Principal Financial Statements And Notes

The principal financial statements included in this report have been prepared in accordance with the requirements of the Chief Financial Officers Act of 1990, the Government Management Reform Act of 1994, and the Office of Management and Budget's Circular A-136, "Financial Reporting Requirements." The responsibility for the integrity of the financial information included in these statements rests with the management of the Department of Defense. The Department's fiscal years 2006 and 2005 principal financial statements were audited by the Office of Inspector General. The auditors' report accompanies the principal statements.

The Department's principal financial statements for fiscal years 2006 and 2005 consisted of the following:

The Balance Sheet

The Balance Sheet, which presents as of September 30, 2006 and 2005 those resources owned or managed by the Department which are available to provide future economic benefits (assets); amounts owed by the Department that will require payments from those resources or future resources (liabilities); and residual amounts retained by the Department, comprising the difference (net position).

The Statement of Net Cost

The Statement of Net Cost, which presents the net cost of the Department's operations for the years ended September 30, 2006 and 2005. The Department's net cost of operations includes the gross costs incurred by the Department less any exchange revenue earned from Department activities.

The Statement of Changes in Net Position

The Statement of Changes in Net Position, which presents the change in the Department's net position resulting from the net cost of the Department's operations, budgetary financing sources other than exchange revenues, and other financing sources for the years ended September 30, 2006 and 2005.

The Statement of Budgetary Resources

The Statement of Budgetary Resources, which presents the budgetary resources available to the Department during FY 2006 and 2005, the status of these resources at September 30, 2006 and 2005, and the outlay of budgetary resources for the years ended September 30, 2006 and 2005.

The Statement of Financing

The Statement of Financing, which reconciles the net cost of operations with the obligation of budgetary resources for the years ended September 30, 2006 and 2005.

The Statement of Custodial Activity

The Statement of Custodial Activity, which presents the sources and disposition of nonexchange revenues collected or accrued by the Department on behalf of other recipient entities for the years ended September 30, 2006 and 2005.

Principal Financial Statements

CONSOLIDATED BALANCE SHEET

Department of Defense

As of September 30, 2006 and 2005

($ in millions)

		2006		2005 Restated
Assets (Note 2)				
Intragovernmental				
Fund Balance with Treasury (Note 3)	$	327,138.3	$	290,657.1
Investments and Related Interest (Note 4)		299,261.2		263,367.8
Accounts Receivable, Net (Note 5)		2,927.4		1,291.3
Other Assets (Note 6)		1,189.6		1,519.1
Total Intragovernmental Assets		630,516.5		556,835.3
Cash and Other Monetary Assets (Note 7)		2,199.8		2,072.7
Accounts Receivable, Net (Note 5)		7,864.1		7,615.5
Loans Receivable (Note 8)		191.7		75.6
Inventory and Related Property, Net (Note 9)		231,823.2		222,573.3
General Property, Plant and Equipment, Net (Note 10)		465,439.5		452,541.4
Investments and Related Interest (Note 4)		1,089.8		605.0
Other Assets (Note 6)		27,928.7		23,822.1
Total Assets	**$**	**1,367,053.3**	**$**	**1,266,140.9**
Liabilities (Note 11)				
Intragovernmental				
Accounts Payable (Note 12)	$	1,549.8	$	2,058.0
Debt (Note 13)		382.1		467.1
Other Liabilities (Notes 15 and 16)		12,822.2		11,150.8
Total Intragovernmental Liabilities		14,754.1		13,675.9
Accounts Payable (Note 12)		27,320.9		28,575.4
Military Retirement and Other Federal Employment Benefits (Note 17)		1,815,769.5		1,736,057.8
Environmental and Disposal Liabilities (Note 14)		69,985.1		65,027.6
Loan Guarantee Liability (Note 8)		36.8		41.1
Other Liabilities (Notes 15 and 16)		31,566.1		29,985.4
Total Liabilities		1,959,432.5		1,873,363.2
Net Position				
Unexpended Appropriations - Earmarked Funds (Note 23)		11.4		-
Unexpended Appropriations - Other Funds		307,698.0		271,493.6
Cumulative Results of Operations - Earmarked Funds		(1,271,684.5)		-
Cumulative Results of Operations - Other Funds		371,595.9		(878,715.9)
Total Net Position		(592,379.2)		(607,222.3)
Total Liabilities and Net Position	**$**	**1,367,053.3**	**$**	**1,266,140.9**

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

CONSOLIDATED STATEMENT OF NET COST

Department of Defense

For the years ended September 30, 2006 and 2005

($ in millions)

	2006		2005	
Program Costs				
Gross Costs	$	629,736.4	$	680,086.6
Less: Earned Revenue		(48,350.3)		(45,207.1)
Net Program Costs		581,386.1		634,879.5
Cost Not Assigned to Programs		-		-
Less: Earned Revenue Not Attributable to Programs		-		-
Net Cost of Operations	**$**	**581,386.1**	**$**	**634,879.5**

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

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

Department of Defense
As of September 30, 2006 and 2005
($ in millions)

	FY 2006		
	Earmarked Funds	All Other Funds	Eliminations
Cumulative Results of Operations			
Beginning Balances	$ (1,170,876.1)	$ 300,193.3	$ -
Prior Period Adjustments:			-
Changes in Accounting Principles	-	-	-
Correction of Errors	-	(8,033.1)	-
Beginning Balances, as adjusted	(1,170,876.1)	292,160.2	-
Budgetary Financing Sources			
Appropriations used	2.1	548,113.6	-
Nonexchange revenue	3,037.2	19.9	-
Donations and forfeitures of cash and cash equivalents	25.4	-	-
Transfers in(out) without reimbursement	225.7	732.8	-
Other budgetary financing sources	0.6	-	-
Other Financing Sources (Non-Exchange)			
Donations and forfeitures of property	-	47.3	-
Transfers in(out) without reimbursement	(152.4)	135.7	-
Imputed financing from costs absorbed by others	-	4,409.6	-
Other	(25.0)	3,440.9	-
Total Financing Sources	3,113.6	556,899.8	-
Net Cost of Operations	39,006.8	542,379.3	-
Net Change	(35,893.2)	14,520.5	-
Cumulative Results of Operations	**$ (1,206,769.3)**	**$ 306,680.7**	**$ -**
Unexpended Appropriations			
Beginning Balances	$ 13.4	$ 271,480.2	$ -
Prior Period Adjustments:			
Changes in accounting principles	-	-	-
Corrections of errors	-	-	-
Beginning balances, as adjusted	13.4	271,480.2	-
Budgetary Financing Sources			
Appropriations received	0.1	594,653.4	-
Appropriations transferred in(out)	-	(146.8)	-
Other adjustments (rescissions, etc)	-	(10,175.2)	-
Appropriations used	(2.1)	(548,113.6)	-
Total Budgetary Financing Sources	(2.0)	36,217.8	-
Total Unexpended Appropriations	**11.4**	**307,698.0**	**-**
Net Position	**$ (1,206,757.9)**	**$ 614,378.7**	**$ -**

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

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

Department of Defense

As of September 30, 2006 and 2005

($ in millions)

	2006	2005
	Consolidated Total	Consolidated Total Restated
Cumulative Results of Operations		
Beginning Balances	$ (870,682.8)	$ (745,441.3)
Prior Period Adjustments:		
Changes in Accounting Principles	-	3,632.4
Correction of Errors	(8,033.1)	(776.5)
Beginning Balances, as adjusted	(878,715.9)	(742,585.4)
Budgetary Financing Sources		
Appropriations used	548,115.7	491,580.5
Nonexchange revenue	3,057.1	1,665.0
Donations and forfeitures of cash and cash equivalents	25.4	42.6
Transfers in(out) without reimbursement	958.5	3,176.4
Other budgetary financing sources	0.6	0.5
Other Financing Sources (Non-Exchange)		
Donations and forfeitures of property	47.3	1.5
Transfers in(out) without reimbursement	(16.7)	(14.3)
Imputed financing from costs absorbed by others	4,409.6	4,465.3
Other	3,415.9	(2,168.5)
Total Financing Sources	560,013.4	498,749.0
Net Cost of Operations	581,386.1	634,879.5
Net Change	(21,372.7)	(136,130.5)
Cumulative Results of Operations	**$ (900,088.6)**	**$ (878,715.9)**
Unexpended Appropriations		
Beginning Balances	$ 271,493.6	$ 243,813.9
Prior Period Adjustments:		
Changes in accounting principles	-	-
Corrections of errors	-	-
Beginning balances, as adjusted	271,493.6	243,813.9
Budgetary Financing Sources		
Appropriations received	594,653.5	524,990.1
Appropriations transferred in(out)	(146.8)	(651.7)
Other adjustments (rescissions, etc)	(10,175.2)	(5,078.2)
Appropriations used	(548,115.7)	(491,580.5)
Total Budgetary Financing Sources	36,215.8	27,679.7
Total Unexpended Appropriations	**307,709.4**	**271,493.6**
Net Position	**$ (592,379.2)**	**$ (607,222.3)**

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

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2006	
	Budgetary Financing Accounts	Non-Budgetary Credit Reform Financing Accounts
Budgetary Resources		
Unobligated balance, brought forward, October 1	$ 68,589.5	$ 35.0
Recoveries of prior year unpaid obligations	30,242.2	-
Budget Authority:		
Appropriations received	681,682.7	-
Borrowing authority	-	93.8
Contract authority	59,451.7	-
Spending authority from offsetting collections:		
Earned:		
Collected	164,717.5	58.5
Receivable from federal sources	649.0	-
Change in unfilled customer orders:		
Advanced received	313.9	-
Without advance from federal sources	179.1	(46.8)
Subtotal	906,993.9	105.5
Nonexpenditure transfers, net, anticipated and actual	(182.2)	-
Temporarily not available pursuant to Public Law	(35,746.3)	-
Permanently not available	(71,854.5)	(0.1)
Total Budgetary Resources	**$ 898,042.6**	**$ 140.4**
Status of Budgetary Resources		
Obligations Incurred:		
Direct	$ 646,432.0	$ 108.9
Reimbursable	165,521.3	-
Subtotal	811,953.3	108.9
Unobligated balance:		
Apportioned	74,622.3	0.5
Exempt from apportionment	1,220.4	-
Subtotal	75,842.7	0.5
Unobligated balances not available	10,246.6	31.0
Total Status of Budgetary Resources	**$ 898,042.6**	**$ 140.4**

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

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2006	
	Budgetary Financing Accounts	Non-Budgetary Credit Reform Financing Accounts
Change in Obligated Balance		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	300,445.5	446.3
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(54,586.9)	(123.7)
Total unpaid obligated balance	245,858.6	322.6
Obligations incurred net	811,953.3	108.9
Less: Gross outlays	(763,627.4)	(176.8)
Obligated balance transferred, net:		
Actual transfers, unpaid obligations	-	-
Actual transfers, uncollected customer payments from federal sources	-	-
Total unpaid obligated balance transferred, net	-	-
Less: Recoveries of prior year unpaid obligations, actual	(30,242.2)	-
Change in uncollected customer payments from federal sources	(827.8)	46.8
Obligated balance, net, end of period:		
Unpaid obligations	318,529.2	378.4
Less: Uncollected customer payments from federal sources	(55,414.7)	(76.9)
Total, unpaid obligated balance, net, end of period	**263,114.5**	**301.5**
Net Outlays		
Net Outlays:		
Gross outlays	$ 763,627.4	$ 176.8
Less: Offsetting collections	(165,031.5)	(58.5)
Less: Distributed offsetting receipts	(61,978.2)	-
Net Outlays	**$ 536,617.7**	**$ 118.3**

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

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2005	
	Budgetary Financing Accounts	Non-Budgetary Credit Reform Financing Accounts
Budgetary Resources		
Unobligated balance, brought forward, October 1	$ 73,282.9	$ 24.6
Recoveries of prior year unpaid obligations	36,376.7	-
Budget Authority:		
Appropriations received	604,969.5	-
Borrowing authority	-	170.3
Contract authority	56,753.1	-
Spending authority from offsetting collections:		
Earned:		
Collected	158,928.0	16.9
Receivable from federal sources	(18.2)	-
Change in unfilled customer orders:		
Advanced received	642.0	-
Without advance from federal sources	5,065.9	40.6
Subtotal	826,340.3	227.8
Nonexpenditure transfers, net, anticipated and actual	264.5	-
Temporarily not available pursuant to Public Law	(31,875.4)	-
Permanently not available	(58,299.7)	(2.2)
Total Budgetary Resources	**$ 846,089.3**	**$ 250.2**
Status of Budgetary Resources		
Obligations Incurred:		
Direct	$ 601,516.8	$ 215.2
Reimbursable	175,983.1	-
Subtotal	777,499.9	215.2
Unobligated balance:		
Apportioned	59,206.9	1.5
Exempt from apportionment	725.9	-
Subtotal	59,932.8	1.5
Unobligated balances not available	8,656.6	33.5
Total Status of Budgetary Resources	**$ 846,089.3**	**$ 250.2**

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

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2005	
	Budgetary Financing Accounts	**Non-Budgetary Credit Reform Financing Accounts**
Change in Obligated Balance		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	282,772.9	238.8
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(49,538.8)	(83.1)
Total unpaid obligated balance	233,234.1	155.7
Obligations incurred net	777,499.9	215.2
Less: Gross outlays	(723,450.6)	(7.7)
Obligated balance transferred, net:		
Actual transfers, unpaid obligations	-	-
Actual transfers, uncollected customer payments from federal sources	-	-
Total unpaid obligated balance transferred, net	-	-
Less: Recoveries of prior year unpaid obligations, actual	(36,376.7)	-
Change in uncollected customer payments from federal sources	(5,048.0)	(40.6)
Obligated balance, net, end of period:		
Unpaid obligations	300,445.5	446.3
Less: Uncollected customer payments from federal sources	(54,586.9)	(123.7)
Total, unpaid obligated balance, net, end of period	**245,858.6**	**322.6**
Net Outlays		
Net Outlays:		
Gross outlays	$ 723,450.6	$ 7.7
Less: Offsetting collections	(159,570.1)	(16.9)
Less: Distributed Offsetting receipts	(55,072.9)	-
Net Outlays	**$ 508,807.6**	**$ (9.2)**

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

CONSOLIDATED STATEMENT OF FINANCING

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2006	2005
Resources Used to Finance Activities		
Bugetary Resources Obligated		
Obligations incurred	$ 812,062.2	$ 777,715.1
Less: Spending authority from offsetting collections and recoveries	(196,113.4)	(201,052.5)
Obligations net of offsetting collections and recoveries	615,948.8	576,662.6
Less: Offsetting receipts	(61,978.2)	(55,072.9)
Net Obligations	553,970.6	521,589.7
Other Resources		
Donations and forfeitures of property	$ 47.3	$ 1.5
Transfers in(out) without reimbursement	(16.7)	(14.3)
Imputed financing from costs absorbed by others	4,409.6	4,465.3
Other	3,415.9	(2,168.5)
Net other resources used to finance activities	7,856.1	2,284.0
Total resources used to finance activities	**$ 561,826.7**	**$ 523,873.7**
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided		
Undelivered orders	$ (19,661.9)	$ (42,391.5)
Unfilled customer orders	446.2	5,748.6
Resources that fund expenses recognized in prior periods	(6,365.6)	(2,610.0)
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	5,091.7	3,325.1
Resources that finance the acquisition of assets	(131,868.4)	(112,714.7)
Other resources or adjustments to net obligated resources that do not affect Net Cost of Operations		
Less: Trust or Special Fund Receipts Related to Exchange	(10.0)	(10.0)
Other	(3,446.2)	2,176.3
Total resources used to finance items not part of the Net Cost of Operations	(155,814.2)	(146,476.2)
Total resources used to finance the Net Cost of Operations	**$ 406,012.5**	**$ 377,397.5**
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in the Future Period:		
Increase in annual leave liability	$ 7,401.2	$ 615.1
Increase in environmental and disposal liability	5,632.5	1,100.3
Upward (downward) reestimates of credit subsidy expense	(2.2)	-
Increase in exchange revenue receivable from the public	(47.7)	40.5
Other	73,776.0	168,069.4
Total components of Net Cost of Operations that will require or generate resources in future periods	86,759.8	169,825.3
Components not Requiring or Generating Resources:		
Depreciation and amortization	$ 65,116.2	$ 48,944.0
Revaluation of assets and liabilities	5,174.4	1,775.1
Other		
Trust fund exchange revenue	(26,827.3)	(26,007.0)
Cost of goods sold	47,718.4	46,172.4
Operating materials and supplies used	10,062.5	246.8
Other	(12,630.4)	16,525.4
Total components of Net Cost of Operations that will not require or generate resources	88,613.8	87,656.7
Total components of Net Cost of Operations that will not require or generate resources in the current period	**175,373.6**	**257,482.0**
Net Cost of Operations	**$ 581,386.1**	**$ 634,879.5**

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

COMBINED STATEMENT OF CUSTODIAL ACTIVITY

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2006	2005
Revenue Activity		
Sources of Cash Collections:		
Deposits by foreign governments	$ 13,719.7	$ 10,693.1
Seized Iraqi cash	-	-
Total cash collections	$ 13,719.7	$ 10,693.1
Accrual adjustments	-	-
Total custodial revenue	$ 13,719.7	$ 10,693.1
Disposition of Collections		
Disbursed on behalf of foreign governments and international organizations	$ 12,555.1	$ 11,070.7
Seized assets disbursed on behalf of Iraqi people	31.2	52.1
Increase (decrease) in amounts to be transferred	1,164.6	(377.6)
Collections used for refunds and other payments	-	-
Retained by the reporting entity	-	-
Seized assets retained for support of the Iraqi people	(31.2)	(52.1)
Total disposition of collections	$ 13,719.7	$ 10,693.1
Net Custodial Activity	**$ -**	**$ -**

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

Notes to the Principal Statements

Note 1. Significant Accounting Policies

1.A. Basis of Presentation

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

The Department is unable to fully implement all elements of GAAP and OMB Circular No. A-136 due to limitations of its financial management processes and systems, and non-financial systems and processes that feed into the financial statements. The Department derives its reported values and information for major asset and liability categories largely from non-financial systems, such as inventory systems and logistics systems. These systems were designed to support reporting requirements for maintaining accountability over assets and reporting the status of federal appropriations rather than preparing financial statements in accordance with GAAP. The Department continues to implement process and system improvements addressing these limitations. The Department currently has 11 previously identified auditor material weaknesses: (1) Financial Management Systems, (2) Intragovernmental Eliminations, (3) Unsupported Accounting Entries, (4) Fund Balance with Treasury, (5) Environmental Liabilities, (6) General Property, Plant and Equipment, (7) Government Property and Material in Possession of Contractors, (8) Inventory, (9) Operating Materials and Supplies, (10) Statement of Net Cost, and (11) Statement of Financing.

1.B. Mission of the Reporting Entity

The National Security Act of 1947 established the Department of Defense. The Department's mission is to organize, train, and equip armed forces to deter aggression and, if necessary, defeat aggressors against the United States and its allies. Fiscal year (FY) 2006 is the eleventh year that the Department has prepared audited Agency-wide financial statements as required by the Chief Financial Officers (CFO) Act and Government Management Reform Act (GMRA). Auditors are required to audit the financial statements of the following stand-alone reporting entities: (1) Army General Fund, (2) Army Working Capital Fund, (3) Navy General Fund, (4) Navy Working Capital Fund, (5) Air Force General Fund, (6) Air Force Working Capital Fund, (7) Military Retirement Fund, (8) Medicare-Eligible Retiree Health Care Fund, and (9) U.S. Army Corps of Engineers (Civil Works).

The Department requires the Marine Corps General and Working Capital Funds and the following Defense Agencies to prepare internal stand-alone auditable financial statements: 1) Defense Logistics Agency, 2) Defense Finance and Accounting Service, 3) Defense Information Systems Agency, 4) Defense Contract Audit Agency,

5) Defense Commissary Agency, 6) Defense Security Service, 7) Defense Threat Reduction Agency, 8) Defense Advanced Research Projects Agency, 9) Chemical and Biological Defense Program, 10) Missile Defense Agency, 11) Services Medical Activity, 12) TRICARE Management Activity, and 13) U.S. Special Operations Command.

1.C. Appropriations and Funds

The Department receives its appropriations and funds as general, working capital (revolving), trust, special, and deposit funds. The Components use these appropriations and funds to execute their missions and report on resource usage.

General funds are used for financial transactions funded by congressional appropriations, including personnel, operations and maintenance, research and development, procurement, and military construction accounts.

Working capital funds (WCF) receive their initial funding through an appropriation or a transfer of resources from existing appropriations or funds and use those capital resources to finance the initial startup. The WCF entities provide goods and services on a reimbursable basis. Reimbursable receipts fund ongoing operations and generally are available in their entirety for use without further congressional action.

Trust funds contain receipts and expenditures of funds held in trust by the government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute.

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

Deposit funds are used to record amounts held temporarily until paid to the appropriate government or public entity. The Department is acting as an agent or a custodian for funds awaiting distribution, for example payroll taxes.

Earmarked funds are trust or special funds designated by statute to be used only for specific activities, benefits or purposes. Earmarked funds are financed by specifically identified revenues and remain available over time. Earmarked funds also have a requirement to account for and report on the receipt, use and retention of revenues and other financing sources that distinguish them from general revenues.

1.D. Basis of Accounting

For FY 2006, the Department's financial management systems are unable to meet all of the requirements for full accrual accounting. Many of the Department's financial and non-financial feeder systems and processes were designed and implemented prior to the issuance of GAAP for federal agencies. These systems were not designed to collect and record financial information on the full accrual accounting basis as required by GAAP. Most of the Department's legacy systems were designed to record information on a budgetary basis.

The Department has undertaken efforts to determine the actions required to bring its financial and non-financial feeder systems and processes into compliance with GAAP. One such action is the current revision of its accounting systems to record transactions based on the United States Standard General Ledger (USSGL). Until all of the Department's financial and non-financial feeder systems and processes are updated to collect and report financial information as required by GAAP, the Department's financial data will be based on budgetary transactions (obligations, disbursements, and collections), transactions from non-financial feeder systems, and adjustments for known accruals of major items such as payroll expenses, accounts payable, and environmental liabilities.

In addition, the Department identifies program costs based upon the major appropriation groups provided by the Congress. Current processes and systems do not capture and report accumulated costs for major programs based upon the performance measures as required by the Government Performance and Results Act (GPRA). The Department is in the process of reviewing available data and attempting to develop a cost reporting methodology that balances the need for cost information required by GPRA and the Statement of Federal Financial Accounting Standard (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," with the need to keep the financial statements from being overly voluminous.

1.E. Revenues and Other Financing Sources

The Department receives congressional appropriations as financing sources for general funds on either an annual or multi-year basis. When authorized, these appropriations are supplemented by revenues generated by sales of goods or services. The Department recognizes revenue as a result of costs incurred for goods and services provided to other federal agencies and the public. Full cost pricing is the Department's standard policy for services provided as required by OMB Circular No A-25 "Transmittal Memorandum #1, User Charges". The Department recognizes revenue when earned within the constraints of current system capabilities. In some instances, revenue is recognized when bills are issued.

Depot Maintenance and Ordnance WCF activities recognize revenue according to the percentage of completion method. Supply Management WCF activities recognize revenue from the sale of inventory items.

The Department does not include non-monetary support provided by U.S. allies for common defense and mutual security in amounts reported in the Statement of Net Cost and the Statement of Financing. The U.S. has cost-sharing agreements with other countries. Examples include countries where there is a mutual or reciprocal defense agreement, where U.S. troops are stationed, or where the U.S. Fleet is in a port.

1.F. Recognition of Expenses

For financial reporting purposes, the Department's policy requires the recognition of operating expenses in the period incurred. However, because the Department's financial and non-financial feeder systems were not designed to collect and record financial information on the full accrual accounting basis, accrual adjustments are made for major items such as payroll expenses, accounts payable, environmental liabilities, and unbilled revenue. The Department's expenditures for capital and other long-term assets are recognized as operating expenses based on depreciation. In the case of Operating Materials and Supplies (OM&S), operating expenses are generally recognized when the items are purchased. Efforts are underway to migrate towards the consumption method for recognizing OM&S expenses.

1.G. Accounting for Intragovernmental Activities

Preparation of reliable financial statements requires the elimination of transactions occurring among entities within the Department or between two or more federal agencies. However, the Department cannot accurately identify most of its intragovernmental transactions by customer because the Department's systems do not track buyer and seller data needed to match related transactions. Seller entities within the Department provide summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal Department accounting offices. In most cases, the buyer-side records are adjusted to agree with Department seller-side balances. Intra-Department intragovernmental balances are then eliminated. The Department is developing long-term systems improvements that will include sufficient up-front edits and controls to eliminate the need for after-the-fact reconciliations. The volume of intragovernmental transactions is so large that an after-the-fact reconciliation cannot be accomplished effectively with existing or foreseeable resources.

The Department of the Treasury Financial Management Service is responsible for eliminating transactions between the Department and other federal agencies. The Treasury Financial Manual Part 2 – Chapter 4700, "Agency Reporting Requirements for the Financial Report of the United States Government," and the Treasury's "Federal Intragovernmental Transactions Accounting Policies Guide," provide guidance for reporting and reconciling intragovernmental balances. While the Department is unable to fully reconcile intragovernmental transactions with all federal partners, the Department is able to reconcile balances pertaining to investments in federal securities, borrowings from the U.S. Treasury and the Federal Financing Bank, Federal Employees' Compensation Act transactions with the Department of Labor (DOL), and benefit program transactions with the Office of Personnel Management (OPM). The Department's proportionate share of public debt and related expenses of the federal government are not included. The federal government does not apportion debt and its related costs to federal agencies. The Department's financial statements, therefore, do not report any portion of public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

Financing for the construction of Department facilities is obtained through appropriations. To the extent this financing ultimately may have been obtained through the issuance of public debt, interest costs have not been capitalized since the Department of the Treasury does not allocate such interest costs to the benefiting agencies.

1.H. Transactions with Foreign Governments and International Organizations

Each year, the Department sells defense articles and services to foreign governments and international organizations under the provisions of the "Arms Export Control Act of 1976." The provisions of the Act authorize the Department to sell defense articles and services to foreign countries and international organizations, generally at no profit or loss to the U.S. Government. Payment is required in advance.

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

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

In addition, the DFAS sites and the USACE Finance Center submit reports to the Department of the Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The Department of the Treasury records this information to the applicable Fund Balance with Treasury (FBWT) account. Differences between the Department's recorded balance in the FBWT accounts and Treasury's FBWT accounts are reconciled.

1.J. Foreign Currency

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

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

The Department conducts a significant portion of its operations overseas. The Congress established a special account to capture the gains and losses from foreign currency transactions for five general fund appropriations (operations and maintenance, military personnel, military construction, family housing operations and maintenance, and family housing construction). The gains and losses are computed as the variance between the exchange rate at the date of payment and a budget rate established at the beginning of each fiscal year. Foreign currency fluctuations related to other appropriations require adjustments to the original obligation amount at the time of payment. The Department does not separately identify currency fluctuations.

1.K. Accounts Receivable

As presented in the Balance Sheet, accounts receivable includes accounts, claims, and refunds receivable from other federal entities or from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. The Department does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies (per the Code of Federal Regulations 4 CFR 101).

The Department bases the estimate of uncollectible accounts receivable from the public as either a percentage of actual prior-year write-offs or a percentage of aged accounts receivable from the public.

1.L. Direct Loans and Loan Guarantees

The Department operates a direct loan and loan guarantee program authorized by the National Defense Authorization Act for FY 1996, Public Law 104-106, Stat 186, Section 2801. The Act includes a series of authorities that allow the Department to work with the private sector to renovate military housing. The Department's goals are to obtain private capital to leverage government dollars, make efficient use of limited resources, and use a variety of private sector approaches to build and renovate military housing faster and at a lower cost to American taxpayers.

The Act also provides the Department with a variety of authorities to obtain private sector financing and expertise to improve military housing. The Department uses these authorities individually or in combination. They include guarantees (both loan and rental); conveyance/leasing of existing property and facilities; differential lease payments; investments (both limited partnerships and stock/bond ownership); and direct loans. In addition, the "Federal Credit Reform Act of 1990" governs all amended direct loan obligations and loan guarantee commitments made after FY 1991 resulting in direct loans or loan guarantees.

The Department also operates a loan guarantee program designed to encourage commercial use of inactive government facilities. The revenue generated from property rental offsets the cost of maintaining these facilities.

The National Defense Authorization Act for FY 2005, Public Law 108-375, Section 2805, provided permanent authorities to the Military Housing Privatization Initiative.

1.M. Inventories and Related Property

The Department values approximately 60 percent of resale inventory using the moving average cost method. An additional 2 percent (fuel inventory) is reported using the first-in-first-out method. The Department reports the remaining 38 percent of resale inventories at an approximation of historical cost using latest acquisition cost adjusted for holding gains and losses. The latest acquisition cost method is used because legacy inventory systems were designed for materiel management rather than accrual accounting. Although these systems provide visibility and accountability over inventory items, they do not maintain historical cost data necessary to comply with SFFAS No. 3, "Accounting for Inventory and Related Property." Additionally, these systems cannot produce financial transactions using the USSGL, as required by the Federal Financial Management Improvement Act of 1996 (P.L. 104-208). By utilizing new systems development processes, Department Components are continuing to transition the balance of their inventories to the moving average cost method. However, since the on-hand balances which transitioned were not, for the most part, baselined to auditable historical cost, the reported values remain non-compliant with SFFAS No. 3 and GAAP.

The Department manages only military or government-specific materiel under normal conditions. Items commonly used in and available from the commercial sector are not managed in the Department's materiel management activities. Operational cycles are irregular, and the military risks associated with stock-out positions have no commercial parallel. The Department holds materiel based on military need and support for contingencies. Therefore, the Department does not attempt to account separately for "inventory held for sale" and "inventory held in reserve for future sale" based on SFFAS No. 3 definitions.

Related property includes operating materials and supplies (OM&S) and stockpile materials. The OM&S, including munitions not held for sale, are valued at standard purchase price. The Department uses both the consumption method and the purchase method of accounting for OM&S. Items that are centrally managed and stored, such as ammunition and engines, are generally recorded using the consumption method and reported on the Balance Sheet as OM&S. When current systems cannot fully support the consumption method, the Department uses the purchase method. Under this method materials and supplies are expensed when purchased. During FY 2006, the Department expensed significant amounts using the purchase method either because the systems could not support the consumption method or because management deemed that the item was in the hands of the end user.

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

The Department recognizes condemned materiel as "Excess, Obsolete, and Unserviceable." The cost of disposal is greater than the potential scrap value; therefore, the net value of condemned materiel is zero. Potentially redistributed materiel, presented in previous years as "Excess, Obsolete, and Unserviceable," is included in "Held for Use" or "Held for Repair" categories according to its condition.

Past audits identified uncertainties about the completeness and existence of the reported values of inventory. Inventory available and purchased for resale includes consumable spare and repair parts and repairable items owned and managed by the Department. This inventory is retained to support military or national contingencies. Inventory held for repair is damaged inventory that requires repair to make suitable for sale. It is more economical to repair than to procure these inventory items. Because the Department often relies on weapon systems and machinery no longer in production, the Department supports a process that encourages the repair and rebuilding of certain items. This repair cycle is essential to maintaining a ready, mobile, and armed military force. Finally, work in process balances include costs related to the production or servicing of items, including direct material, direct labor, applied overhead and other direct costs. Work in process balances include costs related to the production or servicing of items, including direct material, direct labor, applied overhead and other direct cost. Work in process also includes the value of finished products or completed services pending the submission of bills to the customer. The work in process designation may also be used to accumulate amounts paid to contractors under cost reimbursable contracts, including amounts withheld from payment to ensure performance, and amounts paid to other government plants for accrued costs of end items of material ordered but not delivered. Work in process includes munitions in production and depot maintenance work with its associated labor, applied overhead, and supplies used in the delivery of maintenance services.

1.N. Investments

The Department reports investments in U.S. Treasury securities at cost, net of amortized premiums or discounts. Premiums or discounts amortize into interest income over the term of the investment using the effective interest rate method or another method obtaining similar results. The Department's intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

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

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

Other investments represent limited partnerships, entered into on behalf of the U.S. Government in support of the Military Housing Privatization Initiative authorized by Public Law 104-106 Section 2801. These investments do not require market value disclosure.

1.O. General Property, Plant and Equipment

The Department is moving away from a standard capitalization threshold for all categories (e.g. real property, military equipment, etc.) of General Property, Plant, and Equipment (PP&E) to one that is specific for each individual category.

In FY 2006 the capitalization threshold was revised from $100,000 to $20,000 for real property. The current $100,000 capitalization threshold remains unchanged for the remaining General PP&E categories.

General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of two or more years, and when the acquisition cost equals or exceeds the Department's capitalization threshold of $100,000, except for the USACE and WCF as discussed below. The Department also requires capitalization of improvement costs over the Department's capitalization threshold of $100,000 for General PP&E. The Department depreciates all General PP&E, other than land, on a straight-line basis.

Prior to FY 1996, General PP&E was capitalized if it had an acquisition cost of $15,000, $25,000, and $50,000 for FYs 1993, 1994, and 1995, respectively, and an estimated useful life of two or more years. General PP&E previously capitalized at amounts below $100,000 were written off General Fund financial statements in FY 1998. No adjustment was made for WCF assets. These assets remain capitalized and reported on WCF financial statements.

The USACE Civil Works General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of two or more years, and when the acquisition cost exceeds $25,000. One exception is all buildings and structures related to hydropower projects, which are capitalized regardless of cost. During FY 2003, the Corps increased its buildings and structures threshold from $0 to $25,000 for all Civil Works appropriations with the exception of Revolving Fund and Power Marketing Agency assets. All Civil Works buildings and structures currently capitalized under $25,000 (excluding Revolving Fund and Power Marketing Agency) were expensed in FY 2003 and removed from the Corps of Engineers Financial Management System. Beginning in FY 2004, all Civil Works Buildings and Structures under $25,000 are expensed except for

Power Marketing Agency assets.

When it is in the best interest of the government, the Department provides government property necessary to contractors to complete contract work. The Department either owns or leases such property, or it is purchased directly by the contractor for the government based on contract terms. When the value of contractor-procured General PP&E exceeds the Department's capitalization threshold, it must be reported on the Department's Balance Sheet.

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

The SFFAS No. 23, "Eliminating the Category National Defense Property, Plant, and Equipment," establishes generally accepted accounting principles for valuing and reporting military equipment (e.g., ships, aircraft, combat vehicles, weapons) in federal financial statements. The standard provides for the use of estimated historical cost for valuing military equipment if obtaining actual historical cost information is not practical. The Department estimated historical costs using the Bureau of Economic Analysis (BEA) estimates to calculate the value of the military equipment for reporting periods from October 1, 2002 through March 31, 2006.

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

1.P. Advances and Prepayments

The Department records payments in advance of the receipt of goods and services as advances or prepayments and reports them as assets on the Balance Sheet. The Department recognizes advances and prepayments as expenses when it receives the related goods and services.

1.Q. Leases

Lease payments for the rental of equipment and operating facilities are classified as either capital or operating leases. An operating lease does not substantially transfer all the benefits and risk of ownership. Payments for operating leases are charged to expense over the lease term as it becomes payable.
Capital leases convey certain benefits and risks of ownership, and therefore require recognition of an asset and

corresponding lease liability equal to the present value of the rental and other lease payments during the lease term (excluding portions representing executory costs paid to the lessor) or the asset's fair market value. The discount rate for the present value calculation is either the lessor's implicit interest rate or the government's incremental borrowing rate at the inception of the lease. The Department as the lessee receives the use and possession of leased property, for example real estate or equipment, from a lessor in exchange for a payment of funds.

Office space and leases entered into by the Department in support of contingency operations are the largest components of operating leases. These costs were gathered from existing leases, General Services Administration (GSA) bills, and Inter-service Support Agreements. Future year projections use the Consumer Price Index (CPI), rather than the Department's inflation factor. The CPI impacts increases to the leases, especially those at commercial lease sites. Equipment leases have a variety of lease terms, which are not expected to be renewed upon expiration. Other operating leases are generally one-year leases. The Department expects to continue to reduce the level of owned assets while increasing the number of leased assets. The Department will strive to displace commercial leases with more economical GSA leases.

1.R. Other Assets

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

Contract financing payments are defined in the Federal Acquisition Regulation (FAR), Part 32, as authorized disbursements of monies to a contractor prior to acceptance of supplies or services by the government. These payments are designed to alleviate the potential financial burden on contractors performing certain long-term contracts and facilitate competition for defense contracts. Contract financing payments clauses are incorporated in the contract terms and conditions and may include advance payments, performance-based payments, commercial advance and interim payments, progress payments based on cost, and interim payments under certain cost-reimbursement contracts.

Contract financing payments do not include invoice payments, payments for partial deliveries, lease and rental payments, or progress payments based on a percentage or stage of completion, which the Defense Federal Acquisition Regulation Supplement (DFARS) authorizes only for construction of real property, shipbuilding, and ship conversion, alteration, or repair. Progress payments for real property and ships are reported as Construction in Progress in Note 10.

1.S. Contingencies and Other Liabilities

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

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. Examples of loss contingencies include the collectibility of receivables, pending or threatened litigation, and possible claims and assessments. The Department's loss contingencies arise as a result of pending or threatened litigation or claims; and assessments occur due to events such as aircraft, ship and vehicle accidents, medical malpractice, property or environmental damages, and contract disputes.

Other liabilities arise as a result of anticipated disposal costs for the Department's assets. This type of liability has two components: nonenvironmental and environmental. Consistent with SFFAS No. 6, "Accounting for Property, Plant, and Equipment," recognition of an anticipated environmental disposal liability begins when the asset is placed into service. Nonenvironmental disposal liabilities are recognized for assets when management decides to dispose of an asset based upon the Department's policy, which is consistent with SFFAS No. 5, "Accounting for Liabilities of the Federal Government." The Department recognizes nonenvironmental disposal liabilities for nuclear-powered military equipment when placed into service. Such amounts are developed in conjunction with, and not easily separately identifiable from, environmental disposal costs.

1.T. Accrued Leave

The Department reports earned military and civilian leave, except sick leave, as accrued liabilities. Sick leave is expensed when taken. The liability reported at the end of the accounting period reflects the current pay rates.

1.U. Net Position

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

Unexpended Appropriations represent amounts of authority that are unobligated and have not been rescinded or withdrawn. Unexpended appropriations also represent amounts obligated for which legal liabilities for payments have not been incurred.

Cumulative Results of Operations represent the difference, since inception of an activity, between expenses and losses and financing sources (including appropriations, revenue, and gains). Beginning with FY 1998, these results included the cumulative amount of donations and transfers of assets in and out without reimbursement.

1.V. Treaties for Use of Foreign Bases

The Department has the use of land, buildings, and other overseas facilities that are obtained through various international treaties and agreements negotiated by the Department of State. The Department purchases capital assets overseas with appropriated funds; however, the host country retains title to land and improvements. Generally, treaty terms allow the Department continued use of these properties until the treaties expire. In the event treaties or other agreements are terminated, whereby use of the foreign bases is prohibited, losses are recorded for the value of any nonretrievable capital assets. This takes place after negotiations between the U.S. and the host country have determined the amount to be paid to the U.S. for such capital investments.

1.W. Comparative Data

Financial statement fluctuations greater than two percent of total assets on the Balance Sheet or ten percent from the prior period presented are generally explained within the notes to the financial statements.

1.X. Unexpended Obligation

The Department obligates funds to provide goods and services for outstanding orders not yet delivered. The financial statements do not reflect this liability for payment for goods and services not yet delivered.

1.Y. Undistributed Disbursements and Collection

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

The Department's policy is to allocate supported undistributed disbursements and collections between federal and nonfederal categories based on the percentage of federal and nonfederal accounts payable and accounts receivable. The majority of the Department's components follow this allocation procedure. Unsupported undistributed disbursements are recorded in accounts payable. Unsupported undistributed collections are recorded in other liabilities.

Note 2. Nonentity Assets

As of September 30	2006	2005
(amount in millions)		
Intragovernmental Assets		
Fund Balance with Treasury	$ 2,896.6	$ 1,653.5
Accounts Receivable	11.6	0.3
Total Intragovernmental Assets	2,908.2	1,653.8
Nonfederal Assets		
Cash and Other Monetary Assets	2,085.2	1,959.4
Accounts Receivable	5,486.7	4,469.6
Other Assets	196.8	156.9
Total Nonfederal Assets	7,768.7	6,585.9
Total Nonentity Assets	10,676.9	8,239.7
Total Entity Assets	1,356,376.4	1,257,901.2
Total Assets	$ 1,367,053.3	$ 1,266,140.9

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

Fluctuations

Nonentity assets increased $2.4 billion (30%) primarily due to an increase of $1.2 billion in nonentity Fund Balance with Treasury and $1.0 billion in Accounts Receivable. The increase in nonentity Fund Balance with Treasury primarily results from the withdrawal of $1.0 billion in Foreign Military Sales funds in FY 2005 with no corresponding withdrawal in FY 2006. The remaining increase in nonentity Accounts Receivable is attributable to Accounts Receivable associated with litigation cases, and the reclassification of assets from entity to nonentity.

Note 3. Fund Balance with Treasury

As of September 30	2006	2005
(amount in millions)		
Fund Balances		
Appropriated Funds	$ 312,055.6	$ 278,565.8
Revolving Funds	9,619.6	8,249.0
Trust Funds	2,212.2	406.2
Special Funds	328.1	344.3
Other Fund Types	2,922.8	3,091.8
Total Fund Balances	327,138.3	290,657.1
Fund Balances Per Treasury Versus Agency		
Fund Balance per Treasury	329,921.4	294,103.0
Fund Balance per Agency	327,138.3	290,657.1
Reconciling Amount	$ 2,783.1	$ 3,445.9

Fluctuations

Fund Balance with Treasury increased $36.5 billion (13%) primarily due to an increase of $32.0 billion in appropriations for critical mission related efforts such as procurement of military equipment, the Global War on Terror, Base Realignment and Closure, and hurricane relief in the Gulf Coast region during FY 2006.

Other Disclosures

The Department shows a reconciling net difference of $2.8 billion with the Department of the Treasury, which is comprised of:

- $3.4 billion of canceling year authority recorded by Treasury, but not reported by the Department.
- $(1.2) billion of Foreign Military Sales (FMS) advances from foreign customers based on future requirement forecast recorded by the Department, but not reported by the Treasury as Department funds.
- $369.0 million of unavailable receipts recorded by Treasury, but not reported by the Department.
- $115.8 million of transfer funds with the Executive Office of the President, the Department of Transportation (DOT), and the U.S Department of Agriculture (USDA) recorded by Treasury, but not reported by the Department.
- $120.5 million in additional availability of funds due to invalid program years recorded by Treasury, but not reported by the Department.
- $(64.9) million of transfer funds with the DOT and the USDA recorded by the Department, but not reported by the Treasury as Department funds.

Status of Fund Balance with Treasury		
As of September 30	2006	2005
(amount in millions)		
Unobligated Balance		
Available	$ 75,401.0	$ 59,934.1
Unavailable	302,033.4	8,690.4
Obligated Balance not yet Disbursed	318,907.6	556,162.3
Nonbudgetary FBWT	7,640.4	8,783.4
NonFBWT Budgetary Accounts	(376,844.1)	(342,387.7)
Total	$ 327,138.3	$ 291,182.5

The Status of Fund Balance with Treasury (FBWT) consists of unobligated and obligated balances. These balances reflect the budgetary authority remaining for disbursements against current or future obligations. In addition, the balances include various accounts that affect either budgetary reporting or FBWT, but not both.

Unobligated Balance represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. Unobligated Balance is classified as available or unavailable and is associated with appropriations expiring at fiscal year end that remain available only for obligation adjustments until the account is closed. Certain unobligated balances may be restricted for future use and are not apportioned for current use. These balances are only available for investing in nonmarketable market-based securities purchased through Treasury.

Obligated Balance not yet Disbursed represents funds that have been obligated for goods that have not been received or services that have not been performed.

Nonbudgetary FBWT includes entity and nonentity FBWT accounts which do not have budgetary authority, such as unavailable receipt accounts or clearing accounts.

NonFBWT Budgetary Accounts include budgetary accounts that do not affect FBWT, such as contract authority, borrowing authority, and investment accounts. This category reduces the Status of FBWT.

The status of fund balance with Treasury disagrees with the FBWT by $525.4 million for FY 2005 due to an error, which was corrected for FY 2006.

Fluctuations

Total Status of FBWT increased $36.0 billion (13%). Unobligated Balance Unavailable increased $293.3 billion and Obligated Balance not yet Disbursed decreased $237.3 billion due to the reclassification of certain special and trust fund balances in FY 2006. This reclassification brings the Department into compliance with the Office of Management and Budget Circular No. A-136, “Financial Reporting Requirements,” and permits better reconciliation of FBWT to the President’s Budget.

Disclosures Related to Suspense/Budget Clearing Accounts				
As of September 30	2004	2005	2006	(Decrease)/ Increase from FY2005 - 2006
(amount in millions)				
Account				
F3845 – Personal Property Proceeds	$ 0.0	$ 0.9	$ 0.7	$ (0.2)
F3875 – Disbursing Officer Suspense	(608.5)	263.5	903.9	640.4
F3880 – Lost or Cancelled Treasury Checks	(1.4)	11.9	26.4	14.5
F3882 – Uniformed Services Thrift Savings Plan Suspense	(59.5)	83.5	108.5	25.0
F3885 – Interfund/IPAC Suspense	(118.2)	(211.6)	(114.9)	96.7
F3886 – Thrift Savings Plan Suspense	0.2	(4.9)	(6.4)	(1.5)
Total	$ (787.4)	$ 143.3	$ 918.2	$ 774.9

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

The F3875, F3885, and the F3886 suspense clearing accounts temporarily hold collections or disbursements until they can be assigned or identified to a valid appropriation. The F3875 suspense clearing account represents the Disbursing Officer's suspense. Account F3885 represents the Interfund and Intragovernmental Payment and Collection (IPAC) suspense. Account F3886 represents payroll deductions for the Thrift Savings Plan (TSP) suspense.

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

The F3882 suspense account was established for the Uniformed Services TSP in FY 2002. The amounts in this account represent a timing difference between the posting of the TSP deductions by the USDA National Finance Center and the posting of these amounts in the military accounting systems in the following month.

Fluctuations

Total suspense accounts increased $774.9 million. This increase is primarily attributable to the $640.4 million increase in Disbursing Officer suspense caused by timing differences in disbursements of military and civilian payroll in the 4th Quarter, FY 2006. In 4th Quarter, FY 2006, these accounts included individual income and Federal Insurance Contributions Act tax withholdings, whereas, 4th Quarter, FY 2005 payroll tax withholdings were disbursed prior to the end of the accounting period.

Other Disclosures

The total amount reported above for FY 2005 does not agree with balances reported last year-end due to the inclusion of the Personal Property Proceeds account in the current year schedule. The note schedule did not include this account for 4th Quarter, FY 2005.

Disclosures Related to Problem Disbursements and In-Transit Disbursements								
As of September 30	2004		2005		2006		(Decrease)/ Increase from FY2005 - 2006	
(amount in millions)								
Total Problem Disbursements, Absolute Value								
Unmatched Disbursements (UMDs)	$	817.7	$	2,198.6	$	3,345.4	$	1,146.8
Negative Unliquidated Obligations (NULO)		88.8		89.1		78.6		(10.5)
Total In-transit Disbursements, Net	$	4,197.0	$	4,130.8	$	4,588.8	$	458.0

An unmatched disbursement (UMD) occurs when a payment is not matched to a corresponding obligation in the accounting system. Absolute value is the sum of the positive values of debit and credit transactions without regard to the sign (plus or minus).

A negative unliquidated obligation (NULO) occurs when a payment is made against a valid obligation, but the payment is greater than the amount of the obligation recorded in the official accounting system. These payments have been made using available funds and are based on valid receiving reports for goods and services delivered under valid contracts.

The In-transits represent the net value of disbursements and collections made by the Department disbursing activity on behalf of an accountable activity and have not been posted to the accounting system.

Fluctuations

The Department reported a $1.1 billion increase (52%) in UMDs. This fluctuation is primarily attributable to systemic problems, insufficient documentation, erroneous data, and input errors.

The Department reported a $10.5 million decrease (12%) in NULOs. This decrease consists of $7.4 million due to more timely receipt of supporting documentation.

The Department reported an increase in In-transits of $458 million (11%) primarily attributable to $799.5 million in Mechanization of Contract Administration Services files for payments that were not posted by the Department as of 4th Quarter, FY 2006. This increase was partially offset by a $472.9 million decrease in an effort to identify systemic errors and implement corrective actions to validate data throughout FY 2006.

Other Disclosures

The amounts reported in FY 2004 and FY 2005 have been changed to reflect correct balances reported in the prior year problem disbursements and in-transits. Due to timing issues in receipt of expenditure information in prior years, the Department corrected prior year balances to better reflect year-end reporting.

Note 4. Investments and Related Interest

As of September 30	2006								
(amount in millions)	Cost		Amortization Method	Amortized (Premium) / Discount		Investments, Net		Market Value Disclosure	
Intragovernmental Securities									
Nonmarketable, Market-Based	$	304,523.2	Effective Interest	$	(9,105.6)	$	295,417.6	$	291,259.5
Accrued Interest		3,843.6					3,843.6		3,843.6
Total Intragovernmental Securities		308,366.8			(9,105.6)		299,261.2		295,103.1
Total Other Investments	$	1,089.8		$	0.0	$	1,089.8		N/A

As of September 30	2005								
(amount in millions)	Cost		Amortization Method	Amortized (Premium) / Discount		Investments, Net		Market Value Disclosure	
Intragovernmental Securities									
Nonmarketable, Market-Based	$	273,976.0	Effective Interest	$	(14,551.2)	$	259,424.8	$	262,243.7
Accrued Interest		3,943.0					3,943.0		3,943.0
Total Intragovernmental Securities	$	277,919.0		$	(14,551.2)	$	263,367.8	$	266,186.7
Total Other Investments	$	605.0		$	0.0	$	605.0		N/A

Fluctuations

Intragovernmental Securities

Total Intragovernmental Securities, Net Investments increased $35.9 billion (14%). The increase was primarily due to increased cash flow made available for investing. The Medicare-Eligible Retiree Health Care Fund investments increased $24.7 billion because of contributions (in excess of beneficiary payments) from the Treasury, the Military Services and other Uniformed Services (U.S. Coast Guard, U.S. Public Health Service, and the National Oceanic Atmospheric Administration) plus accrued interest earned. The Military Retirement Fund investments increased $10.6 billion because of contributions (in excess of beneficiary payments) from Treasury and the Military Services, the maturation of U.S. Treasury notes and bills that were reinvested in overnight Treasury securities yielding a higher interest rate, and accrued interest earned.

Other Investments

Other Investments (with the Public) increased $484.8 million (80%) from new investments in limited partnerships in support of military housing.

Other Disclosures

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash receipts collected from the public for an earmarked fund are deposited in the Treasury, which uses the cash for general Government purposes. Treasury securities are issued to the Department as evidence of its receipts. Treasury securities are an asset to the Department and a liability to the Treasury. Because the Department and the Treasury are both parts of the Government, these assets and liabilities offset each other from the standpoint of the Government as a whole. For this reason, receipts do not represent an asset or a liability in the U.S. Governmentwide financial statements. Treasury securities provide the Department with authority to draw upon the Treasury to make future benefit payments or other expenditures. When the Department requires redemption of these securities to make the expenditures, the Government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same way that the Government finances all other expenditures.

Note 5. Accounts Receivable

As of September 30	2006			2005
(amounts in millions)	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
Intragovernmental Receivables	$ 2,927.4	N/A	$ 2,927.4	$ 1,291.3
Nonfederal Receivables (From the Public)	8,214.5	(350.4)	7,864.1	7,615.5
Total Accounts Receivable	$ 11,141.9	$ (350.4)	$ 10,791.5	$ 8,906.8

Intragovernmental accounts receivables increased $1.6 billion primarily due to the direct support provided to the Federal Emergency Management Agency for hurricane relief efforts in the Gulf Coast.

Aged Accounts Receivable				
As of September 30	2006		2005	
	Intragovernmental	Nonfederal	Intragovernmental	Nonfederal
(amounts in millions)				
Category				
Nondelinquent				
Current	$ 7,735.6	$ 1,840.8	$ 8,446.6	$ 2,242.5
Noncurrent	232.1	1,740.9	341.3	1,713.1
Delinquent				
1 to 30 days	321.1	159.9	221.3	110.3
31 to 60 days	345.7	53.4	23.5	63.3
61 to 90 days	57.2	117.8	95.4	77.2
91 to 180 days	716.5	130.0	100.9	185.3
181 days to 1 year	908.7	207.2	134.2	255.9
Greater than 1 year and less than or equal to 2 years	44.4	192.2	107.6	833.9
Greater than 2 years and less than or equal to 6 years	55.0	896.2	100.4	152.8
Greater than 6 years and less than or equal to 10 years	1.2	676.0	9.2	284.1
Greater than 10 years	0.0	2,640.5	0.0	2,557.8
Subtotal	$ 10,417.5	$ 8,654.9	$ 9,580.4	$ 8,476.2
Less Supported Undistributed Collections	(492.7)	(478.9)	(587.6)	(451.8)
Less Eliminations	(6,986.3)	0.0	(7,647.1)	0.0
Less Other	(11.1)	38.5	(54.4)	(33.7)
Total	$ 2,927.4	$ 8,214.5	$ 1,291.3	$ 7,990.7

Nondelinquent noncurrent accounts receivable total $1.9 billion for 4th Quarter, FY 2006 and represent those amounts that are due beyond the next 12 months. These accounts are not considered delinquent since the associated repayment schedules allow for repayment after a 30-day period and are not yet due under the contract or billing documents pertaining to the receivable.

The Less Other line item above consists primarily of adjustments posted after closure of the accounting records. These include (1) adjustments to supported undistributed collections, (2) reclassifications between intragovernmental and nonfederal as part of the Department of Defense trading partner process that were not included on the elimination line, and (3) any discrepancies between the subsidiary detail transactions and the trial balance.

The Department utilizes several different programs (Treasury Offset Program, Vendor Pay Offset Program, Central Debt System, Intragovernmental Payment and Collection, Defense Cash Accountability System, Delinquent Debt

Management System, Salary Offset Program, and Private Collection Services) to pursue collection action on delinquent and nondelinquent accounts receivable in accordance with Office of Management and Budget Circular A-129, "Policies for Federal Credit Programs and Non-Tax Receivables." In certain instances, the status of litigation impacts the Department's ability to pursue collection actions.

The Department is working with the Federal Emergency Management Agency (FEMA) to reduce the intragovernmental accounts receivable balances. The Department implemented a modified Intragovernmental Payment and Collection agreement with FEMA which has accelerated collections. In addition, FEMA agreed to make partial payments for the portion of a bill that can be supported. The Department has also implemented procedures to monitor the turnaround time for providing billing information to FEMA to avoid unnecessary delays in receiving payment. During 4th quarter, the Department reduced its delinquent FEMA receivables by $552.0 million.

Note 6. Other Assets

As of September 30	2006	2005 Restated
(amounts in millions)		
Intragovernmental Other Assets		
Advances and Prepayments	$ 1,064.7	$ 1,394.2
Other Assets	124.9	124.9
Total Intragovernmental Other Assets	1,189.6	1,519.1
Nonfederal Other Assets		
Outstanding Contract Financing Payments	25,630.4	21,776.1
Other Assets (With the Public)	2,298.3	2,046.0
Total Nonfederal Other Assets	27,928.7	23,822.1
Total Other Assets	$ 29,118.3	$ 25,341.2

Fluctuations

Intragovernmental Other Assets

Intragovernmental Other Assets decreased $329.5 million (22%), primarily due to $222.5 million in Department advances returned from the Department of the Interior. These advances were returned as a result of a Department-wide effort to review all Department funds with non-Department federal entities and coordinate the return of funds that had either expired or were no longer available for use.

Nonfederal Other Assets

Nonfederal Other Assets increased $4.1 billion (17%), primarily due to a $3.3 billion increase in estimated future contract financing payments. Beginning 4th Quarter, FY 2006, the Department changed its reporting practices to recognize estimated future contract financing payments and a contingent liability (additional discussion in Note 15, Other Liabilities), conditional upon the future delivery and Government acceptance of a satisfactory product.

Other Disclosures

Intragovernmental Other Assets include a $124.9 million prior-period adjustment to recognize the Department's right to approximately 6.4 million barrels of crude oil held by the Department of Energy (DOE) on behalf of the Department. The Department provided funds to DOE in FY 1993 to acquire the reserve; however, due to an accounting error, no asset was established. See Note 25 for further disclosures.

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

Other Assets (With the Public) are primarily comprised of advances for military and travel pay, fish and wildlife migration studies performed by the U.S. Army Corps of Engineers, and an advance payment pool agreement with the Massachusetts Institute of Technology and other nonprofit institutions.

Note 7. Cash and Other Monetary Assets

As of September 30	2006	2005
(amounts in millions)		
Cash	$ 1,389.0	$ 1,494.0
Foreign Currency	810.8	578.7
Total Cash, Foreign Currency, & Other Monetary Assets	$ 2,199.8	$ 2,072.7

Approximately $1.3 billion in cash and $810.8 million in foreign currency are nonentity and their use is restricted.

Note 8. Direct Loan and/or Loan Guarantee Programs

Direct Loan and/or Loan Guarantee Programs

The entity operates the following direct loan and/or loan guarantee program(s):
- Military Housing Privatization Initiative
- Armament Retooling & Manufacturing Support Initiative

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

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

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

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

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

Military Housing Privatization Initiative

The Military Housing Privatization Initiative (MHPI) includes both direct loan and loan guarantee programs. The Department obtains private sector capital to leverage government dollars. The Department provides protection against specific risks, such as base closure or member deployment, for the private sector partner. The loan guarantee program is authorized by the National Defense Authorization Act for FY 1996, Public Law 104-106, Section 2801.

Armament Retooling and Manufacturing Support Initiative

The Armament Retooling and Manufacturing Support Initiative (ARMS), Title 10 United States Code 4551-4555, is a loan guarantee program designed to encourage commercial use of the Army's Inactive Ammunition Plants through many incentives for businesses willing to locate to a government ammunition production facility. The production capacity of these facilities is greater than current military requirements; however, this capacity may be needed by the military in the future. The revenues from the property rental are used to pay for the operation, maintenance and environmental cleanup at the facilities. The resulting savings in overhead costs lower the production cost of the goods manufactured and fund environmental cleanup at no cost to the government.

Direct Loans Obligated After FY 1991		
As of September 30	2006	2005
(amounts in millions)		
Loan Programs		
Military Housing Privatization Initiative		
Loans Receivable Gross	$ 296.3	$ 141.5
Allowance for Subsidy Cost (Present Value)	(104.6)	(65.9)
Value of Assets Related to Direct Loans	191.7	75.6
Total Loans Receivable	$ 191.7	$ 75.6

Fluctuations

Total Loans Receivable increased $116.1 million. The increase is due to five new direct loans disbursed in FY 2006 for Wright-Patterson Air Force Base (AFB), Ohio; Elmendorf AFB, Alaska; and Kirtland AFB, New Mexico.

Other Disclosures

Subsidy costs are recognized when direct loans are disbursed to borrowers and are reestimated each year as of the date of the financial statements. The allowance for subsidy cost is the difference between the outstanding principal of the loans and the present value of their net cash flows.

The Department's loans receivable are not the same as the proceeds that it would expect to receive from selling the loans.

Gross direct loans for the MHPI program from inception consist of the following:

FY 2006 Direct Loans	*(Amount in millions)*
Elmendorf AFB, Alaska	$122.5
Kirtland AFB, New Mexico	58.6
Camp Pendleton Marine Corps Base, California	29.4
Dyess AFB, Texas	28.9
Robins AFB, Georgia	22.3
Wright-Patterson AFB, Ohio	21.9
Lackland AFB, Texas	10.2
Kingsville AFB, Texas	2.5
Total Loans Receivable Gross	**$296.3**

Total Amount of Direct Loans Disbursed		
As of September 30	2006	2005
(amounts in millions)		
Direct Loan Programs		
Military Housing Privatization Initiative	$ 155.0	$ 0.0
Total	$ 155.0	$ 0.0

The Department disbursed new direct loans for Wright-Patterson AFB, Ohio ($21.9 million); Kirtland AFB, New Mexico ($58.6 million); and Elmendorf AFB, Alaska ($74.5 million) in FY 2006. The demand for direct loans by private developers varies from year to year depending upon the progress of planned construction and renovation, and upon economic factors unrelated to the operations of the Department.

Subsidy Expense for Post FY 1991 Direct Loan					
As of September 30					
(amounts in millions)					
2006	**Interest Differential**	**Defaults**	**Fees**	**Other**	**Total**
New Direct Loans Disbursed:					
Military Housing Privatization Initiative	$ 27.9	$ 20.7	$ 0.0	$ 0.0	$ 48.6
2005	**Interest Differential**	**Defaults**	**Fees**	**Other**	**Total**
New Direct Loans Disbursed:					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
2006	**Modifications**	**Interest Rate Reestimates**	**Technical Reestimates**	**Total Reestimates**	**Total**
Direct Loan Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ (0.3)	$ (7.8)	$ (8.1)	$ (8.1)
2005	**Modifications**	**Interest Rate Reestimates**	**Technical Reestimates**	**Total Reestimates**	**Total**
Direct Loan Modifications and Reestimates:					
Military Housing Privatization Initiative	$ (0.3)	$ (0.9)	$ (3.6)	$ (4.5)	$ (4.8)

	2006	2005
Total Direct Loan Subsidy Expense:		
Military Housing Privatization Initiative	$ 40.5	$ (4.8)

Fluctuations

The total subsidy expense for direct loans is $40.5 million due to interest differential and defaults related to the new loans disbursed for FY 2006 and reestimates on outstanding direct loans.

Subsidy Rate for Direct Loans					
As of September 30	Interest Differential	Defaults	Fees and other Collections	Other	Total
Direct Loan Programs					
Military Housing Privatization Initiative	19.44%	8.95%	0.00%	0.00%	28.39%

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

Schedule for Reconciling Subsidy Cost Allowance Balances for Post 1991 Direct Loans		
As of September 30	2006	2005
(amounts in millions)		
Beginning Balance of the Subsidy Cost Allowance	$ 65.9	$ 70.7
Add: Subsidy Expense for Direct Loans Disbursed during the Reporting Years by Component		
Interest Rate Differential Costs	27.9	0.0
Default Costs (Net of Recoveries)	20.7	0.0
Total of the above Subsidy Expense Components	48.6	0.0
Adjustments		
Subsidy Allowance Amortization	(1.8)	(0.3)
Total of the above Adjustment Components	(1.8)	(0.3)
Ending Balance of the Subsidy Cost Allowance before Re-estimates	112.7	70.4
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimate	(0.3)	(0.9)
Technical/Default Reestimate	(7.8)	(3.6)
Total of the above Reestimate Components	(8.1)	(4.5)
Ending Balance of the Subsidy Cost Allowance	$ 104.6	$ 65.9

Defaulted Guaranteed Loans from Post FY 1991 Guarantees

The Department had a defaulted guaranteed loan in FY 1999 in the ARMS Initiative Program that was paid in FY 2006 in the amount of $11.4 million. The third party contractor filed bankruptcy in FY 2000 and dissolved operations. Therefore, the Department is unable to pursue collection from the contractor. The Department borrowed $11.4 million and will pursue appropriate methods of reimbursement to the Treasury.

The Department had a guaranteed loan that defaulted in September 2006. The Department is currently working on issues related to this default.

Guaranteed Loans Outstanding		
As of September 30	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
(amounts in millions)		
Guaranteed Loans Outstanding		
Military Housing Privatization Initiative	$ 551.3	$ 551.3
Armament Retooling & Manufacturing Support Initiative	20.5	18.2
Total	$ 571.8	$ 569.5
New Guaranteed Loans Disbursed		
Armament Retooling & Manufacturing Support Initiative	2.7	2.3
Total	$ 2.7	$ 2.3
New Guaranteed Loans Disbursed		
Military Housing Privatization Initiative	$ 165.0	$ 165.0
Armament Retooling & Manufacturing Support Initiative	0.7	0.6
Total	$ 165.7	$ 165.6

The Guaranteed Loans Outstanding for the MHPI program as of the 4th Quarter, FY 2006, consists of the following:

Loan Guarantees	*(Amount in millions)*
Fort Polk, Louisiana	$165.0
Fort Carson, Colorado	144.3
Kirtland AFB, New Mexico	74.0
Wright Patterson AFB, Ohio	65.0
Elmendorf AFB, Alaska	48.0
Lackland AFB, Texas	29.4
Robins AFB, Georgia	25.6
Total	**$551.3**

Liabilities for Post FY 1991 Loan Guarantees, Present Value		
As of September 30	2006	2005
(amounts in millions)		
Loan Guarantee Program(s)		
Military Housing Privatization Initiative	$ 23.8	$ 28.7
Armament Retooling & Manufacturing Support Initiative	13.0	12.4
Total	$ 36.8	$ 41.1

For additional information, see the Schedule for Reconciling Loan Guarantee Liability Balances for Post 1991 Loan Guarantees.

Subsidy Expense for Post FY 1991 Loan Guarantees					
As of September 30					
(amounts in millions)					
2006	**Interest Differential**	**Defaults**	**Fees**	**Other**	**Total**
New Loan Guarantees Disbursed:					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
Armament Retooling & Manufacturing Support Initiative	0.0	0.2	11.6	11.8	11.8
Total	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
2005	**Interest Differential**	**Defaults**	**Fees**	**Other**	**Total**
New Loan Guarantees Disbursed:					
Military Housing Privatization Initiative	$ 0.0	$ 10.3	$ 0.0	$ 0.0	$ 10.3
Total	$ 0.0	$ 10.3	$ 0.0	$ 0.0	$ 10.3
2006	**Modifications**	**Interest Rate Reestimates**	**Technical Reestimates**	**Total Reestimates**	**Total**
Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ (6.4)	$ (6.4)	$ (6.4)
Total	$ 0.0	$ 0.2	$ 5.2	$ 5.4	$ 5.4
2005	**Modifications**	**Interest Rate Reestimates**	**Technical Reestimates**	**Total Reestimates**	**Total**
Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 1.1	$ (1.5)	$ (3.4)	$ (4.9)	$ (3.8)
Total	$ 1.1	$ (1.5)	$ (3.4)	$ (4.9)	$ (3.8)

	2006	2005
Total Loan Guarantee:		
Military Housing Privatization Initiative	$ (6.4)	$ 6.5
Armament Retooling & Manufacturing Support Initiative	11.8	0.0
Total	$ 5.4	$ 6.5

The total subsidy expense for guaranteed loans is $5.4 million due to interest rate reestimates and technical reestimates.

Subsidy Rates for Loan Guarantees					
As of September 30	Interest Supplements	Defaults	Fees and other Collections	Other	Total
(amounts in millions)					
Loan Guarantee Programs:					
Military Housing Privatization Initiative	0.00%	9.65%	0.00%	0.00%	9.65%
Armament Retooling & Manufacturing Support Initiative	0.00%	20.00%	0.00%	0.00%	20.00%

The subsidy rates disclosed pertain only to loan agreements contracted during the current fiscal year. These rates cannot be applied to the guarantees of loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new loans reported in the current year result from disbursements of loans from both current year loan agreements and prior year(s) loan agreements. The subsidy expense reported in the current year also includes modifications and reestimates.

Schedule for Reconciling Loan Guarantee Liability Balances for Post FY 1991 Loan Guarantees		
As of September 30	2006	2005
(amounts in millions)		
Beginning Balance of the Loan Guarantee Liability	$ 41.1	$ 34.4
Add: Subsidy Expense for Guaranteed Loans Disbursed during the Reporting Years by Component		
Default Costs (Net of Recoveries)	0.0	10.3
Total of the above Subsidy Expense Components	$ 0.0	$ 10.3
Adjustments		
Fees Received	0.0	0.1
Claim Payments to Lenders	(11.4)	0.0
Interest Accumulation on the Liability Balance	1.7	1.1
Total of the above Adjustments	$ (9.7)	$ 1.2
Ending Balance of the Loan Guarantee Liability before Reestimates	$ 31.4	$ 45.9
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimate	0.2	(1.5)
Technical/default Reestimate	5.2	(3.3)
Total of the above Reestimate Components	$ 5.4	$ (4.8)
Ending Balance of the Loan Guarantee Liability	$ 36.8	$ 41.1

Fluctuations

The Loan Guarantee Liability decreased $4.3 million (11%) primarily due to a loan default for the ARMS Initiative Program. The loan defaulted in August 1999 and was previously in litigation to determine the actual amount of debt owed. This claim of $11.4 million was paid during 2nd Quarter, FY 2006. In addition, the Department had a defaulted loan guarantee in September 2006 which increased the technical reestimate.

Administrative Expenses

Administrative Expense is limited to separately identified expenses administered to direct and guaranteed loans. The Department does not maintain a separate program to capture the expenses related to direct and guaranteed loans for the MHPI Program. Administrative expense for the ARMS Initiative Program is a fee paid to the U.S. Department of Agriculture Rural Business Cooperative Service for administering the loan guarantees under ARMS, which is a joint program.

Note 9. Inventory and Related Property

As of September 30	2006		2005	
(amounts in millions)				
Inventory, Net	$	83,861.1	$	79,699.1
Operating Materials & Supplies, Net		146,883.3		141,533.6
Stockpile Materials, Net		1,078.8		1,340.6
Total	$	231,823.2	$	222,573.3

Inventory, Net

As of September 30	2006			2005	
(amounts in millions)	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	Inventory, Net	Valuation Method
Inventory Categories					
Available and Purchased for Resale	$ 86,473.7	$ (29,798.8)	56,674.9	$ 54,451.6	LAC,MAC
Held for Repair	30,457.7	(4,108.7)	26,349.0	24,454.0	LAC,MAC
Excess, Obsolete, and Unserviceable	9,785.3	(9,785.3)	0.0	0.0	NRV
Raw Materials	43.1	0.0	43.1	25.8	MAC,SP,LAC
Work in Process	794.1	0.0	794.1	767.7	AC
Total	$ 127,553.9	$ (43,692.8)	83,861.1	$ 79,699.1	

Legend for Valuation Methods:

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

Restrictions

There are no restrictions on disposition of inventory as related to environmental liabilities or issues. Restrictions on disposition related to other liabilities include material pending litigation or negotiation with contractors or common carriers. This material is restricted from disposition until litigation or negotiation is completed. The balance of this restricted inventory as of September 30, 2006, was $89.9 million.

Generally, there are no restrictions on the use, sale, or disposition of inventory except in the following situations:

- Distributions without reimbursement are made when authorized by Department directives.
- War reserve material includes fuels and subsistence items that are considered restricted.
- Inventory, with the exception of safety stocks, may be sold to foreign, state and local governments, private parties, and contractors in accordance with the current policies and guidance or at the direction of the President.

General Composition of Inventory

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

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

The relevant cost associated with maintaining the available inventory and the time required to replenish the inventory are the criteria used in determining the assigned category.

Operating Materials and Supplies, Net

As of September 30	2006			2005	
(amounts in millions)	OM&S Gross Value	Revaluation Allowance	OM&S, Net	OM&S, Net	Valuation Method
OM&S Categories					
Held for Use	$ 130,617.2	$ (0.0)	$ 130,617.2	$ 126,300.0	SP, LAC
Held for Repair	17,624.0	(1,357.9)	16,266.1	15,233.6	SP, LAC
Excess, Obsolete, and Unserviceable	2,141.6	(2,141.6)	0.0	0.0	NRV
Total	$ 150,382.8	$ (3,499.5)	$ 146,883.3	$ 141,533.6	

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses
SP = Standard Price
AC = Actual Cost
NRV = Net Realizable Value
O = Other

Restrictions

Some munitions included in Operating Materials and Supplies (OM&S) are restricted for use. Restricted munitions are items that cannot be expected to meet performance requirements under all conditions. The restricted munitions are only used in emergency combat situations in which no other suitable munitions are immediately available.

General Composition of Operating Materials and Supplies

OM&S includes spare and repair parts, ammunition, tactical missiles, aircraft configuration pods, and centrally managed aircraft engines held for consumption. The Held for Use category includes a total of $56.9 million held for future use.

The relevant cost associated with maintaining the available operating materials and supplies, as well as the time required to replenish the operating materials and supplies, are the criteria used in determining the assigned category. There were no changes in accounting methods.

Stockpile Materials, Net					
As of September 30	2006			2005	
(amounts in millions)	Stockpile Materials Amount	Allowance for Gains (Losses)	Stockpile Materials, Net	Stockpile Materials, Net	Valuation Method
Stockpile Materials Categories					
Held for Sale	$ 984.7	$ 0.0	$ 984.7	$ 1,246.5	AC, LCM
Held in Reserve for Future Sale	94.1	0.0	94.1	94.1	AC, LCM
Total	$ 1,078.8	$ 0.0	$ 1,078.8	$ 1,340.6	
Legend for Valuation Methods:					
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses				NRV = Net Realizable Value	
SP = Standard Price				LCM = Lower of Cost or Market	
AC = Actual Cost				O = Other	

Restrictions

There are legal restrictions on the use of stockpile materials. All materials held by the National Defense Stockpile (NDS) are classified as Material Held in Reserve until congressional action declares the materials are no longer required to be stockpiled, and are available for sale on the open market. Disposals cannot be made from the stockpile except under the following situations: (1) necessary upgrading, refining, or processing, (2) necessary rotation to prevent deterioration, (3) determination as excess with potential financial loss if retained, and (4) as authorized by law.

Mercury sales were voluntarily suspended by the NDS in 1994. The suspension was in response to concerns raised by the United States Environmental Protection Agency regarding the accumulation of mercury in the global environment. An Environmental Impact Statement was issued and storage consolidation at Hawthorne, Nevada, was the selected alternative.

Additional restrictions on the use of materiel are being proposed in the Requirements Report to Congress for beryllium metal, mica block, and quartz.

General Composition of Stockpile Materials

Stockpile materials are strategic and critical materials held due to statutory requirements for use in national defense, conservation, or national emergencies.

The Annual Materials Plan lists the maximum quantity of each commodity that may be sold by the Department in a given fiscal year. Before any materials may be sold, Congress must enact specific enabling legislation (e.g., the National Defense Authorization Act). When NDS receives authorization to offer materials for sale, NDS removes the materials from Material Held in Reserve and reclassifies them as Materials Held for Sale. The estimated market price of the stockpile materials held for sale is $1.5 billion.

Note 10. General PP&E, Net

As of September 30	2006					2005 Restated
(amounts in millions)	Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value	Prior FY Net Book Value
Land	N/A	N/A	$ 10,533.4	$ N/A	$ 10,533.4	$ 10,479.4
Buildings, Structures, and Facilities	S/L	20 or 40	167,909.7	(98,454.5)	69,455.2	68,551.3
Leasehold Improvements	S/L	lease term	328.5	(161.3)	167.2	176.5
Software	S/L	2-5 or 10	8,669.4	(5,278.4)	3,391.0	3,484.3
General Equipment	S/L	5 or 10	59,784.4	(43,066.3)	16,718.1	16,582.2
Military Equipment	S/L	various	640,461.6	(295,516.6)	344,945.0	332,651.9
Assets Under Capital Lease	S/L	lease term	627.8	(478.1)	149.7	185.0
Construction-in- Progress	N/A	N/A	20,019.5	N/A	20,019.5	20,304.3
Other			61.6	(1.2)	60.4	126.5
Total General PP&E			$ 908,395.9	$ (442,956.4)	$ 465,439.5	$ 452,541.4
Legend for Valuation Methods:						
S/L = Straight Line			N/A = Not Applicable			

Military Equipment

The Department changed its method of valuing military equipment in 3rd Quarter, FY 2006. Previously, military equipment was valued using Bureau of Economic Analysis (BEA) data. Beginning with the 3rd Quarter, FY 2006, military equipment value was based on internal records. For comparative purposes, the value of military equipment for the 4th Quarter, FY 2005, was restated from $340.8 billion to $332.7 billion, using the new valuation method.

For 4th Quarter, FY 2006, military equipment is valued at $344.9 billion based on internal records. Under the previously used BEA valuation methodology, this equipment would have been valued at $349 billion.

Heritage Assets and Stewardship Land

The Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Standards 29, "Heritage Assets and Stewardship Land," requires note disclosures for heritage assets and stewardship land. The Department is committed to preserving and accounting for its heritage assets' historical, cultural, educational, or artistic importance. Additionally, the Department has stewardship land not acquired in connection with General Property, Plant and Equipment (PP&E), such as land donated to the federal government and land previously recorded as public domain.

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

Other

The Department has restrictions on disposal of real property (lands and buildings) located outside the continental United States. The Department has the use of land, buildings, and other overseas facilities that are obtained through various international treaties and agreements negotiated by the Department of State.

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

Assets Under Capital Lease		
As of September 30	2006	2005
(amounts in millions)		
Entity as Lessee, Assets Under Capital Lease		
Land and Buildings	$ 619.6	$ 619.6
Equipment	8.2	10.9
Accumulated Amortization	(478.1)	(445.5)
Total Capital Leases	$ 149.7	$ 185.0

Assets Under Capital Lease consist primarily of leases for the Section 801 Family Housing Program.

Note 11. Liabilities Not Covered by Budgetary Resources

As of September 30	2006	2005
(amounts in millions)		
Intragovernmental Liabilities		
Accounts Payable	$ 1.0	$ 0.0
Debt	13.6	14.3
Other	7,754.1	7,619.4
Total Intragovernmental Liabilities	7,768.7	7,633.7
Nonfederal Liabilities		
Accounts Payable	371.9	425.4
Military Retirement and Other Federal Employment Benefits	1,524,140.2	1,483,425.0
Environmental Liabilities	65,343.7	62,239.1
Other Liabilities	14,664.4	14,014.3
Total Nonfederal Liabilities	1,604,520.2	1,560,103.8
Total Liabilities Not Covered by Budgetary Resources	1,612,288.9	1,567,737.5
Total Liabilities Covered by Budgetary Resources	347,143.6	305,625.7
Total Liabilities	$ 1,959,432.5	$ 1,873,363.2

Liabilities Not Covered by Budgetary Resources are those liabilities which are not legally obligated with realized budgetary resources as of the Balance Sheet date.

Intragovernmental Liabilities Other are primarily comprised of $5.9 billion in custodial liabilities and $1.4 billion in unfunded Employment Compensation Act liabilities.

Nonfederal Other Liabilities are comprised mainly of $9.3 billion in unfunded annual leave liabilities, $2.1 billion in nonenvironmental disposal contingent liabilities, $1.3 billion in contingent liabilities, and $1.2 billion in custodial liabilities.

Note 12. Accounts Payable

As of September 30	2006			2005
(amounts in millions)	Accounts Payable	Interest, Penalties, and Administrative Fees	Total	Total
Intragovernmental Payables	$ 1,549.8	$ N/A	$ 1,549.8	$ 2,058.0
Nonfederal Payables (to the Public)	27,318.9	2.0	27,320.9	28,575.4
Total	$ 28,868.7	$ 2.0	$ 28,870.7	$ 30,633.4

Intragovernmental accounts payable decreased $508.2 million (25%). The majority of the decrease is due to an overstatement of $452.3 million in intragovernmental accounts payable with the General Services Administration, Department of Transportation, and National Aeronautics and Space Administration that occurred during 4th Quarter, FY 2005. The Department is involved in ongoing reconciliation efforts with its major trading partners resulting in information that is more accurate and therefore reducing the reliance on the use of estimates.

Note 13. Debt

As of September 30	2006			2005	
(amounts in millions)	Beginning Balance	Net Borrowing	Ending Balance	Net Borrowing	Ending Balance
Agency Debt (Intragovernmental)					
Debt to the Treasury	$ 85.6	$ 123.3	$ 208.9	$ 0.1	$ 85.6
Debt to the Federal Financing Bank	381.5	(208.3)	173.2	(124.8)	381.5
Total Agency Debt	$ 467.1	$ (85.0)	$ 382.1	$ (124.7)	$ 467.1
Total Debt	$ 467.1	$ (85.0)	$ 382.1	$ (124.7)	$ 467.1

The outstanding debt consists of interest and principal payments due to the U.S. Treasury and the Federal Financing Bank (FFB).

Fluctuations

Debt to the Treasury

The $123.3 million (144%) increase consists primarily of a $112.5 million increase in direct loan borrowings for the Military Housing Privatization Initiative in FY 2006. In addition, $11.4 million of the increase is borrowing in 2nd Quarter, FY 2006 for a loan default relating to the Armament Retooling and Manufacturing Support Initiative. See Note 8 for further disclosures on both programs. This increase is offset by $0.6 million of principal repayments throughout FY 2006 for capital improvements to the Washington Aqueduct.

Debt to the Federal Financing Bank

Outstanding debt decreased $208.3 million (55%) as a result of the reduction in Maritime Prepositioning Ship loans. As part of the Afloat Prepositioning Force program, the Department makes loan repayments to the FFB on behalf of ship owners in lieu of capital lease payments to ship owners.

Note 14. Environmental Liabilities and Disposal Liabilities

As of September 30	2006			2005
(amounts in millions)	Current Liability	Noncurrent Liability	Total	Total
Environmental Liabilities--Nonfederal				
Accrued Environmental Restoration Liabilities				
Active Installations—Installation Restoration Program (IRP) and Building Demolition and Debris Removal (BD/DR)	$ 1,137.7	$ 7,947.1	$ 9,084.8	$ 10,123.9
Active Installations—Military Munitions Response Program (MMRP)	89.5	5,307.0	5,396.5	7,082.0
Formerly Used Defense Sites—IRP and BD/DR	158.1	4,011.4	4,169.5	4,227.5
Formerly Used Defense Sites--MMRP	86.7	14,710.6	14,797.3	14,584.0
Other Accrued Environmental Liabilities—Active Installations				
Environmental Corrective Action	44.4	683.0	727.4	623.2
Environmental Closure Requirements	8.3	401.1	409.4	176.5
Environmental Response at Operational Ranges	6.5	298.5	305.0	304.1
Other	10.8	770.6	781.4	561.5
Base Realignment and Closure (BRAC)				
Installation Restoration Program	260.8	2,621.7	2,882.5	2,849.2
Military Munitions Response Program	21.8	891.4	913.2	699.3
Environmental Corrective Action/Closure Requirements	30.0	151.2	181.2	206.5
Other	149.2	0.0	149.2	342.9
Environmental Disposal for Weapons Systems Programs				
Nuclear Powered Aircraft Carriers	0.0	5,604.3	5,604.3	6,426.1
Nuclear Powered Submarines	0.0	3,377.7	3,377.7	5,837.2
Other Nuclear Powered Ships	0.0	277.2	277.2	223.9
Other National Defense Weapons Systems	0.0	233.8	233.8	197.8
Chemical Weapons Disposal Program	2,461.0	14,996.3	17,457.3	10,450.0
Other	0.0	3,237.4	3,237.4	112.0
Total Environmental Liabilities	$ 4,464.8	$ 65,520.3	$ 69,985.1	$ 65,027.6

Service Component – Environmental Restoration (Cleanup) Liabilities and Environmental Disposal Liabilities					
(Amounts in millions)	Army	Navy	Air Force	ODO	Total
Environmental Liabilities-Nonfederal					
Accrued Environmental Restoration Liabilities:					
Active Installations--Installation Restoration Program(IRP) and Building Demolition and Debris Removal (BD/DR)	$ 2,919.2	$ 2,329.2	$ 3,638.6	$ 197.8	$ 9,084.8
Active Installations--Military Munitions Response Program (MMRP)	3,317.8	685.0	1,393.7	0.0	5,396.5
Formerly Used Defense Sites--IRP and BD/DR	4,169.5	0.0	0.0	0.0	4,169.5
Formerly Used Defense Sites--MMRP	14,797.3	0.0	0.0	0.0	14,797.3
Other Accrued Environmental Liabilities--Active Installations					
Environmental Corrective Action	372.0	40.6	136.9	177.9	727.4
Environmental Closure Requirements	96.9	185.8	99.5	27.2	409.4
Environmental Response at Operational Ranges	304.1	0.0	0.0	0.9	305.0
Other	689.0	0.0	0.0	92.4	781.4
Base Realignment and Closure (BRAC)					
Installation Restoration Program	523.7	1,117.1	1,204.9	36.8	2,882.5
Military Munitions Response Program	800.4	112.8	0.0	0.0	913.2
Environmental Corrective Action/Closure Requirements	32.3	67.5	81.4	0.0	181.2
Other	149.2	0.0	0.0	0.0	149.2
Environmental Disposal for Weapons Systems Programs					
Nuclear Powered Aircraft Carriers	0.0	5,604.3	0.0	0.0	5,604.3
Nuclear Powered Submarines	0.0	3,377.7	0.0	0.0	3,377.7
Other Nuclear Powered Ships	0.0	277.2	0.0	0.0	277.2
Other National Defense Weapons Systems	0.0	233.8	0.0	0.0	233.8
Chemical Weapons Disposal Program	17,457.3	0.0	0.0	0.0	17,457.3
Other	0.0	3,237.4	0.0	0.0	3,237.4
Total Nonfederal Environmental Liabilities:	$ 45,628.7	$ 17,268.4	$ 6,555.0	$ 533.0	$69,985.1

Others Category Disclosure Comparative Table		
As of September 30	2006	2005
(amounts in millions)		
Other Accrued Environmental Liabilities-Active Installations-Other		
U.S. Army Corps of Engineers Pollution Control & Abatement	$653.4	$529.6
Army Low Level Radioactive Waste Program	$35.8	$0.0
National Defense Stockpile (NDS) Transaction	$52.2	$0.0
Defense Commissary Agency	$29.0	$31.9
TRICARE Management Activity Uniformed Services University of Health Sciences - Operation and Maintenance	$11.0	$0.0
Total	$781.4	$561.5
Base Realignment and Closure (BRAC)-Other		
Army cleanup contracts at BRAC installations	$149.2	$112.1
Air Force contractual support for environmental program management at BRAC installations.	$0.0	$230.8
Total	$149.2	$342.9
Environmental Disposal for Weapons Systems Programs-Other		
Navy Spent Nuclear Fuel	$3,237.4	$0.0
NDS - Other Defense Organizations (ODO)	$0.0	$54.2
ODO's Environmental Disposal unliquidated obligations that cannot be identified to a specific program/project.	$0.0	$57.8
Total	$3,237.4	$112.0

Environmental Disclosures		
As of September 30	2006	2005
(amounts in millions)		
A. Amount of operating and capital expenditures used to remediate legacy waste. Legacy wastes are the remediation efforts covered by IRP, MMRP, and BD/DR regardless of funding source.	924.6	730.8
B. The unrecognized portion of the estimated total cleanup costs associated with general property, plant, and equipment.	1,527.4	152.1
C. The estimated cleanup costs associated with general property, plant, and equipment placed into service during each fiscal year.	0.0	0.0
D. Changes in total cleanup costs due to changes in laws, regulations, and/or technology.	(44.9)	0.0
E. Portion of the changes in estimated costs due to changes in laws and technology that is related to prior periods.	0.0	0.0

Fluctuations

Environmental Disclosures – Line A represents the amount of operating and capital expenditures used to remediate legacy waste. The amount on Line A increased $193.8 million (27%) from FY 2005. This increase is primarily due to increases in land sales and BRAC activity which led to a greater amount of environmental corrective actions and environmental restoration cleanup. The Department is working to more accurately disclose the amount of operating and capital resources disbursed to remediate legacy waste. As these processes are being developed, fluctuations due to updated information will occur.

Environmental Disclosures – Line B represents the unrecognized costs associated with General Property, Plant, and Equipment (PP&E). The amount on Line B increased approximately $1.4 billion from FY 2005, which is attributed to costs that were recognized in 3rd Quarter, FY 2006 for nuclear aircraft carriers and submarines, and conventional ships. The Department is working to more accurately disclose the unrecognized portion of the estimated cleanup costs associated with General PP&E. As these processes are being developed, fluctuations due to updated information will occur.

Environmental Disclosures – Line C represents the estimated cleanup costs associated with general property, plant, and equipment placed into service during the fiscal year. The Department is unable to report this cost due to system and internal control weaknesses. The Department is working to more accurately disclose estimates for cleanup cost in FY 2007.

Environmental Disclosures – Line D represents the amount of changes in total cleanup costs due to changes in laws, regulations, and/or technology. The decrease of $44.9 million represents an additional improvement in the method used to report this information for the Defense Environmental Restoration Program liability. This improvement is the result of an automated process used to track and report FY 2006 information, whereas the FY 2005 information was based on a manual process. The Department is working to specifically identify the causes for changes in estimated liabilities and to more accurately disclose estimates for costs due to changes in laws and technology.

Environmental Disclosures – Line E represents the portion of changes in estimated costs due to changes in laws and technology that is related to prior periods. The Department is unable to report this amount due to system and internal control weaknesses. The Department is working to more accurately disclose the amount of change in estimates for cost due to changes in laws and technology relating to prior periods in FY 2007.

Other Disclosures

Applicable Laws and Regulations for Cleanup Requirements

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

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

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

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

Methods for Assigning Total Cleanup Costs to Current Operating Periods

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

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

For General PP&E placed into service after September 30, 1997, the Department expenses the associated environmental costs systematically over the life of the asset. The Department expenses the full cost to clean up contamination for Stewardship PP&E at the time the asset is placed into service.

The Department uses two methods for systematic recognition: physical capacity for operating landfills, and life expectancy in years for all other assets.

Types of Environmental Liabilities and Disposal Liabilities Identified

The Department has clean-up requirements for the DERP sites at active installations, BRAC installations, Formerly Used Defense Sites, sites at active installations that are not covered by the DERP, weapon systems programs, and chemical weapons disposal programs. The weapons systems program consists of chemical weapons disposal, nuclear-powered aircraft carriers, nuclear-powered submarines, and other nuclear ships.

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

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

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

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

The Department is uncertain regarding the extent of the liabilities at installations that are realigning or closing as a result of BRAC requirements. The Department is in the process of determining the extent of environmental liabilities at the BRAC installations, in particular those liabilities associated with unexploded ordnance on training ranges.

In addition to the liabilities reported above, the Department has the potential to incur costs for restoration initiatives in conjunction with returning overseas Defense facilities to host nations. The Department is unable to provide a reasonable estimate at this time because the extent of restoration required is not known.

The Army has a liability to take environmental restoration/corrective action for buried chemical munitions, and agents. The Army is unable to provide a reasonable estimate at this time, because the extent of the buried chemical munitions and agents is not known.

The Navy is currently surveying installations to identify the inventory of operational assets that may impact environmental liabilities. The Navy anticipates completing their survey and recording the impact on the environmental liability for the FY 2007 financial statements.

The U.S. Army Corps of Engineers is unable to provide a complete estimate for the Formerly Utilized Sites Remedial Action Program. The U.S. Army Corps of Engineers has studies on-going and will update its liabilities as it identifies additional liabilities.

Note 15. Other Liabilities

As of September 30	2006			2005
(amounts in millions)	Current Liability	Noncurrent Liability	Total	Total
Intragovernmental				
Advances from Others	$ 448.8	$ 0.0	$ 448.8	$ 394.6
Deposit Funds and Suspense Account Liabilities	2,009.3	0.0	2,009.3	742.1
Disbursing Officer Cash	2,273.2	0.0	2,273.2	2,092.0
Judgment Fund Liabilities	164.2	0.0	164.2	162.6
FECA Reimbursement to the Department of Labor	555.5	849.1	1,404.6	1,395.4
Other Liabilities	4,863.6	1,658.5	6,522.1	6,364.1
Total Intragovernmental Other Liabilities	10,314.6	2,507.6	12,822.2	11,150.8
Nonfederal				
Accrued Funded Payroll and Benefits	4,497.9	0.0	4,497.9	7,382.8
Advances from Others	2,074.3	0.0	2,074.3	1,697.5
Deferred Credits	0.0	0.0	0.0	11.8
Deposit Funds and Suspense Accounts	205.5	0.0	205.5	413.9
Temporary Early Retirement Authority	0.1	0.0	0.1	0.7
Nonenvironmental Disposal Liabilities				
(1) Military Equipment (Nonnuclear)	0.0	285.2	285.2	683.5
(2) Excess/Obsolete Structures	59.4	626.2	685.6	235.9
(3) Conventional Munitions Disposal	0.0	1,217.8	1,217.8	1,318.4
Accrued Unfunded Annual Leave	9,403.9	0.0	9,403.9	8,566.1
Capital Lease Liability	16.7	209.4	226.1	317.2
Other Liabilities	9,613.4	3,356.3	12,969.7	9,357.6
Total Nonfederal Other Liabilities	25,871.2	5,694.9	31,566.1	29,985.4
Total Other Liabilities	$ 36,185.8	$ 8,202.5	$ 44,388.3	$ 41,136.2

Fluctuations

Total Intragovernmental Other Liabilities increased approximately $1.7 billion (15%), primarily due to a $1.3 billion increase in Deposit Funds and Suspense Account Liabilities. This increase is attributable to timing differences in the amount of $490.3 million in the disbursement of payroll tax and Federal Insurance Contributions

Act withholdings in the 4th Quarter FY 2006. In 4th Quarter, FY 2005, the disbursement for these withholdings occurred in September 2005. In 4th Quarter, FY 2006, the disbursement did not occur until 1st Quarter, FY 2007. In addition, the Department processed collections from various contractors for the settlement of negotiations for contract nonperformance, resulting in a $480.9 million increase. The Department also implemented the Defense Finance and Accounting Service Transaction Interface Module - Intragovernmental Payment and Collection (DTIM-IPAC) in 3rd Quarter, FY 2006. The DTIM-IPAC greatly reduced disbursements that remained in suspense, thereby increasing Deposit Fund and Suspense Account Liabilities by $131.6 million.

Other Disclosures

Intragovernmental Other Liabilities are comprised primarily of custodial liabilities from accounts receivable for cancelled appropriations and interest, penalties, fines, and administrative fees from the public. The amounts collected cannot be used by the Department and must be distributed to the Treasury.

Nonfederal Other Liabilities primarily consist of contingent liabilities and other accrued liabilities for contractual services.

The Department has delinquent Federal Employment Compensation Act bills for 4th Quarter, FY 2006, totaling $9.7 thousand. The National Defense University owes the majority of the delinquency. The bill is expected to be paid during 1st Quarter, FY 2007.

Contingent Liabilities balance includes $3.3 billion in estimated future contract financing payments that will be paid to the contractor upon delivery and government acceptance of a satisfactory product. In accordance with contract terms, specific rights to the contractor's work vests with the government when a specific type of contract financing payment is made, thereby protecting taxpayer funds in the event of contract nonperformance. These rights should not be misconstrued as the rights of ownership. The Department is under no obligation to pay the contractor for amounts greater than the amounts authorized in the contract until delivery and government acceptance of a satisfactory product. Because it is probable that the contractor will complete its efforts and deliver a satisfactory product to the Department and the amount of potential future payments are estimable, the Department has recognized a contingent liability for estimated future payments, which are conditional pending delivery and government acceptance of a satisfactory product.

Capital Lease Liability					
As of September 30	2006				2005
	Asset Category				
(amounts in millions)	Land and Buildings	Equipment	Other	Total	Total
Future Payments Due					
2006	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 64.0
2007	57.9	5.1	0.0	63.0	59.0
2008	47.1	0.2	0.0	47.3	51.1
2009	43.9	0.1	0.0	44.0	44.0
2010	43.9	0.0	0.0	43.9	43.9
2011	36.8	0.0	0.0	36.8	0.0
After 5 Years	52.0	0.0	0.0	52.0	137.6
Total Future Lease Payments Due	281.6	5.4	0.0	287.0	399.6
Less: Imputed Interest Executory Costs	60.8	0.1	0.0	60.9	82.4
Net Capital Lease Liability	$ 220.8	$ 5.3	$ 0.0	$ 226.1	$ 317.2
Capital Lease Liabilities Covered by Budgetary Resources				181.2	74.1
Capital Lease Liabilities Not Covered by Budgetary Resources				$ 44.9	$ 243.1

All leases entered into prior to FY 1992 are funded on an annual basis and subject to the availability of funds. Noncurrent amounts for these leases are shown as not covered by budgetary resources.

Leases originating after FY 1992 are required to be fully funded in the year of their inception. Therefore, budgetary resources show the present value of those lease payments as covered by budgetary resources.

Note 16. Commitments and Contingencies

Legal Contingencies

The Department is a party in various administrative proceedings and legal actions, with claims including environmental damage claims, equal opportunity matters, and contractual bid protests. The Department has accrued contingent liabilities for legal actions where the Department's Office of the General Counsel considers an adverse decision probable and the amount of loss is measurable. In the event of an adverse judgment against the government, some of the liabilities may be payable from the Judgment Fund. The Department records Judgment Fund liabilities in Note 12, "Accounts Payable" and Note 15, "Other Liabilities." See Notes 12 and 15 for details.

The Department's Office of General Counsel reported 65 legal actions with individual claims greater than the FY 2006 Department-wide materiality threshold of $107.6 million. Management determined that claims totaling approximately $484 billion had a remote probability of an adverse decision against the Department.

Other Commitments and Contingencies

The Department also had a number of potential claims that individually do not meet the FY 2006 Department-wide materiality threshold of $107.6 million, but do meet individual DoD Component materiality thresholds. These claims are disclosed in the Components' financial statements.

The undelivered orders for open (unfilled or unreconciled) contracts citing cancelled appropriations, for which the Department may incur a contractual commitment for payment, are $1.5 billion.

Note 17. Military Retirement and Other Federal Employment Benefits

As of September 30	2006				2005
(amounts in millions)	Present Value of Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liability	Present Value of Benefits
Pension and Health Actuarial Benefits					
Military Retirement Pensions	$ 963,696.1	6.0	$ (202,031.9)	$ 761,664.2	$ 892,111.6
Military Retirement Health Benefits	299,203.8	6.25	0.0	299,203.8	296,473.2
Military Medicare-Eligible Retiree Benefits	538,032.5	6.25	(84,268.7)	453,763.8	537,397.0
Total Pension and Health Actuarial Benefits	1,800,932.4		(286,300.6)	1,514,631.8	1,725,981.8
Other Actuarial Benefits					
FECA	6,856.0	5.17	0.0	6,856.0	6,918.9
Voluntary Separation Incentive Programs	1,391.2	4.0	(656.4)	734.8	1,495.7
Department Education Benefits Fund	1,785.3	5.2	(1,241.8)	543.5	1,661.4
Total Other Actuarial Benefits	10,032.5		(1,898.2)	8,134.3	10,076.0
Other Federal Employment Benefits	4,804.6		(3,430.5)	1,374.1	0.0
Total Military Retirement and Other Federal Employment Benefits:	$ 1,815,769.5		$ (291,629.3)	$ 1,524,140.2	$ 1,736,057.8

Actuarial Cost Method Used: Aggregate entry-age normal method
Assumptions: See below
Market Value of Investments in Market-based and Marketable Securities: $287.7 billion

Fluctuations

The present value of Military Retirement and Other Federal Employment Benefits increased $79.7 billion (5%) and is primarily attributable to an increase of $71.6 billion (8%) in the actuarial liability for Military Retirement Pensions. Other Federal Employment Benefits due and payable are included for FY 2006 and contributed another $4.8 billion to the increase. In prior years, these liabilities were reported in Note 15, "Other Liabilities."

Military Retirement Pensions

The $71.6 billion increase in the actuarial liability for Military Pensions is largely the result of a decrease in the assumed interest rate on invested balances, and thus a decrease in the associated assumed earnings of $32.8 billion and an increase in the actuarial liability. The majority of the remaining change is due to expected liability increases.

The Military Retirement Fund is a single-employer, defined benefit plan. Administrative costs of the Fund are not ascertainable. Projected revenues into the Fund, authorized by Public Law 98-94, come from three sources: interest earnings on Fund assets, monthly Department contributions, and annual contributions from the Treasury. The monthly Department contributions are determined as a percentage (approved by the Department's Retirement Board of Actuaries) of basic pay. The contribution from Treasury is paid into the Fund at the beginning of each fiscal year, and represents the amortization of the unfunded liability for service performed prior to October 1, 1984, as well as the amortization of actuarial gains and losses that have arisen since then. Effective FY 2005, Treasury began making an annual contribution to the Fund that represents the normal cost amount for the concurrent receipt provisions of the FY 2004 National Defense Authorization Act. The Board of Actuaries determines the Treasury's contribution, and the Secretary of Defense directs the Secretary of the Treasury to make the payment.

The long-term economic assumptions for each valuation are set by the Department's Retirement Board of Actuaries. The long-term assumptions for the FY 2005 valuation were 6.25 percent interest, 3.0 percent Consumer Price Index, and 3.75 percent salary increase. The long-term economic assumption for interest was lowered to 6.00 percent by the Board at its August 2006 meeting. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year valuation results as reported in the Department's Office of Actuary Valuation of the Military Retirement System. For purposes of the Fund's financial reporting, this process is applied annually. In calculating the FY 2006 roll-forward amount, the following assumptions were used:

	Inflation	*Salary*	*Interest*
Fiscal Year 2006	4.1% (actual)	3.1% (actual)	6.0%
Fiscal Year 2007	3.0% (estimated)	2.7% (estimated)	6.0%
Long-Term	3.0%	3.75%	6.0%

Change in MRF Actuarial Liability	*(Amounts in billions)*
Actuarial Liability as of 9/30/05	$892.1
Expected Normal Cost for FY 2006	15.5
Plan Amendment Liability	0.1
Assumption Change Liability	35.3
Expected Benefit Payments for FY 2006	(40.5)
Interest Cost for FY 2006	55.0
Actuarial (gains)/losses due to changes in trend assumptions	6.1
Actuarial Liability as of 09/30/06	$963.7
Change in Actuarial Liability	**$71.6**

Actuarial Cost Method Used: Aggregate entry-age normal method.
Market Value of Investments in Market-Based and Marketable Securities: $202.9 billion

Military Retirement Health Benefits (MRHB)

The MRHB are post-retirement benefits the Department provides to non-Medicare-eligible military retirees and other eligible beneficiaries who are not Medicare-eligible, through private sector health care providers and Department Medical Treatment Facilities.

Change in MRHB Actuarial Liability	*(Amounts in billions)*
Actuarial Liability as of 09/30/05	
(Department pre-Medicare + all Uniformed Services Medicare cost-basis effect)	$296.5
Expected Normal Cost for FY 2006	10.0
Expected Benefit Payments for FY 2006	(9.3)
Interest Cost for FY 2006	18.9
Actuarial (gains)/losses due to other factors	39.4
Actuarial (gains)/losses due to changes in trend assumptions	(56.3)
Actuarial Liability as of 09/30/06	
(Pre-Medicare + all Uniformed Services Medicare cost-basis effect)	$299.2
Change in Actuarial Liability	**$ 2.7**

Actuarial Cost Method Used: Aggregate Entry-Age Normal
Assumed Interest Rate: 6.25%

Medical Trend	FY 2005 – FY 2006	Ultimate Rate 2030
Medicare Inpatient	5.62%	6.25%
Medicare Outpatient	7.83%	6.25%
Medicare Prescriptions (Direct Care)	8.13%	6.25%
Medicare Prescriptions (Purchased Care)	11.22%	6.25%
Non-Medicare Inpatient (Direct Care)	7.50%	6.25%
Non-Medicare Outpatient (Direct Care)	4.00%	6.25%
Non-Medicare Prescriptions (Direct Care)	7.00%	6.25%
Non-Medicare Inpatient (Purchased Care)	10.40%	6.25%
Non-Medicare Outpatient (Purchased Care)	7.40%	6.25%
Non-Medicare Prescriptions (Purchased Care)	12.11%	6.25%

Other Information

The MRHB liability represents Department pre-Medicare liabilities for direct care and purchase care benefits, plus the direct-care cost-basis effect for Medicare liabilities for all Uniformed Services. The cost-basis effect is approximately $28 billion as of September 30, 2006, and arises because liabilities for direct care in the total retiree health liability are valued at a higher cost basis than they are in the Medicare-Eligible Retiree Health Care Fund (MERHCF) liability. The $299.2 billion liability includes $600 million for the Coast Guard, $69.8 million for the Public Health Service, and $4.6 million for the National Oceanic and Atmospheric Administration (NOAA).

The actuarial liability reported above does not include $1.4 billion in incurred but not reported liabilities as of September 30, 2006. These liabilities are reflected in Other Federal Employment Benefits in the table above.

Military Medicare-Eligible Retiree Benefits

Public Law 106-398 authorized the establishment of the MERHCF for the purpose of accumulating funds to finance the health care program liabilities of Medicare-eligible retirees for all the Uniformed Services and specific Medicare-eligible beneficiaries. The Fund began operations on October 1, 2002. Projected revenues into the MERHCF, authorized by Chapter 56 of Title 10, United States Code, come from three sources: interest earnings on Fund assets, annual Uniformed Services "normal cost" contributions, and annual contributions from the Treasury. Prior to October 1, 2005, the normal cost contributions by the Services were paid monthly at per capita amount (approved by the Department MERHCF Board of Actuaries) times actual end strength. Beginning in FY 2006, the normal cost is paid annually at the beginning of the fiscal year by the Treasury, from amounts appropriated to the Military Services, and is calculated at the approved rate times the budgeted force strengths. The contribution from Treasury is also paid into the Fund at the beginning of each fiscal year and represents the amortization of the unfunded liability for services performed prior to October 1, 2002, as well as the amortization of actuarial gains and losses that have arisen since then. The Board determines Treasury's contribution, and the Secretary of Defense directs the Secretary of the Treasury to make the payment.

Assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Claims cost assumptions for direct care were based on actual experience. Assumptions for purchased care were developed from industry-based cost estimates adjusted to approximate the military retired population. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year's results. For purposes of the Fund's financial reporting, this process is applied annually. In calculating the FY 2006 roll-forward amount, the following medical trend assumptions were used:

Medical Trend	FY 2005 – FY 2006	Ultimate Rate 2030
Medicare Inpatient	5.62%	6.25%
Medicare Outpatient	7.83%	6.25%
Medicare Prescriptions (Direct Care)	8.13%	6.25%
Medicare Prescriptions (Purchased Care)	11.22%	6.25%

Changes in MERHCF Actuarial Liability	*(Amounts in billions)*
Actuarial Liability as of 09/30/05 (all Uniformed Services Medicare)	$537.4
Expected Normal Cost for FY 2006	11.0
Expected Benefit Payments for FY 2006	(7.5)
Interest Cost for FY 2006	34.0
Actuarial (gains)/losses due to other factors	42.1
Actuarial (gains)/losses due to changes in trend assumptions	(79.1)
Actuarial Liability as of 09/30/06 (all Uniformed Services Medicare)	$538.0
Change in Actuarial Liability	**$0.6**

Actuarial Cost Method Used for MERHCF Liability: Aggregate Entry-Age Normal
Market Value of Investments in Market-Based and Marketable Securities: $83.0 billion
Assumed Interest Rate: 6.25%

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The $538.0 billion liability includes $526.3 billion for the Department, $10.5 billion for the Coast Guard, $1.1 billion for the Public Health Service, and $100 million for NOAA. FY 2006 contributions from each of the services were: $10.8 billion by the Department, $300 million by the Coast Guard, $34.5 million by the Public Health Service, and $1.6 million by NOAA.

The actuarial liability reported above does not include $604.7 million in incurred but not reported liabilities as of September 30, 2006. These liabilities are included in Note 11 "Liabilities Not Covered and Covered by Budgetary Resources" and Note 15 "Other Liabilities".

Federal Employees Compensation Act (FECA)

Assumptions

The liability for future workers' compensation benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The liability is determined using a method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Consistent with past practice, these projected annual benefit payments have been discounted to present value using the Office of Management and Budget's economic assumptions for 10-year Treasury notes and bonds. A 5.17 percent interest rate was assumed in year 1 and 5.31 percent was assumed in year 2 and thereafter.

To provide more specifically for the effects of inflation on the liability for future workers' compensation benefits, wage inflation factors (cost of living adjustments or COLAs) and medical inflation factors (consumer price index medical or CPIMs) were applied to the calculation of projected future benefits. The actual rates for these factors for charge back year (CBY) 2006 were also used to adjust the methodology's historical payments to current year constant dollars.

The compensation COLAs and CPIMs used in the projections for various charge back years were as follows:

CBY	COLA	CPIM
2006	3.50%	4.00%
2007	3.13%	4.01%
2008	2.40%	4.01%
2009	2.40%	4.01%
2010	2.43%	4.09%

The model's resulting projections were analyzed to ensure that the estimates were reliable. The analysis was based on four tests: (1) a sensitivity analysis of the model of economic assumptions, (2) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual payments, (3) a comparison of the incremental paid losses (the medical component in particular) in CBY 2006 (by injury cohort) to the average pattern observed during the prior three charge back years, and (4) a comparison of the ratio of the estimated liability to the actual payment of the beginning year calculated for the current projection to the liability-payment ratio calculated for the prior projection.

Voluntary Separation Incentive Programs (VSI)

Assumptions

The VSI program was established by Public Law 102-190. The intent of this program is to reduce the number of military personnel on active duty. This plan was offered to personnel with a minimum of six years of service who did not qualify for retirement. The incentive payments are spread over a period equivalent to twice the years of active service. The annual payment is based on 2.5% of the person's annual basic pay at the time they departed service multiplied by the number of years of service. The September 30, 2006, VSI Actuarial Present Value of Projected Plan Benefits (Actuarial Liability) was calculated at an assumed annual interest rate of 4%. Since the VSI program is no longer offered, each year the Actuarial Liability is expected to decrease with benefit outlays, and increase with interest cost. The present value of plan benefits actuarial liability for the VSI fund is $1.4 billion as of September 30, 2006. The liability was calculated, as in prior years, at the present value of all remaining payments as of September 30, 2006.

Market Value of Investments in Market-based and Marketable Securities: $615 million.

Department Education Benefits Fund (EBF)

The present value of plan benefits actuarial liability for the EBF is $1.8 billion as of September 30, 2006.

Assumptions

The EBF was established by Public Law 98-525. The program is designed to accumulate funds for the Educational Assistance program, to promote the recruitment and retention of members for the All-Volunteer Forces program and the Total Force Concept of the Armed Forces, and aid in the readjustment of members of the Armed Forces to civilian life after separation from military service.

Market Value of Investments in Market-based and Marketable Securities: $1.2 billion

Other Federal Employment Benefits

The format of this note was changed in FY 2006 to include Other Federal Employment Benefits, such as pension and other post-employment benefits due and payable, which were previously included in Note 15.

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

Intragovernmental Costs and Exchange Revenue		
As of September 30	2006	2005
(amounts in millions)		
Intragovernmental Costs	$ 31,748.6	$ 24,510.0
Public Costs	597,987.8	655,576.6
Total Costs	629,736.4	680,086.6
Intragovernmental Earned Revenue	(24,293.6)	(18,264.1)
Public Earned Revenue	(24,056.7)	(26,943.0)
Total Earned Revenue	(48,350.3)	(45,207.1)
Net Cost of Operations	$ 581,386.1	$ 634,879.5

Fluctuations

Total Costs decreased $50.4 billion (7%). This decrease was primarily due to a $33.1 billion reduction as the result of actuarial assumption changes for drug and other costs and a $57.5 billion reduction primarily due to costs incurred in FY 2005 and not in FY 2006 for a one-time actuarial adjustment in recognition of increasing numbers of retirees taking full advantage of their health care benefits. The decrease was partially offset by $27.3 billion in increased expenses in support of the Global War on Terror, hurricane relief in the Gulf of Mexico, and increased depreciation expense on military equipment.

Other Disclosures

The Department recorded a prior-period adjustment due to a change in the methodology for reporting military equipment. The FY 2005 restatement impacts the value of general property, plant, and equipment and associated accumulated depreciation reported on the Balance Sheet. The Department has determined that developing the prior year value for the depreciation expense is cost-prohibitive, and thus has elected not to restate the Statement of Net Cost (SNC).

The SNC is unique because its principles are driven on understanding the net cost of programs and/or organizations that the Federal Government supports through appropriations or other means. This statement provides gross and net cost information that can be related to the amount of output or outcome for a given program and/or organization administered by a responsible reporting entity. Intragovernmental costs and revenue are related to transactions made between two reporting entities within the Federal Government. Public costs and revenues are exchange transactions made between the reporting entity and a nonfederal entity.

For General Funds, the amounts presented in the SNC are based on obligations and disbursements and therefore may not, in all cases, accrue actual costs. While the Department's Working Capital Funds generally record transactions on an accrual basis, the systems do not always capture actual costs in a timely manner. As such, information presented in the SNC is based on budgetary obligations, disbursements, and collection transactions, as well as nonfinancial feeder systems, adjusted to record known accruals for major items such as payroll expenses, accounts payable, and environmental liabilities.

The majority of the Department's accounting systems do not capture information relative to Heritage Assets separately and distinctly from normal operations. Where it was able to separately identify the cost of acquiring, constructing, improving, reconstructing or renovating heritage assets, the Department has identified $2.3 million for the fiscal year.

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

As of September 30	2006		2005 Restated	
(amounts in millions)	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Prior Period Adjustments Increases (Decreases) to Net Position Beginning Balance				
Changes in Accounting Standards	$ 0.0	$ 0.0	$ 3,632.4	$ 0.0
Errors and Omissions in Prior Year Accounting Reports	(8,033.1)	0.0	(776.5)	0.0
Total Prior Period Adjustments	$ (8,033.1)	$ 0.0	$ 2,855.9	$ 0.0
Imputed Financing				
Civilian CSRS/FERS Retirement	$ 1,553.8	$ 0.0	$ 1,604.1	$ 0.0
Civilian Health	2,646.5	0.0	2,457.1	0.0
Civilian Life Insurance	26.1	0.0	24.7	0.0
Judgment Fund	183.2	0.0	379.4	0.0
IntraEntity	0.0	0.0	0.0	0.0
Total Imputed Financing	$ 4,409.6	$ 0.0	$ 4,465.3	$ 0.0

Prior Period Adjustments

The Department recognized prior period adjustments in FY 2006 and restated cumulative results of operations for FY 2005 and FY 2006 by $8.1 billion. The adjustments related to the revaluation of military equipment, and the recognition of a strategic petroleum reserve established in FY 1993 which was erroneously expensed at that time. Refer to Note 25, Restatements, for additional details relating to these adjustments.

Fluctuations

Budgetary Financing Sources, Appropriations Received increased $69.7 billion from FY 2005, largely due to increased funding received for the Global War on Terror. During FY 2006, the Department received $52.7 billion more in supplemental appropriations than in FY 2005. The balance of the increase is spread across the DoD appropriations.

Other Disclosures

The amounts the DoD remits to the Office of Personnel Management by and for employees covered by the Civil Service Retirement System, the Federal Employees' Retirement System, the Federal Employees' Health Benefits program, and the Federal Employees' Group Life Insurance program do not fully cover the government's cost to provide these benefits. An imputed cost is recognized as the difference between the government's cost of providing these benefits to employees and the Department's contributions for them. The Office of Personnel Management provides cost factors for the computation of imputed financing costs, and their inclusion in the Department's financial statements.

Statement of Federal Financial Accounting Standards Number 27, "Identifying and Reporting Earmarked Funds," effective for reporting years after FY 2005, required that DoD modify the Statement of Changes in Net Position. The Federal Accounting Standards Advisory Board determined that restatement of prior comparative balances would not be allowed. To meet the requirement, additional columns were added to separately display gross amounts for earmarked funds, and all other (non-earmarked) funds. In the Statement of Changes in Net Position, all offsetting balances (i.e. transfers-in and transfers out, revenues and expenses) for intra-DoD activity between earmarked and other (non-earmarked) funds are reported on the same lines. This results in an eliminations column which appears to contain no balances. In reality, the column contains all appropriate elimination entries, but all net to zero within each respective line.

Fiscal year 2006 cumulative results of operation ending balance on the Statement of Changes in Net Position does not agree with the cumulative results reported on the Balance Sheet because the cumulative results on the Balance Sheet are presented net of eliminations.

There is an $87.0 billion difference between Appropriations Received that are reported on the Statement of Changes in Net Position ($594.7 billion) and Appropriations Received in the Statement of Budgetary Resources ($681.7 billion). This difference is primarily due to appropriations transferred to the trust and special funds which are duplicated in the Statement of Budgetary Resources. In addition, a small portion of the difference relates to interest collected by the trust funds. See Note 20, "Disclosures Related to the Statement of Budgetary Resources" for additional information.

Note 20. Disclosures Related to the Statement of Budgetary Resources

As of September 30	2006	2005
(amounts in millions)		
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	$ 295,463.2	$ 275,627.9
Available Borrowing and Contract Authority at the End of the Period	26,045.7	28,006.3

Fluctuations

The Nonbudgetary Financing, Budgetary Resources section of the Statement of Budgetary Resources (SBR) reflects a decrease of $109.8 million (44%). This section of the SBR reports activity for the Military Housing Privatization and the Armament Retooling and Manufacturing Support Initiatives. The fluctuation was primarily due to a decline in borrowing authority and spending authority from offsetting collections without advance from federal sources. During FY 2005, there were no new direct loans issued for the year. However, in FY 2006, there were three new loans issued. The issuance of these new loans had a decreasing effect on borrowing authority and the value of unfilled customer orders without advance.

Reconciliation Differences

There is a difference of $33.5 billion between the Available Borrowing and Contract Authority reported ($26.0 billion) in the table above and the amount reported for Available Borrowing and Contract Authority on the SBR ($59.5 billion). The table above reports current-year activity as well as carry-forward amounts for both categories of authority. The SBR only reports current-year activity for these categories.

Appropriations Received on the Statement of Budgetary Resources (SBR) exceed Appropriations Received on the Statement of Changes in Net Position by $87.0 billion. Appropriations received at the Military Services and Defense Agencies that are subsequently recognized a second time on the SBR as appropriation transferred into trust and special funds comprise $68.2 billion of the excess. Interest earnings on the Military Retirement and Health Care investments make up an additional $16.4 billion. The balance of the difference consists primarily of other revenues collected into the Department's special and trust funds.

Permanent Indefinite Appropriations

The Department received the following permanent indefinite appropriations:

- Department of the Army General Gift Fund (10 USC 2601(b)(1))
- Department of the Navy General Gift Fund (10 USC 2601(b)(2))
- Department of the Air Force General Gift Fund (10 USC 2601 (b)(3))
- Foreign National Employees Separation Pay Account, Defense (10 USC 1581)
- United States Naval Academy Gift and Museum Fund (10 USC 6973-4)
- Ship Stores Profits, Navy (10 USC 7220, 31 USC 1321)
- Midshipmen's Store (10 USC 6971B)
- Burdensharing Contributions Account (10 USC 2350(j))
- Forest Program (10 USC 2665)
- Department of Defense Base Closure Account (10 USC 2687)
- Medicare Eligible Retiree Health Care Fund (MERHCF) (10 USC 1111)
- Military Retirement Fund (MRF) (10 USC 1461)
- Education Benefits Fund (10 USC 2006)
- Reserve Mobilization Income Insurance Fund (10 USC 12528)
- Host Nation Support for U.S. Relocation Activities (10 USC 2350(k))
- National Defense Sealift Fund (10 USC 2218)
- Environmental Restoration, Navy (10 USC 2702)
- Hydraulic Mining Debris Reservoir (33 USC 683)
- Maintenance and Operation of Dams and Other Improvements of Navigable Waters (16 USC 810(a))
- Payments to States (33 USC 701c-3)
- Wildlife Conservation (16 USC 670-670(f))
- Ainsworth Bequest (31 USC 1321)

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

Other Disclosures

The Department received supplemental appropriations totaling $130.5 billion to address the Global War on Terror, the hurricane relief effort in the Gulf of Mexico, and the Pandemic Influenza Act.

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

The Department utilizes borrowing authority for the Military Housing Privatization and the Armament Retooling and Manufacturing Support Initiatives.

There are no legal arrangements affecting the use of unobligated balances of budget authority.

The Department reported the following amounts of direct obligations: $469.4 billion in category A; $129.9 billion in category B, and $47.2 billion in exempt from apportionment. The Department reported the following amounts of reimbursable obligations: $96.9 billion in category A; $62.7 billion in category B; and $5.9 billion in exempt from apportionment. Category A relates to appropriations for a specific period of time (e.g., Military Personnel appropriation), and category B relates to appropriations for a specific project (e.g., Military Construction appropriation).

Note 21. Disclosures Related to the Statement of Financing

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

Resources That Finance the Acquisition of Assets	$11.3 billion
Other - Other Components Not Requiring or Generating Resources	$12.0 million

The following Statement of Financing lines are presented as combined instead of consolidated due to intra-agency budgetary transactions not being eliminated:

- Obligations Incurred
- Less: Spending Authority from Offsetting Collections and Recoveries
- Obligations Net of Offsetting Collections and Recoveries
- Less: Offsetting Receipts
- Net Obligations
- Undelivered Orders
- Unfilled Customer Orders

Fluctuations

Resources Used to Finance Activities

Other Resources – Other increased $5.6 billion primarily due to a change in accounting procedures in 1st Quarter, FY 2006 requiring the inclusion of nonexchange gains and losses necessary to reconcile the proprietary and budgetary accounts. This increase is also comprised of other gains and losses to adjust intragovernmental transfers in and transfers out of construction in progress amounts and property.

Resources Used to Finance Items not Part of the Net Cost of Operations

Resources That Finance the Acquisition of Assets increased $19.2 billion due primarily to a change in the military equipment valuation methodology implemented 3rd Quarter, FY 2006. See Note 10 for further disclosure on military equipment.

Components Requiring or Generating Resources

Components Requiring or Generating Resources in Future Period-Other decreased $94.3 billion due to future funded expenses that are not funded in the period the costs are incurred primarily related to the change in actuarial liability as discussed in Note 17.

Components not Requiring or Generating Resources

Other decreased $29.2 billion primarily due to cost capitalization offsets and other expenses not requiring budgetary resources.

Other Disclosures

The Department recorded other expenses not requiring budgetary resources of $281.8 million to reconcile budgetary activity with current period expenses for allocation transfers. The Department executed allocation transfers on behalf of the Department of Agriculture, Department of Transportation, and Department of Energy for various public work projects. These items include the treatment of disease in trees due to infestation for the State and Private Forestry, public bridge inventory and inspection of the Federal Lands Highway Program, and the maintenance of hydroelectric plants that the U.S. Army Corps of Engineers operates. In addition, the Department executed the funding for Iraqi Relief and Reconstruction Fund on behalf of the Executive Office of the President and Department of Transportation.

Liabilities not covered by budgetary resources on the Balance Sheet total $1.6 trillion and the amount reported as components requiring or generating resources in future periods on the Statement of Financing totals $86.8 billion. The difference of $1.5 trillion is primarily due to the differing perspectives between the two statements. Liabilities not covered by budgetary resources report the cumulative balance for Balance Sheet liabilities not yet funded whereas components requiring or generating resources in future periods reflect only the current period changes for all unfunded liabilities.

Note 22. Disclosures Related to the Statement of Custodial Activity

The Statement of Custodial Activity displays current year collections and disbursements for three custodial accounts: (1) Foreign Military Sales, (2) Development Fund for Iraq, and (3) Seized Assets. Funds held in a custodial activity are only used for the stated purposes and are not available for the Department's use.

Foreign Military Sales

Under authority of the Arms Export and Control Act, the Foreign Military Sales Trust Fund (FMSTF) receives collections from foreign governments that are dedicated specifically to FMS purchases. Funds collected into the FMSTF are in advance of the performance of services or sale of articles. These advance collections constitute a fiduciary relationship with the countries.

Current year Deposits by Foreign Governments into FMSTF are $13.7 billion. Disbursements on Behalf of Foreign Governments and International Organizations total $12.5 billion.

The FMSTF neither recognizes nor reports revenue, except for cost clearing accounts, which are reflected in all other principal financial statements. Since various Department Components actually perform the services and sell the articles, recognition of revenue and expense occurs in the financial statements of the applicable Department Components.

Development Fund for Iraq (DFI)

The DFI is for urgent humanitarian assistance, reconstruction, and other projects carried out for the benefit of the Iraqi people. During FY 2006, there were $34.6 million in disbursements by the Multi-National Force Iraq with no additional deposits. As of September 30, 2006, $18.8 million remains to be disbursed. The Department made adjustments in 1st Quarter, FY 2006 for prior year disbursements, which resulted in a negative disbursement amount for Education, Refugees, Human Rights, and Governance, on the following page.

(amounts in millions)	During FY 2006	Cumulative from Inception
Source of Collections		
Deposits By Foreign Governments	$ 0	$ 136.0
Disposition of Collections		
Security and Law Enforcement	$ .2	$ 1.0
Electric Sector	20.8	45.2
Oil Infrastructure	0	.4
Water Resources and Sanitation	9.9	16.6
Transportation and Telecommunications	.1	5.3
Roads, Bridges and Construction	.8	5.0
Health Care	.2	2.9
Private Sector Development	3.4	7.2
Education, Refugees, Human Rights, and Governance	(.8)	33.6
Total Disbursed on Behalf of Foreign Governments	34.6	117.2
Retained for Future Support of Foreign Governments *	(34.6)	18.8
Total Disposition of Collections	$ 0	$ 136.0
Net Custodial Collection Activity	$ 0	$ 0

**Note – Reported on the Statement of Custodial Activity under Disposition of Collections, Increase (Decrease) in Amounts to be Transferred.*

Seized Assets

During Operation Iraqi Freedom, the U.S. Government seized assets from the Iraqi Government that are used in support of the Iraqi people. In FY 2006, $31.2 million was disbursed with no additional seized assets. As of September 30, 2006, $30.2 million of seized monetary assets remain to be disbursed in support of the Iraqi people as shown below.

(amounts in millions)	During FY 2006	Cumulative from Inception
Source of Collections		
Seized Iraqi Cash	$ 0	$ 927.2
Disposition of Collections		
Iraqi Salaries	$ 0	$ 30.8
Repair/Reconstruction/Humanitarian Assistance	31.2	526.2
Iraqi Ministry Operations (Ministry of Finance, Defense, etc.)	0	264.7
Fuel/Supplies	0	75.3
Total Disbursed on Behalf of Iraqi People	31.2	897.0
Retained for Future Support of Foreign Governments	(31.2)	30.2
Total Disposition of Collections	$ 0	$ 927.2
Net Custodial Collection Activity	$ 0	$ 0

Note 23. Earmarked Funds

BALANCE SHEET As of September 30, 2006 (amounts in millions)	MRF	MERHCF	Other Earmarked Funds	Eliminations	Total
ASSETS					
Fund balance with Treasury	$ 30.7	$ 37.9	$ 1,787.8	$ 0.0	$ 1,856.4
Investments	208,392.1	85,395.0	5,474.1	(0.1)	299,261.1
Accounts and Interest Receivable	23.3	8.8	468.2	(26.4)	473.9
Other Assets	0.0	0.0	1,767.5	0.0	1,767.5
Total Assets	$ 208,446.1	$ 85,441.7	$ 9,497.6	$ (26.5)	$ 303,358.9
LIABILITIES and NET POSITION					
Military Retirement Benefits and Other Federal Employment Benefits	$ 967,106.1	$ 538,032.8	$ 3,176.5	$ 0.0	$ 1,508,315.4
Other Liabilities	1.3	876.9	949.8	(64.0)	1,764.0
Unexpended Appropriations	0.0	0.0	11.4	0.0	11.4
Cumulative Results of Operations	(758,661.3)	(453,468.0)	5,360.0	(64,915.2)	(1,271,684.5)
Total Liabilities and Net Position	$ 208,446.1	$ 85,441.7	$ 9,497.7	$ (64,979.2)	$ 238,406.3
STATEMENT OF NET COST For the Year Ended September 30, 2006					
Program Costs	$ 112,821.7	$ 7,610.6	$ 3,120.2	$ (2,422.4)	$ 121,130.1
Less Earned Revenue	(51,737.7)	(31,802.7)	(1,005.4)	67,512.1	(17,033.7)
Net Program Costs	$ 61,084.0	$ (24,192.1)	$ 2,114.8	$ 65,089.7	$ 104,096.4
Less Earned Revenues Not Attributable to Programs	0.0	0.0	0.0	0.0	0.0
Net Cost of Operations	$ 61,084.0	$ (24,192.1)	$ 2,114.8	$ 65,089.7	$ 104,096.4
STATEMENT OF CHANGES IN NET POSITION As of September 30, 2006					
Net Position Beginning of the Period	$ (697,577.3)	$ (477,660.1)	$ 4,374.7	$ 0.0	$ (1,170,862.7)
Net Cost of Operations	61,084.0	(24,192.1)	2,114.8	65,089.7	104,096.4
Budgetary Financing Sources	0.0	0.0	3,288.9	174.3	3,463.2
Other Financing Sources	0.0	0.0	(177.4)	0.2	(177.2)
Change in Net Position	$ (61,084.0)	$ 24,192.1	$ 996.7	$ (64,915.2)	$ (100,810.4)
Net Position End of Period	$ (758,661.3)	$ (453,468.0)	$ 5,371.4	$ (64,915.2)	$ (1,271,673.1)

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

The Total Earmarked Funds column is shown as consolidated and relates only to Earmarked Funds. The elimination column on this note includes only eliminations associated with Earmarked Funds and exludes the offsetting eliminations from All Other Funds. This exclusion causes assets to not equal liabilites and net position in the note. However, the amount in the Total column equal the amounts reported for Earmarked Funds on the Balance Sheet.

The SFFAS 27, effective for reporting years after FY 2005, required that DoD modify the Statement of Changes in Net Position. To meet the requirement, additional columns were added to separately display gross amounts from Earmarked Funds and All Other (non-earmarked) Funds. Cumulative Results of Operations ending balances for Earmarked Funds on the Statement of Changes in Net Position do not agree with the Cumulative Results of Operations for Earmarked Funds reported on the Balance Sheet because the Cumulative Results on the Balance Sheet are presented net of eliminations. The summation for MRF, MERCHF, and Other Earmarked Funds is equivalent to the gross amount presented on the Statement of Changes in Net Position.

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

Medicare-Eligible Retiree Health Care Fund (MERHCF), 10 USC 1111. The MERHCF accumulates funds to finance, on an actuarially sound basis, liabilities of the Department and the uniformed services health care programs for specific Medicare-eligible beneficiaries. The MERHCF was authorized by Public Law 106-398. Financing sources for MERHCF are provided primarily through an annual actuarial liability payment from Treasury, annual contribution(s) from the Military Services and other Uniformed Services (US Coast Guard, the National Oceanic and Atmospheric Administration, and the US Public Health Service), and interest earned from the Fund's investments.

Other Earmarked Funds

Special Recreation Use Fees, 16 USC 4061-6a note. The United States Army Corps of Engineers (USACE) is granted the authority to charge and collect fair and equitable Special Recreation Use Fees at campgrounds located at lakes or reservoirs that are under the jurisdiction of the USACE. Types of allowable fees include, but are not limited to, daily use fees, admission fees, recreational fees, annual pass fees, and other permit type fees. The receipts are used for the operation and maintenance of the recreational sites.

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

Payments to States, Flood Control Act of 1954, 33 USC 701c-3. Seventy-five percent of all funds received and deposited from the leasing of lands acquired by the United States for flood control, navigation and allied purposes, including the development of hydroelectric power, are returned to the state on which the property is located. The USACE collects lease receipts into a receipt account. Funds are appropriated for the amount of receipts the following fiscal year.

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

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

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

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

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

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

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

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

Defense Commissary Agency Surcharge Revenue, 10 USC 2685. The Defense Commissary Agency Surcharge account was established as the repository for the surcharge on the cost of commissary goods paid for by authorized patrons to finance certain operating expenses and capital purchases of the Commissary System, which are precluded by law from being paid with appropriated funds. The major part of the Surcharge public revenue is generated by the 5% surcharge applied to each sale. These funds may be used to pay for the commissary store-related information technology investments, to purchase commissary equipment, to finance advance design modifications to prior year projects, for both minor and major construction projects and to maintain and repair commissary facilities and equipment. The surcharge account also allows for obligations based on anticipated proceeds without regard to fiscal year limitations, if needed to carry out the uses of the revenue as identified.

Note 24. Other Disclosures

As of September 30	2006 Asset Category			
(amounts in millions)	Land and Buildings	Equipment	Other	Total
ENTITY AS LESSEE-Operating Leases				
Future Payments Due				
FY 2007	$ 188.9	$ 1.3	$ 124.2	$ 314.4
FY 2008	176.6	0.1	127.9	304.6
FY 2009	163.9	0.1	131.7	295.7
FY 2010	155.8	0.1	135.7	291.6
FY 2011	173.0	0.0	139.8	312.8
After 5 Years	188.6	0.0	143.4	332.0
Total Future Lease Payments Due	$ 1,046.8	$ 1.6	$ 802.7	$ 1,851.1

Note 25. Restatements

The Department posted prior period adjustments due to material errors that reduced the FY 2005 and FY 2006 beginning cumulative results of operations by $8.1 billion. The total is comprised primarily of an adjustment due to a change in the methodology for reporting of military equipment resulting in an $8.2 billion restatement, offset slightly by a $124.9 million adjustment to recognize an intragovernmental other asset for 6.4 million barrels of crude oil held by the Department of Energy on behalf of the DoD. A portion of the military equipment adjustment also impacted the FY 2005 Statement of Net Cost however the cost and manpower to develop the prior year value for the depreciation expense prohibited the Department from restating the Statement of Net Cost.

Military Equipment Adjustment

In accordance with Statement of Federal Financial Accounting Standards (SFFAS) Number 23, Eliminating the Category National Defense Property, Plant, and Equipment, the Department reported military equipment values in the financial statements beginning in FY 2003. As an interim measure, while the Department worked to develop its military equipment baseline from internal records, the military equipment values reported were based on estimates obtained from the Bureau of Economic Analysis (BEA).

Effective 3rd Quarter, FY 2006, the Department replaced the BEA estimation methodology with a valuation based on transaction level details. During the process of establishing a baseline, the Department discovered that the BEA estimates had failed to consider disposals, thresholds, and construction in process. While an estimation methodology is acceptable per SFFAS Number 23, due to the nature of the BEA omissions, the Department considers that the method previously used was not compliant with Generally Accepted Accounting Principles, and thus have treated the adjustment as correction of a material error.

The resulting adjustment decreased the value of general property, plant, and equipment and associated accumulated depreciation. This reduced General Plant, Property and Equipment, Net on in the Balance Sheet by $8.2 billion for FY 2005 and FY 2006.

Intragovernmental Other Asset for Strategic Petroleum Reserve

During FY 2006, as part of the trading partner reconciliation process, the Department recognized that it had erroneously expensed funds provided to the Department of Energy (DoE) in FY 1993 for the acquisition of a strategic petroleum reserve for national defense purposes. Legislation enacted in November 1992 Public Law 102-396, Sec. 9149 provided appropriations to DoD and established the requirement that they be transferred to DoE to acquire and maintain the reserve for national defense purposes on behalf of DoD. By law, the reserve cannot be drawn down or released to DoD without the President (with the advice of the Secretary of Defense) making findings under Section 161(d) of the Energy Policy and Conservation Act (42 USC 6241(d)). According to the law, proceeds of any sales of this reserve will be deposited to the accounts of, and remain available to DoD until expended. Due to the unusual nature of this asset and the specifics of the law that enacted the requirement the Department considered it qualitatively material and chose to recognize the asset with restatement.

In 4th quarter, FY 2006 DoD increased the value of Other Assets for FY 2005 and FY 2006 in the Balance Sheet by $124.9 million to recognize the right to the approximately 6.4 million barrels of crude oil. The DoE reports this crude oil as a non-entity asset in its financial statements, with an offsetting custodial liability to DoD. To date none of the reserve has been drawn upon, thus the full inventory remains on hand with DoE.

Required Supplementary Stewardship Information

Nonfederal Physical Property

Department Of Defense Consolidated
Nonfederal Physical Property
Annual Investments In State And Local Governments For Fiscal Years 2002 Through 2006
(In Millions Of Dollars)

Categories	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Transferred Assets:					
National Defense Mission Related	$7	$85	$54	$71	$1,295
Funded Assets:					
National Defense Mission Related	$21	$11	$18	$8	$9
Total	$28	$96	$72	$79	$1,304

The Department incurs investments in Nonfederal Physical Property for the purchase, construction, or major renovation of physical property owned by state and local governments, including major additions, alterations, and replacements, the purchase of major equipment, and the purchase or improvement of other physical assets. In addition, Nonfederal Physical Property Investments include federally-owned physical property transferred to state and local governments. The significant increase in assets from FY 2005 to FY 2006 is a result of assets now reported by the U.S. Army Corps of Engineers.