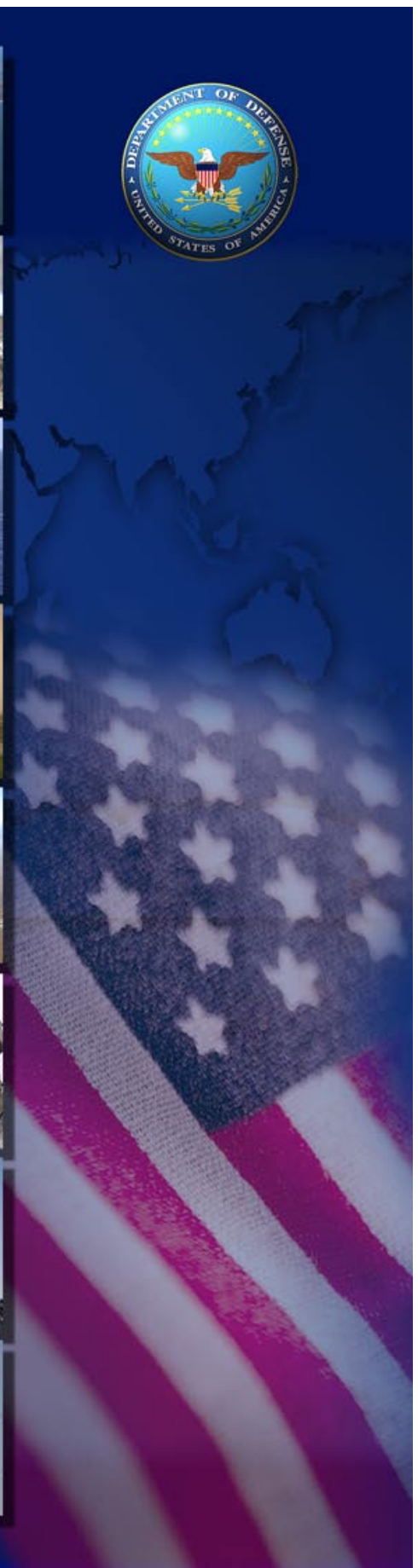


Section 1: *Management's Discussion and Analysis*





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.



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Mission and Organizational Structure

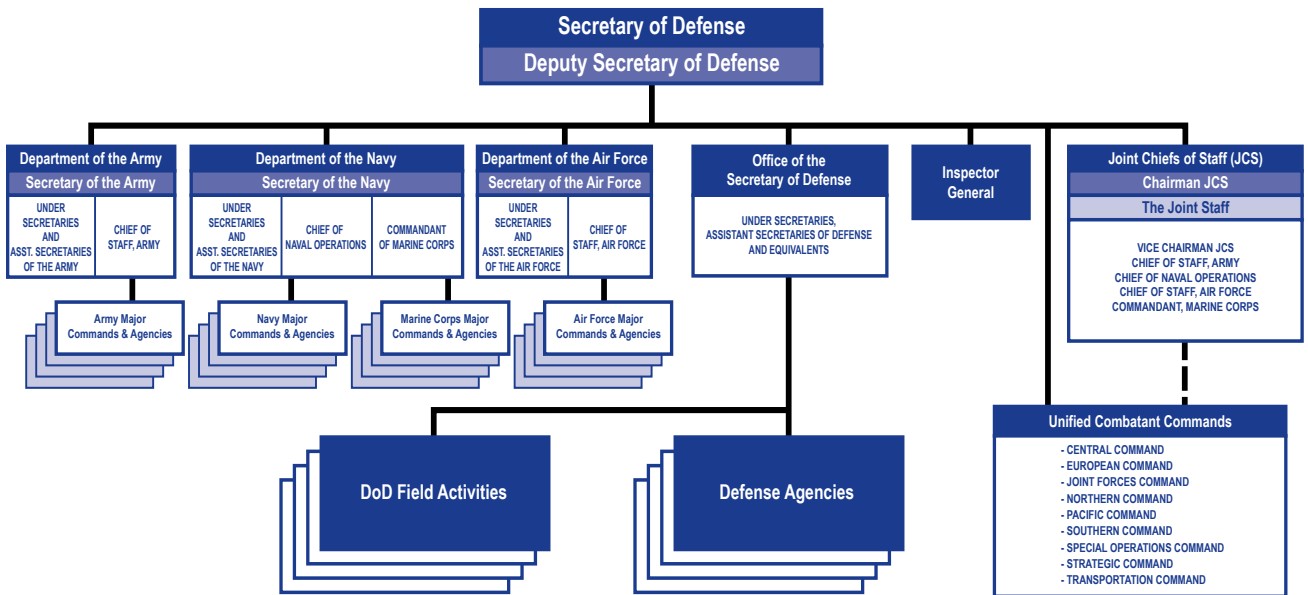
The mission of the Department of Defense is to provide the military forces needed to deter war and to protect the security of our country. The Department is America's largest, busiest, and most successful organization. Since the creation of America's first army in 1775, the Department and its predecessor organizations have evolved into a global presence of 3 million individuals, stationed in more than 140 countries, that are dedicated to defending the United States by deterring and defeating aggression and coercion in critical regions. The Department embraces the core values of leadership, professionalism, and technical knowledge. Its employees are dedicated to duty, integrity, ethics, honor, courage, and loyalty. The 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, 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





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Departments organize, staff, train, equip, and sustain America's military forces. When the President and Secretary of Defense determine that military action is required, these trained and ready forces are assigned to a Combatant Command responsible for conducting military operations.

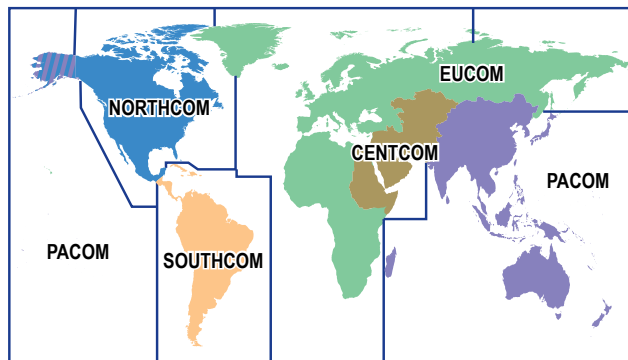
The Military Departments include Active Duty, Reserve, and National Guard forces. Active Duty forces are full-time military Service members. The Reserve, when ordered to active duty by the Congress, supports the Active forces. Reserve forces are an extension of the Active Duty personnel and perform similar jobs when called to active duty. They are also relied on to conduct counter-drug operations, provide disaster aid, and perform other peace-keeping missions. 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, who can 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. The 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 is the principal military advisor to the President, the National Security Council, and the Secretary of Defense. The Chairman assists the President and the Secretary in providing for the strategic direction of the Armed Forces, including operations conducted by the Commanders of the Combatant Commands. As part of this responsibility, the Chairman also assists in the preparation of strategic plans and helps to ensure that plans conform to available resource levels projected by the Secretary of Defense.

Combatant Commands

Combatant Commands are responsible for conducting the Department's missions around the world. The Army, Navy, Air Force, and Marine Corps supply forces to these Commands.



Five Commands have specific mission objectives for their geographic area of responsibility, as shown in the map above:

- 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. This Command is primarily responsible for conducting Operation Enduring Freedom in Afghanistan and Operation Iraqi Freedom.
- U.S. Pacific Command (USPACOM) is responsible for China, South and Southeast Asia, Australia, and the Pacific Ocean.
- 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.

In addition, four Commands have specified worldwide mission responsibilities focused on a particular function(s):



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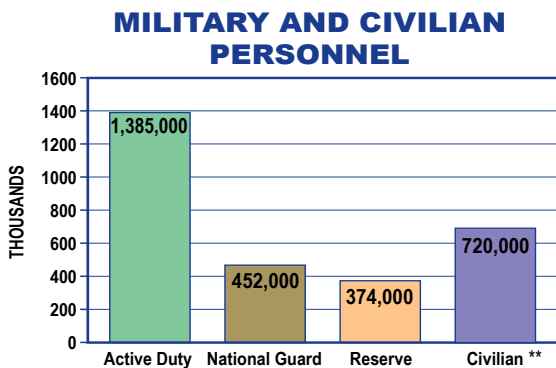
- U.S. Strategic Command provides global deterrence capabilities and synchronizes Department efforts to combat weapons of mass destruction worldwide.
- U.S. Special Operations Command leads, plans, synchronizes and, as directed, executes global operations against terrorist networks.
- U.S. Transportation Command moves military equipment, supplies, and personnel around the world in support of operations.
- U.S. Joint Forces Command develops concepts for joint warfighting.

Defense Agencies and the Department Field Activities

Defense Agencies and the Department Field Activities provide support services commonly used throughout the Department. For instance, the Defense Finance and Accounting Service provides accounting services, contractor and vendor payments, and payroll services; and the Defense Logistics Agency provides logistics support and supplies to all Department activities.

Resources

To provide Americans with the highest level of national security, the Department employs nearly 1.4 million men and women on Active Duty, almost 826,000 in the Reserve and National Guard, and approximately 720,000 civilians. Together, these men and women work daily to protect U.S. interests around the world.



** Source: Defense Civilian Personnel Data System, as of September 30, 2006.

The Department's worldwide infrastructure includes nearly 600,000 facilities (buildings, structures, and utilities) located at more than 3,700 sites around the world, and nearly 30 million acres. To protect the security of the United States, the Department uses approximately 250,000 vehicles, 13,000 aircraft, and 500 oceangoing vessels.

Analysis of Financial Statements and Stewardship Information

The Department's six principal financial statements include a consolidated Balance Sheet along with statements of: Net Cost; Net Position; Budgetary Resources; Financing; and Custodial Activity. These statements reflect the combined financial posture of the Department and include both the proprietary (federal accounting standards) and budgetary resources of the Department.

The Department's financial management environment is complex and diverse. Its FY 2006 financial statements included \$1.4 trillion in assets and nearly \$2 trillion in liabilities. In FY 2006, the Department obtained an audit opinion on the Department-wide financial statements and its nine major reporting components, which include the Military Retirement Fund, the Medicare-Eligible Retiree Health Care Fund, the U.S. Army Corps of Engineers, and the general funds and working capital funds for the Army, Air Force, and Navy.

Of those, only the Military Retirement Fund received an unqualified audit opinion, meaning that the financial statements are presented fairly, in all material respects. The Military Retirement Fund accounts for 15 percent of the Department-wide assets and 49 percent of the liabilities.

The Medicare-Eligible Retiree Health Care Fund, which accounts for 6 percent of the Department's assets and 28 percent of its liabilities, received a qualified opinion, which means that except for certain



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conditions, the financial statements meet the standards for an unqualified opinion as described above.

Overall, the Department (to include the remaining seven major reporting components) expects to receive a disclaimer of opinion from its auditor for FY 2006, which means the financial statements are not auditable.

The Department prepares statements for many of its smaller entities that are rolled into the overall consolidated financial statements and identified as "Other Defense Organizations." Some of these smaller entities are subject to audit each year. Five organizations within this group achieved unqualified audit opinions in FY 2006: the Defense Finance and Accounting Service, the Defense Contract Audit Agency, the Defense Commissary Agency, the Chemical Biological Defense Program, and the Defense Threat Reduction Agency. In addition, at the Department-wide level, the Department received favorable audit reviews for the third consecutive year on three significant financial statement items in FY 2006: (1) Investments, (2) Federal Employees' Compensation Act Liabilities, and (3) Appropriations Received.

As a result of its financial improvement efforts, 15 percent of the Department's assets and 49 percent of its liabilities received clean audit results in FY 2006. The Department's financial statements for FY 2006 are presented in their entirety in Section 3: Financial Information. A summary of results is provided below.

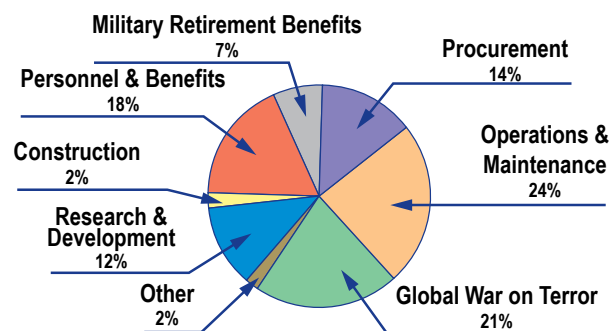
Financial Analysis

In general, the financial statements of the Department show that the short-term financial outlook of the Department is stable. While needing to address priorities and seek supplementary funds from Congress due primarily to the Global War on Terror, the mission of the Department is being achieved. Short-term financial indicators reveal the Department's ability to satisfy immediate objectives while the long-term

financial outlook is impacted primarily by future military retirement benefits.

During FY 2006, the Department received \$594.7 billion in appropriations from the Congress and invested budget resources in the following general areas, as shown in the chart below. The Department, the federal government's single largest agency, receives more than half the discretionary amount of the federal budget.

FY 2006 Budget Allocation



As a result of these investments in people, infrastructure, operations, and technologies, the Department continues to defend the national interests. For example, during FY 2006 the Department reduced the foothold of terrorism, assisted in establishing the Iraqi government, provided humanitarian aid for victims of natural disasters, and continued improving financial accountability.

The complete picture of the Department's financial information shows several trends and insights into the financial health of the organization.

- The financial results of the Department reflect asset growth of 13 percent over the past 3 years, resulting from an increase in funds available, and investments for long-term liabilities and military equipment.
- Concurrent to the growth in assets, liabilities have increased nearly 15 percent primarily due to the long-term liability increases for military retirement benefits.



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- The Department’s net position increased 16 percent over the past 3 years. This increase is due primarily to the timing of a \$68 billion supplemental appropriation for the Global War on Terror late in the fiscal year. The net position is projected to return to previous levels by the end of FY 2007 as the supplemental appropriation is executed.
- Departmental costs changes over the past 3 years are mainly driven by military retirement benefit costs, Global War on Terror costs, and depreciation expense on military equipment.

Long-Term Liabilities Related to Military Retirement Benefits

Eighty-three percent of long-term military retirement benefit liabilities are not currently funded. The Department has a sound investment strategy to address the military retirement benefits requirement. Based on current projections, unfunded liabilities in the Military Retirement Fund will be fully funded in 2033 and the Medicare-Eligible Retiree Healthcare Fund in 2041.

Military Equipment

The net value of military equipment increased \$21 billion over the past 3 years primarily due to a change in valuation method. The baseline of \$345 billion in book value is now accurately established and the Department is well on its way to improved financial health in this area.

Real Property

The Department’s \$100 billion in real property is an increase in 3 percent over the past 3 years. This is due to efforts to accurately identify and report a complete real property inventory.

Environmental Liabilities

Environmental liabilities of \$68 billion is an increase of 8 percent over the past 3 years. This is due to Departmental efforts to improve estimates and its

environmental liabilities inventory. Future challenges will be affected by the impact of valuations at overseas locations, buried munitions, base closure, cleanup, and enforcement of the standards for asbestos.

Improving the Department’s Financial Management

The Financial Improvement and Audit Readiness plan (<http://www.dod.mil/comptroller/FIAR/index.html>) charts financial management transformation for the Department. It provides the construct within which sound financial management can mature and evolve. The Financial Improvement and Audit Readiness (FIAR) plan targets problems arising from weak or nonexistent internal controls, incomplete and inaccurate information, and systems that cannot properly process data and information. Financial management improvement efforts proceed primarily along two tracks:

- Improving the Department’s financial health by streamlining procedures, improving the timeliness and availability of financial information, and capturing more relevant information.
- Preparing the Components for financial statement audits (e.g., testing internal controls).

Fully integrated with other business transformation efforts, the plan ensures accountability and prioritizes financial management improvements. The 3 essential elements—integration, accountability, and prioritization—are interrelated.

The FIAR plan reflects integrated solutions:

- Individual Component financial improvement plans detail corrective actions to accomplish critical milestones in the FIAR plan. For example, the U.S. Army Corps of Engineers’ financial statements are currently under audit. In addition, the Air Force is ready for an audit of its Fund Balance with Treasury



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and Cash and Other Monetary Assets.

- Systems modifications and solutions managed under the Enterprise Transition Plan (http://www.dod.mil/dbt/products/sept-06-bea_etp) are closely aligned to FIAR efforts. The Department has thousands of programs and processes ranging from manual processing to computer-based management systems. Few interact with others, most do not meet congressionally-mandated requirements, and many fail to provide the level of reliability, accuracy, and timeliness demanded by today's complex business environment. Systems initiatives and solutions in the Enterprise Transition Plan eventually will provide the Department with effective and efficient Department-wide financial management systems that provide end-to-end tracking of financial transactions and produce fully auditable financial reports.
- The FIAR plan will enable the Department to comply with internal control requirements set forth by the Office of Management and Budget.
- The FIAR plan breaks down the Department's large number of assets and liabilities into auditable segments based on significant lines on the Department's Balance Sheet.

The FIAR plan sets priorities for the Department's financial management improvement efforts. The Department is focusing first on four items that represent 33 percent of its assets and 31 percent of its liabilities. The four focus areas include Military Equipment, Real Property, Medicare-Eligible Retiree Health Care Fund, and Environmental Liabilities. These lines represent some of the more significant Balance Sheet categories.

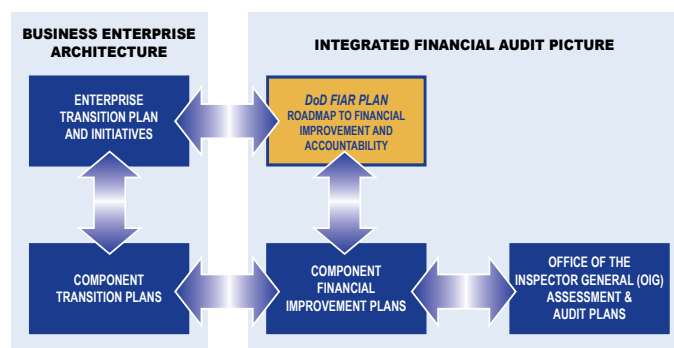
Finally, the FIAR plan ensures accountability:

- Progress toward completing key milestones is reported monthly to the Defense Business Systems Management Committee, chaired by the Deputy Secretary of Defense.
- Various metrics are used to gauge success.
- Accountability for accomplishing milestones will be included in the performance standards of personnel

responsible for implementing the plan.

- Status of financial achievements are reported quarterly to the Office of Management and Budget.

The diagram below shows how the FIAR plan and Enterprise Transition Plan are integrated to focus efforts on improving the Department's financial management.



The financial portion of the Enterprise Transition Plan focuses on Financial Visibility (http://www.dod.mil/dbt/priorities_financial.html), which is defined as having immediate access to accurate and reliable financial information (planning, programming, budgeting, accounting, and cost) in support of financial accountability and auditability, and facilitates effective decision-making throughout the Department. The Department's approach consists of the following key initiatives: Intragovernmental Transactions Initiative, Standard Financial Information Structure, and the U.S. Standard General Ledger.

Intragovernmental transactions involve sales, services, or transfers between two entities of the federal government. Generally accepted accounting principles require the elimination of intragovernmental balances from consolidated financial statements to prevent overstating accounts for intra- or inter-entity activity, or double counting. The Government Accountability Office cited the federal government's inability to adequately account for and reconcile intragovernmental activity and balances as a major impediment to rendering an opinion on the government-wide consolidated financial statements. In FY 2006, the Department developed a set of



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requirements and initiated a demonstration system to enact standard processes, business rules, and data elements. This is the first step towards Department-wide deployment of this initiative to address intragovernmental transactions.

The Standard Financial Information Structure (SFIS) provides a common business language by using standardized terms throughout the Department. The common language ensures consistency in budgeting, accounting, financial reporting, and performance-based management. In FY 2006, the Department created the Standard Financial Information Structure Library (http://www.dod.mil/dbt/sfis_resources.html) to serve as the central repository for maintaining and exposing the Standard Financial Information Structure vocabulary to all Department business systems.

One of the requirements of the Federal Financial Management Improvement Act is that agencies’ financial systems comply substantially with the U.S. Standard General Ledger at the transaction level. This means that agencies must conform to the Department of the Treasury’s standards for recording transactions of the federal government accounting process. In FY 2006, the Department implemented an online U.S. Standard General Ledger Library in the Business Enterprise Architecture. This library breaks down the Department of the Treasury’s general guidance into detailed transaction sets that link to specific business events, a capability that will facilitate standard account transaction postings using Standard Financial Information Structure data elements across the Department.

Based on these integrated plans, the Department made great progress in improving financial management in FY 2006. The Department completed nearly 80 percent of its Enterprise Transition Plan milestones and during fourth quarter, FY 2006 completed 94 percent of its FIAR Plan milestones. The Department’s progress has not gone unrecognized.

The Office of Management and Budget elevated the Department’s progress rating for Improved Financial Performance under the President’s Management Agenda to green. While progress is green, the Department remains red in status and remains on the Government Accountability Office’s high risk list. The Government Accountability Office has issued two consecutive reports citing important business systems modernization progress, and the Comptroller General also has acknowledged publicly the Department’s progress and approach.

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 Bulletin 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 Objectives, Goals, and Results

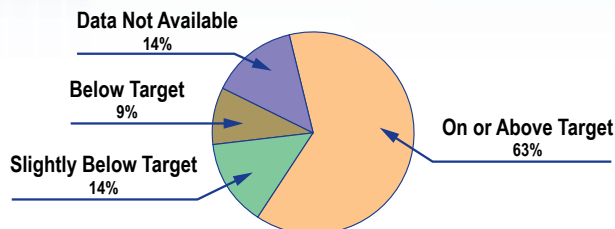
The Department established four strategic goals for FY 2006, each with supporting performance measures. Overall, the Department succeeded in achieving its goals, as shown in the chart on the following page.

The goals and results for selected measures are presented with charts showing the Department’s success in achieving its objectives in that area. Detailed performance information is presented in Section 2; Performance Information.



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Summary of FY 2006 Performance Results (66 Metrics)

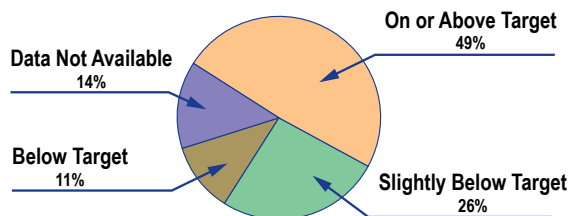


Strategic Goal 1: Balance Force Management Risk

This goal focuses on recruiting, retaining, training, and equipping America's military forces. Key components address issues such as the total strength of the Armed Forces, the number and educational level of Active and Reserve recruits, the ability of the Department to attract and retain critical skills, efforts to close the pay gap with the private sector for enlisted personnel, and the quality of health care provided to Service members and their families.

The chart below shows the performance ratings for the Balance Force Management Risk strategic goal.

Strategic Goal 1 Results Achieved for FY 2006 (35 Metrics)



FY 2006 results include:

- A very successful recruiting year—the Army, Navy, Marine Corps, and Air Force are expected to meet their annual targets. Nearly all recruits met or exceeded the desired educational and aptitude levels.

- High retention rates—the Marine Corps met its annual target.
- Closing the pay gap to within 3 percent between military enlisted and comparable civilian pay.
- Breaking the 90 percent threshold for the first time on overall satisfaction with health care appointments, exceeding the goal of 89 percent. Satisfaction with the Military Health Plan has risen 10 percent since FY 2002.
- The recruitment and retention of Service members in critical skill areas is improving. However, more improvement is needed. The Department is considering various incentives to attract and retain people with the skills that have high entrance standards or are crucial to combat readiness.

Strategic Goal 2: Balance Operational Risk

This goal focuses on achieving and maintaining operational superiority. Key goal components address issues such as incorporating lessons learned, effective real-time plans and operations, and integrating joint operations. By FY 2009, the Department will have a networked capability to seamlessly produce, update, and transition plans through crisis situations. The Department refers to this capability as "Net-Centricity." Net-centricity allows all DoD users and mission partners to share the information they need, when they need it, in a form they can understand and act on with confidence, and protects information from those who should not access it. Net-centricity is achieved through the realization of a networked environment (including infrastructure, systems, processes, and people) that enables a completely different approach to warfighting and business operations.

The Department is on or above target for all eight metrics for the Balance Operational Risk strategic goal. FY 2006 results indicate significant progress toward:

- Implementing the Global Force Management Data Initiative to monitor and provide comprehensive insight into U.S. forces that are available worldwide,



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enabling the Department to allocate the right forces for specific missions, at the right place and time.

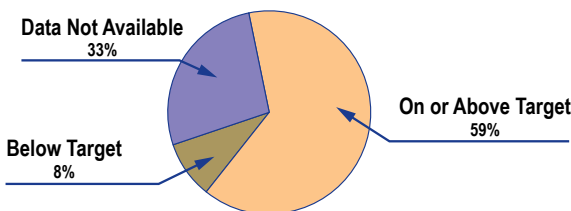
- Adaptive Planning to produce war and contingency plans that are more timely and responsive to the current security environment.
- Analytic Agenda Products that guide analysis through a set of common scenarios and data.
- Expanding the lessons learned program Department-wide. This includes incorporating the lessons learned from Operation Iraqi Freedom, the Department’s response to Hurricane Katrina, and other recent actions.
- Continuing transformation to the joint force model to eliminate military “stovepipes” by seamlessly combining the Armed Forces’ capabilities necessary to address a situation or event. The Capstone Concept for Joint Operations provides a broad description of how the future joint force will operate across the range of military operations 8 to 20 years in the future.

Strategic Goal 3: Balance Institutional Risk

This goal focuses on efforts to align the Department and its resources to support the warfighter. Key goal components address changing the way the Department conducts its daily business, such as controlling infrastructure costs, improving acquisition processes, and effectively managing its assets.

The chart below shows the performance ratings for the Balance Institutional Risk strategic goal.

Strategic Goal 3 Results Achieved for FY 2006 (12 Metrics)



FY 2006 results include:

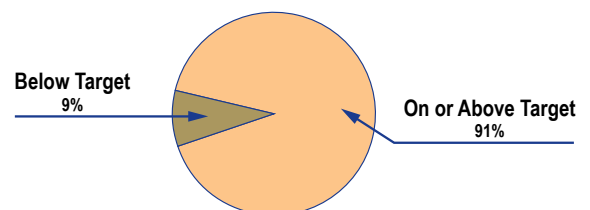
- Eliminating 29,245 inadequate housing units for military personnel, exceeding its target of 27,635. Since FY 2002, the percentage of inadequate housing units has dropped nearly one-third, from 59 to 40 percent. This issue is important enough to warrant a stand-alone initiative in the President’s Management Agenda; as of September 30, 2006, the Department was rated green on both status and progress.
- Meeting its target to allocate 42 percent of its budget to infrastructure activities.
- Continuing efforts to achieve zero percent acquisition cost growth and reduce the time it takes to acquire major defense items and leverage new technologies.
- Strengthening budget guidance to estimate the direct cost of program priorities.

Strategic Goal 4: Balance Future Challenges Risks

This goal focuses on developing new, leading-edge capabilities to meet the challenges of tomorrow by rapidly converting innovative warfighting concepts from prototypes into fielded capabilities. Key components address defining and acquiring the skills required for the future, experimenting with new warfare concepts, enhancing its intelligence-gathering capabilities, and maintaining the Department’s science and technology strengths.

The chart below shows the performance ratings for the Balance Future Challenges Risk strategic goal.

Strategic Goal 4 Results Achieved for FY 2006 (11 Metrics)





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FY 2006 results include:

- Conducting numerous activities to improve the effectiveness of intelligence in military operations and for overall national security, including information sharing, developing a common human resources system for the intelligence components, and establishing standards for training, tradecraft, technology, architecture and operational tactics, techniques, and procedures.
- Achieving the goals for the Department's Defense Technology Objectives, which highlight specific technological advancement, the anticipated date the technology will be available, the specific benefits that should result from the technological advancement, and the funding required (and sources) to achieve the new capability.
- Establishing the Standing Joint Force Headquarters to ensure that in the event of a crisis, a team with the command structure and staff as well as functional and geographic expertise is already in place for rapid reaction with integrated employment of air, land, sea, and information forces.

Data Quality, Accuracy, and Reliability

To the greatest extent possible, the Department ensures that the performance data provided is quantifiable and verifiable by implementing internal management controls and responding to recommendations provided by the Department's Office of Inspector General, the Government Accountability Office, and others. Performance data for most quantifiable measures are generated as a result of the Department's operations. Survey satisfaction data is produced from statistically valid surveys. Accuracy measures come from validated automated systems and are reviewed periodically and verified for correctness. New metrics or metrics under development are subject to the same data quality requirements once the metric is established.

The Department recognizes its shortcomings in integrating performance and financial information caused by inadequate financial management systems. To address these problems and provide decision-makers with accurate, timely, and reliable financial data, the Department launched its Financial Improvement and Audit Readiness Plan and Enterprise Transition Plan in 2005. These plans were discussed earlier in this section.

The data in this report are the latest available at time of publication. In many cases, the data for FY 2006 are incomplete because of lengthy reporting cycles. Therefore, results are projected using partial year data. Incomplete data and projected results are noted for each metric as applicable. The FY 2007 Performance and Accountability Report will include final FY 2006 results and note any significant deviations from targeted and actual results.

Other Program Evaluations Conducted in FY 2006

The Department's Office of Inspector General reviewed many of the Department's activities. These reports also contain management's response and plans to address the issues identified in the reports. They may be viewed at <http://www.dodig.osd.mil/>. Click on Publications & Documents, then select Audits under the heading Reports.

The Government Accountability Office has reviewed a wide range of the Department's activities. The reports, which contain management's response and plans to address the issues identified in the reports, may be viewed at: <http://www.gao.gov/> Click on Reports and Testimony, select browse by Agency, select Department of Defense, and select date range (October 1, 2005 to September 30, 2006 covers FY 2006).



Analysis of Systems, Controls, and Legal Compliance

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 managers 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

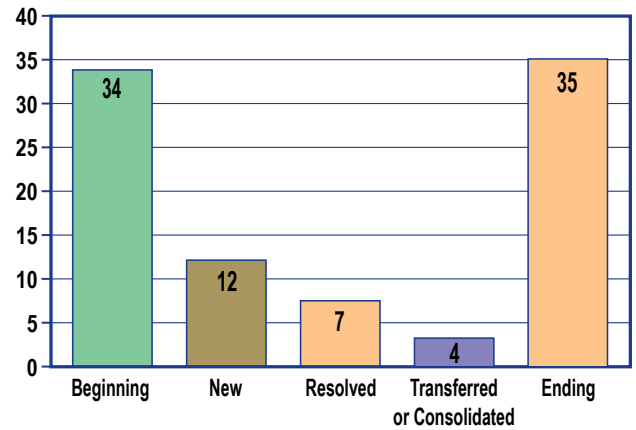
The Department assesses its internal management controls under a formalized program conducted throughout the Department, to include forward deployed units such as the Multi-National Forces - Iraq. Management's philosophy is that effective internal management controls are crucial to all processes and not just financial and accounting processes.

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 2006 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 4: Other Accompanying Information.

The Department uses management-conducted assessments with alternative reviews such as audit results as the source of weaknesses. In addition, the Department of Defense Office of Inspector General has previously identified 11 material weaknesses during its review of the Department, of which seven are covered in the Department's management weaknesses inventory, detailed in Section 4 of this report.

FY 2006 Material Weaknesses



Summary of Material Weaknesses and Corrective Actions

The Department continued an aggressive program of identifying, tracking, and resolving weaknesses in internal controls during FY 2006. Overall, the Department reported 12 new material weaknesses, corrected or consolidated 11, and ended FY 2006 with a total of 35, resulting in a net gain of one material weakness over FY 2005. Each weakness and their corrective action plans are discussed in detail in Section 4: Other Accompanying Information.



Annual Assurance Statement



DEPUTY SECRETARY OF DEFENSE

1010 DEFENSE PENTAGON
WASHINGTON, DC 20301-1010

November 15, 2006

The management of the Department of Defense remains committed to effective internal management controls, full compliance with established requirements, accurate financial reporting, and proper stewardship. Fortright reporting and prompt resolution of weaknesses are priorities.

For the overall statement of assurance pertaining to functional areas other than financial reporting, the Department can provide a qualified statement of reasonable assurance that internal management controls meet the objectives of the Federal Managers Financial Integrity Act and the Office of Management and Budget Circular A-123 except for the weaknesses listed in Section 4 of this report at Tables IIIa, IIIb, and IV. In addition, the Department is not compliant with system requirements of the Act as described in Section 4 of this report at Table V.

The assessments on the financial reporting areas were conducted in compliance with Circular A-123, Appendix A, under the oversight of the Department's Senior Assessment Team for the following areas.

- Fund Balance with Treasury
- Investments
- Real Property
- Military Equipment
- Federal Employee Compensation Act Liabilities
- Environmental Liabilities
- Medicare-Eligible Retiree Health Care Liabilities
- Appropriations Received

The Department can provide a qualified statement of assurance its internal management controls over financial reporting for the areas listed above, as of June 30, 2006, were operating effectively with the exception of the financial reporting weaknesses listed in Section 4 of this report at Table VI. The Department can provide no assurance outside these areas.

In 2006, the Department identified 12 new weaknesses and reduced the total number of outstanding weaknesses by 11, resulting in 35 outstanding weaknesses. Of the 35 weaknesses, five are classified as financial reporting weaknesses.



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Internal Control Program Focus for FY 2006

On July 28, 2006, the Deputy Secretary of Defense announced a new **✓CHECK IT** Campaign to heighten awareness of the internal management control program across the Department. The core message of the campaign is that the Department counts on everyone to do his or her job right. As the campaign slogan states, “**✓CHECK IT because what gets checked gets done.**” The year-long campaign focuses on different functional areas each month, as shown in the chart below.

Month	✓CHECK IT Focus
2006	
August	Financial Management
September	Acquisition
October	Joint Military Operations
November	Personnel
December	Information Technology
2007	
January	Logistical Functions
February	Medical Functions
March	Financial Management
April	Safety
May	Military Operations
June	Intelligence and Security

Government leaders such as the Comptroller General, the Controller of the Office of Management and Budget, and the Under Secretary of Defense (Comptroller) have helped the Department by providing interviews. Stories featuring these interviews were broadcast internally within the Department of Defense on the Pentagon Channel, internationally on the American Forces Network, and are available on the DefenseLink, the Department’s official website. Additionally, stories built around interviews, public service announcements, and posters are emailed directly to Component representatives throughout

the Department in an effort to reach approximately three million Department personnel geographically dispersed in more than 140 countries. The goal is to reach everyone in the Department with this important message.

Statement of Assurance over Financial Reporting Process

The Department is using an incremental approach in implementing Circular A-123, Appendix A. At the beginning of FY 2006, the Deputy Secretary of Defense established a Senior Assessment Team composed of senior leaders as the governing body for the Department’s Appendix A implementation. The team defines the scope of the assessments used within the Department, determines the Department’s financial reporting weaknesses, and monitors the progress of corrective actions. In addition, certain Components, based on materiality, were required to establish Senior Assessment Teams that monitor the Component’s Appendix A implementation process.

The Department issued guidance at the beginning of FY 2006 that prescribed procedures for conducting flow charts, risk assessments, and control analyses to promote consistency and comparability of data throughout the Department. In addition, the test plan guidance issued in March 2006 prescribed a standardized process for developing test plans, which included universe and sample size determination, independent testing, tolerance levels, and test methods.

The Department is leveraging its Financial Improvement and Audit Readiness (FIAR) plan for Appendix A implementation by using the resources and capabilities already established for the FIAR plan. The FIAR plan is the Department’s path to audit readiness and an unqualified audit opinion. It describes major impediments identified by auditors and management and sets milestones for resolving problems affecting the accuracy, reliability, and timeliness of financial information. For process



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solutions, the plan addresses known major deficiencies and captures work done or to be done by large Components in assessing their weaknesses and developing plans to overcome those weaknesses. The Department will continue to maximize resources by aligning its Appendix A efforts with the FIAR plan.

Training and Education

Management understands that training and education are crucial to the successful execution of the internal management control program and the conduct of adequate assessments. The Department conducted training for 21 of the 34 Components at locally-sponsored training workshops. In addition, the Department conducted a Department-wide conference attended by more than 200 representatives from all 34 Components.

To increase the education of managers and employees on the importance of internal management controls and effective assessment techniques, the Department is conducting a Department-wide survey of Department-sponsored schools to assess the extent to which training is already available for internal management controls. The results of the survey will be an indicator of how much additional course work for the internal management controls is needed at the Department of Defense schools.

Systems

The Federal Financial Management Improvement Act requires federal agencies to conform to the U.S. Government Standard General Ledger, comply with all applicable federal accounting standards, establish financial management systems that meet government-wide standards and requirements, and 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 failure to comply with the Act's

requirements. The Department's inability to comply materially with the Act primarily results from structural problems related to legacy accounting systems that do not accurately account for both budgetary and proprietary activities. Quite simply, the Department does not have the systems and accounting structures in place to enable compliance.

To remedy these challenges, the Department of Defense has placed an unprecedented emphasis on reforming its financial management systems and accounting processes. Primarily through the Business Enterprise Architecture and the Enterprise Transition Plan, the Department is identifying the business capabilities and standards at the Department-wide level that will support compliance. The Standard Financial Information Structure and U.S. Standard General Ledger initiatives discussed earlier in this section are major steps toward achieving compliance with the Federal Financial Management Improvement Act.

Improper Payments Information Act Reporting

The Improper Payments Information Act of 2002, as implemented by the Office of Management and Budget, requires federal agencies to review all programs and activities annually and identify those that may be susceptible to significant erroneous payments.

The Department of Defense reports its progress in reducing erroneous payments to both the President and the Congress. The Department's FY 2006 review did not identify any programs or activities at risk for "significant erroneous payments" in accordance with the Office of Management and Budget's criteria (i.e., programs with erroneous payments exceeding both \$10 million and 2.5 percent of program payments). During this review, however, the Department noted that civilian, commercial, and travel pay potentially were susceptible to erroneous payments in excess of \$10 million. For FY 2006, the Department reports



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on three high risk programs: military health benefits, military retirement, and military pay.

In accordance with guidance, the Department calculated statistically-valid estimates of erroneous payments and is implementing plans to reduce them within each of the six programs. Current estimates for FY 2006 improper payments are presented in the table below.

FY 2006 Estimated Improper Payments
Dollars in Millions

Program	Estimated \$	Estimated %
Military Retirement	\$48.8	0.1%
Travel Pay	\$8.0	1.0%
Military Health Benefits	\$140.0	2.0%
Military Pay	\$65.9	0.1%
Civilian Pay	\$62.8	0.1%
Commercial Pay	\$550.0	0.2%

While the Department's overall improper payment percentage is quite low for the over \$750 billion it pays each year to individuals, contractors, agencies, and other entities, the Department has numerous pre- and post-payment controls in place to minimize and eliminate improper payments. For further reporting details about these controls and the Department's Improper Payments Information Act reporting results, see Section 4: Other Accompanying Information.

Other Management Information, Initiatives, and Issues

President's Management Agenda

The President's Management Agenda has been inculcated throughout the Department and has made significant progress since implementation. Further information is available at <http://www.results.gov>. The President's Management Agenda identifies the following five government-wide initiatives:

- Electronic Government (e-Gov)
- Strategic Management of Human Capital
- Competitive Sourcing
- Improved Financial Performance
- Budget and Performance Integration

In addition, the President's Management Agenda includes the following four program initiatives that apply to the Department:

- Eliminating Improper Payments
- Real Property Management
- Coordination of Department of Veterans Affairs and Department of Defense Programs and Systems
- Privatization of Military Housing

As of September 30, 2006, the Department's grades were mixed:

Department Scorecard Results
(September 30, 2006)

Government-Wide Initiatives	Status Score	Progress Score
Electronic Government (e-Gov)	R	G
Strategic Management of Human Capital	Y	G
Competitive Sourcing	Y↑	Y↑
Improved Financial Performance	R	G↑
Budget & Performance Integration	Y	G
Program Initiatives		
Eliminating Improper Payments Initiative	Y	G
Real Property Management Initiative	Y↑	Y↓
Coordination of VA and DoD Programs and Systems	Y	Y
Privatization of Military Housing *	G	G

G - SUCCESS Y - MIXED RESULTS R - FAILURE

Note: ↑↓ Changes in score since FY2005
* = Results as of June 30, 2006



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Following is a brief description of each initiative and actions that the Department has taken toward achieving the President's Management Agenda.

Electronic Government (E-Gov)

Goal: To ensure that the federal government's \$60 billion annual investment in information technology (IT) is well spent.

Agencies are working to ensure that all major IT investments and projects are:

- Justified with strong business cases
- Completed within 10 percent of cost, schedule, and performance goals
- Secured properly and data is protected appropriately

The E-Gov initiative emphasizes the customer. The Department takes an active role in several government-wide initiatives, including SmartBUY, the Integrated Acquisition Environment, and various education and training initiatives.

As one example, the Department developed a multi-tiered Information Assurance workforce certification program in December 2005 which applies to both Department and contractor Information Assurance personnel. This program establishes technical and administrative training requirements; identifies specific commercial certifications applicable to the Department's military, civilian, and contractor Information Assurance support personnel; and requires the development of specific tracking and reporting capabilities to support certification/recertification efforts.

Strategic Management of Human Capital

Goal: To maintain a competent, motivated, and mission-ready workforce able to respond to emerging threats, now and in the future.

In May 2006, the Department issued its Human

Capital Strategic Plan to guide and inform human resource policies, programs, and initiatives. Currently, the Department is re-evaluating and assessing its core mission and critical support occupations by: (1) workforce profile and trends, (2) Components' needs and requirements, and (3) geographical locations to ensure alignment with the capabilities listed in the Quadrennial Defense Review. This assessment will provide specific competency-focused results that will help support current and future workload requirements for the Department.

The Department began implementation of the National Security Personnel System on April 30, 2006, with the conversion of approximately 11,000 employees, supervisors, and managers to the pay band system and new performance management system. Between October 2006 and January 2007, 66,000 employees will be converted to the new system. The Department, however, remains enjoined by decision of the U.S. District Court from implementing the National Security Personnel System labor relations system and appeals process.

Improved Financial Performance

Goal: To ensure transparency over the Department's finances—having timely and reliable financial information on a regular, recurring basis and using that information to make informed decisions about agency or program management. Transparency means knowing the costs and results of the Department's programs and operations and being able to judge the best return on investment. Demonstrating fiscal accountability and achieving unqualified financial statements are good first steps. Ultimately, the Department will use more accurate, precise, and timely financial information in its day-to-day management.

In FY 2006, the Department released the Financial Improvement and Audit Readiness (FIAR) plan, which contains key milestone plans that include four focus areas and the Fund Balance with Treasury. The



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key milestone plans incorporate the critical steps, by quarter, for obtaining favorable audit results, resolving related material weaknesses and other financial deficiencies, and providing improved financial data. The improved financial data will drive improvements in the Department’s key management decisions. The FIAR plan also incorporates efficiency and effectiveness performance metrics for the four FY 2006 focus areas. As a result of the FIAR plan implementation, the Office of Management and Budget scored the Department as green for progress for the Improved Financial Performance initiative of the President’s Management Agenda throughout FY 2006. While progress is green, the Department remains red in status and remains on the Government Accountability Office’s high risk list.

Major FY 2006 accomplishments include:

- The United States Army Corps of Engineers’ Civil Works financial statements are currently under audit.
- The Defense Logistics Agency has asserted that its contingent legal liabilities line item is ready for audit.
- The Department completed the baseline value of military equipment and reported this value in its financial statements.
- The Navy completed validation of its Nuclear and Conventional Ships and Submarines portion of its environmental liabilities, which account for 13.1 percent of the Department’s environmental liabilities.
- The Navy and Air Force completed identification of the universe of units, facilities, property and/or operations where environmental liability issues have been identified.

Budget and Performance Integration

Goal: To improve program results and to ensure that performance is routinely considered in funding and management decisions.

During FY 2006, the Department formulated, justified,

and defended its FY 2007 budget, which requested \$439.3 billion in discretionary budget authority for FY 2007. The budget supports priorities established by the Secretary to fulfill the President’s pledges to defeat global terrorism, restructure America’s Armed Forces and global defense posture, develop and field advanced warfighting capabilities, and provide for the welfare of the forces. To develop the FY 2007 budget, the Department continued to implement the new Planning, Programming, Budgeting, and Execution System, refining the second year of the Department’s 2-year budget. This process increases the effectiveness of the Department’s resource allocation process by linking performance results to programming and budgeting decisions and placing additional emphasis on program execution.

The Department developed and submitted the FY 2006 Emergency Wartime Supplemental Request for funds to finance continuing military operations in Iraq and Afghanistan. The request was formulated, in large part, by calculating the costs, based on current cost and performance data, for specific performance elements (e.g., the deployment of specific units to the theater) and estimating the associated operational tempo.

In addition, the Department met its goal of using the Program Assessment Rating Tool to assess programs representing 80 percent of its resources in the FY 2007 President’s Budget. Details about Department’s results are presented in Section 2; Performance Information.

Competitive Sourcing

Goal: To help agencies become more results-oriented and effective through public-private competition subject to Office of Management and Budget Circular A-76, Performance of Commercial Activities.

The Department uses the A-76 process only when it makes military and economic sense to do so. Competition is the driving force within the American economy, resulting in improved quality, reduced cost, and rapid delivery of better products and services. The



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Department continues to use the process of public-private competition to obtain services clearly identified as commercial to improve support to the warfighter and increase readiness. Alternatives to Circular A-76 are focused primarily on military-to-civilian conversions and high performing organizations, in accordance with section 337 of the National Defense Authorization Act of 2004 (Public Law 108-136). These alternatives also produce significant efficiencies, but the Department does not have systems necessary to quantify such efficiencies.

Public-private competition has produced significant savings for the Department. For competitions conducted between FY 2000 and FY 2006, the Department expects to produce savings (cost avoidance) of nearly \$9.4 billion, regardless of who ultimately wins the competition. During FY 2006, the Department initiated competitions involving more than 7,000 positions with anticipated savings (cost avoidance) of \$150 million.

Real Property Management

Goal: To help agencies efficiently manage the hundreds of billions of dollars in real property owned by the federal government.

The Department has developed and implemented a comprehensive plan to improve real property management with the ultimate goal of ensuring that the right assets are available, when and where needed, with the capabilities necessary to support the warfighter. Accurately capturing the real property inventory, and continuing to refine the performance measures that monitor how well the Department sustains, restores, and modernizes its facilities, are integral steps necessary to accomplish that goal. The Department's plan to monitor progress, identify and correct deficiencies, and address overall management of its real property includes:

- Increased visibility of assets under management through improved real property inventories.

- Application of requirements models that are based on accurate and auditable commercial benchmarks and tied directly to existing and forecasted assets.
- Standardization of performance targets across the Department through improved planning guidance.
- Implementation of mechanisms for continuous tracking of performance through the programming and budgeting cycle.
- Controlling the size of the Department footprint through incentives and robust demolition and disposal programs, including Base Realignment and Closure decisions.
- An up-to-date asset management plan that includes goals and timelines.
- Achieving full sustainment funding levels to prevent deterioration and loss of service life.
- Reaching a recapitalization rate that matches the expected service life of the assets under management, to prevent loss of effectiveness through obsolescence.

To improve asset accountability, the Department has developed a real property unique identification concept. All assets have a Department-wide unique identifier, allowing management and financial systems to better track environmental, operational, and financial data for real property. The Department's concept is being reviewed by industry and other federal agencies for use outside of the Department. Real property is a focus area of the Department's FIAR plan.

Eliminating Improper Payments

Goal: To strengthen financial management controls to better detect and prevent improper payments, enabling the Department to better ensure the taxpayer dollar is put to use as Congress intended.

Each year, the Department makes approximately \$700 billion in payments to individuals and a variety of other entities. An improper payment occurs when the funds go to the wrong recipient, the recipient receives the incorrect amount of funds, or the recipient



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receives payment for an ineligible service. Improper payments also include duplicate payments and payments for products and services not received.

The Department maintains a vigorous review process to identify and prevent duplicate vendor payments and ensure that program dollars are spent as intended. This review process includes pre- and post-payment reviews, continual enhancements to commercial payment systems to detect potential erroneous payments prior to disbursement, post-payment reviews of commercial payments within 180 days of disbursement, and continual review of purchase and travel card payments by the Office of Inspector General. The Department's efforts to eliminate improper payments are described in greater detail in Section 4: Other Accompanying Information.

Coordination of Department of Veterans Affairs and Department of Defense Programs and Systems

Goal: To ensure a seamless transition from Active Duty to veteran status, continuity of care, greater accuracy in forecasting patient population, and increased sharing of services to reduce costs and improve the quality of care.

Both the Department and the Department of Veterans Affairs (VA) operate comprehensive medical care programs for Active Duty military members and veterans. The Department and VA work together to find efficiencies and improve health care to beneficiaries. The Joint Executive Council and its subordinate Health Executive Council and Benefits Executive Council continue to pursue expanded opportunities to share health care resources between the two Departments. Currently, they are updating the Joint Strategic Plan for FY 2007, building on the successful completions of milestones and measures from the 2006 plan.

The plan includes goals, objectives, and performance metrics in the following areas:

- Leadership, commitment, and accountability
- High quality health care
- Seamless coordination of benefits
- Integrated information sharing
- Efficiency of operations
- Joint contingency/readiness capabilities

As part of the integrated information sharing goal, the Departments share a significant amount of data. The federal Health Information Exchange enables the transfer of protected electronic health information from the Department to VA at the time of a Service member's separation. On a monthly basis, the Department transmits to VA:

- Laboratory results
- Radiology results
- Outpatient pharmacy data
- Allergy information
- Discharge summaries
- Consult reports
- Admission, disposition and transfer information
- Elements of the standard ambulatory data records
- Demographic data on separated Service members

VA providers and benefits specialists access this data daily in their delivery of health care and claims adjudication. As of August 2006, the Department had electronically transmitted information to the exchange data repository on more than 3.6 million retired or discharged Service members. More than 1.9 million of these members went to VA for care or claims adjudication. In addition, in FY 2006 electronic pre- and post-deployment health assessment information was added to the information being sent to VA electronically. As of July 2006, more than 703,900 pre- and post-deployment health assessment forms were sent to VA, covering more than 580,000 separated Service members, and (deployed and now demobilized) Reserve and National Guard members.



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Privatization of Military Housing

Goal: To eliminate inadequate family housing and increase the quality of life for Service members and their families.

The Department received green scores on the President's Management Agenda for both status and progress on this initiative. Leveraging the Department's resources with private sector capital revitalizes inadequate housing faster and at a lower lifecycle cost to the taxpayer than traditional construction. Since the end of 2000, when the Department privatized nearly 5,900 housing units, the Department has privatized almost 142,000 units, and plans to privatize a cumulative total of more than 186,000 units by the end of 2007. The Department tracks its progress in four categories: (1) elimination of inadequate housing units; (2) privatization of housing inventory; (3) average housing costs covered for Service members living in non-governmental housing; and (4) satisfaction of Service members with their housing choices.

Looking Forward: 2007 and Beyond

The 2006 Quadrennial Defense Review 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

The 2006 Quadrennial Defense Review process also looked at all aspects of the Department to include:

- Programs and force size
- The right mix of capabilities

- Enablers such as logistics, space, and intelligence, surveillance, and reconnaissance
- Roles, missions, and organizations
- Manning and balancing the force
- Business practices and processes
- Department authorities

The 2006 Quadrennial Defense Review recognized that the United States is a Nation at war and is building on lessons learned from recent and ongoing operations in Iraq and Afghanistan. Senior Department leaders guided and participated in all aspects of the review to avoid "stove-piping" of issues and resource priorities. The Quadrennial Defense Review includes ideas from other government agencies, industry, allies, and partners. The Department consulted closely with Congress throughout the process.

A cross-cutting theme of the Quadrennial Defense Review is how America might help allies and partners develop their capacities to confront common security challenges. Experience in the war on terror has underscored the need for a changed defense establishment—one postured both for extended conflict and continuous transformation.

Based on the Quadrennial Defense Review results, 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 wartime construct, described in detail in the 2006 Quadrennial Defense Review, makes adjustments to better 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, counter-terrorism, counter-insurgency, and military support for stabilization and reconstruction efforts.



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- 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. It calls for the forces and capabilities needed for deterrence, reflecting a shift from “one-size-fits-all” deterrence toward more flexible capabilities to deter advanced military powers, regional weapons of mass destruction states, or non-state terrorists.

The 2006 Quadrennial Defense Review 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 2006 Quadrennial Defense Review emphasizes the needs of the Combatant Commanders as the basis for programs and budgetary priorities.

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, continued success in future missions 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. The Quadrennial Defense Review 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 Quadrennial Defense Review and Department’s FY 2007 Budget Submission

The 2006 Quadrennial Defense Review benefited from the change in the legislation mandating the review. By shifting the completion date of the review to coincide with the submission of the President’s

FY 2007 budget request, the Congress permitted the Department to “front-load” a limited number of initiatives into the budget submission for FY 2007, rather than waiting until the next full budget cycle. This Quadrennial Defense Review recommended a number of adjustments to align defense plans, policies, and programs with the broader strategic direction as “leading edge” measures in the President’s Budget request for FY 2007. The Department will develop additional proposals for the FY 2008 budget submission.

Among the key programmatic decisions the Quadrennial Defense Review proposed to launch in FY 2007 are the following:

- Increasing Special Operations Forces by 15 percent and increasing the number of Special Forces Battalions by one-third to strengthen forces to defeat terrorist networks. U.S. Special Operations Command is establishing the Marine Corps Special Operations Command, an Air Force Unmanned Aerial Vehicle Squadron, and providing an increase of Navy SEAL teams. The Department also is expanding Psychological Operations and Civil Affairs units by 3,700 personnel, a 33 percent increase. Multi-purpose Army and Marine Corps ground forces are increasing their capabilities and capacity to conduct irregular warfare missions.
- Funding a \$1.5 billion initiative over the next 5 years to develop broad-spectrum medical countermeasures against the threat of genetically engineered bio-terror agents. This will strengthen homeland defense and homeland security. Additional initiatives include developing advanced detection and deterrent technologies and facilitating full-scale civil-military exercises to improve interagency planning for complex homeland security contingencies.
- Developing a wider range of conventional and non-kinetic deterrent options while maintaining a robust nuclear deterrent to help shape the choices of countries at strategic crossroads, strengthen deterrence, and hedge against future strategic



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uncertainty. It will convert a small number of Trident submarine-launched ballistic missiles for use in a conventional prompt global strike. The Department is increasing procurement of unmanned aerial vehicles to improve persistent surveillance, nearly doubling today's capacity. It is developing the next generation long-range strike systems, accelerating projected initial operational capability by almost two decades.

- Expanding its capabilities and forces for addressing the dangers posed by states that possess weapons of mass destruction and the possibility of terrorists gaining control of them. The U.S. Strategic Command is the lead Combatant Command for integrating and synchronizing efforts to combat weapons of mass destruction, providing a focal point for the Department's efforts. The Department also is establishing a deployable Joint Task Force headquarters for weapons of mass destruction elimination able to provide immediate command and control of forces for executing those missions.

Aligning Authority and Accountability through Joint Capability Portfolios

Most of the Department's resources are provided to the Military Services. This arrangement can lead to gaps and redundancies within capability areas as individual Service attempts to supply complete warfighting packages rather than organize to depend on capabilities provided by other Military Departments. To optimize the provision of capabilities for the joint warfighter, the Department is working to re-orient its processes around joint capability portfolios. In the acquisition realm, the Department has already instituted several joint capability reviews. These reviews look across major force programs to assess needed investments in specific capability portfolio areas such as integrated air and missile defense, land attack weapons, and electronic warfare.

The Quadrennial Defense Review used this type of portfolio approach to evaluate surveillance capabilities. The Department began by accounting for

all of its current and planned surveillance capabilities and programs, which included a transparent review of capabilities at all levels of classification across the entire portfolio of assets. This review enabled decision-makers to make informed choices about how to reallocate resources among previously stove-piped programs to deliver needed capabilities to the joint force more rapidly and efficiently.

The Department is building on these initial efforts to integrate tasks, people, relationships, technologies, and associated resources more effectively across the Department's many activities. By shifting the focus from Service-specific programs to joint capabilities, the Department will be better positioned to understand the implications of investment and resource trade-offs among competing priorities. As a first step, the Department will manage four capability areas using a capability portfolio concept: Joint Command and Control, Joint Net-Centric Operations, Battlespace Awareness, and Joint Logistics. As the Department learns from experience and gains confidence in this approach, it plans to expand the concept to other capability areas.

Summary

Without question, reshaping the defense enterprise is difficult. The structures and processes developed over the past half-century were forged in the Cold War. However, the strategic landscape of the 21st century demands excellence across a much broader set of national security challenges. With change comes turmoil, and achieving a desired vision requires determination and perseverance within the Department. Cooperation with the Congress is vital. As the Department emphasizes agility, flexibility, responsiveness and effectiveness in the operational forces, its organizations, processes, and practices are changing to embody these characteristics to support the joint warfighter and America's Commander in Chief.