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/

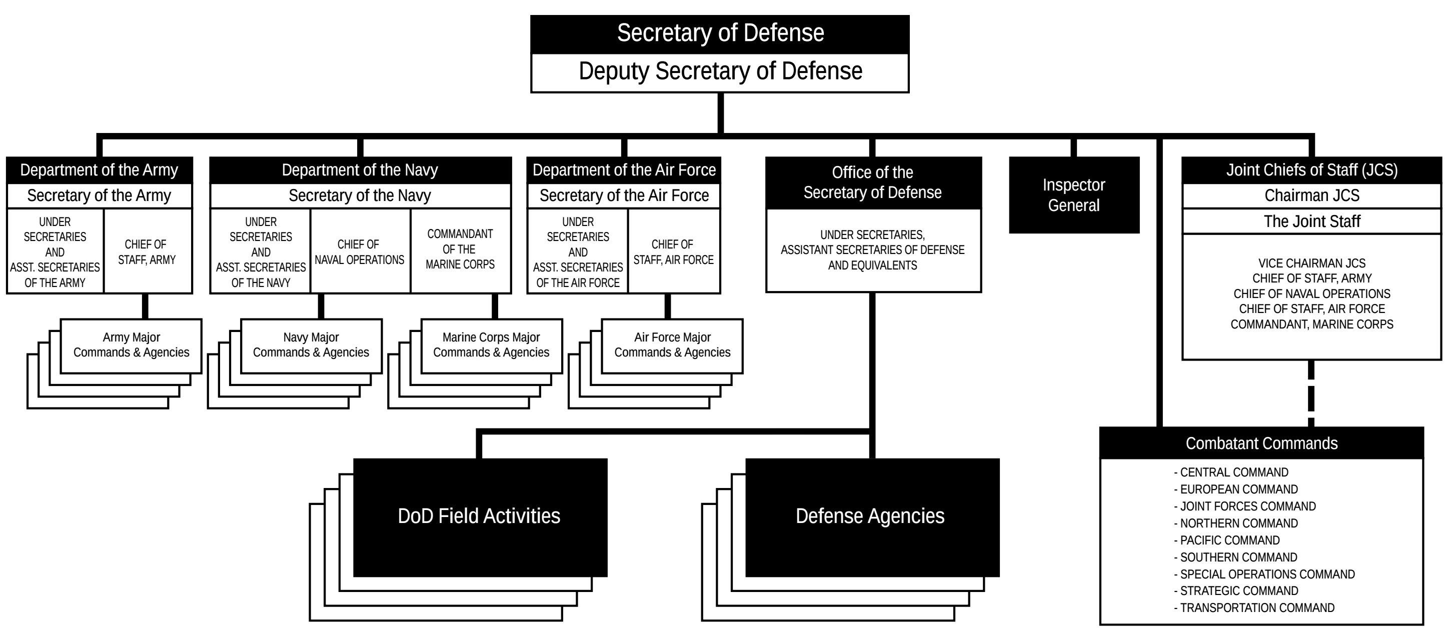
Using this approach the Department projects several significant improvements:
- Enhanced readability by reducing the length of the report.
- Reduced duplicative information in the content of this report.
- Improved performance information by submitting it with our FY 2009 CBJ submission to Congress and 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.

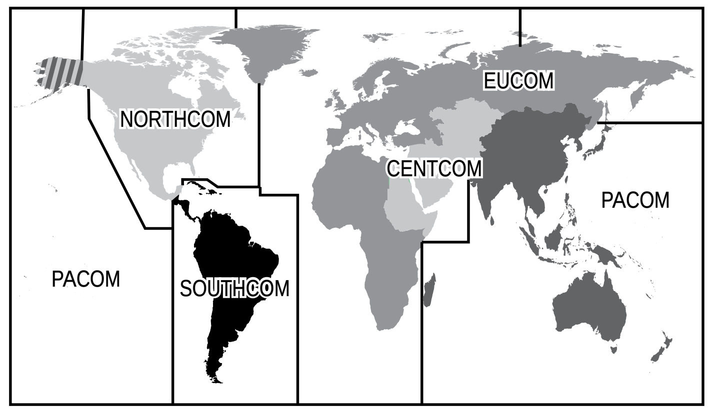
Chairman of the Joint Chiefs of Staff

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.

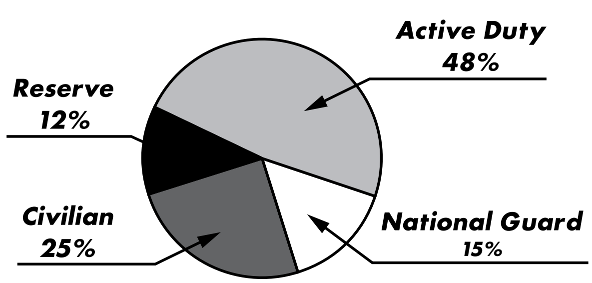
Defense Agencies and Defense Field Activities

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.

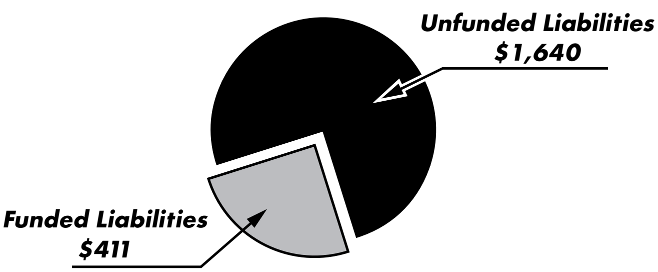
Financial Analysis

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)

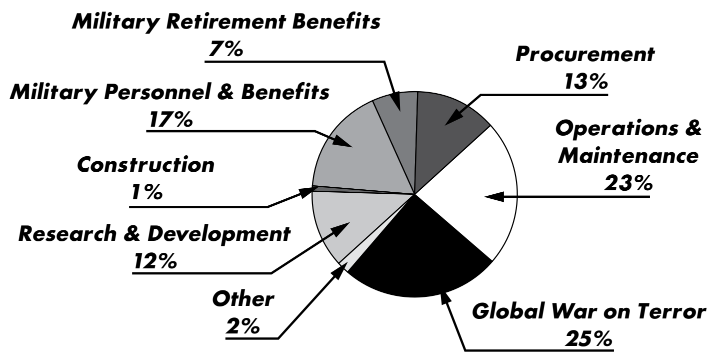


*The amounts reflect data as of September 30, 2007, subject to rounding differences.

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.

Gordon England

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.