# *PERFORMANCE AND ACCOUNTABILITY REPORT*

## Fiscal Year 2006

# DECA-AT-A-GLANCE

| | |
|---|---|
| Established | 1991 |
| Headquarters | 1300 E Street<br>Ft. Lee, VA 23801<br>www.commissaries.com<br>www.deca.mil (for authorized parties) |
| FY 2006 Operations Costs | $1.2 billion |
| FY 2006 Sales | $5.4 billion |
| Total Employees | Approximately 17,900 |
| Regional Offices | 3 (East, West and Europe) |
| Commissaries | 264 |
| Customers | Approximately 11.8 million |

## DeCA MISSION• • •

Deliver a Premier Commissary Benefit to the Armed Services Community that:

- Encourages an exciting shopping experience;
- Satisfies customer demand for quality grocery and household products; and
- Delivers exceptional savings while
  - Enhancing quality of life;
  - Fostering recruitment, retention and readiness; and
  - Supporting war fighters' peace of mind, knowing their families have secure and affordable access to American products.

## DeCA VALUES• • •

**L**eadership – **I**ntegrity – **F**lexibility – **E**njoyment

**"LIFE":** These four words comprise the acronym "LIFE" and are the corporate values DeCA wants employees to represent as the agency moves forward. The values are the engine behind a new vision that highlights DeCA's commitment to the people who deliver and receive the commissary benefit.

**L**eadership: We expect passion, courage and excellence!

**I**ntegrity: We demand honesty, professionalism and trustworthiness!

**F**lexibility: We cultivate innovation, empowerment and competence!

**E**njoyment: We foster teamwork, recognition and opportunity!

## DeCA VISION• • •

Customers, Workforce, Partners → RAVING FANS!

DeCA's VISION will focus on people – all working together to create "Raving Fans."

## DeCA GOALS• • •

**Customers:** Preserve and Deliver a Premier Quality of Life Benefit

**Workforce:** Be the Employer of Choice

**Partners:** Implement Business Process Improvements to Enhance Corporate Performance

# TABLE OF CONTENTS

# FOREWARD

The Defense Commissary Agency (DeCA), a part of the Department of Defense (DoD), is required by DoD to prepare annual financial statements. These financial statements must be prepared in accordance with Office of Management and Budget (OMB) directives, which implement the *Chief Financial Officers Act of 1990* (CFO Act). The DoD uses the information in DeCA's annual financial statements to prepare the DoD annual financial statements.

To enhance the presentation of performance, management, and financial information, OMB requires DoD and other agencies to incorporate their annual financial statements into a Performance and Accountability Report (PAR). Although DeCA is not required to prepare a separate PAR, we have prepared this document to closely align with the statutory guidance framework to demonstrate accountability.

# DIRECTOR'S MESSAGE

Fiscal Year (FY) 2006 has proven to be another positive year in the growth of the Defense Commissary Agency (DeCA). The Performance and Accountability Report for FY 2006 reflects the Agency's commitment to maintaining accurate financial reports and overall fiscal responsibility. During this past year, the continuation of our reorganization and restructuring efforts and the consolidation of above-store functions have enabled us to focus on improving all of our operational processes affecting financial accountability. This new corporate governance approach allows us to better serve our customers by improving and streamlining functional oversight and policy, providing daily support to our stores, and reducing operational costs.

We are pleased that for the fifth year in a row, independent auditors have given our financial statements an unqualified opinion. Except for the nonconformance controls associated with our financial systems and reported by the independent auditors, I certify that DeCA's management control systems, taken as a whole, provide reasonable assurance that the objectives of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 are achieved. We have also evaluated our financial management systems as required by the Federal Financial Management Improvement Act (FFMIA) of 1996. As with most defense agencies, our systems fall short of the integrated systems requirements. As a result, our detail level transactions are not compliant with the U.S. Standard General Ledger. In an effort to meet these requirements, the Department of Defense (DoD), with the participation by DeCA and other entities, is actively working on improving a system-wide architecture for DoD entities that will meet the requirements of FMFIA and FFMIA.

DeCA's FY 2006 performance data indicates positive progress in meeting our established goals and targets. Through the use of metrics, we balance resources to desired outcomes in support of the President's Management Agenda and the DoD Balanced Scorecard. Using a business-based approach, we have increased sales while raising customer satisfaction to an all-time high.

Sales this year increased $48 million over FY 2005, despite the closure of additional commissaries and the continuing impact of last year's hurricane devastation of several stores in the Gulf Coast region. In addition, overall costs remained stable in FY 2006, even with increased oil prices affecting operational costs.

The Agency is proud to be a leader in DoD for implementing the requirements of the Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control***,** Appendix A. Results have shown that our overall internal controls are strong. In FY 2007, our internal control program will expand to assist management in taking steps to improve not only financial reporting, but all business processes. Additionally, we have developed an aggressive internal review and audit program.

Our Lean Six Sigma teams produced favorable results throughout FY 2006. The six Black Belts have completed several projects, initiating improved processes and efficiencies. Some of these projects, such as the equipment inventory project, have assisted in providing timelier and more accurate results for inventory accountability and financial reporting.

Customers will soon see an improved front-end system at their commissary, making checkout easier and more efficient. The Commissary Advanced Resale Transaction System (CARTS) is a state of the art system designed to improve customer service and business functionality as well as, keep pace with commercial industry through self-checkouts, electronic benefit transfers, check truncation, and gift cards. The contract for CARTS was awarded in December 2005. Since that time, DeCA's Program Management Office has been preparing for implementation and deployment of the system to the commissaries. The first system was installed in October 2006 at the Fort Lee, Virginia Commissary for the beginning of the test phase. The testing will include several other locations during the second quarter of FY 2007. Deployment of CARTS is expected to be complete by May 2008.

The Workforce of the Future initiative is one of many programs DeCA began implementing in FY 2006 to better support the needs of our customers. This new type of workforce is built around three basic concepts: (1) simplified organizational structure; (2) training designed to teach employees and managers how to accomplish every task in the store; and (3) new multi-skilled position descriptions creating store associates and general managers. In addition to providing improved customer support, this initiative also provides our employees with an increased range of skills and abilities making them a stronger more flexible workforce.

DeCA remains committed to meeting the expectations of the customers we serve and to providing a premier quality-of-life benefit to the men and women of the United States Armed Services. It is my pledge to our patrons that their commissary is here to serve their needs.

Patrick B. Nixon
Director

October 31, 2006

# PART I

# MANAGEMENT'S DISCUSSION AND ANALYSIS

# OVERVIEW OF DeCA

## ORGANIZATION AND MISSION:

The Defense Commissary Agency (DeCA) is a component of the Department of Defense (DoD) reporting to the Under Secretary of Defense for Personnel and Readiness. In 1989, the House Armed Services Committee appointed the Jones Commission to analyze the commissary systems (i.e., grocery stores or supermarkets) operated by the four military services. In order to provide better service to military patrons at a lower cost, the Commission recommended consolidation of the four separate commissary systems. On October 1, 1991, DeCA was established and we celebrated our 15th anniversary this year.

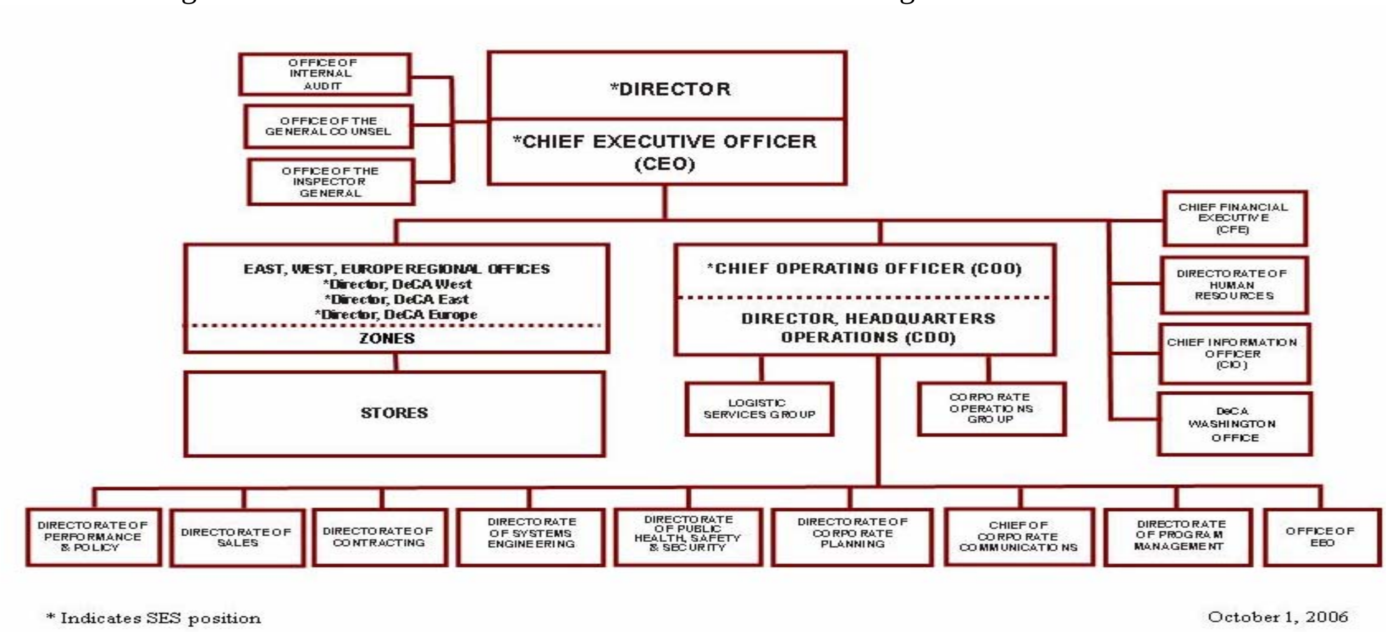
DeCA is headquartered at Fort Lee, Virginia. It operates a worldwide system of 264 commissary stores. Three regional offices provide day-to-day management and support. They are located at Ft Lee, Virginia; Sacramento, California; and Kapaun Air Station, Germany. Our commissaries sell food and related household items to active, reserve, and guard members of the Uniformed Services; retirees of these services; and authorized family members and other patrons. Field Operating Activities (FOA) perform services for the regional offices and their commissaries, including centralized purchasing of national brand sales items and centralized financial management.

During FY 2006, Mr. Patrick Nixon was appointed the Director of DeCA replacing Major General Michael Wiedemer, who retired in August 2004. Previously, Mr. Nixon served as the Acting Director and the Chief Executive Officer. Currently, in addition to serving as DeCA's new Director, Mr. Nixon continues to serve as the Chief Executive Officer.

DeCA continues its restructuring of above store-level operations, which began in FY 2005, to more sharply focus agency resources on supporting store operations. During FY 2006, in consonance with Base Realignment and Closure (BRAC) decisions, DeCA moved to a more centralized support structure. Operational support for the commissaries has transferred from the East and West Regions to DeCA-HQ and FOA for all budget, accounting, information technology, human resources, and contract functions. The DeCA East Region Headquarters in Virginia Beach, VA relocated to DeCA-HQ and the DeCA East Deputy Office in San Antonio, TX is scheduled for closure during the first quarter of FY 2007. The DeCA West Region in Sacramento, CA has been downsized. Lastly, a review of our overseas support activities was initiated with the intent to reorganize them because of future base restructuring. The base restructuring is expected to be implemented in FY 2009.

We continue to emphasize the efficient delivery of the commissary benefit to Armed Services personnel and their families. DeCA continues its business process improvement through the use of Lean Six Sigma to improve performance and resource efficiencies. DeCA is instilling process ownership, greater accountability, efficiency, and effectiveness throughout the commissary system, which is enabling us to streamline processes at the headquarters, the region and the store levels, and ultimately improving store operations and the commissary benefit.

The organizational structure of DeCA is shown in the following chart:




## 2006 HIGHLIGHTS:

During FY 2006, DeCA's operations included commissaries with annual sales of $5.4 billion and 17,900 employees. DeCA operates its commissaries around the world to support the military services. Patrons include approximately 11.8 million active duty military, reservists, retirees, family members, and authorized civilians working overseas. Congress authorizes DoD to operate its commissaries as a significant non-pay benefit to supplement military income as an integral part of the overall military pay and benefit package. DeCA sells its groceries and household supplies to the military community at its cost. Patrons also pay a five percent surcharge, which funds construction programs and our stores' equipment, including information management systems. Selling goods at cost allows DeCA to provide a savings benefit of almost $2,900 per year for an average family of four.

DeCA closed five Outside the Continental U.S. (OCONUS) commissaries and opened a new one in 2006. Commissaries at Bad Kissingen, Kitzingen, and Giebelstadt, Germany; Keflavik, Iceland; and Pusan, Korea were all closed. A new store opened at Camp Eagle, Korea. These actions were all due to global restationing.

FY 2006 is the first year for implementation of the Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, Appendix A, which prescribes a strengthened process to assess the effectiveness of internal controls over financial reporting. In the area of implementing the requirements of Appendix A, DeCA is a leader within the DoD. During the execution of this year's assessment, our efforts resulted in several significant accomplishments:

- The use of DeCA's charter as a model for others written in the DoD;

- Development of a test plan architecture that was adopted, after review of multiple submissions from the other defense agencies, as the standard format for all test plans for the DoD; and
- An invitation by the Office of the Under Secretary of Defense (Comptroller) to brief DoD activities on DeCA's Senior Assessment Team (SAT) involvement, role of the SAT support team, and process owner integration at the lessons learned conference conducted May 9, 2006.

DeCA submitted its Program Assessment and Rating Tool (PART) for 2006 as part of OMB's 2006 PART cycle. The PART is OMB's tool for creating and tracking performance and efficiency outcomes, assess competing funding demands among agencies, and set funding priorities. DeCA's PART looked at all factors that affected and reflected program performance, which included program purpose and design, performance measurement and evaluations, strategic planning and program management, and program results. DeCA evaluated 12 PART efficiency and outcome performance measures that substantiated effectiveness and subsequent funding. DeCA was rated "moderately effective" by OMB, the second highest rating available.

DeCA is implementing several initiatives to increase patrons' savings and satisfaction with their shopping experience. The Standardized Meat Process began in early 2006 and is being further refined as needed. Its purpose is to baseline meat processing in order to standardize product selection, presentation, and potentially prices. The target results are: consistent pricing across commissaries, lower prices, and availability of high demand products. Once fully implemented, the process will allow DeCA to equally measure production levels at all commissaries and establish baseline labor requirements to create labor efficiencies. In addition, during FY 2007, DeCA will complete its phase out of produce procurement from the Defense Logistics Agency (DLA) shifting to commercial sources. Results at several commissaries, where the new procedures have been implemented in FY 2006, showed an increase in produce quality and a decrease in price.

DeCA implemented another shopping alternative for patrons known as the Virtual Commissary, which provides online shopping for authorized customers. Over 100 gift baskets in varying selections are offered for sale with plans to add more. Long range plans include offering hundreds of commissary items to support deployed service members, military retirees, and guard and reserve personnel not living in reasonable proximity to a commissary.

Hurricane Katrina recovery has been ongoing during FY 2006 at three commissaries affected by the August 2005 hurricane. Sales at the New Orleans commissary are down 20 percent over pre-hurricane sales due to the reduced population of the New Orleans area. While the Gulfport commissary was in a temporary facility, sales decreased approximately 50 percent. The permanent facility was re-opened in May 2006 and sales for FY 2006 have exceeded the prior year by 3.6 percent. The Keesler commissary has been operating in a much smaller, temporary facility with sales at about one-third of previous levels. Keesler's new commissary is scheduled to open in March 2008.

**SOURCES OF FUNDS:**

Within DeCA's working capital fund (WCF) there are two activity groups - Commissary Resale Stocks and Commissary Operations. DoD defines these two activity groups as business areas for fund control purposes.  Commissary Resale Stocks finance the purchase of grocery, meat, and produce items for resale to authorized patrons.  The primary revenue source for this activity group is the sale of inventory to commissary patrons.

Commissary Operations finances the operating costs of commissaries, agency and region headquarters, and FOAs.  The primary revenue source for this activity group is a direct appropriation to the Defense WCF, which in turn transfers the funds to the DeCA WCF.  DeCA received approximately $1.2 billion in appropriation transfers during FY 2006.  Commissary Operations also receives limited additional revenues from manufacturers' coupon redemption fees, handling fees for tobacco products, and reimbursements for other support.

DeCA's Surcharge Collections Trust Fund is funded primarily from the five percent surcharge applied to each customer sale.  This fund, established by law, primarily finances DeCA's construction programs as well as equipment, including store-level information systems.

## PERFORMANCE GOALS SUMMARY

### CORPORATE OBJECTIVES:

DeCA's *Corporate Strategic Plan* is the basis for DeCA's mission, values, vision, goals, and objectives and strategies.  DeCA's Balanced Scorecard (BSC) presents our key corporate strategies and compliments the DoD risk management framework in the DoD BSC.  DeCA continues to further refine performance metrics linking resource requirements and outputs.  This effort provides meaningful information for program evaluation and decision-making processes.  Our BSC utilizes the Norton and Kaplan BSC methodology and its associated four perspectives.  The Financial Perspective tracks our Resale Stocks (sales), Commissary Operations (DWCF), and Surcharge execution. Our Internal Business/Process Perspective contains the Facility Condition Index (FCI), Major Construction Project Execution, Competitive Sourcing, Internal Controls over Financial Reporting, and Audit Results of Financial Statements.  The Customer Perspective of the BSC addresses the Commissary Customer Service Survey (CCSS), the American Customer Satisfaction Index (ACSI), and sustaining Customer Savings at 30 percent annually. The BSC Learning and Growth Perspective focuses on Corporate Development – Succession Planning (Leadership/Managerial Development), Implementation of the Workforce of the Future (WOF), and the Above Store Level Reengineering initiative.

These performance measures focus on employee satisfaction, employee retention, and employee productivity, with the purpose of increasing the value of the commissary benefits without increasing costs.  The commissary benefit clearly is critical to strengthening and preserving the Armed Services quality of life and has an exceptionally positive impact on the recruitment, retention, and readiness of today's military.  We are committed to providing our Armed Services military community with a valuable benefit to supplement military income as an integral part of the overall military pay and benefits package.  DeCA remains focused on its customers and will offer them greater conveniences and exciting shopping experiences, providing a quality assortment of groceries and household products at a greater savings than any other time in our history.

## DeCA's STRATEGIC OBJECTIVES, GOALS, AND KEY STRATEGIES:

| *Goals* | *Objectives* | *Key Strategies* |
|---|---|---|
| ***Customers*** *– Preserve and Deliver a Premier Quality of Life Benefit* | Continually improve customer service and sustain customer savings. | ▪ Sustain customer savings at 30 percent as measured by DeCA annual pricing study results.<br>▪ Implement initiatives to attract patrons and improve customer service and satisfaction, as measured by the Commissary Customer Service Survey (CCSS) and the American Customer Satisfaction Index (ACSI). |
| ***Workforce*** *– Be the Employer of Choice* | Foster a corporate culture that creates a satisfying workforce environment and provides opportunities for personal and professional growth. | ▪ Reduce employee skill gaps through training and development programs, including DeCA's Corporate Successor Development Program and the Defense Leadership and Management Program.<br>▪ Develop a survey instrument and conduct surveys to establish a baseline, obtain feedback and continually measure progress in terms of employee and manager work place satisfaction.<br>▪ Link employee performance plans to Agency strategic goals, objectives and performance outcomes.<br>▪ Enhance the Affirmative Employment Program by identifying barriers to alleviate under-represented categories. |
| ***Partners*** *– Implement Business Process Improvements to Enhance Corporate Performance* | Increase effectiveness and efficiency through disciplined integration of technology, infrastructure and business process improvements. | ▪ Reengineer internal business processes through use of Lean Six Sigma procedures to remove non-value added activities and increase support to stores.<br>▪ Deploy leading edge technologies that integrate business processes, enhance Agency performance and promote interoperability throughout DoD and the military resale systems and with our industry partners.<br>▪ Continue to implement and maximize use of E-Gov best practices and initiatives to meet Agency needs.<br>▪ Improve the overall commissary Facility Condition Index (FCI) and capital inventory condition and reduce the backlog by developing and executing approved capital investment fiscal year programs, covering new construction, modernization, maintenance and repair, and store equipment requirements that incorporate state of the art efficiencies.<br>▪ Control Agency operating costs in accordance with Program Budget targets from the FY 04 baseline without inflation, while considering the full cost of achieving Agency performance goals.<br>▪ Ensure compliance with DoD's Business Enterprise Architecture (BEA) for conformance on all major information technology investments.<br>▪ Obtain unqualified opinion through independent |

| Goals | Objectives | Key Strategies |
|---|---|---|
| | | audit of our financial statements to ensure sound financial performance.<br>▪ Study 50 percent of commercially viable candidates in DeCA's inventory by FY 2009, to execute the OMB Circular A-76 competitive sourcing initiative and streamline operations and achieve efficiencies. |

## FISCAL YEAR 2006 PERFORMANCE GOALS AND RESULTS:

DeCA continues its transformation as a DoD leader in the development and execution of performance and process improvement management practices. We have developed a governance and review process that requires strong business cases for all decisions, using metrics to accurately measure performance. We are in the second year of reengineering internal business processes through use of Lean Six Sigma procedures. Lean Six Sigma is a combination of two methodologies – Lean and Six Sigma. Lean is concerned with eliminating waste and improving the flow within a process. Lean eliminates non-value-added steps. Six Sigma focuses on reducing variation and improving process output through the use of specific problem-solving tools. Six Sigma improves quality. By using this methodology, DeCA is removing non-value added activities and continuing to restructure to become more responsive to store-level needs. Our new corporate structure postures us to better focus on store operations, control corporate costs, and prepare for future challenges.

DeCA's FY 2005 – 2011 BSC presents the key performance goals and objectives of the agency. It articulates the expectations for DeCA's performance during FY 2005 – 2011 in investing in technologies, programs, and product support necessary to provide the commissary benefit to military personnel and their families. This "business based" approach is best suited for DeCA's mission. The DeCA BSC complements the DoD Risk Management BSC framework.

These measures have allowed us to link Planning, Programming, Budgeting and Execution (PPBE) to demonstrate our commitment to both performance improvement and cost reductions. The Agency's strategic plan, corporate objectives, and action plans continue to provide a renewed road map to further improve and enhance the commissary benefit with a more balanced approach towards achieving our goals and objectives. We have refined our goals and objectives and continually revisit our strategies to better serve our customers, integrate our business processes, and enhance corporate performance. One key performance goal is to earn an unqualified opinion each year from an independent audit firm. As we began our FY 2006 program, we were one of only five of the Department's subordinate financial statement reporting entities that received an unqualified opinion or "clean audit" on our respective FY 2005 financial statements. We received another unqualified opinion on our FY 2006 financial statements.

## PERFORMANCE-AT-A-GLANCE

| *Performance Measure* | *FY 2004 Actual* | *FY 2005 Actual* | *FY 2006 Estimate* | *FY 2006 Actual* |
|---|---|---|---|---|
| Customer Savings | 32.1% | 32.0% | 30.0% | 32.0% |
| Commissary Customer Service Survey (CCSS) | 4.47 | 4.55 | 4.47 | 4.61 |
| American Customer Satisfaction Index (ACSI) | 76 | 77 | Meet or Exceed Industry Average | Available Feb 07 |
| Facility Condition Index (FCI) | 75.03 | 74.94 | 75.00 | 74.35 |

## FINANCIAL STATEMENT SUMMARY

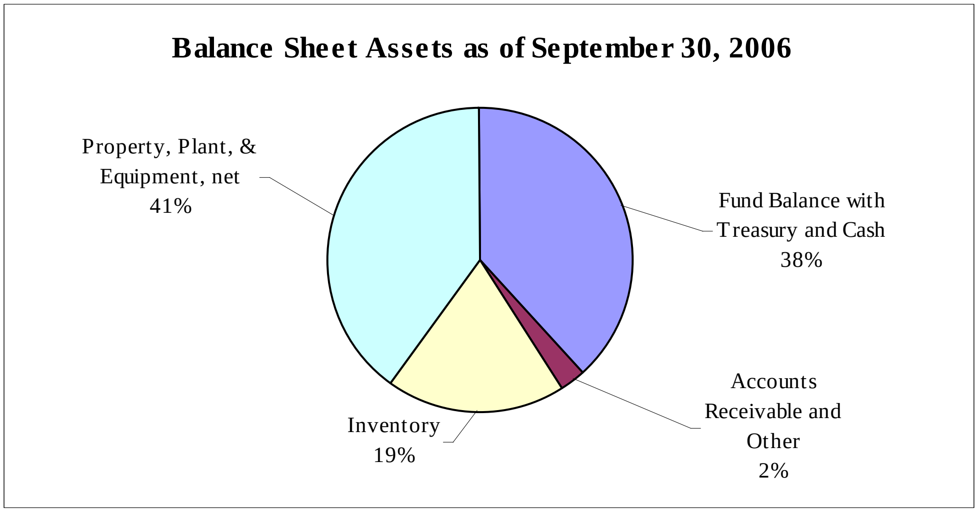
DeCA's financial statements have been prepared to report the financial position and results of operations for the entity, pursuant to the requirements of Title 31, U.S.C. 3515 (b). These statements have been prepared from DeCA's books and records in accordance with the formats prescribed by the OMB. These statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. As such, some liabilities cannot be liquidated without legislation that provides resources to do so.

DeCA's Consolidated Balance Sheets, Statements of Net Cost, Changes in Net Position, Financing, and Combined Statements of Budgetary Resources are presented in a two-year comparative format, as required by OMB Circular A-136, *Form and Content of the Performance and Accountability Report (PAR) Financial Statements*, revised in July 2006. The following section provides a brief description of: (a) the nature of each required financial statement and its relevance to DeCA; (b) significant fluctuations from FY 2005 to FY 2006; and (c) certain significant balances that help clarify their link to DeCA's operations.

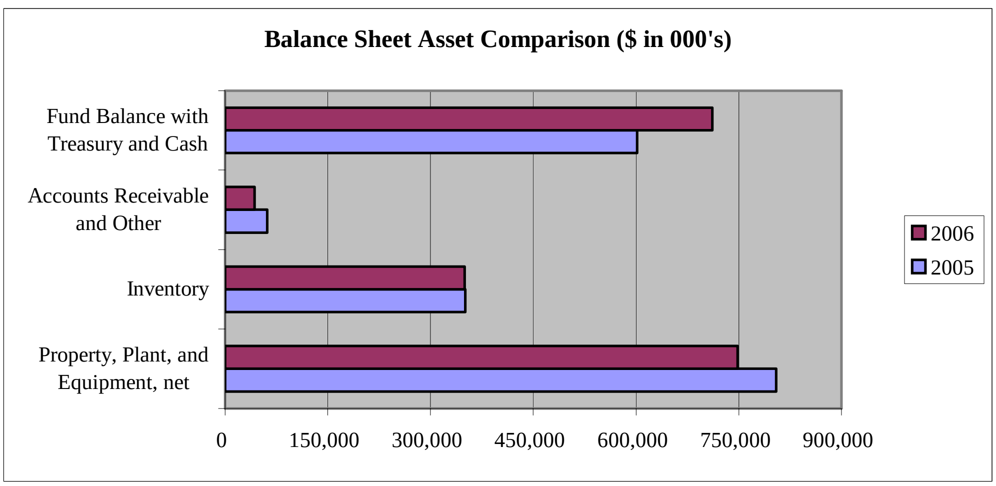
**BALANCE SHEET:**

The Balance Sheet presents the amounts available for use by DeCA (assets) against the amounts owed (liabilities) and amounts that comprise the difference (net position).

**Assets –** As of the September 30, 2006, DeCA's assets were $1,853 million. The assets of DeCA are the resources available to pay liabilities or satisfy future service needs. DeCA's major categories of assets, as a percentage of total assets are presented on the following page:




The following chart presents comparative data of major asset balances as of September 30, 2005, and September 30, 2006. A discussion of significant fluctuations follows.



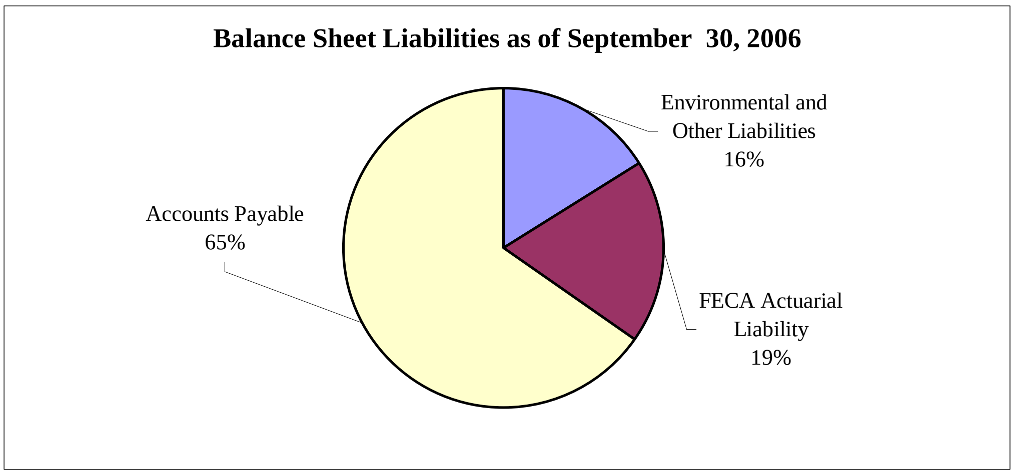

*Fund balance with Treasury (FBWT) and Cash* is primarily funding available through U.S. Department of the Treasury accounts from which DeCA is authorized to make expenditures to pay liabilities. It also includes monies available at commissaries as well as deposits in transit that have not yet been recognized by the U.S. Department of the Treasury. As of September 30, 2006, DeCA has an overall $711.5 million or 38 percent of its assets in FBWT and cash. This is an increase of $110 million or 18 percent over the prior year balance. Increases were due to increased sales and surcharge collections, supplemental funding for Hurricane Katrina damage, and increased appropriations.

*Accounts Receivable and Other* primarily represents amounts due from customers of DeCA. Accounts receivable and other decreased by approximately $18 million or 30 percent. This decrease was primarily caused by the write-off of uncollectible dishonored checks, the implementation of the Returned Check Management program, and overall higher collections in accounts receivable.

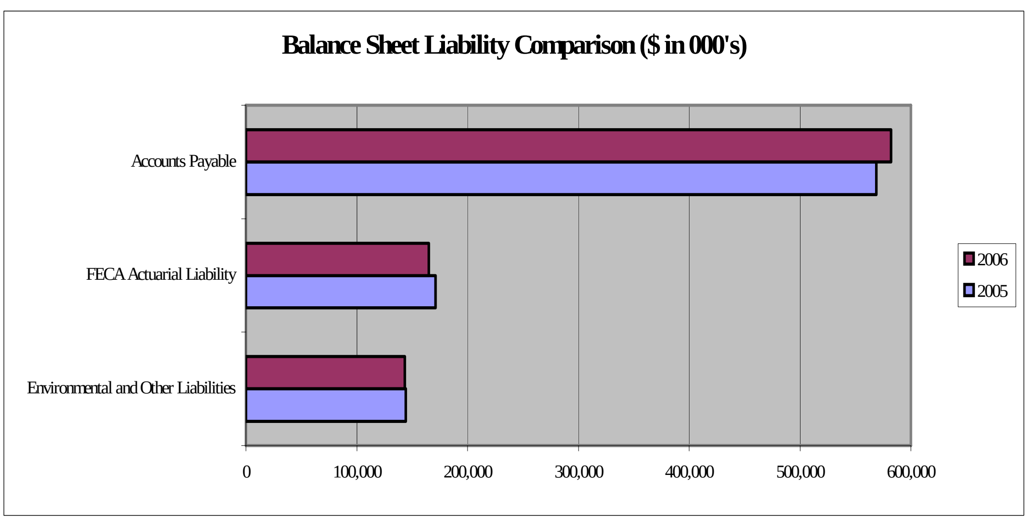
*Inventory* represents 19 percent of DeCA's current year assets and comprises grocery products held for resale to authorized patrons at DeCA facilities. Inventory decreased by $1 million or less than 1 percent over prior year.

*General Property, Plant and Equipment (PP&E), net represents* 41 percent of DeCA's current year assets and is primarily comprised of capitalized real and personal property held to fulfill DeCA's mission of selling groceries to its patrons. PP&E decreased by $57 million or 7 percent from FY 2005. This decrease is primarily due to a real property decrease resulting from store closures, while the equipment decrease is a result of sales, destruction, and losses.

**Liabilities** - On September 30, 2006, DeCA reported liabilities of $891 million. Liabilities are probable and measurable future outflows of resources arising from past transactions or events. The following chart depicts DeCA's major categories of liabilities as a percentage of total liabilities.




The following chart presents comparative data of major liability balances as of September 30, 2005 and September 30, 2006. A discussion of significant fluctuations follows.



*Accounts Payable* consists of DeCA's current liability for goods and services delivered or received, but not yet paid prior to year-end. DeCA's accounts payable increased by $13 million or 2 percent. The increase was due to higher purchases of inventory resulting from increased sales as well as major repairs to commissaries.

*Federal Employees Compensation Act (FECA) Actuarial Liability* comprises 19 percent of DeCA's current year liabilities and consists of DeCA's expected liability for death, disability, and medical costs for approved workers compensation cases as well as a component for incurred, but not yet reported claims. The Department of Labor (DOL) calculates the liability for DoD. DoD attributes a proportionate amount to DeCA based upon actual workers' compensation payments to DeCA employees over the preceding four years. The actuarial liability decreased by $6 million in FY 2006 or 4 percent because of the decreased amount allocated to DeCA by the DoD.

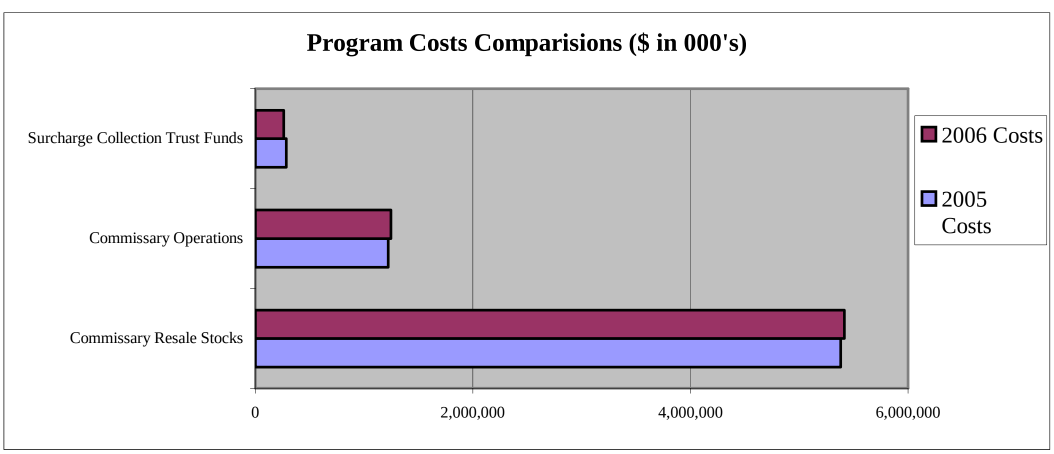
*Environmental and Other Liabilities* are potential costs to clean up items such as asbestos, lead paint, and other hazardous materials from our commissaries. It also includes liabilities for accrued payroll and benefits, accrued unfunded leave, and foreign national separation pay. These liabilities decreased $1 million or less than 1 percent from FY 2005.

**STATEMENT OF NET COST**:

The Statement of Net Cost presents gross and net cost information that can be related to the amount of revenue DeCA generates. The gross costs for DeCA less the earned revenue from grocery sales and other revenue sources are used to derive DeCA's net cost of operations. DeCA's gross costs are primarily accounted for in the three major activity groups of DeCA:

- *Surcharge Collections Trust Fund* includes the costs to construct and remodel commissaries;
- *Commissary Operations* includes the associated payroll and operational costs necessary to operate the commissary system; and
- *Commissary Resale Stocks* includes the costs to purchase grocery inventory for resale.

The chart below compares the gross costs between FY 2005 and FY 2006 in the three major DeCA activity groups.



Total revenues and costs each increased less than 1 percent in FY 2006.

**STATEMENT OF CHANGES IN NET POSITION:**

The Statement of Changes in Net Position represents those accounting transactions that caused the net position of the balance sheet to change from the beginning to the end of the reporting period. Various financing sources increase net position, including appropriations transfers and imputed financing from costs absorbed by others. DeCA's net cost of operations serves to reduce net position.

DeCA's net position increased by $27 million or 3 percent in FY 2006. The change in net position resulted from a $51 million increase in the cumulative results of operations offset by a $24 million decrease in FY 2006 unexpended appropriations.

**STATEMENT OF BUDGETARY RESOURCES**:

This statement provides information on the budgetary resources available to DeCA for FY 2005 and 2006 and the status of those budgetary resources at year-end. The gross outlays reported on this statement reflect the actual cash disbursed for the year by Treasury for DeCA's obligations. The budgetary resources increased by $65 million or 1 percent from FY 2005 to FY 2006. This increase is primarily attributed to increases in appropriation transfers and unobligated balances brought forward from FY 2005.

**STATEMENT OF FINANCING:**

This statement reconciles the resources available to DeCA to finance operations and the net cost of operating the commissary system. *Change in budgetary resources obligated for goods, services, and benefits ordered but not yet provided* includes the change in undelivered orders and unfilled customer orders. *Resources that finance the acquisition of assets* are additions and reductions to capital and other asset balances during the fiscal year. *Components requiring or generating resources in future periods* disclose the net increase in liabilities that are not covered by current budgetary resources.

## CONTROLS AND STATEMENT OF FINANCIAL ASSURANCE

DeCA accepts the responsibility of reporting performance and financial data accurately and reliably with the same vigor as we accept and conduct business and manage commissary operations. All performance data for this report is gathered and reported through a system of rigorous controls and quality checks. Representatives from each directorate or process gather year-end performance data from their respective program and project officers. The process owners and/or directors for each area or office review and validate this data. Accountants and analysts in the Office of the Chief Financial Executive also review this data before it is archived with all pertinent source information. In addition, DeCA uses various management information systems regularly to track and report on performance and financial data. FY 2006 marked the third year that DeCA produced financial reports within accelerated timeframes.

DeCA experienced and surmounted significant challenges this year to maintain our unqualified audit opinion from an independent audit firm. This was primarily due to the recent transfer of the accounting functions and records to the Financial Business Unit at DeCA-HQ. These functions were previously performed by personnel at the East and West Regions.

**OMB CIRCULAR NO. A-123, APPENDIX A:**

The implementation of the assessment of the internal controls (ICs) over financial reporting was a major undertaking for FY 2006. This required the full resources of DeCA and the unqualified support of managers at every level. Although DeCA has had an unqualified audit opinion on our financial statements since FY 2002 and ICs over financial reporting were clearly in place, the process had never been documented or tested with the rigor required by OMB Circular No. A-123, Appendix A. Documentation in the form of process narratives and flow charts was developed. Risks were assessed and 727 ICs were identified to mitigate these risks. Finally, 249 separate tests were used to assess the effectiveness of our ICs. No material weaknesses were found in the design or operation of the ICs over DeCA's financial reporting.

**FEDERAL MANAGERS FINANCIAL INTEGRITY ACT (FMFIA) STATEMENT OF ASSURANCE:**

In FY 2006, DeCA reported an unqualified assurance statement. In determining the type of assurance, the director considered information from various sources, which included management reviews, Inspector General and Government Accountability Office reports, audits of financial statements, reviews of financial and computer systems, and other information provided by committees of jurisdiction. Internal control reports and assessments discussed those issues considered to be material at the agency level. However, they were just one piece of DeCA's multi-faceted reporting strategy. Other elements of the strategy included our internal performance and results report, which presented annual measurements of DeCA's performance indicators and our annual financial statement and audit report, which presented findings from an independent audit firm.

**FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT (FFMIA) STATEMENT OF ASSURANCE:**

During FY 2006, we noted that our systems fell short of the integrated systems requirements and are not compliant with the U.S. Standard General Ledger. DeCA, jointly with DoD, is actively working on improving the system-wide architecture in order to meet the system requirements of FFMIA.

**IMPROPER PAYMENTS:**

In compliance with the Improper Payments Information Act of 2002 and specific guidance from the OMB, DeCA used a systematic process for reviewing all programs that are susceptible to significant improper payments. In FY 2004, DeCA resource management locations were tasked to sample payments to determine the rate, volume, and amount of payments that were made improperly. DeCA's performance was better than the OMB error rate threshold and was not at risk for significant improper payments. Our low rate of improper payments is due to improved internal controls.

## LIMITATIONS OF THE FINANCIAL STATEMENTS

DeCA prepared its financial statements to report its financial position and results of operations, pursuant to the requirements established by the DoD to comply with the *Chief Financial Officers Act of 1990* and the *Government Management Reform Act of 1994.*

While DeCA's statements have been prepared from its books and records in accordance with the formats prescribed by the OMB, the statements are, in addition to the financial reports, used to monitor and control budgetary resources, which are prepared from the same books and records.

These statements should be read with the understanding that they are for a component of the U.S. Government, a sovereign entity. The U. S. Congress cannot liquidate liabilities not covered by budgetary resources without the enactment of an appropriation, and the Federal Government, other than for contracts, can abrogate payment of all liabilities.

# PART II

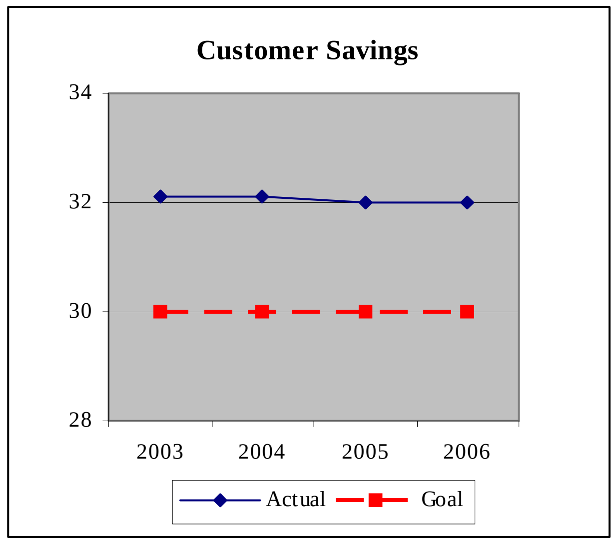
# PERFORMANCE SECTION

## PERFORMANCE ANALYSIS

DeCA exceeded its performance goals for FY 2006, except for the Facility Condition Index (FCI). The following charts and discussions illustrate how our achievements compare to our targets. The charts also depict our performance for the last four years, if data was available as DeCA did not establish some targets until 2004. The American Customer Satisfaction Index (ACSI) score will not be available until February 2007.

### Customer Savings:

**Background**: The patron savings are calculated using a comprehensive database of actual prices for Universal Product Coded (UPC) items from commercial grocery stores and commissaries to perform the analysis for locations within the 48 contiguous states (over 30,000 items are compiled). All major supermarket chains (e.g., Kroger Co., Winn Dixie, Giant Foods, HEB, etc.) as well as super centers are included in the comparison. Because the database contains only items with a UPC, prices for fresh meat and produce are obtained by physical audit at randomly selected commissaries and nearby commercial grocery stores.

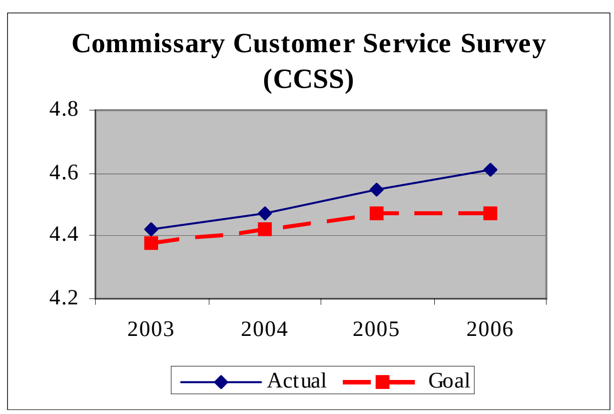



**Results:** DeCA's FY 2006 customer savings of 32 percent continue to exceed our goal of 30 percent.

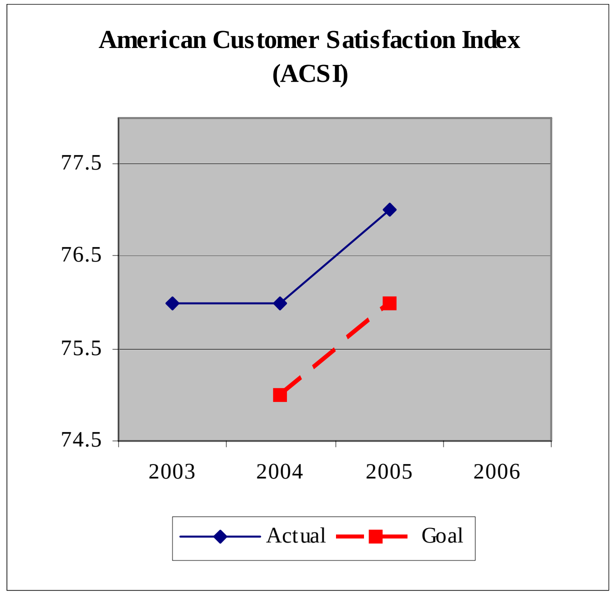
### Commissary Customer Service Survey (CCSS):

**Background:** Customer satisfaction is evaluated by surveys based on statistically sound sampling techniques and all scores are weighted to account for differences in commissary size.

**Results:** Once again, DeCA's CCSS score exceeded our target. The survey was administered to almost 22,000 commissary patrons who gave higher marks this year than last year in all 14 categories. The result was an overall score of 4.61 vice a target of 4.47. The highest rated category was "courteous, friendly, and helpful employees", which received a score of 4.77.



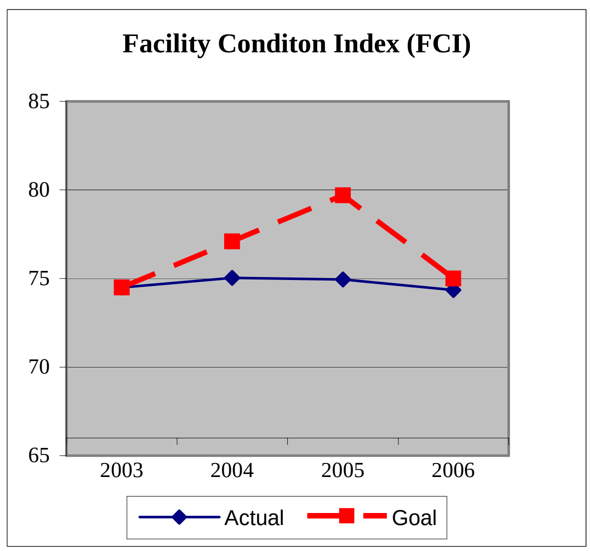
## American Customer Satisfaction Index (ACSI):




**Background:** The ACSI is produced annually through a partnership of the University of Michigan Business School, the American Society for Quality, and the consulting firm, Claes Fornell International Group. The ACSI is a uniform, independent measure that is general enough to be comparable across sectors, industries, and organizations of the U.S. economy. The ACSI measures a multivariable set of equations and utilizes cause and effect relationships to explain customer loyalty and ties that loyalty to customer satisfaction.

**Results:** The FY 2005 goal was a score of 76. In the February 2006 report, DeCA received a score of 77 for FY 2005. This score was significantly higher than the grocery industry average of 74. In addition, DeCA's strong customer satisfaction led to a below-average complaint rate. The FY 2006 goal is to meet or exceed the industry average. Results of the ACSI for FY 06 will not be available until February 2007.

## Facility Condition Index (FCI):




**Background:** The FCI is a numerical expression of the physical state of a commissary store. The FCI is a weighted measure of a commissary's condition, refrigeration system, and energy usage and efficiency. The FCI reflects the overall condition of commissary plants and facilities and is used as a leading indicator in assessing the effectiveness of surcharge-funded building investments. The FCI goals were originally developed in FY 2000 based on facility capital investment budgets that were at least $70 million more than those included in the budget for FY 2005 through FY 2009. The incremental increase for each annual goal was straight lined from the FY 2000 baseline to the FY 2009 end goal. No attempt was made to calculate a specific goal for each year based on projected investments for that year. The FCI goals were reevaluated and realigned in FY 2006 due to information technology, reduced construction budgets, and decreased buying power as a result of higher costs. In addition, previous BRACs have resulted in the closure of several commissaries and BRAC 2005 and

Global Basing will close approximately 30 more. Many of the targeted facilities are modern stores with good FCI scores. The revised goal for FY 2006 is a score of 75.

**Results:** The FY 2006 FCI goal was 75. The preliminary 74.35 FCI for FY 2006 resulted in a 99.1% achievement of our goal.

## ACCOMPLISHMENTS

DeCA continues to implement initiatives that support the President's Management Agenda (PMA) and that honor its commitment to prudent stewardship of taxpayer funds. These actions have resulted in improved levels of service to our customers, corporate succession planning, reduction in skill gaps, and more effective use of our resources.

**STRATEGIC MANAGEMENT OF HUMAN CAPITAL:**

The Commissary Career Program (CCP) and Corporate Successor Development Program (CSDP) ensures a steady pipeline of highly qualified and trained individuals to fill anticipated vacancies in key mission-critical and senior leadership positions. The agency's CSDP is a systematic leadership program for DeCA employees in grades GS-12 through GS-14. The CDSP ensures development of multi-skilled employees through a program of cross-training and rotational assignments at every level of the agency. Through the CSDP, the agency makes a concerted effort to identify competencies required by commissary management specialists to become future leaders of the agency. We then develop these employees to become proficient in identified competencies. DeCA is presently working to develop a concept for expanding the CDSP to GS-9 through GS-11 commissary management employees. This will support our effort to ensure a cadre of highly qualified and well trained employees exists at every level of commissary management. In addition, DeCA offers the Civilian Academic Degree Program for permanent/full-time employees in grades GS-05 or equivalent through GS-15. It helps employees obtain college/university degrees, thereby increasing DeCA's knowledge base and decreasing skill gaps. The degree must be part of a planned, systematic, and coordinated program of professional development that supports the agency's organizational strategic goals, objectives, and mission. There are currently 14 employees in the Academic Degree Program, 21 employees in the CSDP, and 1,285 employees in the CCP.

**COMPETITIVE SOURCING**:

DeCA was on track to meet our goal to study 50 percent of the Federal Activities Inventory Reform Act (FAIR) inventory by the end of FY 2008. However, the National Defense Authorization Act of FY 2006 stated, "Until December 31, 2008, the Defense Commissary Agency is not required to conduct any cost comparison study under the policies and procedures of Office of Management and Budget Circular A-76 relating to the possible contracting out of commissary store functions." In preparation for meeting future store requirements, DeCA has initiated a "Workforce of the Future" (WOF) concept. This concept is discussed further under Near and Long-Term Plans on page 21.

DeCA publicly announced the competition of DeCA's Resale Accounting functions, containing 141 positions, on June 13, 2006. We have identified participants to assist an independent contractor to develop the resale accounting performance work statement (PWS). Workload data is being accumulated and documented for inclusion in the PWS. This study will result in the re-engineering and consolidation of various functions and services, which will allow for staffing reductions and projected savings over the next 5 years.

**IMPROVED FINANCIAL PERFORMANCE**:

DeCA's financial performance continues to improve. Once again, we received an unqualified audit opinion on our consolidated financial statements in FY 2006 - our fifth unqualified opinion in a row. DeCA's FY 2006 travel card delinquency rate as of August 23, 2006 was 1.3 percent; well within the DoD mandate of less than 2 percent. DeCA's Government Purchase Card delinquency rate as of September 26, 2006 was 0 percent; the allowable amount by DoD.

**EXPANDED ELECTRONIC GOVERNMENT**:

DoD mandates that all major IT investments have an acceptable business case, which includes security, measures of success linked to the modernization blueprint, program management, and risk management as well as cost, schedule, and performance goals. Also, all services/agencies must submit an Exhibit 300 to OMB for all major IT investments and receive a score of four or higher from OMB. DeCA's new front-end system replacement, Commissary Advanced Resale Transaction System (CARTS), is an Acquisition Category 1AC system with the Assistant Secretary Defense, Networks and Information Integration, as the Milestone Decision Authority. This authority was in turn delegated to DeCA. The initial CARTS OMB Exhibit 300 score was a four. The Program Management Office (PMO) is tracking cost, schedule, and performance for CARTS in compliance with DoD's Earned Value Management policy. The DoD Acquisition Decision Memorandum, dated November 17, 2005, granted Milestone B approval and entry into the System Development and Demonstration Phase for the CARTS Program. As part of that process, the Acquisition Program Baseline (APB) was approved November 14, 2005. The CARTS contract was awarded December 31, 2005, earlier than the projected second quarter FY 2006 date. The PMO is monitoring program execution and costs, and submits an ABP status through the quarterly Defense Acquisition Executive Summary report.

All other major operational IT systems and mission critical systems are properly secured (certified, accredited, or otherwise authorized). This system information and security status will be recorded in the DoD Information Technology Portfolio Repository (DITPR). To date, DeCA has ten operational systems in DITPR that have Certification and Accreditation (C&A) and an Authority to Operate status. Four systems are in pre-deployment stage (C&A is not applicable).

As required by DoD, agencies/services must contribute to and participate in E-Gov initiatives, rather than creating redundant or agency unique IT projects. DeCA supports the E-Gov initiatives and has no redundant E-Gov initiatives or Lines of Business (LoB). DeCA has implemented processes supporting: (1) government-to-business (transactions with our business partners via Electronic Commerce/Electronic Data Interchange); and (2) government-to-citizen transactions (Virtual Commissary and other services available through www.commissaries.com provide added value to the benefit.). Additionally, DeCA has realized internal efficiencies and effectiveness by using DoD systems applicable to the Agency such as the Defense Travel System (DTS), the Defense Property Accountability System (DPAS), the Defense Civilian Personnel Data System (DCPDS), and the Defense Civilian Payroll System (DCPS).

**BUDGET AND INTEGRATION**:

Performance plans for all Senior Executive Service (SES) and senior professionals include expectations of accomplishment relative to position requirements and DeCA's mission as well as appropriate external standards such as the President's Management Agenda (PMA). Each SES's and senior professional's plan supports and facilitates performance excellence, accountability, and strategic alignment. Performance is linked to budget and organizational results. All other individuals' performance plans are tied to strategic planning and the PMA, which are cascaded appropriately throughout the organization with employees being responsible for and understanding the importance of their positions. Review of employee performance plans to ensure linkage to the agency's strategic goals and objectives has been incorporated into DeCA's standard IG review checklist. The Agency stresses the importance of this effort through its continued use of staff assistance visits and other information media.

DeCA senior managers regularly utilize financial and performance measures from the BSC and the PMA scoring results in the conduct of senior staff meetings and quarterly senior management business reviews. DeCA also established a Corporate Governance Board (CGB) during the 3d Qtr, FY 2006. Meetings are held every two to three weeks and address: (1) proposed concepts and initiatives to include approval, program assistance, and resourcing; (2) Quarterly Program Reviews related to cost, schedule, and performance; (3) process owner support issues and major initiatives; (4) significant policy changes or external mandate activities; and (5) financial and planning guidance to managers.

## NEAR AND LONG-TERM PLANS

**DeCA ENTERPRISE BUSINESS SYSTEM (DEBS)**:

DEBS is a new IT system in development that will retire multiple legacy systems that currently support the cataloging, ordering, receiving, inventory accountability, and promotions business processes. DeCA completed the Concept Refinement Phase for DEBS, which defined the Initial Concept and developed the technology and strategy for the system. The plan is to achieve high system availability with low maintenance costs, improve business functionality and management reporting, enhance data security, and improve its flexible open systems architecture. Utilizing a leading edge supply chain management capability, this system will allow DeCA to keep pace with the commercial grocery industry. The current business process is managed by a large and diverse group of information systems that do not meet current DoD security standards. These systems require manual support of complex interfaces and are becoming increasingly expensive to maintain. DeCA has identified the redundancies and inefficiencies and streamlined the current business processes for the Requirement Management Plan. The program is on schedule to obtain Milestone A approval in October 2006.

**EQUIPMENT "PUSH" PACKAGES FOR COMMISSARIES**:

Starting in FY 2007, tailored "push" packages are at the heart of a new way for commissaries in DeCA East and West to maintain and order equipment. A push package is a 12-year roadmap that identifies all the equipment in a store, takes into account the store's business volume for estimating equipment wear and tear, and projects replacement dates. The push program acknowledges DeCA's steady move toward equipment standardization. As an agency formed by consolidating four individual military services' commissary systems into one, DeCA inherited a variety of store designs, layouts, and equipment. The variance among the stores is currently being documented via on-site inspections of store equipment. These visits will set the baseline for future equipment needs and forecasts. With the push method and the 12-year life-cycle plan, requirements will be generated based on each store's needs. Push packages will keep equipment up-to-date, provide better customer service with less downtime, and save resources.

**ORGANIZATION AND PROCESS REENGINEERING**:

DeCA is nearing completion of consolidating many corporate and store support functions such as procurement, comptroller, operations, and human resources, at DeCA-HQ and FOA. This above-store level reengineering process eliminates layering and was identified in the BRAC process for realignment to DeCA-HQ.

**WORKFORCE OF THE FUTURE:**

DeCA is creating high performing commissary organizations via its business process reengineering initiative that constructs a WOF store concept of operations. This concept of operation enables commissaries to operate more efficiently and effectively thus evolving into the model of the Most Efficient Organization. Savings efficiencies are achieved through increased productivity and a reduction of full-time equivalents. Also, this new store model will posture DeCA to be more competitive under an A-76 competition. DeCA implemented two stores under this concept in FY 2005 and another five locations in Hawaii on October 1, 2006.

**COMMISSARY ADVANCED RESALE TRANSACTION SYSTEM (CARTS)**:

CARTS received a preliminary OSD score of 5 on the most recent Exhibit 300. The CARTS team is working with the new CARTS vendor to complete various stages of testing and to prepare the system for deployment. These tests involve an Operational Capabilities Demonstration of the CARTS system to ensure it operates properly within DeCA's commissary environment and complies with contractual requirements and integration testing. A Milestone C decision, System Development and Demonstration Phase, will be granted upon successful testing. This milestone decision will allow DeCA to begin Operational Testing and then fully deploy the system in FY 2007.

In summary, DeCA's past performance and FY 2006 performance indicates positive progress. DeCA's investment in human capital, technologies, programs, and product support are necessary to achieve and provide the commissary benefit to the Total Force personnel and their families.

# PART III

# FINANCIAL SECTION

## CHIEF FINANCIAL EXECUTIVE'S MESSAGE

Fiscal Year (FY) 2006 was a year of significant improvements and accomplishments. Achievements in the area of financial processes and accountability were especially remarkable as the Defense Commissary Agency (DeCA) led the Department of Defense (DoD) in the implementation of the requirements of the Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control,* Appendix A.

In FY 2006, DeCA began the intensive management efforts required to meet the new OMB Circular A-123, Appendix A requirements. The formulation of DeCA's Senior Assessment Team (SAT) was hailed by DoD as a model governing body because its members crossed many functional areas. Our efforts yielded outstanding results as many products developed by DeCA were implemented as the DoD standard for all agencies. An added benefit of this effort was a greater understanding, across all functional areas of DeCA, of the impact of their processes on the DeCA financial statements.

In addition, DeCA was one of only five DoD entities who earned an independent "unqualified" audit opinion at the end of FY 2005 and now we have obtained our fifth for FY 2006. This significant accomplishment made DeCA one of the select group of DoD agencies who earned five consecutive annual unqualified audit opinions from an independent audit firm. The Agency made significant strides this year in improving our procedures for Property, Plant, and Equipment accountability, as it is no longer a reportable condition. Information technology control and compliance, while improved, is still a reportable condition in FY 2006.

Resource management processes and structure underwent a substantial change in FY 2006. All budget, manpower, accounting, and payroll liaison functions, previously performed at the Continental U.S. (CONUS) Regions, were realigned to the DeCA-HQ and Field Operating Activities (FOA) at Fort Lee. Three separate directorates were also reorganized into two - the Budget and Manpower Directorate and the Accounting Directorate. In the coming year, we will be conducting a commercial activities study of DeCA's resale accounting functions and also reviewing our Outside of CONUS operations for further efficiencies.

DeCA's audit committee, with members from the Office of the Under Secretary of Defense (Comptroller), DoD (Inspector General), Defense Finance and Accounting Service, and multiple DeCA offices, continued to meet regularly with our independent audit firm, KPMG, to discuss issues, develop policies, and implement procedures to enhance accountability and financial management. The committee maintained oversight of the audit progress. With the transitioning region workload, these efforts were complex and demanding on all parties. Nevertheless, real progress is evident as DeCA continues to manage additional challenges and still maintain a clean audit opinion.

DeCA submitted its Program Assessment and Rating Tool (PART) for first time in FY 2006 as part of the OMB's 2006 PART cycle. The Agency evaluated twelve PART efficiency and outcome performance measures that substantiate effectiveness and future funding, and was rated Moderately Effective by OMB, the second highest rating available.

Despite significant challenges, DeCA excelled in most aspects of performance measurement. Sales increases were higher than forecast while operating costs, in constant dollars, were lower than in FY 2005. Customer satisfaction scores – measured by the American Customer Service Index (ASCI) and Commissary Customer Service Survey (CCSS) – were high. In keeping with the DoD focus, DeCA has transitioned to a Balanced Scorecard process in FY 2006, which incorporates and compliments the President's Management Agenda. Patron savings continued to exceed the goal of 30 percent by achieving an average of 32 percent. Thus, the commissary benefit remains a major quality of life benefit for Service members around the world.

In summary, FY 2006 was another challenging year, but teamwork, a corporate approach to governance, and attention to detail resulted in significant improvements for our patrons and other stakeholders. We look forward to the challenges ahead in FY 2007 as we continue to raise the bar higher for financial reporting and accountability.

Pamela F. Conklin
Chief Financial Executive

October 31, 2006

**DEFENSE COMMISSARY AGENCY**
**CONSOLIDATED BALANCE SHEETS**
**AS OF SEPTEMBER 30,**
**(in thousands)**

| | 2006 | 2005 |
|---|---|---|
| **Assets** | | |
| Intragovernmental: | | |
| Fund balance with Treasury (Note 2) | $ 617,791 | $ 502,163 |
| Accounts receivable and other | 179 | 539 |
| Total intragovernmental assets | 617,970 | 502,702 |
| Cash | 93,755 | 99,198 |
| Accounts receivable and other | 43,001 | 61,079 |
| Inventory | 349,937 | 350,948 |
| General property, plant, and equipment, net (Note 3) | 748,033 | 804,914 |
| **Total assets** | $ 1,852,696 | $ 1,818,841 |
| **Liabilities (Note 4)** | | |
| Intragovernmental: | | |
| Accounts payable | $ 120,267 | $ 121,443 |
| Other liabilities | 40,532 | 39,898 |
| Total intragovernmental liabilities | 160,799 | 161,341 |
| Accounts payable | 461,930 | 447,293 |
| Federal Employees Compensation Act actuarial liability | 165,173 | 171,207 |
| Environmental liabilities | 29,040 | 31,866 |
| Other liabilities | 73,885 | 72,665 |
| **Total liabilities** | 890,827 | 884,372 |
| **Net position (Note 5)** | | |
| Unexpended appropriations | 26,346 | 50,384 |
| Cumulative results of operations - earmarked funds (Note 9) | 990,807 | - |
| Cumulative results of operations - other funds | (55,284) | - |
| Total cumulative results of operations | 935,523 | 884,085 |
| **Total net position** | 961,869 | 934,469 |
| **Total liabilities and net position** | $ 1,852,696 | $ 1,818,841 |

*The accompanying notes are an integral part of the financial statements.*

**DEFENSE COMMISSARY AGENCY**
**CONSOLIDATED STATEMENTS OF NET COST**
**FOR THE YEARS ENDED SEPTEMBER 30,**
**(in thousands)**

| | 2006 | 2005 |
|---|---|---|
| Gross costs | $ 6,923,518 | $ 6,888,983 |
| Less: Earned revenue | (5,718,836) | (5,683,551) |
| **Net cost of operations (Note 6)** | $ 1,204,682 | $ 1,205,432 |

*The accompanying notes are an integral part of the financial statements.*

## DEFENSE COMMISSARY AGENCY
## CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
## FOR THE YEARS ENDED SEPTEMBER 30,
## (in thousands)

| | 2006 | | | 2005 |
|---|---|---|---|---|
| | Earmarked Fund | All Other Funds | Consolidated Total | Consolidated Total |
| **Cumulative Results of Operations:** | | | | |
| **Beginning balance** | $ 949,289 | $ (65,204) | $ 884,085 | $ 897,446 |
| **Budgetary financing sources** | | | | |
| Non-exchange revenue | - | 19,840 | 19,840 | 21,359 |
| Appropriations transfers used | - | 1,208,974 | 1,208,974 | 1,140,999 |
| Transfers in (out) | 4,431 | 7,569 | 12,000 | 729 |
| Other | - | - | - | (1,898) |
| **Other financing sources (uses)** | | | | |
| Imputed financing (Note 7) | - | 35,816 | 35,816 | 36,028 |
| Other - Gain (losses) in capital assets | (20,062) | (448) | (20,510) | (5,146) |
| **Total financing sources (uses)** | (15,631) | 1,271,751 | 1,256,120 | 1,192,071 |
| **Net (cost) income from operations** | 57,149 | (1,261,831) | (1,204,682) | (1,205,432) |
| **Net Change** | 41,518 | 9,920 | 51,438 | (13,361) |
| **Cumulative Results of Operations** | $ 990,807 | $ (55,284) | $ 935,523 | $ 884,085 |

*The accompanying notes are an integral part of the financial statements.*

## DEFENSE COMMISSARY AGENCY
## CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
## FOR THE YEARS ENDED SEPTEMBER 30,
## (in thousands)

| | 2006 | | | 2005 |
|---|---|---|---|---|
| **Unexpended Appropriations:** | **Earmarked Fund** | **All Other Funds** | **Consolidated Total** | **Consolidated Total** |
| **Beginning balance** | $ - | $ 50,384 | $ 50,384 | $ 17,816 |
| **Budgetary financing sources** | | | | |
| Appropriation transfer | - | 1,197,021 | 1,197,021 | 1,174,609 |
| Appropriations transfers used | - | (1,208,974) | (1,208,974) | (1,140,999) |
| Transfers (out) | - | - | - | (929) |
| Other | - | - | - | (113) |
| **Other financing sources (uses)** | | | | |
| Other adjustments (rescissions) | - | (12,085) | (12,085) | - |
| **Total financing sources (uses)** | - | (24,038) | (24,038) | 32,568 |
| **Unexpended Appropriations** | $ - | $ 26,346 | $ 26,346 | $ 50,384 |

*The accompanying notes are an integral part of the financial statements.*

## DEFENSE COMMISSARY AGENCY
## COMBINED STATEMENTS OF BUDGETARY RESOURCES
## FOR THE YEARS ENDED SEPTEMBER 30,
## (in thousands)

| | 2006 | 2005 |
|---|---|---|
| **Budgetary resources (Note 8)** | | |
| Unobligated balance brought forward | $ 11,472 | $ (27,097) |
| Recoveries of prior year unpaid obligations | 11,926 | 12,521 |
| Budget authority | 1,197,537 | 1,189,778 |
| Spending authority from offsetting collections | 5,772,118 | 5,681,421 |
| Net transfers and adjustments | 12,000 | 701 |
| Permanently not available | (86,924) | (4,604) |
| **Total budgetary resources** | $ 6,918,129 | $ 6,852,720 |
| | | |
| **Status of budgetary resources** | | |
| Obligations incurred: | | |
| Direct | $ 1,189,969 | $ 1,142,469 |
| Reimbursable | 5,708,644 | 5,698,779 |
| Total obligations incurred | 6,898,613 | 6,841,248 |
| Unobligated balance - apportioned | 6,417 | 11,457 |
| Unobligated balance - not available | 13,099 | 15 |
| **Total status of budgetary resources** | $ 6,918,129 | $ 6,852,720 |
| | | |
| **Change in obligated balance** | | |
| Obligated balance, net - beginning of year (Note 8) | $ 774,090 | $ 749,542 |
| Total obligations incurred | 6,898,613 | 6,841,248 |
| Less: gross outlays | (6,870,722) | (6,804,907) |
| Less: recoveries of prior year unpaid obligations | (11,926) | (12,521) |
| Change in uncollected customer payments from Federal sources | 13,929 | 728 |
| **Obligated balance, net - end of year (Note 8)** | $ 803,984 | $ 774,090 |
| | | |
| **Net outlays** | | |
| Gross outlays | $ 6,870,722 | $ 6,804,907 |
| Offsetting collections | (5,786,047) | (5,682,149) |
| **Net outlays** | $ 1,084,675 | $ 1,122,758 |

*The accompanying notes are an integral part of the financial statements.*

## DEFENSE COMMISSARY AGENCY
## CONSOLIDATED STATEMENTS OF FINANCING
## FOR THE YEAR ENDED SEPTEMBER 30,
## (in thousands)

| **Resources used to finance activities** | **2006** | **2005** |
|---|---|---|
| Budgetary resources obligated: | | |
| Obligations incurred | $ 6,898,613 | $ 6,841,248 |
| Less: Spending authority from offsetting collections and recoveries | (5,784,044) | (5,693,942) |
| Obligations, net of offsetting collections and recoveries | 1,114,569 | 1,147,306 |
| Other resources: | | |
| Imputed financing from costs absorbed by others (Note 7) | 35,816 | 36,028 |
| Other - Gain (losses) in capital assets | (20,510) | (5,146) |
| Net other resources used to finance activities | 15,306 | 30,882 |
| **Total resources used to finance activities** | 1,129,875 | 1,178,188 |
| **Resources used to finance items not part of net costs of operations** | | |
| Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided: | | |
| Undelivered orders | (6,202) | (21,686) |
| Unfilled customer orders | 532 | (587) |
| Resources that fund expenses recognized in prior periods | (8,860) | (3,221) |
| Resources that finance the acquisition of assets | (5,461,000) | (5,158,296) |
| Other resources that do not affect net cost of operations | 20,938 | - |
| **Total resources used to finance items not part of the net cost of operations** | (5,454,592) | (5,183,790) |
| **Total resources used to finance the net cost of operations** | (4,324,717) | (4,005,602) |
| **Components of the net cost of operations that will not require or generate resources in the current period** | | |
| Components requiring or generating resources in future periods - | | |
| Increase in exchange revenue receivable from the public and other | (3,625) | 8,158 |
| Components not requiring or generating resources in future periods: | | |
| Cost of goods sold | 5,412,194 | 5,091,390 |
| Depreciation and amortization | 104,488 | 91,685 |
| Revaluation of assets/liabilities | (6,368) | (1,765) |
| Non-exchange revenue and other | 22,710 | 21,566 |
| Total components of net cost of operations that will not require or generate resources in the current period | 5,529,399 | 5,211,034 |
| **Net cost of operations** | $ 1,204,682 | $ 1,205,432 |

*The accompanying notes are an integral part of the financial statements.*

## DEFENSE COMMISSARY AGENCY
## NOTES TO THE FINANCIAL STATEMENTS

### *NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES*

### A. <u>Description of Reporting Entity</u>

The Defense Commissary Agency (DeCA) provides grocery, meat, and produce items to members of the U. S. Armed Forces, their dependents, retirees, and other authorized patrons, including other governmental entities. DeCA is a Department of Defense (DoD) agency under the control of the Under Secretary of Defense for Personnel and Readiness. DeCA was created in 1991 after the House Armed Services Committee-appointed Jones Commission recommended that a single agency be responsible for operating the military commissary system to increase effectiveness and at a lower cost.

DeCA, with its headquarters located at Fort Lee, Virginia, has three regional offices located at Kaiserslautern, Germany; Fort Lee, Virginia; and Sacramento, California. DeCA operations are financed primarily by a working capital fund (WCF) and surcharge collections. Additionally, for FY 2006, the Office of Management and Budget (OMB) established a new fund to be used by DeCA in support of Hurricane Katrina relief efforts. This fund reimbursed the Surcharge Collections Trust Fund for the reconstruction of buildings and the replacement of equipment lost during Hurricane Katrina. DeCA also receives minor amounts of military construction appropriated funds.

DeCA's WCF is considered part of the DoD's WCF, which includes the financial activity of several Defense agencies. Within DeCA's WCF, there are two activity groups, Commissary Resale Stocks and Commissary Operations. DoD defines these two activity groups as business areas for fund control purposes. Commissary Resale Stocks finances the purchase of grocery, meat and produce items for resale to authorized patrons. The primary revenue source for this activity group is the sale of inventory to commissary patrons. Commissary Operations finances the operating costs of resale stores, agency and region headquarters, field operating activities, and support services. The primary revenue source for this activity group is a direct appropriation to the Defense WCF, which in turn transfers the funds to the DeCA WCF. Commissary Operations also receives additional revenues from manufacturers' coupon redemption fees, handling fees for tobacco products, and reimbursements for other support. DeCA receives an annual operating budget from DoD that establishes limitations for annual cost authority and annual capital expenditures for the two business areas.

DeCA's Surcharge Collections Trust Fund is funded primarily by a five percent surcharge applied to each sale. This fund, established by law, primarily finances DeCA's store-level information management equipment and support, and construction programs. The use of resources associated with the Surcharge Collections Trust Fund is limited by public law and, as described in Note 9, the fund has been identified as an earmarked fund.

## B. Basis of Presentation and Accounting

These financial statements have been prepared to report the financial position, net cost of operations, changes in net position, status and availability of budgetary resources, and the reconciliation between proprietary and budgetary accounts of DeCA. The Chief Financial Officers (CFO) Act of 1990, expanded by the Government Reform Act (GMRA) of 1994, requires DoD to prepare financial statements. DoD, in turn, requires DeCA to prepare audited financial statements. The financial statements have been prepared from the books and records of DeCA in accordance with accounting principles generally accepted in the United States of America and DoD accounting policies, which are summarized in this note. These financial statements, with the exception of the Statement of Budgetary Resources, are, therefore different from the financial management reports prepared by DeCA that are used to monitor and control DeCA's use of budgetary resources pursuant to Office of Management and Budget (OMB) directives.

Transactions are recorded on both an accrual accounting basis and budgetary basis. Under the accrual method, revenues are recognized when earned, and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal requirements on the use of Federal funds. All material intra-agency transactions and balances have been eliminated for presentation on a consolidated basis. However, the Statement of Budgetary Resources is presented on a combined basis in accordance with OMB Circular A-136.

In 2006, DeCA has accounted for revenues and other financing sources for earmarked funds separately from other funds. This new method was adopted in accordance with the provisions of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*, which became effective October 1, 2005. This new standard amended SFFAS No.7, *Revenue and Other Financing Sources*, by:

- elaborating the special accountability needs associated with dedicated collections;
- separating dedicated collections into two categories – earmarked funds and fiduciary activity; and
- defining and providing accounting and reporting guidance for earmarked funds.

In accordance with SFFAS No. 27, DeCA did not restate the prior period columns of the consolidated financial statements and related disclosures.

See Note 9 for specific required disclosures related to DeCA's earmarked fund. Also, beginning in fiscal year 2006, DeCA has adopted OMB Circular A-136 required changes in the presentation of the statements of net cost and budgetary resources.

All dollar amounts are in thousands.

**C. Fund Balance with Treasury**

Fund balance with Treasury (FBWT) is the aggregate amount of funds in DeCA's accounts with the U.S. Department of Treasury (Treasury). FBWT primarily represents appropriated, revolving, and trust funds that are available to pay current liabilities and finance authorized purchases.

Note 2 provides detailed information concerning FBWT.

**D. Cash**

Cash primarily consists of receipts from sales occurring during the last several days of the fiscal year that have been deposited into financial institutions, but are not yet transferred to DeCA's FBWT.

**E. Accounts Receivable**

Accounts receivable consists of amounts owed to DeCA by other Federal agencies and the public. Federal accounts receivable arise generally from the provision of goods and services to other federal agencies. No allowance for doubtful accounts is determined for Federal accounts receivable.

Receivables from the public generally arise from the sale of grocery, meat, and produce items to authorized patrons. An allowance for doubtful accounts is established for reporting purposes based on past experience in the collection of accounts receivable and analysis of outstanding balances using the percentage of receivables. The allowance for loss on receivables account is adjusted accordingly at the time of collection or write-off during the fiscal year. Non-Federal accounts receivable are reported net of the allowance of $341 and $686 thousand as of September 30, 2006 and 2005, respectively.

**F. Inventory**

Inventory consisting primarily of grocery, meat, and produce items held for resale and is stated at approximate cost.

**G. General Property, Plant and Equipment**

General property, plant and equipment (PP&E) consists of building, structures, and facilities (BSF), software, equipment, and construction-in-progress. PP&E is stated at acquisition cost, less accumulated depreciation. DoD establishes capitalization and depreciation policies for PP&E.

BSF is included in PP&E under DoD's "Preponderance of Use" policy. This policy recognizes that the DoD agencies that gain the most benefit by virtue of space usage should record the asset as general PP&E.

PP&E acquisitions are capitalized if the acquisition cost equals or exceeds $100,000 with the exception of real property. The capitalization threshold for real property was revised this fiscal year from $100,000 to $20,000, which must be fully implemented by March 2008. In addition, the asset must also meet the following criteria: (1) an estimated useful life of two or more years; (2) not intended for sale; and (3) acquired or constructed with the intent of being used by DeCA.

Depreciation is recognized on all PP&E, except construction-in-progress, on the straight-line basis over the estimated useful life of the asset. The useful life for buildings, warehouses, and other real property buildings is generally 40 years. The useful life of ADP software and hardware is 5 years, and 10 years for all other equipment.

Note 3 provides detailed information concerning general property, plant, and equipment.

## H. Other Liabilities

Other liabilities consist of payments DeCA owes to the Department of Labor (DOL) for workers' compensation paid under the Federal Employees Compensation Act (FECA), accrued payroll and benefits (including employer contributions and payroll taxes), foreign national separation pay, and accrued leave.

***Workers' Compensation.*** FECA provides income and medical cost protection to covered Federal civilian employees injured on the job, employees who have incurred a work-related occupational disease, and beneficiaries of employees whose death is attributable to a job-related injury or occupational disease. DOL is responsible for administering the program and making payments for claims from eligible individuals. Subsequently, DOL bills Federal agencies for those claims from the individuals associated with the respective agency. The actuarially determined liability related to workers' compensation is described below.

***Accrued Payroll and Benefits***. Accrued payroll and benefits includes the portion of employee compensation earned, but not paid, at the end of the fiscal year along with DeCA's share of associated taxes, benefits, and retirement plan contributions.

***Foreign National Separation Pay.*** DeCA operates in numerous foreign countries. These countries establish tariff agreements that outline certain employment terms and conditions related to its citizens. Under these tariff agreements, citizens for certain countries are entitled to special pay in the event their employment is terminated.

***Accrued Leave.*** Federal employees' annual leave is accrued as it is earned. The accrual is reduced annually for actual leave taken and increased for leave earned. Each year, the accrued annual leave balance is also adjusted to reflect the latest pay rates. To the extent current or prior year appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources. DeCA employees can earn compensatory leave in lieu of overtime pay.

Note 4 provides detailed information about other liabilities.

**I. Actuarial Liability**

In addition to the liabilities discussed above, DeCA records an actuarial liability for its remaining workers' compensation benefits. This liability, which is developed by DOL and provided to DoD after the end of each fiscal year, includes the expected future costs associated with death, disability, medical, and miscellaneous items for approved compensation cases. DOL determines the liability using a method that employs historical benefit payment patterns to predict the ultimate payments. The projected annual benefit payments are then discounted to the present value using the OMB's economic assumptions for 10-year U.S. Treasury notes and bonds. The assumed interest rate for 10-year U.S. Treasury notes and bonds is 5.17% and 4.52% at September 30, 2006 and 2005, respectively. DoD uses a three-year moving average to distribute the actuarial liability to the various DoD agencies based on actual costs incurred by the respective DoD components.

**J. Imputed Financing and Costs**

DeCA recognizes imputed financing and costs related to Federal retirement plans, health benefits and life insurance, and the Treasury Judgment Fund.

***Retirement Plans***. There are two primary retirement systems for Federal employees. Employees hired before January 1, 1984, may participate in the Civil Service Retirement System (CSRS). On January 1, 1984, the Federal Employees Retirement System (FERS) went into effect pursuant to Public Law 99-335. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security.

Employees hired before January 1, 1984, elected to either join FERS and Social Security or remain in CSRS. A primary feature of FERS is that it offers a savings plan to which

DeCA automatically contributes one percent of pay and matches any employee contribution up to an additional four percent of pay. For most employees hired since December 31, 1983, DeCA also contributes the employer's matching share for Social Security.

DeCA does not report CSRS or FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is the responsibility of the Office of Personnel Management (OPM). DeCA recognizes an imputed financing source and program expense for the difference between its contributions to Federal employee pension and other retirement benefits and the estimated actuarial costs as computed by the OPM.

***Health Benefits and Life Insurance***. The majority of DeCA employees are authorized to participate in the Federal Employees' Health Benefit (FEHB) program and the Federal Employees Group Life Insurance (FEGLI) program, which are administered by OPM. DeCA recognizes an imputed financing source and a program expense for these benefits.

***Treasury Judgment Fund.*** Lawsuit settlements against DeCA may be paid by the Department of Treasury's Judgment Fund. DeCA recognizes an imputed financing source and a program expense for the amounts the Judgment Fund pays on behalf of DeCA.

## K. Environmental Liabilities

DeCA's environmental liabilities reflect the potential liability associated with the clean-up and removal of environmentally hazardous materials, which are primarily asbestos and lead-based paint in DeCA's facilities. DeCA estimates its environmental liability based on the number of facilities constructed before 1988 that have not been remediated. The portion of the liability associated with those facilities with planned renovation projects during the next year are reported as current liabilities. The estimate is periodically adjusted upon completion of scheduled renovation projects. Actual costs may differ from the estimate due to possible changes resulting from inflation, deflation, technology, and/or applicable laws and regulations.

## L. Net Position

Net position is the residual difference between assets and liabilities and comprises unexpended appropriations and cumulative results of operations.

Unexpended appropriations represent the amount of unobligated and unexpended budget authority. Unexpended appropriations are reduced for appropriations used and adjusted for other changes in budgetary resources, such as transfers and rescissions.

Cumulative results of operations represent the excess of revenues over expenses and transfers to the U.S. Treasury in the WCF and GF since inception.

Note 5 provides detailed information on net position.

**M. Non-Exchange Revenue**

DeCA recognizes non-exchange revenue for the labor received at no cost for local nationals working in the country of Japan. The Government of Japan pays the salary for local national employees up to a specified annual ceiling amount. Payroll over this ceiling is charged to DeCA.

**N. Use of Estimates**

DeCA has made certain estimates and assumptions relating to the reporting of assets and liabilities, the disclosure of contingent liabilities, and the reporting of revenue and expenses in the financial statements. Actual results could differ from these estimates.

**O. Reclassifications**

Certain FY 2005 balances have been reclassified, retitled, or combined with other financial statement line items for consistency with current year presentation.

### *NOTE 2 - FUND BALANCE WITH TREASURY*

FWBT consists of three types of funds – appropriated funds, revolving, and trust funds. Revolving funds involve DeCA's Resale fund, trust funds involve the Surcharge Collections fund, and appropriated funds include commissary operations, military construction and procurement funds.

The following table shows the balance for each type of fund as of September 30, 2006 and 2005:

| Fund balances: | 2006 | 2005 |
|---|---|---|
| Appropriated funds | $ 241,213 | $ 233,476 |
| Revolving funds | 69,765 | 59,154 |
| Trust funds | 306,813 | 209,533 |
| Total | $ 617,791 | $ 502,163 |

The following table shows the status of the fund balances as of September 30, 2006 and 2005:

| Status of fund balances: | Appropriated | Revolving | Trust | Total |
|---|---|---|---|---|
| Unobligated balance available | $ 6,417 | $ - | $ - | $ 6,417 |
| Unobligated balance unavailable | 15 | - | 13,084 | 13,099 |
| Obligated balance not yet disbursed, net of contract authority | 234,781 | 69,765 | 293,729 | 598,275 |
| **Total as of September 30, 2006** | $ 241,213 | $ 69,765 | $ 306,813 | $ 617,791 |

| Status of fund balances: | Appropriated | Revolving | Trust | Total |
|---|---|---|---|---|
| Unobligated balance available | $ 11,457 | $ - | $ - | $ 11,457 |
| Unobligated balance unavailable | 15 | - | - | 15 |
| Obligated balance not yet disbursed, net of contract authority | 222,004 | 59,154 | 209,533 | 490,691 |
| **Total as of September 30, 2005** | $ 233,476 | $ 59,154 | $ 209,533 | $ 502,163 |

### *NOTE 3 - GENERAL PROPERTY, PLANT, AND EQUIPMENT*

General property, plant, and equipment (PP&E) at September 30, 2006 and 2005 is summarized as follows:

| PP&E category | Acquisition Value | Accumulated Depreciation | Net |
|---|---|---|---|
| Buildings, structures, and facilities | $ 1,833,065 | $ (1,176,896) | $ 656,169 |
| Software | 10,356 | (6,223) | 4,133 |
| Equipment and other assets | 168,228 | (145,875) | 22,353 |
| Construction-in-progress | 65,378 | - | 65,378 |
| **Total as of September 30, 2006** | $ 2,077,027 | $ (1,328,994) | $ 748,033 |

| PP&E category | Acquisition Value | Accumulated Depreciation | Net |
|---|---|---|---|
| Buildings, structures, and facilities | $ 1,812,264 | $ (1,134,248) | $ 678,016 |
| Software | 9,660 | (5,555) | 4,105 |
| Equipment and other assets | 175,318 | (126,989) | 48,329 |
| Construction-in-progress | 74,464 | - | 74,464 |
| **Total as of September 30, 2005** | $ 2,071,706 | $ (1,266,792) | $ 804,914 |

**DEFENSE COMMISSARY AGENCY**
**NOTES TO THE FINANCIAL STATEMENTS**

### *NOTE 4 - LIABILITIES*

The following table summarizes total liabilities covered and not covered by budgetary resources as of September 30, 2006 and 2005:

| **Intragovernmental:** | **Covered by Budgetary Resources** | **Not Covered by Budgetary Resources** | **Total** |
|---|---|---|---|
| Accounts payable | $ 120,267 | $ - | $ 120,267 |
| Other liabilities | 2,796 | 37,736 | 40,532 |
| **Subtotal** | 123,063 | 37,736 | 160,799 |
| | | | |
| **With the public:** | | | |
| Accounts payable | 461,930 | - | 461,930 |
| Federal Employees Compensation Act actuarial liability | - | 165,173 | 165,173 |
| Environmental liability | - | 29,040 | 29,040 |
| Other liabilities | 20,415 | 53,470 | 73,885 |
| **Subtotal** | 482,345 | 247,683 | 730,028 |
| **Total as of September 30, 2006** | $ 605,408 | $ 285,419 | $ 890,827 |

| **Intragovernmental:** | **Covered by Budgetary Resources** | **Not Covered by Budgetary Resources** | **Total** |
|---|---|---|---|
| Accounts payable | $ 121,443 | $ - | $ 121,443 |
| Other liabilities | 2,722 | 37,176 | 39,898 |
| **Subtotal** | 124,165 | 37,176 | 161,341 |
| | | | |
| **With the public:** | | | |
| Accounts payable | 447,293 | - | 447,293 |
| Federal Employees Compensation Act actuarial liability | - | 171,207 | 171,207 |
| Environmental liability | - | 31,866 | 31,866 |
| Other liabilities | 22,260 | 50,405 | 72,665 |
| **Subtotal** | 469,553 | 253,478 | 723,031 |
| **Total as of September 30, 2005** | $ 593,718 | $ 290,654 | $ 884,372 |

Other liabilities consist primarily of workers' compensation, accrued payroll and benefits, accrued unfunded annual and other leave, and foreign national separation pay. The following table summarizes other liabilities current and non-current as of September 30, 2006 and 2005.

| **Other liabilities** | **Current Liabilities** | **Non-Current Liabilities** | **Total** |
|---|---|---|---|
| **Intragovernmental:** | | | |
| Workers compensation | $ 16,336 | $ 21,400 | $ 37,736 |
| Employer contributions and payroll taxes payroll | 2,796 | - | 2,796 |
| **Subtotal** | 19,132 | 21,400 | 40,532 |
| | | | |
| **With the public:** | | | |
| Accrued funded payroll and benefits | 20,415 | - | 20,415 |
| Foreign national separation pay | 13,722 | - | 13,722 |
| Accrued unfunded annual leave | 39,748 | - | 39,748 |
| **Subtotal** | 73,885 | - | 73,885 |
| **Total as of September 30, 2006** | $ 93,017 | $ 21,400 | $ 114,417 |

| **Other liabilities** | **Current Liabilities** | **Non-Current Liabilities** | **Total** |
|---|---|---|---|
| **Intragovernmental:** | | | |
| Workers compensation | $ 15,938 | $ 21,238 | $ 37,176 |
| Employer contributions and payroll taxes payroll | 2,722 | - | 2,722 |
| **Subtotal** | 18,660 | 21,238 | 39,898 |
| | | | |
| **With the public:** | | | |
| Accrued funded payroll and benefits | 22,260 | - | 22,260 |
| Foreign national separation pay | 12,336 | - | 12,336 |
| Accrued unfunded annual leave | 38,069 | - | 38,069 |
| **Subtotal** | 72,665 | - | 72,665 |
| **Total as of September 30, 2005** | $ 91,325 | $ 21,238 | $ 112,563 |

### *NOTE 5 - NET POSITION*

The following table summarizes the net position by fund type as of September 30, 2006 and 2005:

| Net position: | General Fund | Working Capital Fund | Total |
|---|---|---|---|
| Unexpended appropriations | $ 934 | $ 25,412 | $ 26,346 |
| Cumulative results of operations - earmarked funds | 990,807 | - | 990,807 |
| Cumulative results of operations - other funds | - | (55,284) | (55,284) |
| Total cumulative results of operations | 990,807 | (55,284) | 935,523 |
| **Total as of September 30, 2006** | $ 991,741 | $ (29,872) | $ 961,869 |

| Net position: | General Fund | Working Capital Fund | Total |
|---|---|---|---|
| Unexpended appropriations | $ 598 | $ 49,786 | $ 50,384 |
| Cumulative results of operations | 949,289 | (65,204) | 884,085 |
| **Total as of September 30, 2005** | $ 949,887 | $ (15,418) | $ 934,469 |

### *NOTE 6 – INTRAGOVERNMENTAL AND PUBLIC COST AND EXCHANGE REVENUE*

The Consolidated Statement of Net Cost reflects intragovernmental and public cost and exchange revenue as summarized in the following table as of the September 30, 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| Intragovernmental costs | $ 467,690 | $ 744,254 |
| Public costs | 6,455,828 | 6,144,729 |
| Intragovernmental earned revenue | (2,995) | (9,766) |
| Public earned revenue | (5,715,841) | (5,673,785) |
| **Net cost of operations** | $ 1,204,682 | $ 1,205,432 |

Intragovernmental transactions and balances result from exchange transactions made between DeCA and another Federal entity, while those classified as “with the public” result from the exchange transactions between DeCA and non-Federal entities. However, when DeCA purchases goods from a federal entity, capitalizes them into inventory, and later sells to a non-federal entity, the revenue and related cost of goods sold is classified as “with the public.” The purpose of this classification is to enable the Federal government to prepare consolidated financial statements, and not to match public and intragovernmental revenue with costs that are incurred to produce public and intragovernmental revenue.

### *NOTE 7 – IMPUTED FINANCING*

The imputed financing and cost for employee benefits for FY 2006 and 2005 is summarized below:

| Benefit category | 2006 | 2005 |
|---|---|---|
| CSRS/FERS | $ 9,838 | $ 10,482 |
| FEHB | 25,886 | 25,451 |
| FEGLI | 92 | 91 |
| Judgment Fund | - | 4 |
| **Total** | $ 35,816 | $ 36,028 |

### *NOTE 8 - STATEMENT OF BUDGETARY RESOURCES*

The Statement of Budgetary Resources is a combined statement and, as such, intra-entity transactions have not been eliminated. The combined Statement of Budgetary Resources has been prepared to coincide with the amounts shown in the President’s Budget (Budget of the United States of America). However, the President’s Budget is prepared from the Standard Form (SF) 133, Report on Budget Execution. Due to timing and the need for accelerated reporting at fiscal year end, the SF 133 is prepared using estimates, while the Statement of Budgetary Resources has been adjusted for actual results. As such, the FY 2006 Statement of Budgetary Resources may differ from the amounts in the President’s Budget by the differences between estimates used for the SF 133 and the actual results reported in the Statement of Budgetary Resources.

The amounts reported in the FY 2005 Statement of Budgetary Resources are in agreement with the amounts reported for the DeCA Working Capital Fund of the President’s Budget. The FY 2006 amounts will be available in the President’s Budget during FY 2007. Both documents can be located at the OMB website (http://www.whitehouse.gov/omb).

Total budget authority in FY 2006 and 2005 includes an appropriation transfer from the Defense WCF in the amount of $1,197,021 and $1,174,609, respectively and $516 and $16,070, respectively of contract authority. Budget authority in FY 2005 also includes ($901) in net transfers.

Permanently not available budgetary resources in FY 2006 was $86.9 million. This amount consists of $12.1 million, related to the WCF as the result of budgetary rescissions, and $74.8 million, related to the Surcharge Collections Trust Fund. The $74.8 million is attributable to a decrease in FY 2006 obligations related to the delay of four major construction projects that had received congressional approval and the related budgetary authority. Since these funds could not be obligated in the current year, OMB reduced DeCA's FY 2006 budgetary authority. This reduction, combined with the larger than expected collections, resulted in Spending Authority from Offsetting Collections that exceeded the Fund's current year obligations by $87.9 million. From this remaining Spending Authority, $74.8 million was recorded as permanently not available; thereby liquidating the Surcharge Collections Trust Fund's outstanding contract authority from prior years; and the remaining $13.1 million was recorded as unobligated balance not available.

Undelivered orders as of September 30, 2006 and 2005 are $333,300 and $327,098, respectively.

The obligated balances, net – beginning and end of year are comprised of the following components as of September 30, 2006 and 2005:

| **Obligated balance, net - beginning of year** | **2006** | **2005** |
|---|---|---|
| Unpaid obligations - brought forward | $ 920,354 | $ 896,534 |
| Uncollected customer payments from Federal sources - brought forward | (146,264) | (146,992) |
| Total obligated balance, net - beginning of year | $ 774,090 | $ 749,542 |
| | | |
| **Obligated balance, net - end of year** | | |
| Unpaid obligations | $ 936,319 | $ 920,354 |
| Uncollected customer payments from Federal sources | (132,335) | (146,264) |
| Total obligated balance, net - end of year | $ 803,984 | $ 774,090 |

### *NOTE 9 – EARMARKED FUND*

The following table presents condensed data relating to DeCA's earmarked fund, the Surcharge Trust Fund, as of and for the year ended September 30, 2006:

| | |
|---|---|
| **Balance Sheet** | |
| Assets | |
| Fund balance with Treasury | $ 306,813 |
| Cash and accounts receivable | 5,071 |
| Property, plant, and equipment | 729,155 |
| Total assets | $ 1,041,039 |
| Liabilities | |
| Accounts payable | $ 21,192 |
| Environmental liabilities | 29,040 |
| Total liabilities | 50,232 |
| Cumulative results of operations | 990,807 |
| Total liabilities and net position | $ 1,041,039 |
| **Statement of Net Cost** | |
| Program costs | $ 261,781 |
| Less: earned revenue | (318,930) |
| Net (income) of operations | $ (57,149) |

# DEFENSE COMMISSARY AGENCY
# REQUIRED SUPPLEMENTARY INFORMATION
# COMBINING SCHEDULE OF BUDGETARY RESOURCES
# FOR THE YEAR ENDED SEPTEMBER 30, 2006
*(in thousands)*

| | Defense Working Capital Funds | | | General Funds | | | |
|---|---|---|---|---|---|---|---|
| | Operations | Resale | Other | Surcharge | Military Construction | Katrina - Relief | Combined |
| **Budgetary resources** | | | | | | | |
| Unobligated balance brought forward | $ 11,366 | $ - | $ - | $ - | $ 106 | $ - | $ 11,472 |
| Recoveries of prior year obligations | - | 11,909 | - | 17 | - | - | 11,926 |
| Budget authority | 1,161,224 | (1,770) | - | - | 397 | 37,686 | 1,197,537 |
| Spending authority from offsetting collections | 26,635 | 5,420,603 | - | 324,880 | - | - | 5,772,118 |
| Net transfers and adjustments | 12,000 | - | - | - | - | - | 12,000 |
| Permanently not available | (11,647) | (438) | - | (74,832) | (7) | - | (86,924) |
| **Total budgetary resources** | $ 1,199,578 | $ 5,430,304 | $ - | $ 250,065 | $ 496 | $ 37,686 | $ 6,918,129 |
| **Status of budgetary resources** | | | | | | | |
| Obligations incurred: | | | | | | | |
| Direct | $ 1,148,910 | $ 2,908 | $ - | $ - | $ 465 | $ 37,686 | $ 1,189,969 |
| Reimbursable | 44,267 | 5,427,396 | - | 236,981 | - | - | 5,708,644 |
| Total obligations incurred | 1,193,177 | 5,430,304 | - | 236,981 | 465 | 37,686 | 6,898,613 |
| Unobligated balances - apportioned | 6,401 | - | - | - | 16 | - | 6,417 |
| Unobligated balances - not available | - | - | - | 13,084 | 15 | - | 13,099 |
| **Total status of budgetary resources** | $ 1,199,578 | $ 5,430,304 | $ - | $ 250,065 | $ 496 | $ 37,686 | $ 6,918,129 |
| **Change in obligated balance** | | | | | | | |
| Obligated balance, net - beginning of year | $ 250,371 | $ 224,769 | $ 9,262 | $ 289,189 | $ 499 | $ - | $ 774,090 |
| Total obligations incurred | 1,193,177 | 5,430,304 | - | 236,981 | 465 | 37,686 | 6,898,613 |
| Less: gross outlays | (1,175,031) | (5,423,301) | - | (234,643) | (61) | (37,686) | (6,870,722) |
| Less: recoveries of prior year obligations | - | (11,909) | - | (17) | - | - | (11,926) |
| Change in uncollected customer payments from Federal sources | 1,309 | 10,401 | - | 2,219 | - | - | 13,929 |
| Obligated balance, net - end of year | 269,826 | 230,264 | 9,262 | 293,729 | 903 | - | 803,984 |
| **Net outlays** | | | | | | | |
| Gross outlays | $ 1,175,031 | $ 5,423,301 | $ - | $ 234,643 | $ 61 | $ 37,686 | $ 6,870,722 |
| Offsetting collections | (27,944) | (5,431,004) | - | (327,099) | - | - | (5,786,047) |
| **Total net outlays** | $ 1,147,087 | $ (7,703) | $ - | $ (92,456) | $ 61 | $ 37,686 | $ 1,084,675 |

# DEFENSE COMMISSARY AGENCY
# REQUIRED SUPPLEMENTARY INFORMATION
# COMBINING SCHEDULE OF BUDGETARY RESOURCES
# FOR THE YEAR ENDED SEPTEMBER 30, 2005
***(in thousands)***

| | Defense Working Capital Funds | | | General Funds | | | |
|---|---|---|---|---|---|---|---|
| | Operations | Resale | Other | Surcharge | Military Construction | Procurement | Combined |
| **Budgetary resources** | | | | | | | |
| Unobligated balance brought forward | $ (27,279) | $ - | $ - | $ - | $ 154 | $ 28 | $ (27,097) |
| Recoveries of prior year obligations | 1,297 | 6,949 | - | 4,163 | 112 | - | 12,521 |
| Budget authority | 1,178,958 | 10,421 | - | - | 399 | - | 1,189,778 |
| Spending authority from offsetting collections | 24,957 | 5,373,193 | (27) | 283,298 | - | - | 5,681,421 |
| Net transfers and adjustments | 729 | - | - | - | - | (28) | 701 |
| Permanently not available | - | - | - | (4,492) | (112) | - | (4,604) |
| **Total budgetary resources** | $ 1,178,662 | $ 5,390,563 | $ (27) | $ 282,969 | $ 553 | $ - | $ 6,852,720 |
| **Status of budgetary resources** | | | | | | | |
| Obligations incurred: | | | | | | | |
| Direct | $ 1,142,022 | $ - | $ - | $ - | $ 447 | $ - | $ 1,142,469 |
| Reimbursable | 25,274 | 5,390,563 | (27) | 282,969 | - | - | 5,698,779 |
| Total obligations incurred | 1,167,296 | 5,390,563 | (27) | 282,969 | 447 | - | 6,841,248 |
| Unobligated balances - appropriated | 11,366 | - | - | - | 91 | - | 11,457 |
| Unobligated balances - not available | - | - | - | - | 15 | - | 15 |
| **Total status of budgetary resources** | $ 1,178,662 | $ 5,390,563 | $ (27) | $ 282,969 | $ 553 | $ - | $ 6,852,720 |
| **Change in obligated balance** | | | | | | | |
| Obligated balance, net - beginning of year | $ 244,250 | $ 233,520 | $ 9,378 | $ 262,112 | $ 282 | $ - | $ 749,542 |
| Total obligations incurred | 1,167,296 | 5,390,563 | (27) | 282,969 | 447 | - | 6,841,248 |
| Less: gross outlays | (1,158,395) | (5,390,154) | (116) | (256,124) | (118) | - | (6,804,907) |
| Less: recoveries of prior year obligations | (1,297) | (6,949) | - | (4,163) | (112) | - | (12,521) |
| Change in uncollected customer payments from Federal sources | (1,483) | (2,211) | 27 | 4,395 | - | - | 728 |
| Obligated balance, net - end of year | 250,371 | 224,769 | 9,262 | 289,189 | 499 | - | 774,090 |
| **Net outlays** | | | | | | | |
| Gross outlays | $ 1,158,395 | $ 5,390,154 | $ 116 | $ 256,124 | $ 118 | $ - | $ 6,804,907 |
| Offsetting collections | (23,474) | (5,370,982) | - | (287,693) | - | - | (5,682,149) |
| **Total net outlays** | $ 1,134,921 | $ 19,172 | $ 116 | $ (31,569) | $ 118 | $ - | $ 1,122,758 |

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**KPMG LLP**
2001 M Street, NW
Washington, DC 20036

## Independent Auditors' Report

Audit Committee
Defense Commissary Agency:

We have audited the accompanying consolidated balance sheets of the Defense Commissary Agency (DeCA) as of September 30, 2006 and 2005, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statements of budgetary resources (hereinafter referred to as "consolidated financial statements") for the years then ended. The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our fiscal year 2006 audit, we also considered DeCA's internal controls over financial reporting and performance measures, and tested DeCA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on these consolidated financial statements.

### SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that DeCA's consolidated financial statements as of and for the years ended September 30, 2006 and 2005, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 1 and 9 to the consolidated financial statements, DeCA changed its method of accounting for and reporting earmarked funds in fiscal year 2006 to adopt the provisions of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards No. 27, *Identifying and Reporting Earmarked Funds.*

Our consideration of internal controls over financial reporting and performance measures resulted in the following condition being identified as a reportable condition:

- ***Information Technology.*** The general and application controls associated with DeCA's financial and financial-related systems continue to need improvement.

However, this reportable condition is not believed to be a material weakness.

The results of our tests of compliance with certain provisions of laws and regulations, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin No. 06-03.

The results of our tests of FFMIA disclosed instances where DeCA's financial management systems did not substantially comply with Federal financial management system requirements, and were not compliant with the U.S. Standard General Ledger at the transaction level.

The results of our tests of FFMIA disclosed no instances in which DeCA's financial management systems did not substantially comply with Federal accounting standards.

The following sections discuss our opinion on DeCA's consolidated financial statements: our consideration of DeCA's internal controls over financial reporting and performance measures; our tests of DeCA's compliance with certain provisions of applicable laws and regulations; and management's and our responsibilities.

**OPINION ON THE FINANCIAL STATEMENTS**

We have audited the accompanying consolidated balance sheets of the Defense Commissary Agency as of September 30, 2006 and 2005, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statements of budgetary resources for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of DeCA as of September 30, 2006 and 2005, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 1 and 9 to the consolidated financial statements, DeCA changed its method of accounting for and reporting earmarked funds in fiscal year 2006 to adopt the provisions of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards No. 27, *Identifying and Reporting Earmarked Funds*.

The information in the Management Discussion and Analysis and Performance Section and Required Supplementary Information sections on pages 2 to 21 and 46 to 47 is not a required part of the consolidated financial statements, but is supplementary information required by U.S. generally accepted accounting principles and OMB Circular No. A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

**INTERNAL CONTROL OVER FINANCIAL REPORTING**

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect DeCA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud, in amounts that would be material in relation to the consolidated financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

In our fiscal year 2006 audit, we noted a certain matter, discussed in Exhibit 1, involving the internal control over financial reporting and its operation that we consider to be a reportable condition. However, the reportable condition is not believed to be material weaknesses. Exhibit 2 presents the status of prior year reportable conditions.

## INTERNAL CONTROLS OVER PERFORMANCE MEASURES

Under OMB Bulletin No. 06-03, the definition of material weaknesses is extended to other controls as follows. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud, in amounts that would be material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

Our consideration of the internal control over the existence and completeness assertions related to key performance measures would not necessarily disclose all matters involving the internal control and its operation related to the design and operation of the internal control over the existence and completeness assertions related to key performance measures that might be reportable conditions.

In our fiscal year 2006 audit, we noted no matters involving the design and operation of the internal control over the existence and completeness assertions related to key performance measures that we considered to be material weaknesses as defined above.

## COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws and regulations, as described in the Responsibility section of this report, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin No. 06-03.

The results of our tests of FFMIA disclosed instances, described in Exhibit 3, where DeCA's financial management systems did not substantially comply with Federal system requirements, and were not compliant with the United States Standard General Ledger at the transaction level.

The results of our tests of FFMIA disclosed no instances in which DeCA's financial management systems did not substantially comply with Federal accounting standards.

* * * * *

We noted certain additional matters that we have reported to management of DeCA in a separate letter.

## RESPONSIBILITIES

**Management's Responsibilities**. The United States Code Title 31 Section 3515 and 9106 require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To assist the Department of Defense in meeting these reporting requirements, DeCA prepares and submits financial statements in accordance with OMB Circular No. A-136.

Management is responsible for the consolidated financial statements, including:

- Preparing the consolidated financial statements in conformity with U.S. generally accepted accounting principles;

KPMG

- Preparing the Management Discussion and Analysis (including the performance measures) and Required Supplementary Information;

- Establishing and maintaining effective internal control; and

- Complying with laws, regulations, contracts, and grant agreements applicable to DeCA, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies.

**Auditors' Responsibilities**. Our responsibility is to express an opinion on the fiscal year 2006 and 2005 consolidated financial statements of DeCA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 06-03. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of DeCA's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;

- Assessing the accounting principles used and significant estimates made by management; and

- Evaluating the overall consolidated financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2006 audit, we considered DeCA's internal control over financial reporting by obtaining an understanding of DeCA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 06-03. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide an opinion on DeCA's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 06-03, in our fiscal year 2006 audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management Discussion and Analysis and Performance sections, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether these internal controls had been placed in operation. We limited our testing to those controls necessary to test and report on the internal control over key performance measures in accordance with OMB Bulletin No.

06-03. However, our procedures were not designed to provide an opinion on internal control over reported performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether DeCA's fiscal year 2006 consolidated financial statements are free of material misstatement, we performed tests of DeCA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of the consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws and regulations applicable to DeCA. However, providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 06-03 and FFMIA, we are required to report whether DeCA's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

**RESTRICTED USE**

This report is intended for the information and use of DeCA's management, the Department of Defense, OMB, the Government Accountability Office, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 31, 2006

**Reportable Condition**

Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect DeCA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

We consider the following matter to be a reportable condition:

**Information Technology**

***Condition***

The general and application controls associated with DeCA's financial systems continue to need improvement. Due to the sensitive nature of the issues identified, we will provide DeCA officials with a separate, restricted distribution report, which contains the detailed results of our review, along with specific recommendations.

***Discussion***

As part of our fiscal year 2006 audit of DeCA's financial statements, we reviewed information technology application controls over the following key DeCA applications that support financial transactions and reporting:

- DeCA Interactive Business System (DIBS);
- Standard Automated Voucher Examination System (SAVES);
- Accounting and Inventory Management System (AIMS);
- Point of Sale – Technical Refresh (POS-TR); and
- Pick ticket Warehouse Management System (PkMS).

We also performed a follow-up to our prior year limited applications controls review over those applications owned and operated by other DoD components that support DeCA financial transactions and reporting. These applications included:

- Defense Business Management System (DBMS);
- Standard Finance System (STANFINS);
- Columbus Cash Accountability System (CCAS);
- Defense Property Accountability System (DPAS);
- Modern Defense Civilian Personnel Data System (Modern DCPDS); and
- Defense Civilian Payroll System (DCPS).

We conducted our review during the period May 2006 to August 2006. Our separate report will identify internal control weaknesses for the financial systems that require management attention. We will also provide management with an evaluation of the current status of previously identified information technology vulnerabilities.

***Criteria***

We performed our review in compliance with guidance established in the Government Accountability Office's *Financial Audit Manual* and *Federal Information System Controls Audit Manual*. We also used the following Federal and DoD security guidelines as criteria for determining whether controls were in place and operating as intended:

- OMB Circular Number A-130, *Management of Federal Information Resources*;
- OMB Circular Number A-127, *Financial Management Systems*;
- OMB Circular Number A-123, *Management's Responsibility for Internal Control;*
- Public Law 100-235, *The Computer Security Act of 1987*;
- National Institute of Standards and Technologies (NIST) publications;
- DoD Instruction 8500.2, *Information Assurance Implementation*;
- DoD Directive 5200.28, *Security Requirements for Automated Information Systems*;
- DoD 5200.28-STD, *Department of Defense Trusted Computer System Evaluation Criteria*; and
- DoD Instruction 5200.4, *DoD Information Technology Security Certification and Accreditation Process (DITSCAP)*.

***Recommendation***

Due to the sensitive nature of these findings, our separate report will recommend that DeCA management implement certain procedures to address the application control vulnerability of its financial systems.

***Management Response***

Management's responses will be included in the separate report.

**Exhibit 2**

***Status of Prior Year Reportable Conditions***

| Area | Status as of September 30, 2005 | Status as of September 30, 2006 |
|---|---|---|
| **Property, Plant, and Equipment** | **<u>Reportable Condition:</u>** DeCA does not have adequate policies and procedures in place to ensure the proper accountability and record-keeping of its capitalized and non-capitalized equipment. | No longer considered a reportable condition. |
| **Information Technology** | **<u>Reportable Condition:</u>** The general and application controls associated with DeCA's financial and financial-related systems continue to need improvement. | **<u>Continue as a reportable condition:</u>** Improvements have been made to resolve some weaknesses noted in the prior year. However, significant effort must be made to resolve security and access control weaknesses over key systems. |

## Compliance with Laws and Regulations

This section discusses issues related to noncompliance with laws and regulations that could have a material impact on DeCA's financial statements.

### Federal Financial Management Improvement Act of 1996 (FFMIA)

***Condition***

We again noted that DeCA was not in substantial compliance with FFMIA.

***Discussion***

The Defense Finance and Accounting Service (DFAS) uses two separate accounting systems to process DeCA transactions. DBMS accounts for transactions associated with the appropriated funds and surcharge collections and STANFINS accounts for all resale inventory transactions. In addition, STANFINS does not interface with DBMS. Thus, there are two core accounting systems that DFAS uses to account for DeCA transactions. Since these systems do not interface, DeCA is not in compliance with Federal financial management system requirements, which call for a single, integrated financial system.

In addition, both STANFINS and DBMS are not compliant with the U.S. Standard General Ledger. Neither system is able to process transactions in accordance with the U.S. Standard General Ledger at the detail level, and extensive manual processes are required to adjust STANFINS and DBMS balances to allow for compilation of DeCA's financial statements. For example, DBMS does not contain a general ledger account to record unexpended appropriation transfers. DFAS-Columbus and DeCA personnel must use a combination of information inside and outside of DBMS to calculate unexpended appropriation transfers at the end of each reporting period.

***Criteria***

FFMIA requires that an agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level.

***Recommendation***

We again recommend that DeCA continue to work with DFAS to implement actions to comply with the requirements of FFMIA.

***Management Response***

During fiscal year 2006, DeCA has continued to work with the Business Transformation Agency (BTA), in conjunction with other defense agencies, including DFAS, on the Defense Agencies Initiative (DAI). This initiative is a critical DoD effort to modernize the Defense Agencies' financial management capabilities.

One of DAI's objectives is to aid in achieving auditable CFO compliant business environments with accurate, timely, and authoritative financial data. Its primary goal is to deploy a standardized system solution, which would replace current systems such as STANFINS and DBMS, to improve overall financial management and comply with all laws and regulatory requirements.

DeCA has and will continue to assist in this initiative by providing agency requirements, describing current process flows of accounting and operational systems, participating in briefings and discussions, and providing other support as needed in relation to this project. Current milestones suggest that business modeling will continue throughout fiscal year 2007. A pilot deployment is then anticipated to begin by fiscal year 2008 for the first wave of agencies. Additional deployment waves will continue until the project is complete, which is estimated to be through fiscal year 2011.

DEFENSE COMMISSARY AGENCY
HEADQUARTERS
1300 E AVENUE
FORT LEE, VIRGINIA 23801-1800

REPLY TO
ATTENTION OF

IG

October 10, 2006

MEMORANDUM FOR DIRECTOR, DEFENSE COMMISSARY AGENCY

SUBJECT: Summary of Serious Management and Performance Challenges

OMB Memorandum dated October 18, 2002, and OMB Memorandum M-03-13 dated May 21, 2003, requires this office provide you with the IG perspective on the most serious management and performance challenges facing DeCA for inclusion in the Agency's annual *Performance and Accountability Report.*

The *Reports Consolidation Act of 2000 (Public Law 106-531)* left the determination and threshold of what constitutes a most serious management challenge to the discretion of the Inspectors General. As a result, I applied the following definition in preparing this statement for Fiscal Year 2006:

Serious management challenges are mission critical areas or programs that have the potential for a perennial vulnerability that, without management's focused attention, could adversely impact agency operations or strategic goals vital to the Agency's mission.

The DeCA-IG believes that by continuing to address program performance challenges and testing program control points DeCA can improve benefit delivery efficiency and effectiveness; avoid serious operational and financial problems; and decrease fraud, waste, abuse and mismanagement.

Information Technology & Security Management

DeCA's Information Systems Program Management and Control is critical to benefit delivery. The Agency increasingly relies on electronic financial and operational reporting accuracy. Our FY 2006 Federal Information Security Management Act (FISMA)[1] review found that DeCA FISMA compliance improved over FY 2005 and the Agency's progress should again cause it to receive very good information assurance grades on certification, accreditation, and security configuration. DeCA converted to the Defense Information Technology Portfolio Registry (DITPR) in January 2006 and a new business process for updating this registry in July 2006. DeCA's score, as measured by the Joint Chief of Staff, increased from an F to a C. While results have improved the Office of the Inspector General (OIG) believes this area must be regularly tested through the use of internal management controls. The DeCA OIG intends to

[1] FISMA provides a comprehensive framework for ensuring that information resources supporting Federal operations and assets employ effective security controls. FISMA requires agencies to conduct annual information security program reviews and Offices of the Inspector General to perform independent evaluations of those programs.

review quarterly in FY 2007 the DeCA-CIO and functional process owner corrective actions taken on issues identified and report results accordingly.

Critical to DeCA's future mission accomplishment is the ability to timely and successfully deploy the Commissary Advanced Resale Transaction System (CARTS). The Agency assured CARTS complied with DoD's Business Management Modernization Program (BMMP) for discipline (cost, schedule, performance) and management of the CARTS purchase and interface with legacy system replacement and new requirement systems from an enterprise perspective. The challenge of successfully migrating from the legacy system to CARTS in order to meet the deployment schedule remains.

### Financial Management

DeCA received an unqualified opinion from its external auditor for FY 2005 that it's financial and performance reporting was reliable with no material weaknesses found.

#### Plant, Property, Equipment Program Management

Plant, property and equipment management were of special interest to DeCA Senior Assessment Team and the OIG in FY 06. The OIG will test the new DeCA internal control procedures in the Defense Property Accountability System (DPAS) at commissaries during FY 2007 through the its Inspection Compliance Program The new procedures, to include bar code scanning, are designed to reduce the time required to conduct the equipment inventory and reconcile the differences between book and physical inventory. It should be noted that DeCA reduced these differences to an acceptable level in FY 2006. The challenge remains to ensure the DeCA standard is met for FY 2007.

#### Internal Controls

At the benefit delivery point the OIG tested 12 percent (32) of all commissaries in FY 2006 and found there continued to be regulatory compliance improvement. The FY 2006 average unannounced inspection compliance score was 86.0 percent or almost 5 percent better than FY 2005. The OIG tested regulatory compliance at 8 percent of the Agency's Central Distribution Centers (CDCs) and found an average compliance rating score of 90.1 percent on items tested. This was a 16 percent improvement over FY 2005. As of September 30 management reported that 100 percent of reportable IG findings had been corrected. DeCA's challenge in FY 2007 will be to ensure the Agency successfully employs the new financial control requirements of OMB Circular No. A-123, Appendix A and it's related OSD guidance in mission critical and high risk areas so that acceptable compliance ratings continue.

### Human Capital Management & Future Workforce Configuration

As of September 30, 2006 DeCA had approximately 18,000 employees worldwide. There were approximately 100 contractors at Headquarters DeCA. The major agency challenge in human capital remains multifaceted under a timetable where projected workforce of the future (WOF) savings must ensue to reach program budget goals. DeCA must ensure its civilian and contractor workforce "buys into" the WOF strategy that a multi-skilled workforce is one better suited to function in an integrated and stovepipe-free environment. DeCA centralized its functional processes, reduced and flattened its organizational structure and staff in FY 2006 with Commissary Operating Board (COB) concurrence. DeCA solidified this transformation through a new Corporate Governance process that includes business case justification and identified action plans necessary to become the employer of choice and create a professional growth culture based on values of change leadership and integrity.

Personnel issues were the major FWA investigation and assistance items in FY 2006 and represented 17 percent of all issues/complaints/allegations received. The OIG database revealed that 39 percent of all congressional inquires concerned DeCA personnel issues. Congressional inquiries increased 8 percent in FY 2006. The total number of OIG allegations, complaints, issues, contacts and referrals received in FY 2006 increased by 16 percent over FY 2005. The challenge is to ensure Agency personnel initiatives, such as the continued implementation of WOF and alternative hiring and work assignment flexibilities, designed to give DeCA the ability to better execute benefit delivery, are perceived by associates as positive and necessary to reach FYOP goals and ensure benefit survival.

John T. Maffei
Inspector General

## Glossary of Acronyms

ACSI – American Customer Satisfaction Index

CCSS – Commissary Customer Service Survey

COB – Commissary Operating Board

COOP – Contingency Operations Plan

DBMS – Defense Business Management System

DeCA – Defense Commissary Agency

DITSCAP – DoD Information Technology Security Certification and Accreditation Process

DoD – Department of Defense

DOL – Department of Labor

DPAS – Defense Property Accountability System

DWCF – Defense Working Capital Fund

EDI – Electronic Data Interchange

FBWT – Fund Balance With Treasury

FCI – Facility Condition Index

FECA – Federal Employees Compensation Act

FFMIA – Federal Financial Management Improvement Act of 1996

FMFIA – Federal Managers' Financial Integrity Act

FTE – Full Time Equivalent

FWA – Fraud, Waste, and Abuse

GAO – Government Accountability Office

IPT – Integrated Process Team

KPMG – Klynveld Peat Marwick Goerdler (Independent Audit Firm)

LIFE - Leadership – Integrity – Flexibility – Enjoyment

MD&A – Management Discussion and Analysis

OMB – Office of Management and Budget

OSD (P&R) - Office of Secretary of Defense (Personnel & Readiness)

PA&E – Program Analysis and Evaluation

PBD – Program Budget Decision

PMA – President's Management Agenda

POS – Point of Sale

PPBE – Planning, Programming, Budgeting and Execution

PP&E – Property, Plant and Equipment

SES – Senior Executive Service

STANFINS – Standard Finance System

UPC – Universal Product Code

USD(C) – Under Secretary of Defense (Comptroller)

WCF – Working Capital Fund

WOF – Workforce of the Future