SFFAS	Statement of Federal Financial Accounting Standards

Useful Internet Links

Link	**Topic/Subject**
Internal links	
http://www.defenselink.mil	Main Department of Defense website, provides daily news about activities and events, photographs, and links to all Department of Defense websites.
http://www.dod.mil/comptroller/afr	The Department's Comptroller's website, which includes the FY 2007 Agency Financial Report and Highlights Document and Performance and Accountability Reports.
http://www.dodig.osd.mil	Office of the Inspector General, which contains information about the OIG's activities and reports.
http://www.defenselink.mil/comptroller	Congressional Budget Justification February 2008
http://www.defenselink.mil/dbt	The Department's Business Transformation Agency. This agency is responsible for transforming business operations to achieve improved warfighter support while enabling financial accountability across the Department.
http://www.defenselink.mil/qdr/report/Report20060203.pdf	Quadrennial Defense Review (2006)
External Links	
http://www.results.gov	Information about the President's Management Agenda
http://www.expectmore.gov	Information about the Program Assessment Rating Tool
http://www.whitehouse.gov/omb	Office of Management and Budget's website
http://www.gao.gov	U.S. Government Accountability Office's website
http://www.cfoc.gov	Chief Financial Officers Council
http://www.firstgov.gov	U.S. Government's Official Web Portal

WELCOME TO THE DEPARTMENT OF DEFENSE

We are interested in your feedback regarding the content of this report. Please feel free to email your comments, or requests for copies of this report to DoDAFR@osd.mil or write to:

United States
Department of Defense
Office of the Under Secretary of Defense (Comptroller)
1100 Defense Pentagon
Washington, DC 20301-1100

You may also view this document at: www.dod.mil/comptroller/afr

WWW.DOD.MIL