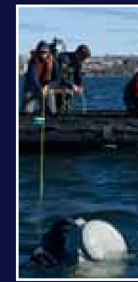

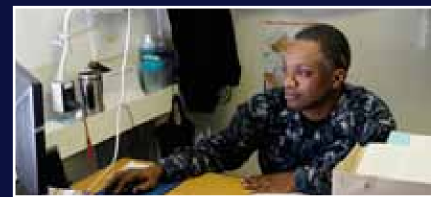

Department of the Navy Fiscal Year 2012 Annual Financial Report

PROTECT THE NATION, PROJECT POWER, PROVIDE FREEDOM OF THE SEAS

Department of the Navy Fiscal Year 2012 Annual Financial Report

PROTECT THE NATION,
PROJECT POWER,
PROVIDE FREEDOM OF THE SEAS

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CONTENTS

THE SECRETARY OF THE NAVY
WASHINGTON, DC 20350-1000

November 2012

This year marks the 200 year anniversary of the War of 1812 and the writing of our National Anthem, the Star Spangled Banner. As the Department of the Navy (DON) reflects upon the sacrifices that guaranteed our independence and ensured our future, we prepare for future challenges under a new National Defense Strategy (NDS).

Our new strategy requires the Navy and Marine Corps to remain uniquely positioned to continue to defend American freedoms with the best expeditionary fighting force known. Our Sailors and Marines are standing the watch and sustaining people across the global commons. From the mountains of Afghanistan to the coasts of Africa, they stand ready to provide unsurpassed military capability where and when necessary and compassionate humanitarian aid wherever catastrophe strikes.

While we remain committed to this mission, we continue our quest toward global force superiority through new initiatives such as our movement toward energy independence and new fuel sources as well as upgrading technology to ensure the cyber security of our forces.

Achieving all of these goals is closely linked to our ability to improve our financial posture and comply with Federal audit readiness standards. To that end, we continue to improve the reliability of our financial and performance data and correct material control weaknesses that impact the DON's fiscal efficiency.

We remain mindful of the fiscal challenges facing our country as we begin to execute our NDS. While outlining our mission, goals and accomplishments, the DON's Fiscal Year 2012 Annual Financial Report, *Protect the Nation, Project Power, Provide Freedom of the Seas*, also conveys our enduring commitment to maintaining efficient, accountable, and transparent financial processes.

I'm pleased to present the results of this report and hope you join me in recognizing the significant accomplishments we have made in the DON in 2012.

Ray Mabus

THE ASSISTANT SECRETARY OF THE NAVY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, DC 20350-1000

November 2012

The guiding principle in overseeing Navy and Marine Corps financial operations is to provide seamless support, allowing warfighters to meet their mission objectives for the nation's defense. Our deployed forces, as well as those at our home stations, must have the right resources and capabilities at the right time. Our business and financial systems must enable effective employment of our national defense capacity. At the same time, we must ensure the confidence of the public that taxpayer dollars are being used most efficiently. We take serious our commitment to both the warfighter and the taxpayer, thus achieving audit readiness is a key component of our ongoing efforts.

To this end, we continue to progress toward a sustainable, financially auditable business environment. Our commitment to audit readiness spans the entire Department of the Navy (DON). At every level, we have expended significant time and energy toward this end with our efforts resulting in greater ownership, accountability and awareness. We have made considerable progress in improving our business processes and fiscal discipline. In addition, the DON emphasizes the importance of cost analysis in informing decisions about where and when to apply resources to national defense requirements.

Just as every individual in the DON contributes to our national defense, they must also be conscientious in supporting financial audit readiness. Our business and financial processes touch every area of warfighting and improvements will only enhance our ability to effectively and efficiently support our warfighters. We continue to train and offer career broadening assignments for our financial management workforce and to provide support for our business process owners.

Secretary Mabus and I remain committed to supporting the National Defense Strategy (NDS) objectives while assuring the public that the Department is carefully and efficiently managing the taxpayer's resources with integrity and dedication.

Gladys J. Commons

Department of the Navy Fiscal Year 2012 Annual Financial Report

PROTECT THE NATION,
PROJECT POWER,
PROVIDE FREEDOM OF THE SEAS

MANAGEMENT'S DISCUSSION AND ANALYSIS

Department of the Navy Fiscal Year 2012 Annual Financial Report

An Explosive Ordnance Disposal Technician is hoisted to a MH- 60S Sea Hawk helicopter from the Eightballers of Helicopter Strike Squadron (HSC 8) attached to the Nimitz-class aircraft carrier USS John C. Stennis (CVN 74). John C. Stennis is deployed to the U.S. 5th Fleet area of responsibility conducting maritime security operations and support missions as part of Operation Enduring Freedom.

Convoys drive to Camp Buehring, Kuwait, as U.S. forces depart Iraq.

OVERVIEW

The U.S. Navy was founded on 13 October 1775, and the Department of the Navy (DON) was established on 30 April 1798. The DON primarily consists of two uniformed Services: the U.S. Navy and the U.S. Marine Corps, and, in time of war, the U.S. Coast Guard (in peace, a component of the Department of Homeland Security).

The service and sacrifice of Sailors and Marines is a daily reminder that we are a nation at war. Today's Navy and Marine Corps team maintains its active contribution to continuing Overseas Contingency Operations, and remains committed to supporting non-traditional joint requirements in Iraq, Afghanistan, the Horn of Africa, and other locations worldwide. The Navy has over 40,000 active and reserve sailors continually deployed in support of the contingency operations overseas serving as members of Carrier Strike Groups (CSGs), Expeditionary Strike Groups (ESGs), Special Operating Forces, Seabee units, Marine forces, Medical units, and as Individual Augmentees (IAs). Our Sailors and Marines are fully engaged on the ground, in the air, and at sea in support of operations in Iraq and Afghanistan. As the DON continues to operate forward across the globe, providing the nation offshore options to deter and defeat aggression today and in the future, the Navy and Marine Corps capabilities and capacity will prove crucial as our nation's focus shifts to the Asia-Pacific region.

Currently, the DON's forces are split 50/50 between the Asia-Pacific and the Middle East. This new strategy would shift 60% of our naval forces to Pacific ports. The mobilization of warships will be accompanied by an increase in the number of military exercises conducted by the Pentagon in the region, involving air, sea, and land forces. Most will be carried out in conjunction with countries that are openly or tacitly allied with the U.S., including Japan, South Korea, Australia, and the Philippines. Essential to this

An Air Traffic Controller loads water bottles to assist service members in need of water during the aftermath of Hurricane Isaac at Naval Air Station Joint Reserve Base New Orleans.

Some of the 2,534 solar photovoltaic (PV) panels installed on the roof of Naval Air Station Jacksonville's Hangar 1122 to help reduce the building's conventional energy usage and promote environmental sustainability.

strategy are the DON's efforts to strengthen alliances and partnerships in the Asian-Pacific region to advance a common security vision for the future. The DON plans to develop military to military relations by creating teams to work on difficult issues such as cyber threats. However, as the focus shifts, the DON will face challenges as budget constraints have led to a leaner workforce.

The total naval workforce is shaped and optimized to support the National Defense Strategy. In doing so, the DON has instituted the 21st Century Sailor's and Marine's initiative, which lays out a set of objectives and policies that maximize every Sailor's and Marine's personal readiness. Although we are in an era of budget cuts, the DON has remained focused on maintaining U.S. maritime dominance by having our Sailors and Marines continue to promote security, stability, and trust around the world. Together, we provide a persistent forward presence, power projection abroad and protection of the world's sea lanes. In Fiscal Year (FY) 2012, our Sailors and Marines, in cooperation with our foreign partners and allies, continued to provide training and deliver humanitarian aid, disaster relief and other assistance throughout the globe. This was most evident during the bi-annual Rim of the Pacific (RIMPAC) demonstration. For the first time during RIMPAC, the exercise featured a 22-nation humanitarian assistance/disaster relief event that facilitated training and certification for expeditionary forces to respond to foreign disasters as a Crisis Response Adaptive Force Package.

Despite the fact that we are in an era of reduced budgets and The Budget Control Act of 2011 mandates a reduction of federal spending, the DON fleet will be no smaller in the future than it is today. As such, the DON is dedicated to cutting cost in the coming years by reducing the cost of doing business, promoting acquisition excellence, driving innovative transformation and leading the nation in sustainable energy. While the DON maintains a healthy industrial base to ensure future innovation and technological advances, the DON remains focused on reducing the budget. As such, the DON has decreased the construction of new ships, terminated the procurement of the ocean surveillance ship (called T-AGOS) and reduced and/or delayed the procurement of various other projects, including the Virginia Class Submarine.

Readily available energy is essential for deploying our Sailors and Marines around the globe in support of our nation's interests. Since our operational flexibility and sustainability are directly linked to our energy supplies, energy reliability is a strategic concern for our forces. The potential vulnerability of energy supplies could threaten our ability to perform on the battlefield and energy costs siphon resources from warfighting requirements. Therefore, the DON is working to develop greater energy independence and conservation ashore and afloat. Energy reform improves the capability and efficiency of ships, aircraft and weapons systems, and ultimately makes us better warfighters and ensures the safety of our Sailors and Marines. In Fall 2009, Secretary Mabus set an ambitious energy goal for the DON that no later than 2020 at least half of all the energy used by the two services, both afloat and ashore, will come from non-fossil fuel sources. Also by 2020, at least half of all bases will be net-zero in terms of consumption, and in many cases returning power to the grid rather than pulling from it. The DON's progress on this target includes submarines that are powered using nuclear energy representing 17 percent of total energy consumed.

The DON continued to make significant progress toward reaching the Secretary's energy goals in 2012. The DON is working to improve the efficiency of bases by monitoring electricity usage in buildings. The DON has signed contracts for larger uses of solar power, and is considering geothermal, hydrothermal, wave, solar, and wind. During FY 2012, the DON's largest solar project began with the construction of a 118 acre solar farm at the Naval Air Weapons Station (NAWS) in China Lake, California. The focus of these initiatives is to ensure that alternate power continues to decrease fossil fuel usage by the DON because more than half the ships and aircraft that will be around in 2020 are in the fleet today. The DON continues to focus on sustainable energy by offering military contract opportunities to small businesses with sustainable energy programs, pilots, and initiatives. The DON's efforts support a clean energy economy and will make Americans better stewards of our planet.

The DON recognizes the value of investing in audit readiness as part of the Department of Defense (DoD) mission. The pursuit of auditability will result in improved stewardship, reduced cost of business operations, and compliance with congressional direction. In FY 2012 the U.S. Marine Corps was in its third year of the Statement of Budgetary Resources (SBR) audit. Concurrently the DON Financial Improvement and Audit Readiness (FIAR) team is preparing the rest of the Department for SBR audit readiness with focused efforts to ready people, processes, and business systems for a financial audit. The DON understands that fundamental improvements to establish tighter internal controls and more standardized processes are needed within its operations. To standardize and enforce uniform business processes, especially within disparate commands, the DON has established the Navy Enterprise Resource Planning (ERP) system. Although processes are not yet standardized, DON has employed control gap analysis to identify when a command's process and/or controls differ significantly from suggested controls. Control gap analysis allows DON to track and address significant deviations. Additionally, DON has begun a concerted, multi-year effort to standardize processes and controls within the Navy ERP environment.

DON continued to demonstrate its commitment to effectively managing and mitigating risks to reflect progress with respect to mission objectives by establishing a new set of objectives for FY 2012 and beyond. Given the current climate of budgetary restrictions and uncertainty, it is critical that the DON track progress and monitor change pertaining to the following high priority objectives:

- Take Care of Our People
- Maintain Warfighter Readiness in an Era of Reduced Budgets
- Lead the Nation in Sustainable Energy
- Promote Acquisition Excellence and Integrity
- Dominate in Unmanned Systems
- Drive Innovative Enterprise Transformation

ORGANIZATION AND MISSION

United States Navy	United States Marine Corps
Founded 13 October 1775	Founded 10 November 1775
Title 10 U.S. Code, Section 5062	Title 10 U.S. Code, Section 5063

To maintain, train, and equip combat-ready Naval forces capable of winning wars, deterring aggression, and maintaining freedom of the seas.

—Department of the Navy Mission

We are structured to respond to a broad range of mission priorities that preserve our nation's freedom and protect U.S. global interests. The Secretary of the Navy (SECNAV), a civilian appointed by the President, is responsible for, and has authority under title 10 of the United States Code to conduct all the affairs of the DON, including: recruiting, organizing, supplying, equipping, training, mobilizing, and demobilizing. SECNAV also oversees the construction, outfitting, and repair of naval ships, equipment, and facilities. SECNAV is responsible for the formulation and implementation of policies and programs that are consistent with the national security policies and objectives established by the President and the Secretary of Defense. Under the purview of SECNAV are the Under Secretary of the Navy (UNSECNAV), four Assistant Secretaries of the Navy, the General Counsel, and two key military leaders—the Chief of Naval Operations (CNO), a four-star Admiral who is responsible for the command and operating efficiency of the U.S. Navy, and the Commandant of the Marine Corps, a four-star General who is responsible for the performance of the U.S. Marine Corps.

Founded 30 April 1798

Title 10 U.S. Code, Section 5061

SECRETARY OF THE NAVY

UNDER SECRETARY OF THE NAVY

Assistant Secretary of the Navy (Research, Development & Acquisition)

Assistant Secretary of the Navy (Manpower & Reserve Affairs)

Assistant Secretary of the Navy (Financial Management & Comptroller)

Assistant Secretary of the Navy (Energy, Installation, and Environment)

General Counsel of the Department of the Navy

CHIEF OF NAVAL OPERATIONS

- U.S. Navy Shore Establishment
- U.S. Navy Reserves
- U.S. Navy Operating Forces

COMMANDANT OF THE MARINE CORPS

- U.S. Marine Corps Operating Forces
- U.S. Marine Corps Reserves
- U.S. Marine Corps Supporting Establishment

*Dashed line signifies collaboration of the U.S. Navy and the U.S. Marine Corps operating forces.

The U.S. Navy and the U.S. Marine Corps have numerous commands that operate under the authority and responsibility of a commander or other designated official and typically support a network of subordinate commands. Each command has a clearly defined mission that supports the overall DON mission in support of the DoD's responsibilities. Both Services provide ready forces to support the U.S. joint military commands in conducting their worldwide missions.

NAVAL SEA SYSTEMS COMMAND (NAVSEA)

With a force of 53,000 civilian, military and contract support personnel, NAVSEA engineers build, buy, and maintain the DON's ships and submarines and their combat systems. NAVSEA manages 150 acquisition programs and manages foreign military sales cases that include billions of dollars in annual military sales to partner nations.

Today, the NAVSEA organization has 33 activities in 16 states. NAVSEA strives to be an efficient provider of defense resources for the nation, and it plays an important role in the Navy Enterprise. As a provider command, it has the responsibility of directing resource sponsors into the proper mix of manpower and resources to properly equip the fleet. NAVSEA has the further responsibility of establishing and enforcing technical authority in combat system design and operation. These technical standards use the organization's technical expertise to ensure systems are engineered effectively, and that they operate safely and reliably.

NAVAL AIR SYSTEMS COMMAND (NAVAIR)

NAVAIR is headquartered in Patuxent River, Maryland, with military and civilian personnel stationed at eight locations across the continental United States and one site overseas. NAVAIR's mission is to provide full life-cycle support of naval aviation aircraft, weapons, and systems operated by Sailors and Marines. This support includes research, design, development, and systems engineering; acquisition; test and evaluation; training facilities and equipment; repair and modification; and in-service engineering and logistics support. NAVAIR is organized into eight "competencies" or communities of practice including: Program Management, Contracts, Research and Engineering, Test and Evaluation, Logistics and Industrial Operations, Corporate Operations, Comptroller, and Counsel. NAVAIR provides support (people, processes, tools, training, mission facilities, and core technologies) to Naval Aviation Program Executive Office (PEOs) and their assigned program managers, who are responsible for meeting the cost, schedule, and performance requirements of their assigned programs. NAVAIR is the principal provider for the Naval Aviation Enterprise (NAE), while contributing to every Warfare enterprise in the interest of national security.

NAVAL FACILITIES ENGINEERING COMMAND (NAVFAC)

NAVFAC is the systems command that delivers and maintains quality, sustainable facilities, acquires and manages capabilities for the DON's expeditionary combat forces, provides contingency engineering response, and enables energy security and environmental stewardship. NAVFAC manages the planning, design, construction, contingency engineering, real estate, environmental, and public works support for the DON shore facilities around the world. They provide the Navy's forces with the operating, expeditionary, support, and training bases needed. NAVFAC is a global organization with an annual volume of business in excess of $11 billion. As a major Navy systems command and an integral member of the Navy and Marine Corps team, NAVFAC delivers timely and effective facilities engineering solutions worldwide.

NAVAL SUPPLY SYSTEMS COMMAND (NAVSUP)

NAVSUP's mission is to provide Navy, Marine Corps, joint and allied forces with products and services that deliver Combat Capability through logistics. They manage supply chains that provide material for DON aircraft, surface ships, submarines and their associated weapons systems and provide centralized inventory management for the DON's non-nuclear ordnance stockpile. NAVSUP provides a wide range of base operating and waterfront logistics support services, coordinating material deliveries, contracting for supplies and services, and providing material management and warehousing services. NAVSUP is responsible for many of the quality of life programs that touch the lives of Sailors and their families every day, including Navy Exchanges, Navy Lodges, the Navy Personal Property Program, and the Navy Postal System. They administer the Navy Food Service Program, with responsibility for the policies and procedures that govern the day to day operations of general messes afloat and ashore.

SPACE AND NAVAL WARFARE SYSTEMS COMMAND (SPAWAR)

SPAWAR is an acquisition command. SPAWAR delivers higher-end DON information technology products and services to the fleet and other Defense Department stakeholders. As the DON's information dominance systems command, SPAWAR designs, develops and deploys advanced communications and information capabilities. With more than 8,900 active duty military and civil service professionals located around the world and close to the fleet, SPAWAR is at the forefront of research, engineering, acquisition, and support services that provide vital decision superiority to our forces at the right time and for the right cost. It is SPAWAR's mission to make the DON's information dominance vision a reality. SPAWAR products and services transform ships, aircraft, and vehicles from individual platforms into integrated battle forces, enhancing information dominance and awareness among Navy, Marine, joint forces, federal agencies and international allies.

STRATEGIC SYSTEMS PROGRAM (SSP)

SSP is a highly specialized workforce composed of military and civilian, scientific, engineering, and professional personnel who work closely with private contractors and consultants. They direct the end-to-end effort of the DON's strategic weapons systems to include training, systems, equipment, facilities, and personnel; and fulfill the terms of the U.S./United Kingdom Polaris Sales Agreement.

BUREAU OF MEDICINE AND SURGERY (BUMED)

BUMED is the headquarters command for Navy Medicine. Under the leadership of the Navy Surgeon General, Navy Medicine provides high quality health care to beneficiaries in wartime and in peacetime. Highly trained Navy Medical personnel deploy with Sailors and Marines worldwide - providing critical mission support aboard ship, in the air, under the sea, and on the battlefield. At the same time, Navy Medicine's military and civilian health care professionals are providing care for uniformed services' family members and retirees at military treatment facilities around the globe. Today, BUMED is the site where the policies and direction for Navy Medicine are developed to ensure the DON's Patient and Family Center Care vision is carried out.

BUREAU OF NAVAL PERSONNEL (BUPERS)

BUPERS strives to support the needs of the DON by providing the fleet with the right person in the right place at the right time, using the most efficient Human Resource process. The BUPERS organization serves to provide administrative leadership, policy planning, and general oversight of the Commands.

MILITARY SEALIFT COMMAND (MSC)

MSC operates approximately 110 noncombatant, civilian-crewed ships that replenish DON ships, conduct specialized missions, strategically preposition combat cargo at sea around the world, and move military cargo and supplies used by deployed U.S. forces and coalition partners. MSC is headquartered at the Washington Navy Yard in Washington, D.C., and operates six subordinate commands worldwide. Five operational commands operate in the Atlantic, Pacific, Europe/Africa, Central, and Far East areas.

NAVAL SPECIAL WARFARE COMMAND (NSW)

NSW Groups command, train, equip, and deploy components of NSW Squadrons to meet the exercise, contingency, and wartime requirements of the regional combatant commanders, theater special operations commands, and numbered fleets located around the world. Additionally, support is provided by permanently deployed NSW units in Guam, Bahrain, and Germany. NSW Squadrons are built around deployed Sea, Air, and Land (SEAL) Teams and include senior leadership, SEAL Delivery Vehicle Teams, Special Boat Teams, and support technicians such as mobile communications teams, tactical cryptologic support and explosive ordnance disposal specialists. NSW Squadrons are among the most responsive, versatile, and effective force packages fighting the global war on terrorism today. Because SEALs are experts in special reconnaissance and direct action missions — the primary skill sets needed to combat terrorism — NSW is postured to fight a globally-dispersed enemy, whether ashore or afloat, before they can act.

U.S. PACIFIC FLEET

The U.S. Pacific Fleet, the world's largest fleet command, encompasses 100 million square miles, more than half the Earth's surface, from the West Coast of the United States into the Indian Ocean. The Pacific Fleet consists of approximately 180 ships, nearly 2,000 aircraft and 125,000 Sailors, Marines, and Civilians. Pacific Fleet was established in February 1941 and is headquartered at Pearl Harbor, Hawaii. U.S. Pacific Fleet protects and defends the collective maritime interests of the United States and its allies and partners in the Asia-Pacific region. In support of U.S. Pacific Command and with allies and partners, U.S. Pacific Fleet enhances stability, promotes maritime security and freedom of the seas, deters aggression and when necessary, fights to win. Commands that fall directly under the Pacific Fleet include "type" commands for surface ships, submarines, and aircraft as well as Navy construction. Operational commands that report directly to the U.S. Pacific Fleet include Third Fleet in the Eastern Pacific and Seventh Fleet in the Western Pacific and Indian Ocean.

COMMANDER NAVY INSTALLATIONS COMMAND (CNIC)

Established on 1 October 2003, CNIC is the Echelon II command under the CNO responsible for Navy-wide shore installation management. CNIC enables and sustains naval forces from the shore by designing, developing and delivering integrated shore capabilities to our fleet, the fighter, and the family. On any given day, our programs and services launch every shore-based ship, submarine, and aircraft, and take care of every sailor and their families. CNIC includes 11 regions, 70 Installations, and 126 Naval Operations Support Centers. CNIC has overall shore installation management responsibility and authority as the Budget Submitting Office (BSO) for installation support and as the DON point of contact for installation policy and program execution oversight.

U.S. FLEET FORCES COMMAND

The U.S. Fleet Forces Command supports both the CNO and Combatant Commanders worldwide by providing responsive, relevant, sustainable Naval forces ready for tasking. The command provides operational and planning support to Combatant Commanders and integrated warfighter capability requirements to the CNO. Additionally, U.S. Fleet Forces Command serves as the CNO's designated Executive Agent for Anti-Terrorism/Force Protection, IA, and Sea Basing. In collaboration with U.S. Pacific Fleet, U.S. Fleet Forces Command organizes, mans, trains, maintains, and equips Navy forces, develops and submits budgets, and executes readiness and personnel accounts to develop both required and sustainable levels of fleet readiness.

UNITED STATES MARINE CORPS (USMC)

The USMC is a branch of the U.S. military responsible for providing power projection from the sea, utilizing the mobility of the DON to rapidly deliver combined-arms task forces to global crises. The USMC is the nation's Expeditionary Force in Readiness. Established originally by an act of the Second Continental Congress on 10 November 1775, the Marine Corps has evolved into a balanced air-ground-logistics team that is forward deployed and forward engaged: shaping, training, deterring, and responding to all manner of crises and contingencies. Through the ongoing support of Congress and the American people, the Marine Corps is a cohesive force of 198,193 active duty Marines; 39,544 selected reserve Marines; and 22,310 civilian Marines. At any given time, approximately 30,000 Marines are forward deployed in operations supporting our nation's defense.

OFFICE OF NAVAL RESEARCH (ONR)

As the DON's science and technology provider, ONR provides technology solutions for Navy and Marine Corps needs. ONR's missions, defined by law is to plan, foster, and encourage scientific research in recognition of its paramount importance as related to the maintenance of future naval power, and the preservation of national security. Further, ONR manages Navy and Marine Corps basic and early applied research and advanced technology development to foster science and technology transition to higher levels of research, development, test, and evaluation for ultimate use in the fleet and force. ONR provides technical advice to the CNO and the SECNAV. Led by the Chief of Naval Research, its senior leadership oversees a portfolio of investments ranging from immediate, quick-turnaround technologies to long term basic research.

OFFICE OF NAVAL INTELLIGENCE (ONI)

The ONI is America's leading maritime intelligence service and a core element of the DON's Information Dominance Corps. Established in 1882, ONI is chartered to provide products and services to meet DON, DoD and national maritime intelligence requirements. ONI specializes in the analysis, production and dissemination of vital, timely and accurate scientific, technical, and military intelligence. ONI supports a broad range of customers worldwide including the fleet, warfighters, the Navy acquisition community, national intelligence community, law enforcement agencies, foreign and coalition partners, and national decision makers. The organizational structure is designed to strengthen the DON's conventional and irregular war fighting capacities, and to expand America's foresight into new technologies, future platforms, weapons, sensors, C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance) and cyber capabilities.

NAVAL RESERVE FORCE COMMAND (NAVRESFOR)

The mission of the U.S. Navy Reserve is to provide mission-capable units and individuals to the Navy and Marine Corps Team throughout the full range of operations from peace to war. In today's environment this mandate takes on added meaning and responsibilities as the Navy Reserve is called on to play an increasingly active role in the day-to-day planning and operational requirements of the active Navy. The Navy Reserve represents 20 percent of the DON's total assets and is a significant force multiplier the fleet must have to meet its growing global commitments. The Navy Reserve consists of the Ready Reserve, the Standby Reserve and the Retired Reserve.

FIELD SUPPORT ACTIVITY (FSA)

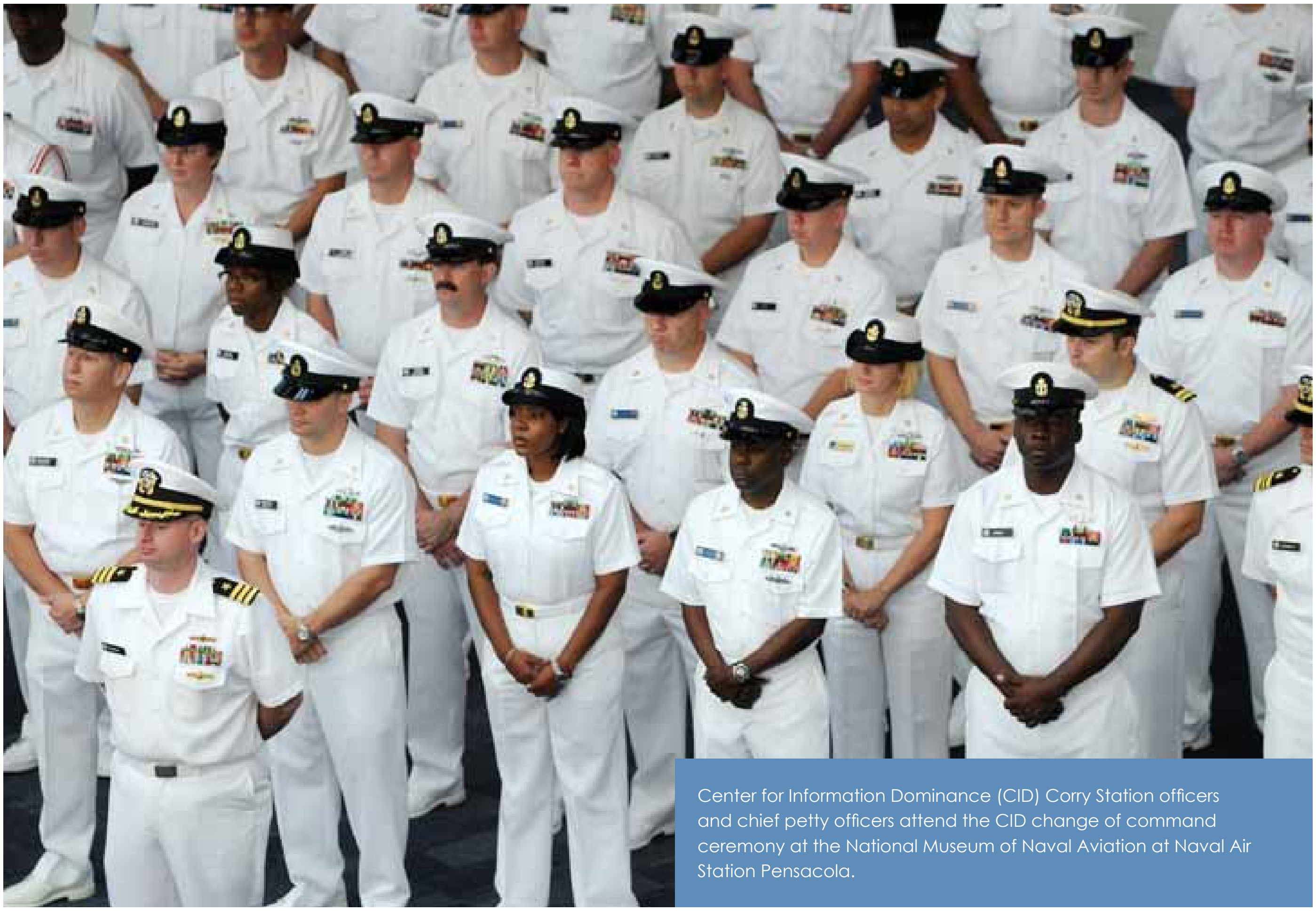
The mission of FSA is to establish, maintain and provide a system of financial services as the BSO and Principal Administering Office (PAO) for assigned unified commands, Navy Headquarters and activities; to initiate action in matters pertaining to the provision of funds and manpower, and to evaluate the utilization of such resources and initiate or recommend appropriate corrective action.

DEPARTMENT OF NAVY ADMINISTRATIVE ASSISTANT (AA)

The DON/AA organization provides administrative management and support to the Office of the SECNAV, its 6,000 member Secretariat, staff offices, field activities and supported organizations. These administrative divisions consist of Customer Service, Directives and Records Management, Contract Management, Executive Dining, Facilities and Support Services, Financial Management, Human Resources, Information Technology, and Security.

Navy Civilians: *(Full-time Equivalents)*	**190,247**
Marine Corps Civilians: *(Full-time Equivalents)*	**22,310**
U.S. Navy Active: *(Officers, Enlisted, and Midshipmen)*	**318,406**
U.S. Marine Corps Active: *(Officers and Enlisted)*	**198,193**
U.S. Navy Reserve: *(Drilling Reserve and Full-time Support)*	**64,715**
U.S. Marine Corps Reserve: *(Drilling Reserve and Full-time Support)*	**39,544**

Personnel Data as of Fiscal Year Ended September 30, 2012



Center for Information Dominance (CID) Corry Station officers and chief petty officers attend the CID change of command ceremony at the National Museum of Naval Aviation at Naval Air Station Pensacola.

STRATEGIC MANAGEMENT

We are committed to improving core capabilities that support the U.S. maritime strategy, "A Cooperative Strategy for 21st Century Seapower." These core capabilities are critical to U.S. maritime power and reflect an increased emphasis on activities that prevent war and build partnerships—forward presence, deterrence, sea control, power projection, maritime security, humanitarian assistance, and disaster response.

The cooperative strategy, guided by the objectives articulated in the National Strategy for Maritime Security, National Security Strategy, National Defense Strategy, and National Military Strategy, was developed to be a unified and enduring approach that will apply maritime power to the crucial responsibility of protecting vital U.S. interests in an increasingly interconnected and uncertain world. It binds the three maritime services—U.S. Navy, U.S. Marine Corps, and U.S. Coast Guard (during wartime)—closer together than ever before in a mission to more fully safeguard maritime interests at home and abroad.

Our six priority objectives (on the pages that follow) support the U.S. maritime strategy by focusing on key efforts that will increase our effectiveness and improve the lives of our Sailors, Marines, and their families, which results in greater security for our nation and U.S. global interests. A summary of key accomplishments by objective begins below.

In addition, as a separate and supporting element of our priority objectives, we are committed to transforming the way we do business. A summary of our key business transformation initiatives follows our discussion on priority objectives.

Objective 1: Take Care of Our People

Our Sailors, Marines, and civilians are the critical component to the U.S. maritime strategy, and we must ensure that we provide them with adequate compensation, medical care, and career training opportunities. These are key factors in attracting and retaining highly motivated and qualified personnel. We remain committed to providing a competitive pay and benefits package to aid in recruitment and retention. The package includes benefits, such as: basic pay, housing allowances, and incentives for critical specialties in health care, explosive ordnance disposal, and nuclear propulsion.

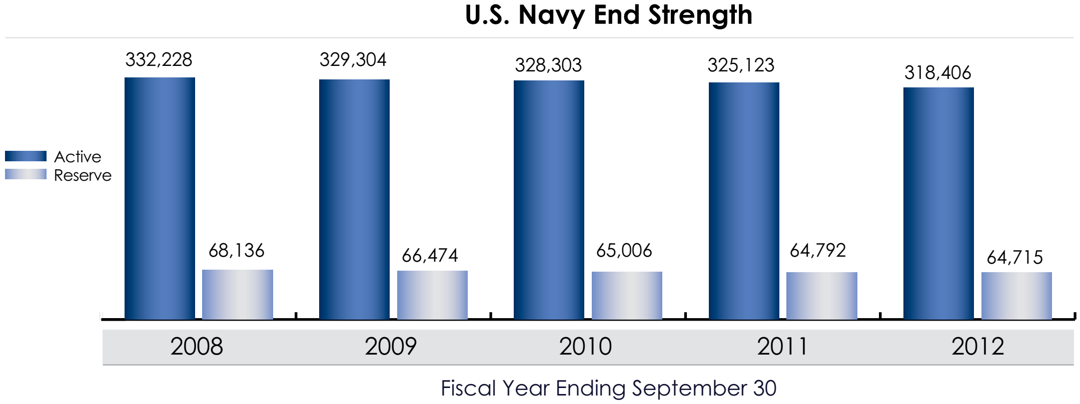
We are committed to providing our wounded, ill, and injured service members and their families with exceptional, individually tailored medical and non-medical care and support worthy of their service and sacrifice. Through the Navy Safe Harbor Program and the Marine Corps Wounded Warrior Regiment, our service members receive support and assistance throughout their recovery, rehabilitation, return to full duty, and reintegration into their communities. We also continue to provide encouragement and support for our wounded Sailors and Marines, in partnership with the Department of Veterans Affairs, long after they have left the Service. Additionally, the National Naval Medical Center has a new state-of-the-art unit to treat Traumatic Brain Injury (TBI). TBI is the defining wound of Operation Iraqi Freedom, and this clinic provides unsurpassed inpatient care for polytrauma patients with TBI, serving all blast exposed or head-injured casualties medically evacuated from theater. Further, to address Post Traumatic Stress Disorder (PTSD) and other psychological conditions that affect more and more of our force, the Navy and the Marine Corps continue to improve their Operational Stress Control (OSC) programs. This comprehensive approach seeks to not only promote psychological resilience, but also a culture of psychological health among our Sailors, Marines, and their families.

We remain invested in recruiting, training, and retaining DON personnel to create an environment that offers opportunity and promotes professional and personal growth. The DON's goal is to maintain an end strength and force structure in which seniority, experience and skills are matched to requirements. As America's naval forces are and will remain combat ready, the end of the combat in Iraq, drawdown in Afghanistan, and the transformation to the joint force of 2020 (outlined in the defense strategic guidance) has allowed our forces to become smaller and leaner, yet agile, flexible, and ready. With the development and retention of qualified personnel, the reduced level of strength will provide for affordability while still maintaining a ready, capable, and more senior force in support of the new Department guidance.

ARABIAN SEA (April 26, 2012) Sailors aboard the guided-missile destroyer USS Sterett (DDG 104) heave around a line during replenishment-at-sea. Sterett is deployed as part of the Abraham Lincoln Carrier Strike Group to the U.S. 5th Fleet area of responsibility conducting maritime security operations, theater security cooperation efforts and support missions as part of Operation Enduring Freedom.

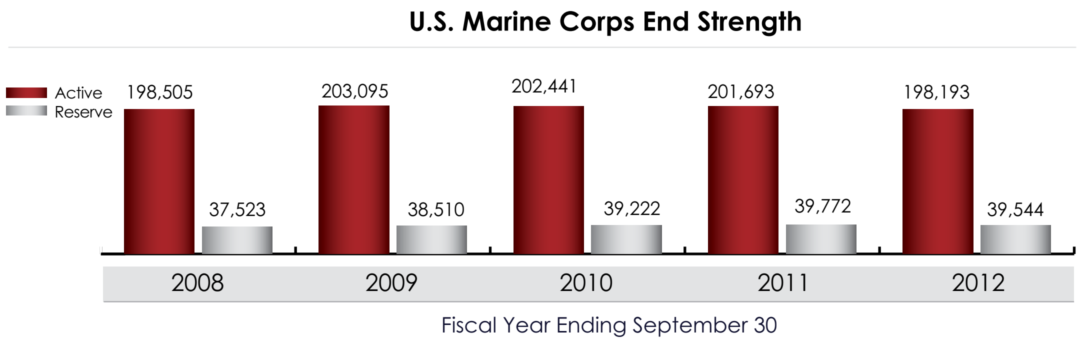
U.S. Navy

The Navy continues to resize and reshape its forces to meet its mission requirements more efficiently and effectively. This is especially important in an environment of limited budgetary resources and rising personnel costs. Over the last five years, the Navy has resized its active and reserve components by 4% and 5%, respectively. The Navy has been able to accomplish all assigned missions at this level because of force structure changes, efficiencies gained through technology, modifications in workforce mix, and new manning practices.



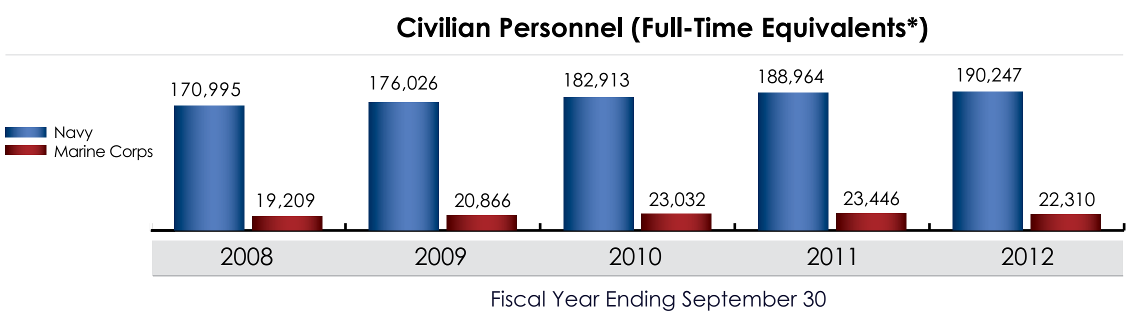
U.S. Marine Corps

To remain a force capable and optimized to support the National Defense Strategy, the Marine Corps completed a comprehensive force structure review in FY 2011. The review focused on the organization, posture, and capabilities required to meet future challenges and threats. A copy of the Force Structure Review Report is available at www.marines.mil. In FY 2012, the Marine Corps affirms the results of the initial strategy-driven effort, but has begun to readjust its parameters based on the fiscal realities of spending cuts and is moving to a final end strength of 182,100. This drawdown will begin in FY13.



Navy and Marine Corps Civilian Personnel

The size of the civilian workforce, which has increased by 12% over the last five fiscal years, continues to support the mission and daily functions of the Navy and Marine Corps. Civilian personnel provide various types of support, such as research and development, engineering, acquisition, depot maintenance, and financial management and budget.



** Full-time equivalents are the total number of regular straight-time hours (i.e., not including overtime or holiday hours) worked by employees divided by the number of compensable hours applicable to each fiscal year.*

Objective 2: Maintain Warfighter Readiness in an Era of Reduced Budgets

Today's security environment has created new demands for naval forces. This demand includes support for security, stabilization, transition and reconstruction operations, support for homeland security, and continued preparedness for contingency operations. The evolving dynamics of the 21st-century security environment require our forces to be ready to deploy globally. Although we are in an era of reduced budgets, DON will maintain strong, agile, and capable military forces. Operational readiness is the catalyst that brings naval power to bear whenever it is needed. Our budget supports requirements for our CSGs, ESGs, and Marine Expeditionary Forces (MEFs) to execute the National Military Strategy and respond to persistent as well as emerging threats. Our Navy-Marine Corps team has become an integral part of continuing overseas contingency operations. We continue funding the necessary requirements to ensure our ability to protect vital U.S. interests and assure and assist our friends and allies in crisis situations.

The DON's top readiness priority is ensuring that forces are fully supported while deployed. In order to do so, the DON requires a highly educated and trained, highly skilled and disciplined force. Using advanced technologies, we have shifted training from the traditional classroom to the use of simulators, trainers, computer-based interactive curriculums, and other media-based approaches. This initiative provides our naval workforce with appropriate training in a more efficient manner and prepares them to better perform mission-critical tasks.

The DON has the most effective combat force in history and it is our job to maintain that effectiveness. With the new Defense Strategy putting an increased responsibility on the Navy and Marine Corps in the years to come, it is the duty of DON's leadership to provide its most essential assets, Sailors and Marines, with the resources to maintain that resiliency. In doing so, the DON instituted the 21st Century Sailor and Marine initiative which lays out a set of objectives and policies, new and existing, to maximize every Sailor's and Marine's personal readiness.

Sailors assigned to Riverine Squadron (RIVRON) 1 set a security perimeter while conducting a hot extract drill during Exercise Bold Alligator 2012. Bold Alligator is the largest amphibious exercise in the past 10 years and represents the Navy and Marine Corps' revitalization of the full range of amphibious operations.

21st Century Sailor and Marine

We want to provide our Sailors, Marines, and families with the tools needed to face the challenges of the 21st Century and to help Sailors and Marines preserve the skills and talents they bring to the fight. This initiative will advance progress by leveraging programs under the following five areas: Readiness, Safety, Physical Fitness, Inclusion, and Continuum of Service. These areas focus on equipping Sailors, Marines, and their families to meet both the physical and mental challenges of serving in our military. This new approach will help to interrelate dozens of programs that have been implemented to improve the health, well-being, and safety of Sailors and Marines.

Fleet Response Plan

We remain focused on providing ready naval forces, from individual units to CSGs and ESGs, that are forward deployed and capable of providing a substantial surge force. The Fleet Response Plan (FRP), which supports the National Military Strategy, provides the readiness for this capability. The FRP provides adaptable, flexible, and sustainable naval forces necessary not only to fight current ongoing contingencies, but also to support the needs of the combatant commanders to maintain a global forward presence and any other evolving national defense requirements.

Individual Augmentees

IAs have been instrumental in fulfilling combatant commanders' mission requirements for overseas contingency operations. They are assigned individually, rather than as part of a traditional unit, to fill shortages or provide specialized knowledge or skill sets. The Navy identifies both active and reserve service members with specific skill sets to fill IA roles, and the Marine Corps relies principally on activated reserve members to fill IA positions vacated by forward-deployed active component Marines.

Marines assigned to Amphibious Reconnaissance Platoon, 31st Marine Expeditionary Unit (31st MEU) depart the well deck of the forward deployed amphibious-assault ship USS Essex (LHD 2) to conduct combat rubber raiding craft training. Essex is part of the Essex Amphibious ready Group and is conducting operations in the western Pacific region.

Marine Corps Operating Forces

MEFs provide highly trained, versatile expeditionary forces capable of rapid response to global contingencies. Each MEF consists of a command element, one infantry division, one aircraft wing, and one Marine logistics group. Embedded within each MEF are three Marine Expeditionary Units, which deploy regularly in the ESGs. Each MEF also has an embedded capability to source a Marine Expeditionary Brigade.

Objective 3: Lead the Nation in Sustainable Energy

The DON is committed to improving energy security and environmental stewardship by reducing reliance on fossil fuels. The DON is actively developing and participating in energy, environmental and climate change initiatives that will increase the use of alternative energy and help conserve the world's resources for future generations.

Reducing our naval forces' reliance on fossil fuels is critical to our national security, environment, and naval capabilities. Our nation and naval forces rely heavily on a finite source of fuel from volatile global regions. To a certain extent, we have ceded this strategic resource to other nations, creating an obvious vulnerability to our national security. In addition, our reliance on fossil fuels affects our naval forces' operational independence, both in terms of the resources required to obtain fuel and to transport it to the ships, aircraft, and equipment, and the Sailors and Marines whose duty it is to protect the ships and convoys moving the fuel.

With these risks in mind, we have taken a bolder, more aggressive stance toward energy reform by committing to five energy goals (see chart on next page). These goals require adoption of new fuels and development of new systems and energy efficient practices and techniques over the next 10 years. The DON's strategy in achieving these goals is centered on energy security, energy efficiency and sustainability while remaining the preeminent maritime power.

The Rim of the Pacific Exercise

RIMPAC 2012 featured the first demonstration of the DON's "Great Green Fleet," during which U.S. surface combatants and carrier-based aircraft tested, evaluated and demonstrated the cross-platform utility and functionality of biofuels. Twenty two nations, 42 ships, six submarines, more than 200 aircraft and 25,000 personnel participated in the exercise in and around the Hawaiian Islands. The world's largest international maritime exercise, RIMPAC provided a unique training opportunity that helped participants foster and sustain cooperative relationships that are critical to ensuring the safety of sea lanes and security on the world's oceans. This demonstration also incorporated prototype energy efficiency initiatives such as solid state lighting, on-line gas turbine waterwash, and energy management tools.

Solar Farm at Naval Air Weapons Station China Lake

The construction of a SunPower Corporation 13.78 megawatt solar photovoltaic power system, the largest solar project in the DON, officially began at NAWS China Lake. The SunPower's Oasis Power Plant product, a fully-integrated, modular solar block consisting of 31,680 solar panels, is expected to generate more than 30 percent of NAWS China Lake's annual energy load. The solar farm integration will allow the DON to buy electricity below the retail utility rate and reduce costs by an estimated $13 million over the next 20 years.

DEPARTMENT OF THE NAVY ENERGY GOALS

Energy Efficient Acquisition: Evaluation of energy factors will be mandatory when awarding contracts for systems and buildings.

Sail the "Great Green Fleet": The Green Strike Group demonstrated in local operations in 2012 will sail by 2016.

Reduce Non-Tactical Petroleum Use: By 2015, DON will reduce petroleum use in the commercial fleet by 50%.

Increase Alternative Energy Ashore: By 2020, DON will produce at least 50% of shore-based energy requirements from alternative sources; 50% of DON installations will be net-zero.

Increase Alternative Energy Use DON-Wide: By 2020, 50% of total DON energy consumption will be from alternative sources.

SECNAV the Honorable Ray Mabus arrives at Boldak Expeditionary Energy Patrol Base in Afghanistan. Secretary Mabus visited with Sailors and Marines and observed how they are using the Ground Renewable Expeditionary Energy System (GREENS) and other expeditionary energy technologies.

Objective 4: Promote Acquisition Excellence and Integrity

To protect U.S. national interest and achieve the objectives of the 2010 National Security Strategy in this environment, the DON will need to recalibrate its capabilities and make additional selective investments to succeed in its missions. Despite the fact that The Budget Control Act of 2011 mandates the reduction of federal spending, the fleet will be no smaller in the future than it is today. Therefore, as replacement costs of our aging ships, aircraft, and weapons systems continue to rise faster than our procurement budgets' top-line, the DON must reduce the cost of doing business. This entails improving program execution, rebuilding the acquisition workforce, leveraging strategic sourcing, and promoting competition all while protecting a healthy industrial base.

Sailors assigned to the Nimitz-class aircraft carrier USS Abraham Lincoln (CVN 72) man the rails as the ship pulls out of San Diego. Lincoln, underway on deployment to the U.S. 5th and 7th Fleet areas of responsibility, is changing homeports from Everett, Wash. to Norfolk, Va. following deployment for a periodic refueling complex overhaul.

The DON continues to aggressively work to examine and streamline the DON's design and construction processes in accordance with the Weapons System Acquisition Reform Act of 2009. The result will be improved management of the design and schedule processes so that the impact on acquisition and total weapons systems life cycle costs can be better estimated. This will enable the cost impact of design and scheduling changes to be better forecasted and their impact on future fleet sizes to be better understood and anticipated.

In addition, a healthy industrial base and strong performance from our industry partners improve our ability to deliver an affordable combat capability to the fleet. We have worked diligently to procure our ships, aircraft, and weapon systems at a rate intended to bring stability to the industrial base and enable efficient production. We will continue to work with our shipyards, aircraft manufacturers, and weapon systems providers to benchmark performance, to identify improvements, to provide the proper incentives for capital investments, and to reward strong performance with terms and conditions that reflect our desire for a strong government-industry partnership.

We are also rebuilding the acquisition workforce through a number of parallel efforts. These include expansion of recruitment at all levels, including interns, journeymen, and highly qualified experts, and the retention and credentialing of qualified personnel at the middle and senior career levels. We remain committed to preventing capability gaps in the acquisition workforce, with a view of ensuring that the Navy and Marine Corps maintain a healthy technical authority within the Department.

Objective 5: Dominate in Unmanned Systems

Unmanned systems expand our naval capabilities in Intelligence, Surveillance, and Reconnaissance (ISR), and reduce the exposure of our naval forces to unnecessary threats. The DON's vision is to achieve an integrated hybrid force of manned and unmanned systems with the ability to sense, comprehend, predict, communicate, plan, make decisions, and take appropriate actions to achieve its goals. The employment of these systems will reduce risk for Sailors and Marines and increase capability. During 2012, the DON has continued to work towards achieving this goal with the continued development of programs such as: Knifefish (underwater drone), Remote Environmental Monitoring Unit Systems (REMUS), Unmanned Carrier Launched Surveillance and Strike program (UCLASS) and other Unmanned Aircraft Vehicles (UAV's).

Objective 6: Drive Innovative Enterprise Transformation

Business Transformation

As a separate and supporting element of our priority objectives, we are committed to transforming the way we do business by using our people, processes, and systems more effectively. The DON FIAR plan is the integrating financial element of our business transformation strategy and a supporting initiative of the DoD FIAR plan, which organizes and prioritizes the audit readiness and financial improvement efforts of DoD Components. Audit readiness is a goal of business transformation and a key metric for measuring its success and progress. Navy ERP is the key system driver of our business transformation and a key enabler of the DoD Enterprise Transition Plan, which organizes and prioritizes efforts to modernize DoD business and financial systems. Continuous Process Improvement/Lean Six Sigma (CPI/LSS) initiatives, part of the DoD-wide CPI/LSS program, enable more effective and efficient operations across the DON enterprise.

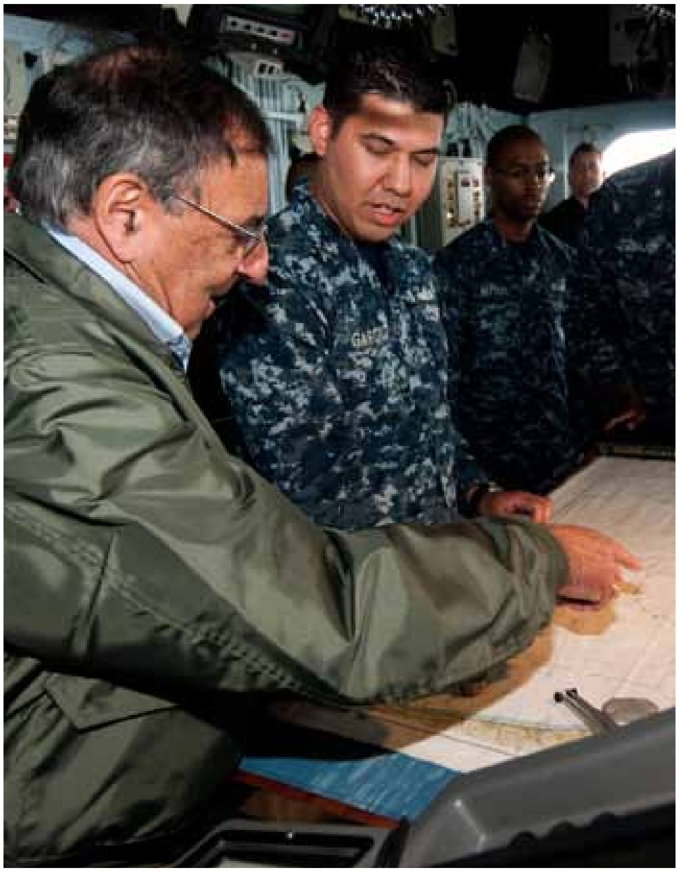
DON Financial Improvement and Audit Readiness Plan

The DON FIAR plan is a multi-year Department-wide effort to modernize Navy-Marine Corps financial processes and systems to better serve worldwide operations. The goal of our efforts is to produce financial management information more timely and with greater accuracy, reliability, and accessibility. With improved information, we can allocate DON resources in a more precise way and move closer to producing auditable DON-wide financial statements.

Our efforts align with the new priorities and associated strategy established by the Under Secretary of Defense (Comptroller) for bringing DoD into a state of financial audit readiness and in compliance with the Chief Financial Officers Act of 1990 (as amended). These priorities focus on improving processes, controls, and systems that support information most often used and relied upon by both civilian and military leaders in daily business operations—budgetary information reported on the SBR, and mission critical asset information such as military equipment and real property reported on the Balance Sheet. These priorities demonstrate the value of the financial statements to our daily business operations, particularly for funds control and resource utilization.

The DON has asserted on a Major Defense Acquisition Program (MDAP), General Fund (GF) Transportation of People (TOP), and Civilian Payroll (CIVPAY), to ensure the business processes or segments are audit ready. For FY 2013, the Office of Financial Operations (FMO) is on target to assert Reimbursable Work Orders (Grantor and Performer), Financial Statement Compilation and Reporting (FSCR), Military Standard Requisitioning and Issue Procedures (MILSTRIPS), Contractor Vendor Payments (CVP), Military Payroll (MILPAY), and GF Fund Balance with Treasury. The DON, in conjunction with our primary service provider Defense Finance and Accounting Service (DFAS) continues to collaborate on assertion efforts. Jointly, with DFAS, the DON has launched initiatives to promote transparency to the full transaction universe, which will allow meaningful testing and provide audit trails. The joint initiatives will yield considerable value to our audit readiness efforts. In addition, despite various challenges, the Marine Corps SBR audit continues to move forward, providing significant insight and lessons that have led DON to enhance its overall SBR Audit Readiness Plan.

For the DON's Existence and Completeness efforts, we received unqualified audit opinions on our ships, submarines, intercontinental ballistic missiles, satellites, and aircraft in FY 2012. We also plan to re-assert ordnance with an expected audit in FY 2013.



Secretary of Defense the Honorable Leon E. Panetta views navigation charts with the navigation department of the amphibious assault ship USS Peleilu (LHA 5) on the ship's bridge.

Marine Corps Financial Improvement and Audit Readiness Initiative

By means of an independent study, we analyzed the value of the Marine Corps' effort to pursue financial audit readiness in terms of the bottom line impact for improving the efficiency and effectiveness of their financial processes and controls. This impact was measured in terms of the direct return for every dollar appropriated by Congress. The results of this analysis showed that for every dollar invested, nearly three dollars in value were created and that the resulting economies translated directly into the Marine Corps having the capability to purchase more mission supportive weapons for the same amount of appropriated resources. In the future, we will use this return on investment metric as a guide as we implement the substantial lessons learned from the ongoing Marine Corps audit experience to the Navy.

The Marine Corps is the first major operational war-fighting organization to achieve audit readiness for any of the four financial statements and therefore, over a broad part of their business operations. The Marine Corps selected the SBR as the first statement to assert for audit readiness because it is the most heavily used and therefore, most heavily relied upon in the day-to-day management of their resources. The Marine Corps' audit readiness efforts also provide a meaningful pilot for DON as we continue to discover how to use the audit process to improve resource management.

Navy Enterprise Resource Planning

Navy ERP is an integrated business management system that unifies, standardizes, and streamlines Navy business operations. It has replaced multiple older, more costly information systems, with data managed in a single system, providing financial transparency to just over half of the Navy's total obligation authority. Commands who have implemented Navy ERP have realized measurable improvements in accuracy, timeliness, and accessibility of information and efficiencies in business and reporting processes. Navy ERP continues to drive enterprise-wide business process efficiencies and provides financial transparency and total asset visibility through business process and data standardization efforts; it will be a major positive force contributing toward Navy's financial audit readiness.

The Navy ERP system Acquisition and Financial Management functionality has been operational since October 2007, and today includes the following commands, serving over 71,000 users: NAVAIR, NAVSUP, NAVSEA, SPAWAR, ONR, and SSP.

The DON deployed the Single Supply Solution, which consolidates wholesale and retail supply functions, in Spring 2010. This functionality is directly benefiting our warfighters through improved inventory management, with the ability to quickly locate parts anywhere in the world and get them to the warfighter in record time. With inventory enterprise visibility, the DON is achieving significant savings through more effective use of existing global inventory.

More information on Navy ERP is available at http://www.erp.navy.mil.

Continuous Process Improvement

CPI is a primary enabler for managing the effectiveness and efficiency of our processes in support of the warfighter and business operations and a critical path toward financial audit readiness. CPI provides our workforce with proven performance improvement tools, such as Lean/Six Sigma and Audit Readiness Training Symposiums, to build a strong warfighter support foundation for improving cycle time and reliability, aligning the work of subordinate organizations to enterprise-wide goals, and optimizing costs. Under the purview of the UNSECNAV for Business Operations and Transformation, we are bringing together processes and organizations for the accomplishment of strategic and corporate business objectives.

During FY 2012, our workforce continued to demonstrate their commitment to performance improvement. For example, the Navy Medicine Resources Community held an audit readiness training symposium. The training symposium provided resource managers the opportunity to strengthen working relationships, highlight best practices in acquisition and medical equipment management, tools to optimize efficiency of their business practices, and enhance transactional excellence.

SYSTEMS, CONTROLS AND LEGAL COMPLIANCE

Commanders and managers throughout the DON must ensure the integrity of their programs and operations. Part of this responsibility entails compliance with Federal requirements for financial reporting, financial management systems, and internal controls, such as the Federal Financial Management Improvement Act (FFMIA) and the Federal Managers' Financial Integrity Act (FMFIA). These requirements promote the production of more timely, reliable, and accessible financial information, supported by the development and implementation of more effective internal controls. More useful financial information and effective controls save money and improve efficiency, thereby enhancing public confidence in our stewardship of public resources, which is critical for the protection and sustainment of our nation and vital U.S. interests.

Below is the management assurance statement which provides management's assessment of the effectiveness of the DON's internal controls in conjunction with FFMIA and FMFIA. This section also provides the DON's detailed assessment of internal controls over non-financial operations, financial reporting, acquisition, and financial systems.

FY 2012 ASSURANCE STATEMENT

The Department of the Navy's (DON) management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the *Federal Managers' Financial Integrity Act (*FMFIA).

The DON conducted an assessment of the effectiveness of internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations in accordance with the Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Contro*l. Based on the results of this evaluation, the DON identified material weaknesses in its internal control over non-financial operations in the areas of contract administration, procurement, acquisition, communications/security, and intelligence. The DON provides a qualified statement of assurance that the internal control over non-financial operations meets the objectives of FMFIA, Section 2, with the exception of the five material weaknesses. Details of the material weaknesses identified are available in Other Accompanying Information, of this report.

In addition, the DON conducted an assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of OMB Circular A-123, Appendix A, *Internal Control Over Financial Reporting*. The DON did not fully implement the requirements of Appendix A and therefore provides no assurance that internal control over financial reporting meets the objectives of FMFIA, Section 2.

The DON did not complete an assessment of the effectiveness of internal controls over financial systems. Accordingly, the DON provides no assurance that the financial management systems conform to the objectives of FMFIA, Section 4, and the *Federal Financial Management Improvement Act* (FFMIA). A summary of actions the DON will take to achieve compliance is included in the following sections.

Management Assurances

The objectives of the systems of internal accounting and administrative control of the DON are to provide reasonable assurance that:

- Obligations and costs are in compliance with applicable laws;
- Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
- Revenues and expenditures are properly recorded and accounted for to permit the preparation of reliable accounting, financial, and statistical reports and to maintain accountability over the assets.

Internal Control Over Non-Financial Operations

The DON Managers' Internal Control Program (MICP) is the administrative vehicle for monitoring the Department's systems of internal control by evaluating and maintaining sufficient documentation to support its evaluation and level of assurance. The MICP is decentralized and encompasses both shore Commands and afloat forces. The evaluation of internal control extends to every responsibility and activity undertaken by the DON and applies to program, administrative, and operational controls.

Primary responsibility for program execution and reporting resides within a network of 19 Major Assessable Units (MAUs), which include the Assistant Secretaries of the Navy, the CNO, the Commandant of the Marine Corps (CMC), Secretariat Staff Offices and other entities that report directly to the SECNAV or UNSECNAV. The DON MAUs receive internal control certification statements from their subordinate units and in turn provide the UNSECNAV with their annual FMFIA Certification Statements. The signed certification statements are used as the primary source documents for the SECNAV's determination of reasonable assurance over the effectiveness of the Department's system of internal control.

Complementing the self-reporting of control deficiencies, the DON's Auditor General, in collaboration with the Deputy Assistant Secretary of the Navy, Financial Operations (DASN (FO)), reviews audit reports from the Government Accountability Office (GAO), the DoD Inspector General, and the Naval Audit Service (NAVAUDSVC). This review helps identify control deficiencies and utilizes a systematic methodology to determine materiality. The high degree of collaboration and communication between the DASN (FO) MICP administrators and the NAVAUDSVC has resulted in a consistent and comprehensive perspective on the DON's internal control posture.

Outstanding Material Weakness FY 2012

INTERNAL CONTROL REPORTING CATEGORY	MATERIAL WEAKNESS	TARGET CORRECTION YEAR
Contract Administration	Service Contracts	FY 2013
Acquisition	Attenuating Hazardous Noise in Acquisition & Weapon System Design	FY 2012
Communications/ Intelligence/Security	Management of Communications Security (COMSEC) Equipment	FY 2013
Communications/ Intelligence/Security	Safeguarding Personally Identifiable Information (PII)	FY 2013
Procurement/ Contract Administration	Effective Use of Earned Value Management (EVM) Across Shipbuilding Programs	FY 2013

In addition to the operational assessments described above, the DON MICP includes a separate assessment of Internal Control over Financial Reporting (ICOFR) and Internal Control over Financial Systems (ICOFS).

Internal Control over Financial Reporting

The DON continues to implement processes to reach a status of full compliance with OMB Circular A-123, Appendix A in conjunction with overall Navy and Marine Corps audit readiness efforts under the DoD FIAR. The DON's current focus is on achieving the FIAR priorities relative to budgetary information and mission critical asset information priorities. Through the DON FIAR discovery process, we continue to work closely with participating Commands and service providers, such as DFAS, to identify, evaluate, and document the risks and internal controls associated with the end-to-end business processes underlying our financial statements. Attention is focused on remediating material weaknesses that will allow for overall achievement of the DON's assertion goals.

Through the DON FIAR discovery process, documentation efforts continue as the DON moves towards its objective of asserting audit readiness over all financial reporting segments. In FY 2012 GF material weaknesses continued to be reported in Fund Balance with Treasury (FBWT), Reimbursable Work Orders-Grantor (RWO-G), Reimbursable Work Orders-Performer (RWO-P), Military Equipment, General Equipment, Real Property, Inventory, and Operating Materials & Supplies. In FY 2013, FMO plans further discovery and development of corrective action plans with executable tasks to mitigate the material weaknesses.

The Marine Corps continued improving the documentation of specified business processes to assist stakeholders and auditors with their understanding of financial processes and key controls used by the Marine Corps. The Marine Corps' ICOFR program aims to support DON FIAR objectives by targeting specific evaluations that strengthen the integrated objectives of the DON SBR assertion. In FY 2012, the Marine Corps developed risk and internal control assessments impacting Financial Reporting, Reimbursable Orders, Procurement of Material and Services, Miscellaneous Payments, Transportation, and Travel. For FY 2012, the Marine Corps separately reported material weaknesses in Military Equipment, Real Property, Missing Receipt and Acceptance Supporting Documentation for Intra-governmental Transactions, Timely Recording of Obligations, and Information Systems. Pending additional analyses and concurrence by the Marine Corps Senior Assessment Team, corrective action plans will be developed and executed to address the material weakness.

Internal Control over Acquisition

The DON assessed Internal Control over Acquisition Functions using the OMB Guidelines for Assessing the Acquisition Function and OSD Acquisition, Technology and Logistics (AT&L) Guidance. This effort focused on determining whether any new deficiencies or material weaknesses exist within DON and associated corrective action plans within all acquisition programs, abbreviated acquisition programs, non-acquisition programs, and rapid deployment capability programs.

The DoD and OMB templates were used as the primary guides for assessing the effectiveness of internal controls over acquisition functions. The DON's implementation of controls was evaluated in comparison to elements of OMB Circular A-123 cornerstones (organizational alignment and leadership, policies and processes, human capital, and information management and stewardship).

The DON Gate Review process is the primary mechanism for program insight and governance of select acquisition programs. The Gate Review process ensures alignment between service-generated capability requirements and acquisition, as well as improving senior leadership decision-making through better understanding of risks and costs throughout a program's entire life cycle. Overall program health is assessed at each Gate Review and addressed in the resulting decision document upon completion of the review. As part of all Gate Reviews, the DON uses probability of program success as the key metric to assess overall program health, taking into account program requirements, resources, planning and execution, and external influences. Current program decision meetings provide the forum for the component acquisition executive to review program cost, schedule, and performance in preparation for a key acquisition decision. These forums may be integrated with the updated Gate Review process.

National Defense Authorization Act for FY 2012 Section 901 includes revisions to the defense business systems requirements for investment review and certification before funds can be expended. Section 901 establishes a single Investment Review Board (IRB) chaired by the Deputy Chief Management Officer (DCMO) and significantly expands the scope of systems requiring certification to include any defense business system with a total cost in excess of $1M over the period of the current future-years defense program, regardless of type of funding or whether any development or modernization is planned.

The ASN (RD&A) Dashboard system is a live database that provides SECNAV, ASN (RD&A), OPNAV, Headquarters Marine Corps (HQMC), System Commands (SYSCOMs), Program Executive Office (PEOs), Direct Reporting Program Managers (DRPMs), and the Program Managers (PMs) a tool to manage the various Acquisition Category (ACAT) programs with consistent data throughout the chain of command. PMs must complete Dashboard updates for ACAT I, II, and III programs on a quarterly basis. Dashboard requires general information regarding program milestones and status, and detailed information addressing program assessment, budget information, and metrics information.

The DON uses the Earned Value Management System (EVMS) as a metric to measure contractor performance. Earned Value is an element of program health assessed during the Gate 6 review following the PM's Integrated Baseline Review (IBR) with the contractor. IBR objectives include: assess the Performance Measurement Baseline (PMB) adequacy including identification of risks, achieve a mutual understanding of the PMB and its relationship to EVMS, ensure tasks are planned and objectively measurable relative to technical progress, attain agreement on a plan of action to evaluate any identified risks, and quantify the identified risks and incorporate an updated Estimate At Completion (EAC).

Indicators of practices and activities that facilitate good acquisition outcomes include, but are not limited to: review by the Naval Capabilities Board (NCB), Resources & Requirements Review Board (R3B), and Configuration Steering Boards (CSBs); requirement for Independent Cost Estimates (ICEs); requirement for program Independent Operational Test and Evaluation (OT&E); and the use of Integrated Product Teams (IPTs).

The NCB/R3B recommends validation of all war fighting requirements, including Key Performance Parameters (KPPs) and Key System Attributes (KSAs). The R3B is the Navy's forum for reviewing and making decisions on Navy requirements and resource issues. The R3B acts as the focal point for decision-making regarding DON requirements; the validation of non-acquisition related, emergent, and Joint requirements; the synchronization of Planning, Programming, Budgeting, and Execution (PPBE) milestones; and resolution of cross-enterprise or cross-sponsor issues.

The DON has implemented DoD's requirement for annual CSBs by integrating this function into the Gate Review process. ASN (RD&A), as the Service Acquisition Executive (SAE), chairs the Gate 6 CSB. CSBs consist of broad membership including representation by the Acquisition, Requirements, and Resourcing communities. Gate 6 CSBs review all requirements changes and any significant technical configuration changes which have the potential to result in cost and schedule impacts to programs.

The Naval Center for Cost Analysis (NCCA) prepares life cycle ICEs for those programs delegated to the DON SAE as Milestone Decision Authority (MDA). NCCA also conducts component cost analyses for joint programs led by DON. NCCA chairs a DON Cost Assessment review of program office and independent life cycle cost estimates and component cost analyses to support major milestone decisions for designated programs. Formal presentations of estimates are made to the Director, NCCA. Differences in estimates are noted, explained, and documented in a memorandum from NCCA to ASN (RD&A).

The Commander, Operational Test and Evaluation Force (COMOPTEVFOR) and Director, Marine Corps OT&E Activity are responsible for independent OT&E of assigned DON programs that require it. COMOPTEVFOR plans, conducts, evaluates, and reports the OT&E of designated programs, monitors smaller category programs, evaluates initial tactics for systems that undergo OT&E, and makes fleet release or introduction recommendations to CNO for all programs and those configuration changes selected for OT&E.

IPTs are an integral part of the defense acquisition process used to maintain continuous and effective communications and to execute programs. IPTs may address issues regarding requirements, capabilities needs, acquisition strategy and execution, financial management, milestone, and decision review preparation, etc. MDAs and PMs are responsible for making decisions and leading execution of their programs through IPTs. IPTs typically include representation from acquisition functional areas including program management, cost estimating, budget and financial management, contracting, engineering, test and evaluation logistics, software development, production/quality control, safety, etc. DON effectively balances the use of IPTs with the requirement for PEOs, SYSCOMs, DRPMs, and PMs to ensure separation of functions so the authority to conduct oversight, source selection, and contract negotiations/award does not reside in one person.

Internal Control over Financial Systems

The DON did not complete an internal review of the effectiveness of the ICOFS. As processes are not fully in place to assess control, the DON provides no assurance for FY 2012 that ICOFS is in compliance with the FFMIA and OMB Circular A-127, *Financial Management Systems.*

The DON understands ICOFS plays a key role in the audit of the DON financial statements. The DON implemented a strategy for identifying and prioritizing assessment of financial and mixed systems. Over two hundred systems are utilized to support DON's complete set of financial statements. Once a system was identified as audit relevant or critical to the segment assertion package, the DON worked with the segment to collect additional data points that would affect the assessment scope, approach, and timeline. The DON strategy for assessing legacy system Information Technology (IT) controls was piloted with the Standard Labor Data Collection and Distribution Application (SLDCADA) and Defense Civilian Personnel Data Systems (DCPDS). Strategy improvements were identified and incorporated to develop a joint memo that was distributed to the Command Information Officers requesting leadership's support, involving IT systems audit readiness activities. The DON is also currently assessing the Navy ERP IT controls. This evaluation will identify strengths and weaknesses in the design and operation of Navy ERP IT controls supporting the integrity and reliability of underlying financial data. Additionally, the Marine Corps conducted a limited review of the effectiveness of internal control for four financial management systems: Global Combat Supply System – Marine Corps (GCSS-MC), Marine Corps Permanent Duty Travel (MCPDT), Purchase Request Builder (PR Builder), and Marine Corps Total Force System (MCTFS). Corrective actions are underway to address Notices of Findings and Recommendations received by Marine Corps management.

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The accompanying financial statements and related disclosures represent our enduring commitment to fiscal accountability and transparency. Through our FIAR plan and related business transformation initiatives discussed earlier, we have made significant progress toward improving the quality and timeliness of our financial information. However, we are currently unable to fully implement all elements of U.S. generally accepted accounting principles and OMB Circular A-136, Financial Reporting Requirements, due to limitations of our financial and non-financial management processes and systems feeding into the financial statements. Because of these limitations, the DoD, Office of Inspector General, was unable to express an opinion on our FY 2012 financial statements. It should be noted that these limitations exist primarily in our proprietary accounting processes and less so in the budgetary accounting performed to manage and report on the application of budget authority to the purposes and programs approved in appropriations acts. In fact, the U.S. Marine Corps its GF SBR and DON revised its strategy to place first priority on its audit of the SBR as well. Despite documented material weaknesses and because of compensating measures and close oversight, we believe the budgetary information used for decision-making is accurate and reliable.

For financial reporting purposes, we are organized into two reporting entities: DON GF and Naving Working Capital Fund (NWCF), which include financial information for both the U.S. Navy and the USMC. Each reporting entity has a separate set of financial statements and related disclosures.

DON General Fund

The DON GF supports overall Departmental operations. Enacted appropriations comprise the majority of the GF account structure, which includes five major appropriation groups:

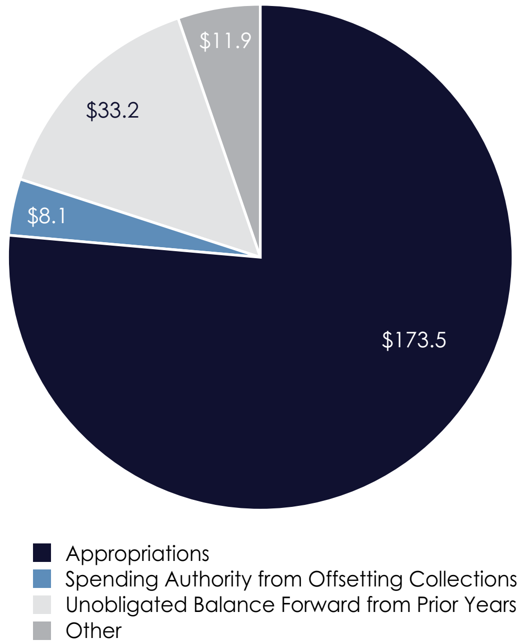
- Operation and Maintenance
- Military Personnel
- Procurement
- Research, Development, Test, and Evaluation
- Family Housing and Military Construction

Enacted appropriations flow through OMB and the Office of the Secretary of Defense to the Office of the Secretary of the Navy, where they are allocated to administering offices and commands. The administering offices and commands, which in turn obligate the appropriations to fund operational expenses and capital investments, are required to exercise a system of effective control over financial operations.

Results of Operations

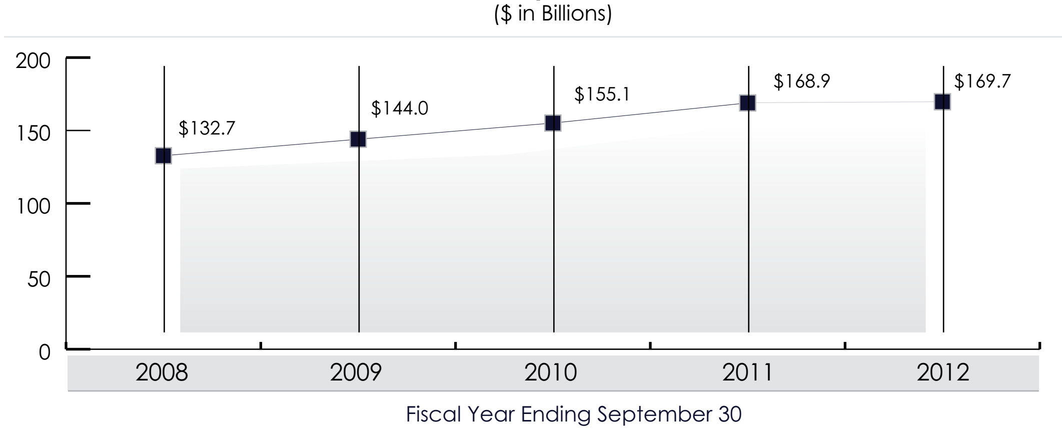
The Combined SBR presents total budgetary resources of $226.7 billion that were available to the DON GF during FY 2012 and the status of those resources at fiscal year end. Total budgetary resources were down $4.9 billion, a 2.1% decrease in FY 2012 compared to FY 2011. The enacted appropriations of $173.5 billion represent 76.5% of total budgetary resources and decreased $2.5 billion compared to FY 2011. The majority of this decrease was with respect to military construction. Additionally, the decrease in total budgetary resources is attributable to the $33.2 billion unobligated balance brought forward from the prior year, which comprised 14.7% of total budgetary resources and decreased $1.8 billion compared to FY 2011. The majority of the decrease in unobligated balance brought forward was in the Procurement appropriation accounts. The DON obligated $194.2 billion of the $226.7 billion total resources in FY 2012, which is a decrease of $4.2 billion or 2.1% compared to FY 2011.

DON GF Sources of Funds, FY 2012
($ in Billions)



The Consolidated Statement of Net Cost presents net cost of operations of $169.7 billion during FY 2012. Net cost of operations represents gross costs incurred by the DON GF less earned revenue. Net cost of operations increased $0.8 billion, which represents a 0.5% increase over FY 2012.

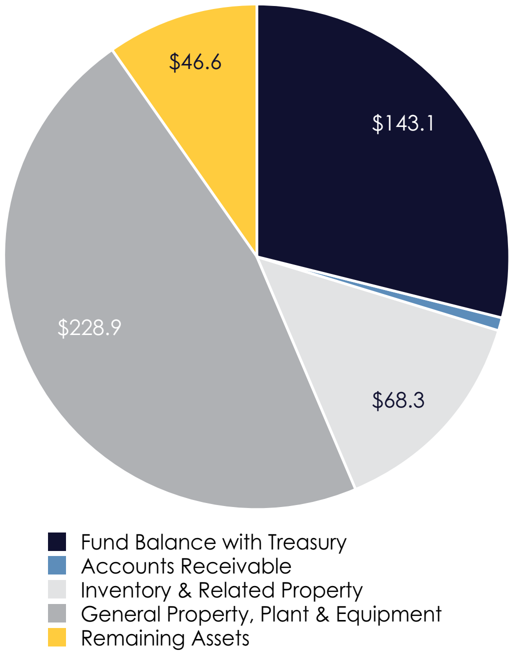
DON GF Net Cost of Operations, FY 2008 – 2012
($ in Billions)



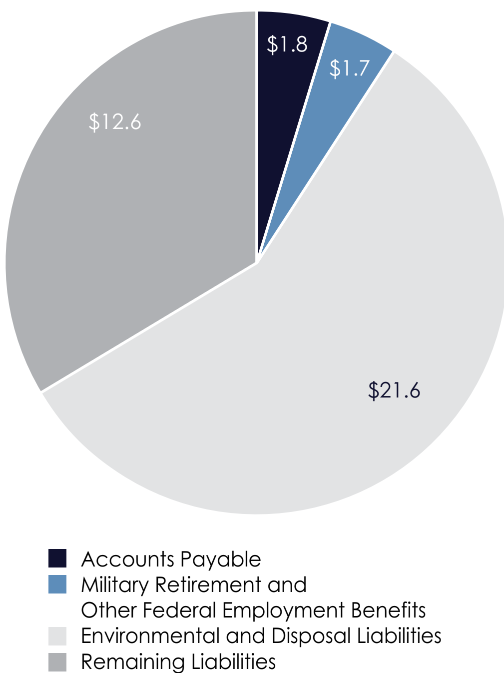
Financial Position

The DON continued to report a positive net position on its Consolidated Balance Sheet. Net position is the difference between total assets and total liabilities. As of 30 September 2012, net position totaled $453.0 billion, which represents a $7.3 billion or 1.6% increase from FY 2011. The overall increase in net position is attributed to the increase of $8.1 billion and $0.8 billion in total assets and total liabilities.

DON GF Total Assets, FY 2012
($ in Billions)



DON GF Total Liabilities, FY 2012
($ in Billions)



Navy Working Capital Fund

NWCF is a revolving fund established to meet the diverse requirements of the Navy and Marine Corps operating forces. Under the revolving fund concept, an appropriation or a transfer of funds finances initial NWCF operations. General or appropriated fund payments from customers for goods delivered or services performed subsequently replenish this initial working capital investment and sustain a continuous cycle of operations, minimizing the need for additional annual appropriations by Congress. The goal of NWCF is to break even over time by matching revenues earned to costs incurred. Achievement of this goal is occasionally complicated by the requirement that NWCF business areas maintain stable budget-driven prices for goods and services, to protect customers from unforeseen price fluctuations.

NAVY WORKING CAPITAL FUND BUSINESS ACTIVITIES BY BUSINESS AREA

Supply Management

Supply Management, Navy
(https://www.navsup.navy.mil)

Supply Management, Marine Corps
(http://www.logcom.usmc.mil)

Depot Maintenance

Depot Maintenance, Aviation
(http://www.navair.navy.mil)

Depot Maintenance, Marine Corps
(http://www.logcom.usmc.mil)

Base Support

Facilities Engineering Commands
(https://portal.navfac.navy.mil)

Naval Facilities Engineering Service Center
(https://portal.navfac.navy.mil)

Transportation

Military Sealift Command
(http://www.msc.navy.mil)

Research and Development

Naval Research Laboratory*
(http://www.nrl.navy.mil)

Naval Surface Warfare Center
(http://www.navsea.navy.mil)

Naval Undersea Warfare Center
(http://www.navsea.navy.mil)

Naval Air Warfare Center
(http://www.navair.navy.mil)

Space and Naval Warfare Systems Centers
(http://spawar.navy.mil)

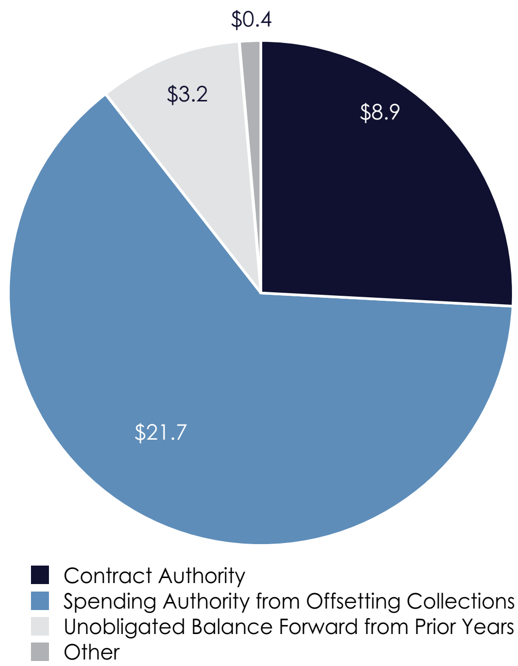
**Also see Office of Naval Research*
(http://www.onr.navy.mil)

Results of Operations

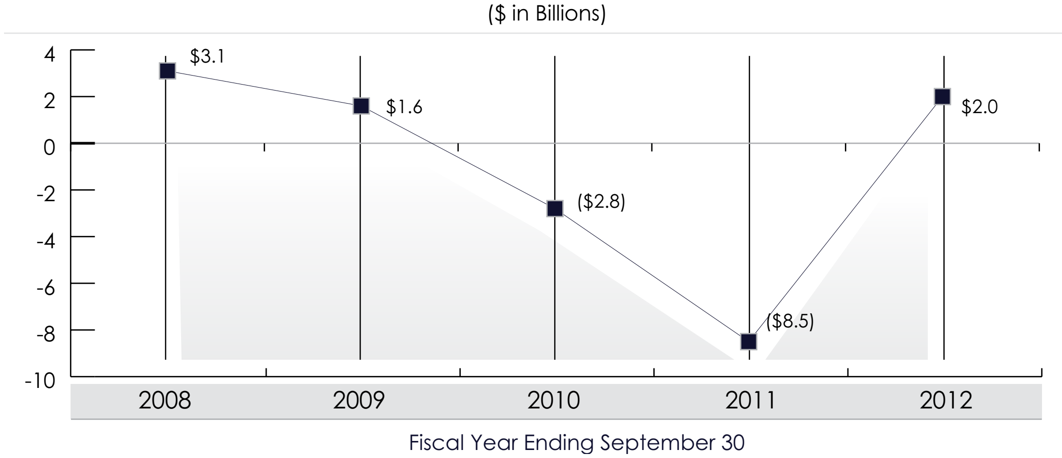
The Combined SBR presents total budgetary resources of $34.2 billion that were available to NWCF during FY 2012 and the status of those resources at fiscal year-end. Total budgetary resources increased $2.1 billion, which was a 6.7% increase over FY 2011. NWCF budget authority is comprised of contract authority and spending authority from offsetting collections of which the latter accounts for 63.4% of total budgetary resources. The majority of the increase in overall budget authority is due to a $1.7 billion increase in contract authority in FY 2012. NWCF business activities obligated $30.4 billion of the $34.2 billion total resources in FY 2012 which represents an increase of $1.6 billion or 5.4% over FY 2011.

The Consolidated Statement of Net Cost presents net cost of operations of $2.0 billion during FY 2012. Net cost of operations represents gross costs incurred by NWCF less earned revenue. Sources of earned revenue include DON, Army, and Air Force GF; Defense Working Capital Funds; other Navy and DoD appropriations; and non-DoD fund sources. The decrease in earned revenue exceeded the decrease in gross costs by $10.5 billion in FY 2012 over FY 2011, which results in a positive net cost of operations.

NWCF Sources of Funds, FY 2012
($ in Billions)



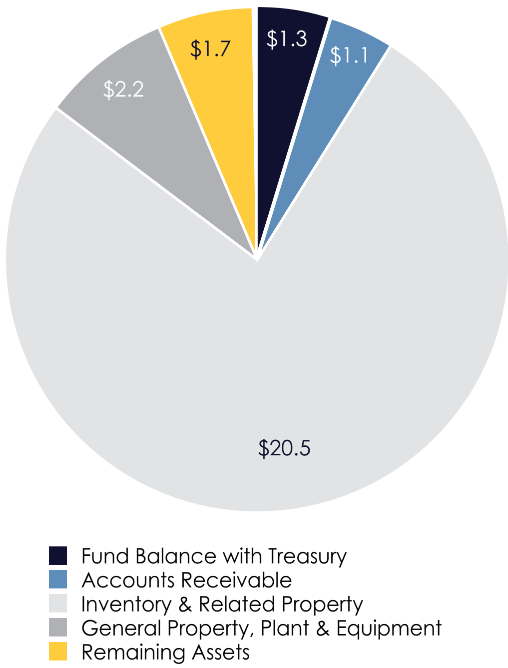
NWCF Net Cost of Operations, FY 2008 – 2012
($ in Billions)



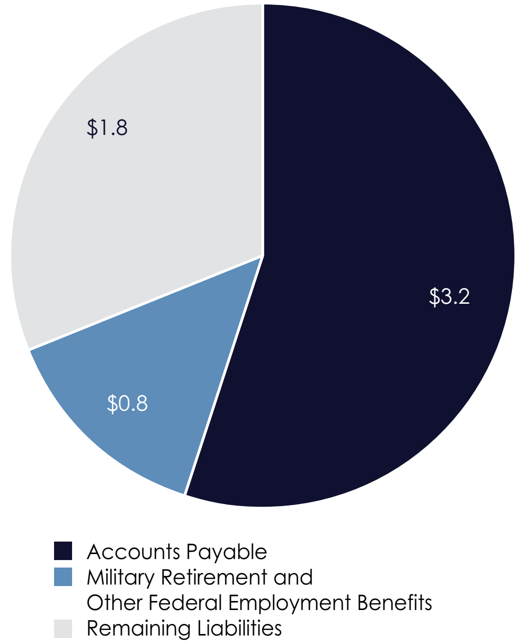
Financial Position

The NWCF continued to report a positive net position on its Consolidated Balance Sheet. Net position is the difference between total assets and total liabilities. As of 30 September 2012, net position totaled $21.0 billion, which represents an increase of $0.5 billion and an 2.4% increase from FY 2011. An increase of $0.7 billion and $0.2 billion in total assets and total liabilities contributed to the overall increase in net position.

NWCF Total Assets, FY 2012
($ in Billions)



NWCF Total Liabilities, FY 2012
($ in Billions)

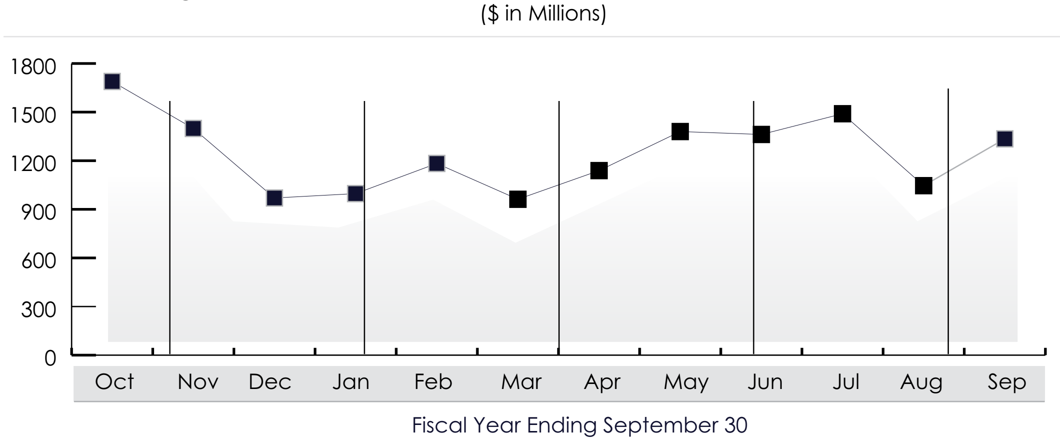


Cash Management

The DON manages working capital fund cash at the Departmental level. It must maintain cash levels at seven to ten days of operational costs, plus have sufficient cash reserves to meet six months of projected capital outlays, as required by the DoD Financial Management Regulation. For FY 2012, the seven-day cash requirement was $0.9 billion and the ten-day requirement was $1.2 billion.

Supply Management, Navy received a $39 million reimbursement for ordered items delivered to Defense Logistics Agency.

Navy Working Capital Fund Cash Balances October 1, 2011 to September 30, 2012
($ in Millions)



An F/A-18C Hornet launches from the flight deck of the aircraft carrier USS Abraham Lincoln (CVN 72). Lincoln is deployed in support of conducting maritime security operations and theater security cooperation efforts.

LOOKING FORWARD

Our achievements during FY 2012 established a firm foundation that will assure future success in executing our mission and building a sound business operating environment. In FY 2013, we will focus on achieving the DON's objectives outlined in the Strategic Management section. Of those objectives, our priority will be to increase our effectiveness and efficiency, improve the lives of our Sailors and Marines, and maintain a leaner and stronger force in a time of constrained budgets. Highlighted below are a few of these priorities.

Maritime Security

The DON is focused on aligning its goals with the new strategic guidance of the DoD. This guidance calls for a smaller and leaner force that is agile, flexible, ready, and technologically advanced. In doing so, in FY 2013 the DON will focus on succeeding in the following ten core missions: counter terrorism and irregular warfare; deter and defeat aggression; project power despite anti-access/area denial challenges; counter weapons of mass destruction; operate effectively in cyberspace and space; maintain a safe, secure, and effective nuclear deterrent; defend the homeland and provide support to civil authorities; provide a stabilizing presence; conduct stability and counterinsurgency operations; and conduct humanitarian, disaster relief, and other operations. In order to achieve success in these missions, the DON must operate globally and effectively by both land and sea. This strategy will allow the DON the ability to prevent conflict by both direct and indirect interactions.

Taking Care of Our People

Development and retention of highly qualified and dedicated people are vital to our continued success. In an era of reduced budgets, it is imperative for the DON to provide the right person with the right skills, at the right time as the best value to the joint force. By doing so, this will allow the DON to remain strong, while becoming leaner and more agile. Our strategy for the future will be guaranteed by focusing on developing policies that bring forth the promise of our people, thereby ensuring full development of their personal and professional capabilities. Our objectives remain: to align the personal and professional goals of our workforce with the needs of the joint force while ensuring the welfare of our Sailors, Marines, and their families; to deliver a high performing, competency-based and mission-focused force to meet the full spectrum of joint operations and maintain total force readiness by enhancing the focus on sailor readiness.

support the energy savings efforts with initiatives such as the joint effort with the Department of Agriculture and the Department of Energy to produce commercial scale biofuels at prices comparable to commercial oil. We remain on track to achieve the goal of cutting petroleum use in non-tactical vehicles by 50 percent by 2015 and allow for 50 percent of DON total energy consumption to come from alternative sources by 2020. The planned "Green" Strike Group is on track to be operational by FY 2016.

A Chief Ship's Serviceman is pinned by her family during a chief petty officer pinning ceremony in the hangar bay aboard the Nimitz-class aircraft carrier USS Abraham Lincoln (CVN 72). Lincoln's new chiefs received their anchors and covers after a six-week chief training program.

The Chief of Naval Operations (CNO) and the Secretary of the Navy (SECNAV) observe as the Military Sealift Command fleet replenishment oiler USNS Henry J. Kaiser (T-AO 187), background, transfers biofuels to the guided-missile cruiser USS Princeton (CG 59) during a replenishment at sea.

Energy Reform

Readily available energy is essential for deploying our Sailors and Marines around the globe in support of our nation's interests. During FY 2012, the DON spearheaded efforts to develop greater energy independence and conservation ashore and afloat. The energy goals from the prior year of cutting petroleum usage and finding alternative energy sources all remain on track. In FY 2013, we will continue to

Business Transformation

The DON continues its commitment to building a performance based culture. During FY 2013, the DON will continue to actively develop process improvements, continue to work in conjunction with the DoD enterprise to improve performance management and budget reporting, and develop its vision for business transformation. In these times of fiscal constraint, the DON is challenged to make necessary investments in future capabilities while sustaining current warfighting effectiveness. As a part of the strategy to meet these goals, the DON has adopted a business transformation policy designed to: employ business process change to reduce cost, exploit process improvements, enhance technology, and ensure continued mission superiority through an effective human capital strategy.

DON business process improvement involves executing, aligning, and integrating a series of enterprise-wide initiatives which will dramatically transform our ability to execute programs and support our mission. The result will be improved efficiency, better decision-making, and an organizational culture that is performance-based. The DON FIAR plan, in concert with the continuing roll-out of Navy ERP and other enterprise business initiatives, will transform the Department's business environment into a "best practices," auditable end-state. This transformed environment will be both transparent and accountable to DON's stakeholders – the Department of Defense, Congress, and the American taxpayer.

Limitations to the Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 United States Code 3515 (b). While the statements have been prepared from the books and records of the entity in accordance with generally accepted accounting principles for Federal entities and the formats prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

GENERAL FUND PRINCIPAL STATEMENTS

Department of the Navy Fiscal Year 2012 Annual Financial Report

PRINCIPAL STATEMENTS

The Fiscal Year 2012 Department of the Navy (DON) General Fund (GF) principal statements and related notes are presented in the format prescribed by the Department of Defense Financial Management Regulation 7000.14, Volume 6B. The statements and related notes summarize financial information for individual funds and accounts within the GF for the fiscal year ending September 30, 2012, and are presented on a comparative basis with information previously reported for the fiscal year ending September 30, 2011.

The following statements comprise the DON GF principal statements:

- Consolidated Balance Sheet
- Consolidated Statement of Net Cost
- Consolidated Statement of Changes in Net Position
- Combined Statement of Budgetary Resources

The principal statements and related notes have been prepared to report financial position pursuant to the requirements of the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994. The accompanying notes should be considered an integral part of the principal statements.

CONSOLIDATED BALANCE SHEET

As of September 30, 2012 and 2011

($ IN THOUSANDS)

	2012 Consolidated	2011 Consolidated
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$ 143,102,685	$ 138,448,267
Investments and Related Interest (Note 4)	7,968	9,289
Accounts Receivable (Note 5)	195,181	321,788
Other Assets (Note 6)	346,428	165,099
Total Intragovernmental Assets	143,652,262	138,944,443
Cash and Other Monetary Assets (Note 7)	93,840	106,042
Accounts Receivable, Net (Note 5)	3,616,372	3,679,317
Inventory and Related Property, Net (Note 8)	68,340,085	66,782,595
General Property, Plant, and Equipment, Net (Note 9)	228,851,453	228,275,598
Other Assets (Note 6)	46,118,969	44,799,298
TOTAL ASSETS	$ 490,672,981	$ 482,587,293
Stewardship Property, Plant, and Equipment (Note 9)*		
LIABILITIES		
Intragovernmental:		
Accounts Payable (Note 11)	$ 1,587,406	$ 1,996,758
Other Liabilities (Note 13)	4,386,160	4,869,187
Total Intragovernmental Liabilities	5,973,566	6,865,945
Accounts Payable (Note 11)	232,068	558,726
Military Retirement and Other Federal Employment Benefits (Note 15)	1,670,760	1,655,019
Environmental and Disposal Liabilities (Note 12)	21,599,934	21,186,694
Other Liabilities (Note 13)	8,172,836	6,564,768
TOTAL LIABILITIES	37,649,164	36,831,152
Commitments and Contingencies (Note 14)*		
NET POSITION		
Unexpended Appropriations - Other Funds	184,561,909	178,477,576
Cumulative Results of Operations - Earmarked Funds	29,532	25,545
Cumulative Results of Operations - Other Funds	268,432,376	267,253,020
TOTAL NET POSITION	453,023,817	445,756,141
TOTAL LIABILITIES AND NET POSITION	$ 490,672,981	$ 482,587,293

* - Disclosure but no value required per Federal Accounting Standards.

The accompanying notes are an integral part of the statements.

CONSOLIDATED STATEMENT OF NET COST

For the Years Ended September 30, 2012 and 2011

($ IN THOUSANDS)

	2012 Consolidated	2011 Consolidated
Program Costs		
Gross Costs		
Military Personnel	$ 47,405,225	$ 47,198,600
Operations, Readiness, & Support	63,204,636	65,501,114
Procurement	50,485,242	48,531,687
Research, Development, Test, & Evaluation	16,764,357	18,201,273
Family Housing & Military Construction	2,434,831	1,966,777
Less: Earned Revenue	(10,599,907)	(12,463,027)
Net Cost of Operations	$ 169,694,384	$ 168,936,424

The accompanying notes are an integral part of the statements.

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

For the Years Ended September 30, 2012 and 2011

($ IN THOUSANDS)

	2012 Earmarked Funds	2012 Other Funds
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	$ 25,545	$ 267,253,020
Budgetary Financing Sources:		
Appropriations Used	(41)	166,059,179
Nonexchange Revenue	218	-
Donations & Forfeitures of Cash & Cash Equivalents	23,734	237
Other Financing Sources:		
Donations and Forfeitures of Property	-	1,742
Transfers-In/Out without Reimbursement	-	(138,094)
Imputed Financing from Costs Absorbed by Others	-	816,514
Other	-	4,114,238
Total Financing Sources	23,911	170,853,816
Net Cost of Operations	19,924	169,674,460
Net Change	3,987	1,179,356
Cumulative Results of Operations	$ 29,532	$ 268,432,376
UNEXPENDED APPROPRIATIONS		
Beginning Balances	$ -	$ 178,477,576
Budgetary Financing Sources:		
Appropriations Received	-	173,531,259
Appropriations Transferred-In/Out	-	1,376,886
Other Adjustments (Rescissions, etc)	(41)	(2,764,633)
Appropriations Used	41	(166,059,179)
Total Budgetary Financing Sources	-	6,084,333
Unexpended Appropriations	-	184,561,909
Net Position	$ 29,532	$ 452,994,285

The accompanying notes are an integral part of the statements.

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

For the Years Ended September 30, 2011 and 2010

($ IN THOUSANDS)

		2012 Consolidated		2011 Consolidated
CUMULATIVE RESULTS OF OPERATIONS				
Beginning Balances	$	267,278,565	$	256,678,137
Budgetary Financing Sources:				
Appropriations Used		166,059,138		165,646,982
Nonexchange Revenue		218		235
Donations & Forfeitures of Cash & Cash Equivalents		23,971		18,422
Other Financing Sources:				
Donations and Forfeitures of Property		1,742		652
Transfers-In/Out without Reimbursement		(138,094)		225,126
Imputed Financing from Costs Absorbed by Others		816,514		881,374
Other		4,114,238		12,764,061
Total Financing Sources		170,877,727		179,536,852
Net Cost of Operations		169,694,384		168,936,424
Net Change		1,183,343		10,600,428
Cumulative Results of Operations	$	268,461,908	$	267,278,565
UNEXPENDED APPROPRIATIONS				
Beginning Balances	$	178,477,576	$	169,307,091
Budgetary Financing Sources:				
Appropriations Received		173,531,259		175,092,446
Appropriations Transferred-In/Out		1,376,886		2,607,610
Other Adjustments (Rescissions, etc)		(2,764,674)		(2,882,589)
Appropriations Used		(166,059,138)		(165,646,982)
Total Budgetary Financing Sources		6,084,333		9,170,485
Unexpended Appropriations		184,561,909		178,477,576
Net Position	$	453,023,817	$	445,756,141

The accompanying notes are an integral part of the statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

For the Years Ended September 30, 2012 and 2011

($ IN THOUSANDS)

	2012 Combined	2011 Combined
Budgetary Resources:		
Unobligated Balance, Brought Forward, October 1	$ 33,205,881	$ 35,002,674
Recoveries of Prior Year Unpaid Obligations	13,249,015	14,169,439
Other Changes in Unobligated Balance	(1,337,751)	(1,125,467)
Unobligated Balance from Prior Year Budget Authority	45,117,145	48,046,646
Appropriations	173,505,214	175,961,434
Spending Authority from Offsetting Collections	8,105,260	7,587,503
Total Budgetary Resources	$ 226,727,619	$ 231,595,583
Status of Budgetary Resources:		
Obligations Incurred	$ 194,177,904	$ 198,389,702
Unobligated Balance, End of Year		
Apportioned	28,451,635	29,803,065
Unapportioned	4,098,080	3,402,816
Unobligated Balance Brought Forward, End of Year	32,549,715	33,205,881
Total Budgetary Resources	$ 226,727,619	$ 231,595,583

The accompanying notes are an integral part of the statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

For the Years Ended September 30, 2012 and 2011

($ IN THOUSANDS)

		2012 Combined		2011 Combined
Change in Obligated Balance:				
Unpaid Obligations, Brought Forward, October 1	$	107,478,038	$	101,601,676
Uncollected Customer Payments from Federal Sources, Brought Forward, October 1		(2,509,887)		(3,154,898)
Obligated Balance Start of Year, Net		104,968,151		98,446,778
Obligations Incurred		194,177,904		198,389,702
Outlays, Gross		(175,479,471)		(178,343,901)
Change in Uncollected Customer Payments from Federal Sources		(119,915)		645,011
Recoveries of Prior Year Unpaid Obligations		(13,249,015)		(14,169,439)
Obligated Balance, End of Year				
Unpaid Obligations, End of Year, Gross		112,927,456		107,478,038
Uncollected Customer Payments from Federal Sources, End of Year		(2,629,802)		(2,509,887)
Obligated Balance, End of Year	$	110,297,654	$	104,968,151
Budget Authority and Outlays, Net:				
Budget Authority, Gross	$	181,610,474	$	183,548,937
Actual Offsetting Collections		(7,985,345)		(8,232,514)
Change in Uncollected Customer Payments from Federal Sources		(119,915)		645,011
Budget Authority, Net	$	173,505,214	$	175,961,434
Outlays, Gross	$	175,479,471	$	178,343,901
Actual Offsetting Collections		(7,985,345)		(8,232,514)
Outlays, Net		167,494,126		170,111,387
Distributed Offsetting Receipts		(226,131)		36,444
Agency Outlays, Net	$	167,267,995	$	170,147,831

The accompanying notes are an integral part of the statements.

Note 1. Significant Accounting Policies

1.A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations of the Department of the Navy (DON) General Fund (GF), 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 DON GF in accordance with, and to the extent possible, U.S. Generally Accepted Accounting Principles (USGAAP) promulgated by the Federal Accounting Standards Advisory Board (FASAB); the Office of Management and Budget (OMB) Circular No. A-136, Financial Reporting Requirements; and the Department of Defense (DoD), Financial Management Regulation (FMR). The accompanying financial statements account for all resources for which DON GF is responsible unless otherwise noted.

Information relative to classified assets, programs, and operations is excluded from the statements or otherwise aggregated and reported in such a manner that it is not discernable.

The DON GF financial statements include information from both financial systems and nonfinancial feeder systems. The Defense Finance and Accounting Service, Cleveland (DFAS-CL) collects information from the financial system and incorporates it into the financial statements for DON GF. The DON GF collects financial information from nonfinancial feeder systems through a data call process and submits it to DFAS-CL for incorporation into the financial statements. On behalf of DON GF, DFAS-CL also collects information from multiple sources, such as intragovernmental data from DON GF's trading partners, which is incorporated into the financial statements. The Defense Departmental Reporting System Data Collection Module (DDRS DCM) captures certain required financial information from non-integrated systems for the DON GF financial statements. The DDRS DCM identifies the information requirements to the source provider, and integrates data into the financial statement preparation process.

The DON GF is unable to fully implement all elements of USGAAP and the OMB Circular No. A-136 due to limitations of its financial and nonfinancial management processes and systems that support the financial statements. The DON GF derives reported values and information for major asset and liability categories largely from nonfinancial systems, such as inventory and logistic 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 USGAAP. The DON GF continues to implement process and system improvements addressing these limitations.

The Department of Defense Inspector General (DoDIG) issued an audit report dated November 8, 2012 and identified 11 financial statement material weaknesses: (1) Financial Management Systems; (2) Fund Balance with Treasury; (3) Accounts Receivable; (4) Other Assets; (5) Inventory and Related Property, Net; (6) General Property, Plant, and Equipment; (7) Accounts Payable; (8) Statement of Net Cost; (9) Problem Disbursements; (10) Unobligated Balances; (11) Statement of Changes in Net Position.

1.B. Mission of the Reporting Entity

The DON was created on April 30, 1798 by an act of Congress (I Stat. 533; 5 U.S.C. 411-12). The overall mission of DON is to maintain, train, and equip combat-ready Navy and Marine Corps forces capable of winning wars, deterring aggression, and maintaining freedom of the seas.

1.C. Appropriations and Funds

The DON receives appropriations and funds as general, working capital (revolving), trust, special, and deposit funds. The DON uses these appropriations and funds (excluding deposit funds) to execute its missions and subsequently report on resource usage.

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

These general funds also include supplemental funds enacted by the American Recovery and Reinvestment Act (Recovery Act) of 2009. Details relating to Recovery Act appropriated funds are available on-line at http://www.defenselink.mil/recovery.

The National Defense Sealift Fund is DON GF's only revolving fund. Revolving funds are generally established for carrying out specific activities. Revolving funds are financed through an appropriation or a transfer to establish a corpus and are replenished through charges made for goods or services without fiscal year limitations. The National Defense Sealift Fund receives an annual appropriation and has no corpus.

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

Special fund accounts are used to record government receipts reserved for a specific purpose. Certain trust and special funds may be designated as earmarked funds. Earmarked funds are financed by specifically identified revenues, required by statute to be used for designated activities, benefits or purposes, and remain available over time. The DON GF is required to separately account for and report on the receipt, use and retention of revenues and other financing sources for earmarked funds.

Deposit funds are used to record amounts held temporarily until paid to the appropriate government or public entity. They are not DON GF funds, and as such, are not available for DON GF's operations. The DON GF is acting as an agent or a custodian for funds awaiting distribution.

The DON GF is a party to allocation transfers with other federal agencies as a transferring (parent) entity or receiving (child) entity. An allocation transfer is an entity's legal delegation of authority to obligate budget authority and outlay funds on its behalf. Generally, all financial activity related to allocation transfers (e.g. budget authority, obligations, outlays) is reported in the financial statements of the parent entity. Exceptions to this general rule apply to specific funds for which OMB has directed that all activity be reported in the financial statements of the child entity. These exceptions include U.S. Treasury-Managed Trust Funds, Executive Office of the President (EOP), and all other funds specifically designated by OMB.

Additionally, the DON GF receives allocation transfers from the EOP for the Foreign Military Financing Program (meeting the OMB exception), the International Military Education and Training Program, U.S. Forest Service, and the Federal Highway Administration. The activities for these funds are reported separately from the DoD financial statements and reported to the parent.

The DON GF receives allocation transfers for the Security Assistance programs that meet the OMB exception for EOP funds. These funds are reported separately from the DoD financial statements based on an agreement with OMB.

1.D. Basis of Accounting

The DON GF's financial management systems are unable to meet all full accrual accounting requirements. Many of the DON GF's financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of USGAAP. These systems were not designed to collect and record financial information on the full accrual accounting basis as required by USGAAP. Most of DON GF's financial and nonfinancial legacy systems were designed to record information on a budgetary basis.

The DON GF financial statements and supporting trial balances are compiled from the underlying financial data and trial balances of DON's sub-entities. The underlying data is largely derived from budgetary transactions (obligations, disbursements, and collections), from nonfinancial feeder systems, and accruals made for major items such as payroll expenses, accounts payable, environmental liabilities, and Federal Employees' Compensation Act (FECA) liabilities. Some of the sub-entity level trial balances may reflect known abnormal balances resulting largely from business and system processes. At the consolidated DON GF level these abnormal balances may not be evident. Disclosures of abnormal balances are made in the applicable footnotes, but only to the extent that the abnormal balances are evident at the consolidated level.

The DoD is determining the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with USGAAP. One such action is the conversion of DON's legacy systems to Navy Enterprise Resource Planning (ERP) which is designed to modernize and standardize Navy's business practices. Navy ERP was developed utilizing the USSGL account structure to better comply with applicable financial management requirements.

1.E. Revenues and Other Financing Sources

The DON GF receives congressional appropriations as financing sources for general funds that expire annually, on a multi-year basis, or do not expire. When authorized by legislation, these appropriations are supplemented by revenues generated by sales of goods or services. The DON GF recognizes revenue as a result of costs incurred for goods and services provided to other federal agencies and the public. Full-cost pricing is DON GF's standard policy for services provided as required by OMB Circular A-25, User Charges. The DON GF recognizes revenue when earned within the constraints of its current system capabilities.

The DON GF does not include nonmonetary support provided by U.S. allies for common defense and mutual security in amounts reported in the Statement of Net Cost. The U.S. has cost sharing agreements with countries having 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, DoD policy requires the recognition of operating expenses in the period incurred. However, current financial and nonfinancial feeder systems were not designed to collect and record financial information on the full accrual accounting basis. Estimates are made for major items such as payroll expenses, accounts payable, environmental liabilities, and FECA liabilities. In the case of Operating Materiel & Supplies (OM&S), operating expenses are generally recognized when the items are purchased. Efforts are underway to transition to the consumption method for recognizing OM&S expenses. Under the consumption method, OM&S would be expensed when consumed. Due to system limitations, in some instances expenditures for capital and other long-term assets may be recognized as operating expenses. The DON GF continues to implement process and system improvements to address these limitations.

1.G. Accounting for Intragovernmental Activities

Accounting standards require that an entity eliminates intra-entity activity and balances from consolidated financial statements in order to prevent overstatement for business with itself. However, the DON GF cannot accurately identify intragovernmental transactions by customer because DON GF's systems do not track buyer and seller data at the transaction level. Generally, seller entities within the DoD provide summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal accounting offices. In most cases, the buyer-side records are adjusted to agree with DoD seller-side balances and are then eliminated. The DoD is implementing replacement systems and a standard financial information structure that will incorporate the necessary elements that will enable DoD to correctly report, reconcile, and eliminate intragovernmental balances.

Treasury Financial Manual Part 2 – Chapter 4700, "Agency Reporting Requirements for the Financial Report of the United States Government" provides guidance for reporting and reconciling intragovernmental balances. While DON GF is unable to fully reconcile intragovernmental transactions with all federal agencies, DON GF is able to reconcile balances pertaining to investments in federal securities, borrowings from the U.S. Treasury and the Federal Financing Bank, FECA transactions with the Department of Labor, and benefit program transactions with the Office of Personnel Management.

The DoD's proportionate share of public debt and related expenses of the Federal Government is not included. The Federal Government does not apportion debt and its related costs to federal agencies. The DoD's financial statements do not report any public debt, interest, or source of public financing, whether from issuance of debt or tax revenues.

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

1.H. Transactions with Foreign Governments and International Organizations

Each year, DON GF sells defense articles and services to foreign governments and international organizations under the provisions of the Arms Export Control Act of 1976. Under the provisions of the Act, DoD has authority to sell defense articles and services to foreign countries and international organizations generally at no profit or loss to the Federal Government. Payment in U.S. dollars is required in advance.

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

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

In addition, DFAS sites and USACE Finance Center submit reports to the U.S. Treasury by appropriation on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records these transactions to the applicable Fund Balance with Treasury (FBWT) account. On a monthly basis DFAS performs a reconciliation between DON GF's FBWT and the U.S. Treasury.

1.J. Cash and Other Monetary Assets

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

The majority of cash and all foreign currency is classified as "nonentity" and is restricted. Amounts reported consist primarily of cash and foreign currency held by disbursing officers to carry out their paying, collecting, and foreign currency accommodation exchange missions.

The DON GF conducts a significant portion of operations overseas. Congress established a special account to handle the gains and losses from foreign currency transactions for five general fund appropriations: (1) operations and maintenance; (2) military personnel; (3) military construction; (4) family housing operation and maintenance; and (5) family housing construction. The gains and losses are calculated as the variance between the exchange rate current at the date of payment and a budget rate established at the beginning of each fiscal year. Foreign currency fluctuations related to other appropriations require adjustments to the original obligation amount at the time of payment. The DON GF does not separately identify currency fluctuation transactions.

1.K. Accounts Receivable

Accounts receivable from other federal entities or the public include: accounts receivable, claims receivable, and refunds receivable. In accordance with SFFAS No. 1, Accounting for Selected Assets and Liabilities, the methodology for losses due to uncollectable amounts are based on an individual account analysis and/or group analysis. The analysis is based on three years of receivable data. This data is used to determine the historical percentage of collections in each age category of receivables. The DON does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Treasury Financial Manual Part 2, Chapter 4700, Appendix 10, "Intragovernmental Business Rules".

1.L. Inventories and Related Property

The DON GF manages only military or government-specific materiel under normal conditions. Materiel is a unique term that relates to military force management, and includes items such as ships, tanks, self-propelled weapons, aircraft, support equipment, etc. As it relates to the DON GF, OM&S includes the related spares and repair parts for materiel. Items commonly used in and available from the commercial sector are not managed in DON GF's materiel management activities. The DON GF holds materiel based on military need and support for contingencies.

The DON GF does not have Inventory and only reports OM&S. The DON GF uses both the consumption method and the purchase method of accounting for OM&S. DON GF OM&S is categorized as operating materiels and supplies held for use, operating materiels and supplies held in reserve for future use (held for repair) (including munitions not held for sale) and excess, obsolete and unserviceable operating material and supplies. Items that are centrally managed and stored, such as ammunition and engines, are generally recorded using the consumption method and are reported on the Balance Sheet as OM&S. When current systems cannot fully support the consumption method, DON GF uses the purchase method. Under this method, materiel and supplies are expensed when purchased. During FY 2012 and 2011, DON GF expensed significant amounts using the purchase method because the systems could not support the consumption method or management deemed that the item was in the hands of the end user. This is a material weakness for the DoD and long-term system corrections are in process. Once the proper systems are in place, these items will be accounted for under the consumption method of accounting.

DON GF OM&S assets held for use and held for repair use three cost valuation methods: Standard Price (SP), Latest Acquisition Cost (LAC), and Moving Average Cost (MAC). Excess, obsolete, and unserviceable OM&S are cost valued using Net Realizable Value. The LAC method is used because legacy logistics systems were designed for materiel management rather than accounting purposes. Although these systems provide visibility and accountability over inventory and related property items, they do not maintain historical cost data necessary to comply with SFFAS No. 3. Additionally, these legacy inventory systems cannot produce financial transactions using the USSGL, as required by the Federal Financial Management Improvement Act of 1996 (FFMIA). The DON GF is continuing to transition OM&S to the MAC method. Most transitioned balances, however, were not baselined to auditable historical cost, and remain noncompliant with SFFAS No. 3.

1.M. Investments in U.S. Treasury Securities

The DON GF reports investments in accordance with SFFAS No. 1, Accounting for Selected Assets and Liabilities. The DON GF reports U.S. Treasury securities at cost, net of amortized premiums or discounts. Premiums or discounts are amortized over the term of the investments using the effective interest rate method or another method obtaining similar results. The DON GF'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 DON GF invests in nonmarketable market-based U.S. Treasury securities, which are issued to federal agencies by the U.S. Treasury's Bureau of Public Debt. They are not traded on any securities exchange but mirror the prices of particular U.S. Treasury securities traded in the government securities market.

1.N. General Property, Plant and Equipment

General Property, Plant and Equipment (PP&E) assets are capitalized in accordance with SFFAS No. 6, Accounting for Property, Plant and Equipment, as amended by SFFAS Nos. 10, 23, and 35, when an asset has a useful life of two or more years and when the acquisition cost equals or exceeds DoD's capitalization threshold. The DoD also requires the capitalization of improvements to existing General PP&E assets if the improvements equal or exceed the capitalization threshold and extend the useful life or increase the size, efficiency, or capacity of the asset. The DON GF depreciates all General PP&E, other than land and Military Equipment (ME) classified as aircraft, on a straight-line basis in accordance with FMR Volume 4 Chapter 6. The DoD's General PP&E capitalization threshold is $100 thousand except for real property, which is $20 thousand.

The DON GF uses a combination of actual expenditure data and program funding to calculate the value for ME in accordance with SFFAS No. 35. The DON GF is developing a process to track and record actual ME costs. The ME value is updated using expenditure, acquisition, and disposal information.

Effective FY11, ME is recorded in Defense Property Accountability System (DPAS), and the Capital Asset Management System-Military Equipment (CAMS-ME) is no longer used for recording ME transactions.

When it is in the best interest of the government, the DON GF provides government property to contractors to complete contract work. The DON GF 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 meets or exceeds the DoD capitalization threshold, federal accounting standards require that it be reported on DON GF's Balance Sheet.

The DoD developed policy and a reporting process for contractors with government furnished equipment that provides appropriate General PP&E information for financial statement reporting in accordance with Federal Acquisition Regulations (FAR). The DoD requires DON to maintain, in their property systems, information on all property furnished to contractors. These actions are structured to capture and report the information necessary for compliance with federal accounting standards. The DON GF has not fully implemented this policy primarily due to system limitations.

1.O. Leases

In accordance with SFFAS No. 5, Accounting for Liabilities of the Federal Government, lease payments for the rental of equipment and operating facilities are classified as either capital or operating leases. When a lease is essentially equivalent to an installment purchase of property (a capital lease), and the value equals or exceeds the current capitalization threshold, DON GF records the applicable asset as though purchased, with an offsetting liability, and depreciates it. The DON GF records the asset and the liability at the lesser of the present value of the rental and other lease payments during the lease term (excluding portions representing executory costs paid to the lessor) or the asset's fair market value. The discount rate for the present value calculation is either the lessor's implicit interest rate or the government's incremental borrowing rate at the inception of the lease. The DON GF, as the lessee, receives the use and possession of leased property, for example real estate or equipment, from a lessor in exchange for a payment of funds. An operating lease does not substantially transfer all the benefits and risk of ownership. Payments for operating leases are expensed over the lease term as they become payable.

Office space and leases entered into by DON GF are the largest component of operating leases and are based on costs gathered from existing leases, General Services Administration bills, and interservice support agreements. Future year projections use the Consumer Price Index.

1.P. Other Assets

Other assets include those assets, such as military and civil service employee pay advances and certain contract financing payments that are not reported elsewhere on DON's Balance Sheet. The DON GF maintains this classification in accordance with SFFAS No. 1.

The DON GF conducts business with commercial contractors under two primary types of contracts: fixed price and cost reimbursable. To alleviate the potential financial burden on the contractor that long-term contracts can cause, DON GF may provide financing payments. Contract financing payments are defined in the FAR, Part 32, as authorized disbursements to a contractor prior to acceptance of supplies or services by the Government. It is DoD policy to record certain contract financing payments as other assets. The DON GF has not fully implemented this policy primarily due to system limitations.

When advances are permitted by law, legislative action, or presidential authorization, DoD's policy as prescribed in SFFAS No. 1, Accounting for Selected Assets and Liabilities is to record advances or prepayments in accordance with USGAAP. As such, payments made prior to the receipt of goods and services should be reported as an asset on the Balance Sheet. The DoD's policy is to expense and/or properly classify assets when the related goods and services are received. The DON GF has not implemented this policy primarily due to system limitations.

Advances are cash outlays made by DON GF to its employees, contractors, or others to cover a part or all of the recipients' anticipated expenses. Military pay advances are advance payments authorized for purposes intended to ease hardships imposed by the lack of regular payments when a military member is mobilized, ordered to duty at distant stations, or deployed aboard ships for more than 30 days. Civilian pay advances are payments advanced to full time DON civilians intended to finance unusual employee expenses associated with oversea assignments that are not otherwise reimbursed and to aid foreign assignment recruitment and retention. Travel advances are disbursed to employees prior to business trips. Travel advances are subsequently reduced when travel expenses are actually incurred.

Due to inconsistencies in the posting logic for Nonfederal Advances and Prepayments, DON GF is noncompliant with the FFMIA, which requires agencies to comply with the Federal financial management systems requirements, standards promulgated by the FASAB, and the USSGL at the transaction level.

1.Q. 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 DON GF recognizes contingent liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. The DON GF's risk of loss and resultant contingent liabilities arise from pending or threatened litigation or claims and assessments due to events such as aircraft, ship, and vehicle accidents; medical malpractice; property or environmental damages; and contract disputes.

Other liabilities also arise as a result of anticipated disposal costs for DON GF's assets. 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. DON GF adheres to the DoD's policy, which is consistent with SFFAS No. 5, Accounting for Liabilities of Federal Government, and states that nonenvironmental disposal liabilities are recognized when management decides to dispose of an asset. The DoD recognizes nonenvironmental disposal liabilities for military equipment nuclear-powered assets when placed into service. These amounts are not easily distinguishable and are developed in conjunction with environmental disposal costs.

1.R. Accrued Leave

Military leave, compensatory and annual leave earned by civilians, but not yet used, is reported as accrued liabilities. The accrued balance is adjusted annually to reflect current pay rates. Any portions of the accrued leave, for which funding is not available, are recorded as an unfunded liability. Sick leave for civilians is expensed as taken.

1.S. Net Position

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations represent the amounts of budget 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 net difference between expenses and losses, and financing sources (including appropriations, revenue, and gains), since inception. The cumulative results of operations also include donations and transfers in and out of assets that were not reimbursed.

1.T. Treaties for Use of Foreign Bases

The DoD 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 DON GF purchases capital assets overseas with appropriated funds; however, the host country retains title to the land and capital improvements. Treaty terms generally allow the DON continued use of these properties until the treaties expire. In the event treaties or other agreements are terminated, use of the foreign bases is prohibited and losses are recorded for the value of any nonretrievable capital assets. The settlement due to the U.S. or host nation is negotiated and takes into account the value of capital investments and may be offset by the cost of environmental cleanup.

1.U. Undistributed Disbursements and Collections

Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to specific obligations, payables, or receivables in the source systems and those reported by the U.S. Treasury. Supported disbursements and collections may be evidenced by the availability of corroborating documentation that would generally support the summary-level adjustments made to accounts payable and receivable. Unsupported disbursements and collections do not have supporting documentation for the transactions and most likely would not meet audit scrutiny. However, both supported and unsupported adjustments may have been made to the DON GF's Accounts Payable and Receivable trial balances prior to validating that the underlying transactions required to establish the Accounts Payable/Receivable were previously made. As a result, misstatements of reported Accounts Payable and Receivables are likely present in the DON GF's financial statements.

Due to noted material weaknesses in current accounting and financial feeder systems, the DoD is generally unable to determine whether undistributed disbursements and collections should be applied to federal or nonfederal accounts payable/receivable at the time accounting reports are prepared. Accordingly, the DoD policy is to allocate supported undistributed disbursements and collections between federal and nonfederal categories based on the percentage of distributed federal and nonfederal accounts payable and accounts receivable. Both supported and unsupported undistributed disbursements and collections are then applied to reduce accounts payable and receivable accordingly.

1.V. Fiduciary Activities

Fiduciary cash and other assets are not assets of the DON GF and are not recognized on the balance sheet. Fiduciary activities are reported on the financial statement note schedules in accordance with SFFAS No. 31, Accounting for Fiduciary Activities.

1.W. Military Retirement and Other Federal Employment Benefits

For financial reporting purposes, the DON's actuarial liability for workers' compensation benefits is developed by the Department of Labor and provided to the DON at the end of each fiscal year. Refer to Note 15, Military Retirement and Other Federal Employment Benefits for additional details and disclosures.

Note 2. Nonentity Assets

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Intragovernmental Assets		
A. Fund Balance with Treasury	$ 288,275	$ 386,464
2. Nonfederal Assets		
A. Cash and Other Monetary Assets	93,840	106,042
B. Accounts Receivable	3,528,238	3,503,156
3. Total Nonfederal Assets	3,622,078	3,609,198
4. Total Nonentity Assets	3,910,353	3,995,662
5. Total Entity Assets	486,762,628	478,591,631
6. Total	$ 490,672,981	$ 482,587,293

Nonentity assets are assets for which the Department of the Navy (DON) General Fund (GF) maintains stewardship accountability and reporting responsibility but are not available for the DON GF's normal operations.

Intragovernmental Fund Balance with Treasury

This nonentity asset category primarily represents amounts in DON's Suspense Funds, Withheld State and Local Taxes Fund, and Withheld Allotment of Compensation for Payment of Employee Organization Dues Fund.

Cash and Other Monetary Assets

This nonentity asset category represents disbursing officers' cash, foreign currency, and undeposited collections as reported on the Disbursing Officer's Statement of Accountability. These assets are held by DON disbursing officers on behalf of other agencies and are not available for DON's use in normal operations.

Nonentity Nonfederal Accounts Receivable (Public)

The primary component of nonentity accounts receivable is an advance payment made to a contractor for the A-12 aircraft procurement program, which remains in litigation and includes associated accrued interest. These receivable balances are being reported in nonentity accounts receivable since the original appropriation year has been cancelled, and any funds collected as a result of this litigation would be remitted to the U.S. Treasury.

Note 3. Fund Balance with Treasury

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Fund Balances		
A. Appropriated Funds	$ 141,644,490	$ 136,450,135
B. Revolving Funds	1,147,198	1,590,127
C. Trust Funds	20,588	19,458
D. Special Funds	2,134	2,083
E. Other Fund Types	288,275	386,464
2. Total	$ 143,102,685	$ 138,448,267

Other Fund Types (Line 1.E) consist primarily of amounts in the following deposit and receipt accounts: General Fund Proprietary Receipts, Pay of the Navy Deposit Fund, and Pay of the Marine Corps Deposit Fund.

Status of Fund Balance with Treasury

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Unobligated Balance		
A. Available	$ 28,451,635	$ 29,803,065
B. Unavailable	4,098,080	3,402,816
2. Obligated Balance not yet Disbursed	112,927,456	107,478,038
3. Nonbudgetary FBWT	263,260	283,450
4. NonFBWT Budgetary Accounts	(2,637,746)	(2,519,102)
5. Total	$ 143,102,685	$ 138,448,267

The Status of Fund Balance with Treasury (FBWT) reflects the budgetary resources to support FBWT and is a reconciliation between budgetary and proprietary accounts. It primarily consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current or future obligations.

Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. The unavailable balance consists primarily of funds invested in U.S. Treasury securities that are temporarily precluded from obligation by law. Certain unobligated balances are restricted for future use and are not apportioned for current use. Unobligated balances for trust fund accounts are restricted for use by the public law that established the funds.

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

Non-budgetary FBWT includes accounts that do not have budgetary authority, such as deposit funds, unavailable receipt accounts, clearing accounts and nonentity FBWT. For the Department of the Navy (DON) General Fund (GF), Non-budgetary FBWT consists of balances in receipt accounts and clearing accounts.

Non-FBWT Budgetary Accounts reduces the Status of FBWT. This amount is comprised of Trust Fund investments in U.S. Treasury securities, unfilled customer orders without advance, and reimbursements receivable.

Other

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Fund Balances Per Treasury Versus Agency		
A. Fund Balance per Treasury	$ 144,586,439	$ 139,907,357
B. Fund Balance per DON	143,102,685	138,448,267
2. Reconciling Amount	$ 1,483,754	$ 1,459,090

The total reconciling amount of $1.5 billion in FBWT is due to trust receipts, saving deposit program differences, and parent-child transactions. The reconciling difference related to allocation transfers results from instances in which DON allocates to or is allocated funds from various governmental entities. In cases in which DON is allocated funds, the amount is excluded from the Fund Balance per DON, but included in Fund Balance per Treasury. In cases in which DON allocates funds, the amount is included in the Fund Balance per DON, but it is excluded from the Fund Balance per Treasury.

DON acknowledges that it has a material internal control weakness in that it does not reconcile its FBWT between accounting systems at the DON Level and Treasury records at the transaction level. To remediate the weakness the DON has partnered with its accounting service provider, Defense Finance and Accounting Service (DFAS) to reconcile its FBWT and to sustain this reconciliation in the future.

Note 4. Investments and Related Interest

As of September 30	2012			
(AMOUNTS IN THOUSANDS)				
	Cost	*Amortized (Premium)/ Discount*	*Investments, Net*	*Market Value Disclosure*
1. Intragovernmental Securities				
A. Nonmarketable, Market-Based				
1. Other Funds	$ 7,985	$ (28)	$ 7,957	$ 7,957
B. Accrued Interest	11		11	11
2. Total	$ 7,996	$ (28)	$ 7,968	$ 7,968

As of September 30	2011			
(AMOUNTS IN THOUSANDS)				
	Cost	*Amortized (Premium)/ Discount*	*Investments, Net*	*Market Value Disclosure*
1. Intragovernmental Securities				
A. Nonmarketable, Market-Based				
1. Other Funds	$ 9,324	$ (71)	$ 9,253	$ 9,259
B. Accrued Interest	36	-	36	36
2. Total	$ 9,360	$ (71)	$ 9,289	$ 9,295

Other Funds (Line 1.A.1) represents DON Trust Fund holdings in interest-bearing securities for the Naval Academy General Gift Fund and the Navy General Gift Fund. These investments are Nonmarketable Market-Based U.S. Treasury securities reported at cost, net of amortized premiums and discounts. In accordance with the SFFAS No. 27, Identifying and Reporting Earmarked Funds, DON Trust Funds are reported as earmarked funds.

Note 5. Accounts Receivable

As of September 30	2012		
(AMOUNTS IN THOUSANDS)			
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net
1. Intragovernmental Receivables	$ 195,181	$ N/A	$ 195,181
2. Nonfederal Receivables (From the Public)	3,636,386	(20,014)	3,616,372
3. Total	$ 3,831,567	$ (20,014)	$ 3,811,553

As of September 30	2011		
(AMOUNTS IN THOUSANDS)			
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net
1. Intragovernmental Receivables	$ 321,788	$ N/A	$ 321,788
2. Nonfederal Receivables (From the Public)	3,694,629	(15,312)	3,679,317
3. Total	$ 4,016,417	$ (15,312)	$ 4,001,105

The accounts receivable represent the Department of Navy (DON) General Fund's (GF) claim for payment from other entities. Intra-governmental Receivables primarily represents amounts due from other federal agencies for reimbursable work performed pursuant to the Economy Act and other statutory authority. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules. Refer to Note 2, Nonentity Assets for additional information on Nonfederal Accounts Receivable. Since the DON is at risk of not collecting on these public accounts receivable, the DON is recognizing an allowance for uncollectible amounts. The methodology used in determining the allowance amount is discussed in Note 1.K.

The DON is currently working on an effort to drive compliance with Office of Management and Budget (OMB) Circular A-11, Section 20.4(b)(4). Non-compliance results in unsupported departmental level adjustments which negatively impacts achievement of the DON's audit readiness goals for its Statement of Budgetary Resources. DON is partnering with its service providers to clarify guidance, resolve funding issues and standardize business practices. In addition, the DON and the Defense Finance and Accounting Service (DFAS) are aggressively pursuing collection mechanisms for amounts currently due from the public.

Note 6. Other Assets

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Intragovernmental Other Assets		
A. Advances and Prepayments	$ 346,428	$ 165,099
2. Nonfederal Other Assets		
A. Outstanding Contract Financing Payments	45,824,661	44,497,095
B. Advances and Prepayments	282,061	289,676
C. Other Assets (With the Public)	12,247	12,527
3. Total Nonfederal Other Assets	$ 46,118,969	$ 44,799,298
4. Total	$ 46,465,397	$ 44,964,397

Intragovernmental Other Assets - Advances and Prepayments
Advances are cash outlays made by a federal entity to cover a part or all of the recipients' anticipated expenses or as advance payments for the costs of goods and services the entity receives. Prepayments are payments made to cover certain periodic expenses before those expenses are incurred.

Nonfederal Other Assets - Outstanding Contract Financing Payments
Contract terms and conditions for certain types of contract financing payments convey certain rights to the Government 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 Federal Government. The Federal Government does not have the right to take the work, except as provided in contract clauses related to termination or acceptance, and the Department of the Navy (DON) is not obligated to make payment to the contractor until delivery and acceptance. Some of the amounts reported as Outstanding Contract Financing Payments (OCFP) may be progress payments based on percentage or stage of completion. However, DON is unable to identify these due to system limitations and all amounts are reported as OCFP.

The balance of OCFP includes $44.4 billion in contract financing payments and an additional $1.4 billion in estimated incurred but unpaid progress payments and government acceptance of a satisfactory product. (See additional discussion in Note 13, Other Liabilities).

Nonfederal Other Assets - Other Assets (With the Public)
Other Assets (With the Public) includes advance pay to DON military personnel, travel advances to military and civilian personnel, and miscellaneous advances to contractors that are not considered outstanding contract financing payments.

Note 7. Cash and Other Monetary Assets

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Cash	$ 65,511	$ 76,772
2. Foreign Currency	28,329	29,270
3. Total	$ 93,840	$ 106,042

Cash and Foreign Currency consist primarily of cash held by the Department of the Navy (DON) Disbursing Officers to carry out their payment, collection, and foreign currency accommodation exchange mission. Foreign Currency is also held in overseas banks in support of contingency operations. The primary source of the amounts reported is the Disbursing Officers Statements of Accountability.

Restriction on Cash, Foreign Currency and Other Monetary Assets
Total Cash and foreign currency reported are nonentity assets that are not available for DON's use in normal operations. Therefore, as of September 30, 2012 and 2011, the $93.8 million and $106 million in Cash and Foreign Currency is restricted as to its use.

Note 8. Inventory and Related Property, Net

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Operating Materiel & Supplies, Net	$ 68,340,085	$ 66,782,595

Operating Materiel and Supplies, Net

As of September 30	2012			
	(AMOUNTS IN THOUSANDS)			
	OM&S Gross Value	Revaluation Allowance	OM&S, Net	Valuation Method
1. OM&S Categories				
A. Held for Use	$ 64,466,653	$ (28,046)	$ 64,438,607	SP, LAC, MAC
B. Held for Repair	4,700,125	(798,647)	3,901,478	SP, LAC, MAC
C. Excess, Obsolete, and Unserviceable	1,249,665	(1,249,665)	-	NRV
2. Total	$ 70,416,443	$ (2,076,358)	$ 68,340,085	

As of September 30	2011			
	(AMOUNTS IN THOUSANDS)			
	OM&S Gross Value	Revaluation Allowance	OM&S, Net	Valuation Method
1. OM&S Categories				
A. Held for Use	$ 61,924,364	$ -	$ 61,924,364	SP, LAC, MAC
B. Held for Repair	6,093,922	(1,235,691)	4,858,231	SP, LAC, MAC
C. Excess, Obsolete, and Unserviceable	1,163,912	(1,163,912)	-	NRV
2. Total	$ 69,182,198	$ (2,399,603)	$ 66,782,595	

Legend for Valuation Methods:

LAC = Latest Acquistion Cost *NRV = Net Realizable Value*
SP = Standard Price *MAC = Moving Average Cost*

Operating Materiel and Supplies (OM&S) includes spare and repair parts, ammunition, conventional missiles, torpedoes, aircraft configuration pods, and centrally managed aircraft engines. The categories of OM&S are Ammunitions and Munitions, Principal End and Secondary Items, Sponsor Owned Materiel (SOM), Realtime Reutilization Asset Management (RRAM) Materiel and Other OM&S. The Moving Average Cost (MAC) valuation method is used for a majority of the OM&S categories; however Latest Acquisition Cost (LAC) is also a valuation method applied depending on the legacy inventory system used to track OM&S. There are no known restrictions on the use of OM&S.

The DON General Fund assigns OM&S items to a category based upon the type and condition of the asset. OM&S Held for Use includes spare and repair parts, clothing and textiles, and petroleum products. OM&S Held for Repair consists of damaged materiel that is more economical to repair than to dispose. Excess, Obsolete, and Unserviceable OM&S consists of scrap materiel or items that cannot be economically repaired and are awaiting disposal.

The DON GF recognizes excess, obsolete, and unserviceable OM&S at a net realizable value of $0 pending development of an effective means of valuing such materiel.

The consumption method shall be applied when accounting for OM&S and valued at historical cost or any method approximating historical cost (e.g. standard cost or LAC). Exceptions to the consumption method is provided when (1) the OM&S are not significant amounts, (2) they are in the hands of the end user for use in normal operations, or (3) it is not cost beneficial to apply the consumption method. In any of these events, the purchase method may be used.

Ammunition and Munitions
Ammunition and Munitions are maintained in the Department of the Navy (DON) Ordnance Information System and valued at the LAC.

Principal End and Secondary Items
Principal End and Secondary Items include OM&S such as shipboard hull, mechanical, and electronic equipment, and uninstalled aircraft engines. They are items of such importance that central inventory control is required. They normally possess one of the following characteristics: essential for combat or training; high dollar value; difficult to procure or produce; or critical basic materiel or components. Principal End and Secondary Items are valued at MAC.

Sponsor-Owned Material
SOM is defined as programmatic materiel required in support of Program Managers' mission requirements for production, life cycle maintenance, and installation of systems and equipment. The materiel usage may involve, but is not limited to: item fabrication, assembly, testing, manufacturing, development, repair, or research and development.

Realtime Reutilization Asset Management Materiel
Materiel maintained and valued in RRAM is considered excess to the owner, or materiel manager responsible for the materiel, but may not be excess to the DON. Standard price is used to value all stock-numbered items. Part-numbered items are valued by best available information. Stock-numbered items represent common items available in the supply system. Part-numbered items are older, unique items, only used in specific types of OM&S.

Other OM&S
Other OM&S consists primarily of Fleet Hospitals held by the Bureau of Medicine and Surgery and War Reserve materiel in possession of the U.S. Coast Guard.

Note 9. General Property, Plant and Equipment, Net

As of September 30	2012				
	(AMOUNTS IN THOUSANDS)				
	Depreciation/ Amortization Method	*Service Life*	*Acquisition Value*	*(Accumulated Depreciation/ Amortization)*	*Net Book Value*
1. Major Asset Classes					
A. Land	N/A	N/A	$ 612,657	$ N/A	$ 612,657
B. Buildings, Structures, and Facilities	S/L	20 or 40	43,733,681	(23,834,274)	19,899,407
C. Leasehold Improvements	S/L	lease term	6,530	(2,702)	3,828
D. Software	S/L	2-5 or 10	3,405	(3,008)	397
E. General Equipment	S/L	5 or 10	14,858,936	(8,900,915)	5,958,021
F. Military Equipment	S/L	Various	416,154,006	(222,121,894)	194,032,112
G. Construction-in-Progress (Excludes Military Equipment)	N/A	N/A	7,189,011	N/A	7,189,011
H. Other			1,156,020	-	1,156,020
2. Total			$ 483,714,246	$ (254,862,793)	$ 228,851,453

As of September 30			2011		
	(AMOUNTS IN THOUSANDS)				
	Depreciation/ Amortization Method	*Service Life*	*Acquisition Value*	*(Accumulated Depreciation/ Amortization)*	*Net Book Value*
1. Major Asset Classes					
A. Land	N/A	N/A	$ 615,579	$ N/A	$ 615,579
B. Buildings, Structures, and Facilities	S/L	20 or 40	40,040,721	(22,578,930)	17,461,791
C. Leasehold Improvements	S/L	lease term	6,530	(2,391)	4,139
D. Software	S/L	2-5 or 10	10,956	(10,439)	517
E. General Equipment	S/L	5 or 10	14,718,004	(8,816,331)	5,901,673
F. Military Equipment	S/L	Various	374,404,232	(177,473,327)	196,930,905
G. Construction-in-Progress (Excludes Military Equipment)	N/A	N/A	6,167,963	N/A	6,167,963
H. Other			1,193,031	-	1,193,031
2. Total			$ 437,157,016	$ (208,881,418)	$ 228,275,598

Legend for Valuation Methods:

S/L = Straight Line *N/A = Not Applicable*

Restrictions on the Use or Convertibility of General Property, Plant, & Equipment

The Department of the Navy (DON) 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. Generally, treaty terms allow DON continued use of these properties until the treaties expire. There are no other known restrictions on General Property, Plant, and Equipment (PP&E).

Accounting Standards for Military Equipment

The DON estimates values for Capitalized Military Equipment using department internal records. The Defense Property Accountability System is a Department of Defense wide system used to provide DON's Military Equipment valuations.

In FY 2012, the DON added 247 new aircraft to the inventory and retired 223.

Other General PP&E consists of Real Property held in caretaker status. Caretaker status is defined as those properties that Navy still owns, but which are being held awaiting further disposal action to another entity, such as Defense Base Closure and Realignment Commission property awaiting sale or transfer to another Federal agency. As of September 30, 2012, the accumulated depreciation related to these assets in caretaker status is currently included in the total accumulated depreciation of Buildings, Structures, and Facilities still in service and is unknown at this time. The DON is researching the dollar value of accumulated depreciation expense related to these assets.

Construction in Progress

Construction in Progress (CIP) is a temporary classification of assets under construction. The costs of new construction and capital improvements are accumulated in a CIP account while the asset is under construction. CIP accounts include all costs incurred to bring the asset to a form and condition suitable for its intended use. The sum of the individual costs in the CIP account will determine the total cost of the asset that is then recorded in the appropriate PP&E general ledger account.

The DON General Fund (GF) is currently reporting outstanding contract financing payments as Nonfederal Other Assets. The DON GF recognizes that U.S. generally accepted accounting principles and federal accounting standards require these payments to be recorded as CIP for items meeting the definition of General PP&E.

Heritage Assets and Stewardship Land

The Federal Accounting Standards Advisory Board's SFFAS No. 29, Heritage Assets and Stewardship Land, requires note disclosures for these types of assets. The DON's policy is to preserve its heritage assets, which are items of historical, cultural, educational, or artistic importance.

Heritage assets within DON consist of buildings and structures, archeological sites, and museum collections. The DON defines these as follows:

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

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

Museum Collection Items
Items that are unique for one or more of the following reasons: historical or natural significance; cultural, educational, or artistic importance; or significant technical or architectural characteristics.

Categories	Measure Quantity	As of September 30, 2011	Additions	Deletions	As of September 30, 2012
Buildings and Structures	Each	10,035	-	-	10,035
Archaeological Sites	Each	18,534	-	-	18,534
Museum Collection Items (Objects, Not Including Fine Art)	Each	649,547	16,757	162,366	503,938
Museum Collection Items (Objects, Fine Art)	Each	40,157	781	125	40,813

DON's Heritage Asset information is entered into the DON Heritage Asset Management System database, and is not based on a physical inventory per the guidance of the Naval Audit Service. Due to a change in the administration of this database, some information pertaining to Museum Collection Items (MCI) from the National Museum of the Marine Corps was not properly collected, resulting in an erroneous ending balance for MCI for FY11. This error was identified and corrected during Q2 of FY12 with the following change to beginning quantities: MCI including fine art increased by 6,341 items and MCI not including fine art decreased by 2,079 items. Efforts to ensure proper collection and reporting of the data are ongoing.

The DON's stewardship land consists mainly of mission essential land acquired by donation or devise. The DON held the following acres of land as of September 30, 2012.

(ACRES IN THOUSANDS)

Facility Code	Facility Title	As of September 30, 2011	Additions	Deletions	As of September 30, 2012
9110	Government Owned Land	5	-	1	4
9120	Withdrawn Public Land	2,030	-	-	2,030
9130	Licensed and Permitted Land	21	-	-	21
				Grand Total	2,055
				TOTAL - All Other Lands	25
				TOTAL - Stewardship Lands	2,030

Relationship of Heritage Assets to DON's Mission
The overall mission of DON is to control and maintain freedom of the seas, project power beyond the sea, and influence events and advance U.S. interests across the full spectrum of military operations. As this mission has been executed, DON has become a large-scale owner of historic buildings, structures, districts, archeological sites and artifacts, ships, aircraft, other cultural resources, and several hundred installations to include stewardship land. Protection of these components of the nation's heritage assets and stewardship land is an essential part of DON's mission; DON is committed to responsible cultural resources stewardship.

Note 10. Liabilities Not Covered by Budgetary Resources

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Intragovernmental Liabilities		
A. Other	$ 519,939	$ 553,572
2. Nonfederal Liabilities		
A. Accounts Payable	20,837	88,870
B. Military Retirement and Other Federal Employment Benefits	1,670,271	1,654,800
C. Environmental Liabilities	21,599,934	21,186,693
D. Other Liabilities	4,924,700	4,764,684
3. Total Nonfederal Liabilities	$ 28,215,742	$ 27,695,047
4. Total Liabilities Not Covered by Budgetary Resources	$ 28,735,681	$ 28,248,619
5. Total Liabilities Covered by Budgetary Resources	8,913,483	8,582,533
6. Total	$ 37,649,164	$ 36,831,152

Liabilities Not Covered by Budgetary Resources are liabilities incurred which are not covered by available budgetary resources. These include liabilities resulting from the receipt of goods or services in the current or prior periods, or the occurrence of eligible events in the current or prior periods, for which revenues of other sources of funds necessary to pay the liabilities have not been made available through Congressional appropriations or earnings of the entity. Notwithstanding an expectation that the appropriations will be made, whether they in fact will be made is completely at the discretion of the Congress.

Intragovernmental Liabilities - Other consists primarily of unfunded Federal Employees' Compensation Act (FECA) liabilities due to the Department of Labor and unemployment compensation that will be funded by future years' budgetary resources.

Accounts payable not covered by budgetary resources is related to cancelled year accounts payable that are not budgeted. Military Retirement and Other Federal Employment Benefits are future actuarial liabilities. Environmental liabilities are estimates related to future events, such as cleanup of nuclear powered assets that will be budgeted for when those assets are removed from service. Finally, other liabilities include annual leave, estimated legal contingent liabilities, and the disposal of excess structures that are not currently budgeted for but will become funded as future events occur.

Military Retirement and Other Federal Employment Benefits consist of unfunded FECA actuarial liabilities not due during the current fiscal year. Refer to Note 15, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

Environmental Liabilities consist of liabilities related to active installations, Defense Base Closure and Realignment Commission sites, equipment and weapons programs, and chemical weapons disposal. Refer to Note 12, Environmental Liabilities and Disposal Liabilities, for additional details and disclosures.

Note 11. Accounts Payable

As of September 30	2012					
(AMOUNTS IN THOUSANDS)						
		Accounts Payable		Interest, Penalties, and Administrative Fees		Total
1. Intragovernmental Payables	$	1,587,406	$	N/A	$	1,587,406
2. Nonfederal Payables (to the Public)		231,951		117		232,068
3. Total	$	1,819,357	$	117	$	1,819,474

As of September 30	2011					
(AMOUNTS IN THOUSANDS)						
		Accounts Payable		Interest, Penalties, and Administrative Fees		Total
1. Intragovernmental Payables	$	1,996,758	$	N/A	$	1,996,758
2. Nonfederal Payables (to the Public)		558,714		12		558,726
3. Total	$	2,555,472	$	12	$	2,555,484

Accounts Payable includes amounts owed to federal and nonfederal entities for goods and services received by Department of the Navy (DON) General Fund (GF). The DON GF's systems do not track intragovernmental transactions by customer at the transaction level. Buyer-side accounts payable are adjusted to agree with interagency seller-side accounts receivable. This is accomplished by 1) reclassifying amounts between federal and nonfederal cost categories, 2) accruing additional accounts payable and expenses, and 3) applying both supported and unsupported undistributed disbursements at the reporting entity level.

Note 12. Environmental and Disposal Liabilities

As of September 30		2012		2011
(AMOUNTS IN THOUSANDS)				
1. Environmental Liabilities–Nonfederal				
A. Accrued Environmental Restoration Liabilities				
1. Active Installations—Installation Restoration Program (IRP) and Building Demolition and Debris Removal (BD/DR)	$	2,511,374	$	2,582,351
2. Active Installations—Military Munitions Response Program (MMRP)		1,979,961		1,898,185
B. Other Accrued Environmental Liabilities—Non-BRAC				
1. Environmental Corrective Action		65,352		69,811
2. Environmental Closure Requirements		374,704		359,376
3. Environmental Response at Operational Ranges		14,168		13,999
4. Asbestos		337,428		348,972
5. Non-Military Equipment		519,390		513,504
6. Other		810		831
C. Base Realignment and Closure Installations				
1. Installation Restoration Program		1,417,953		1,413,412
2. Military Munitions Response Program		153,939		163,564
3. Environmental Corrective Action / Closure Requirements		22,879		24,404
D. Environmental Disposal for Military Equipment / Weapons Programs				
1. Nuclear Powered Military Equipment / Spent Nuclear Fuel		14,055,948		13,637,332
2. Other Weapons Systems		146,028		160,953
2. Total	$	21,599,934	$	21,186,694

The above table excludes estimated total cleanup costs associated with General Property, Plant, and Equipment of $2.8 billion for Fiscal Year (FY) 2012 and $2.5 billion for FY 2011.

The "Other" type of environmental liabilities under Other Accrued Environmental Costs (Line 1.B.6) represents an environmental estimate for disposal of Polychlorinated Biphenyls (PCB) transformers located at various Naval installations.

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

Applicable Laws and Regulations for Cleanup Requirements
The following is a list of significant laws that affect DON's conduct of environmental policy and regulations:

- Superfund Amendments and Reauthorization Act of 1986
- The Resource Conservation and Recovery Act of 1976 as amended by the Hazardous and Solid Waste Amendments of 1984
- The Clean Water Act of 1977, amended the Federal Water Pollution Control Act
- The Safe Drinking Water Act of 1974
- The Clean Air Act, as amended in 1990
- The Atomic Energy Act of 1954
- The Nuclear Waste Policy Act of 1982
- The Low Level Radioactive Waste Policy Amendments Act of 1986
- The National Environmental Policy Act of 1969 (only Defense Base Closure and Realignment Commission (BRAC)

Methods for Assigning Total Cleanup Costs to Current Operating Periods

Active Installations - Defense Environmental Restoration Program (DERP) Funded: Accrued DERP cleanup liabilities represent the cost to correct past releases of hazardous constituents to Property, Plant, and Equipment, including acquired land and Stewardship Land, as described in Chapter 6 of Volume 4 of Department of Defense (DoD) Financial Management Regulations (FMR).

Environmental cleanup of past releases is funded by DERP and carried out under applicable regulatory laws and procedural guidance including the DoD's "Management Guidance for DERP," and "Environmental and Non-Environmental Liabilities," Chapter 13 of Volume 4 of DoD FMR.

Environmental restoration activities may be conducted at operating installations under the Installation Restoration Program (IRP) and at Closed, Transferred, and Transferring Munitions Ranges under the Military Munitions Response Program (MMRP). Determining total environmental cleanup cost considers, on a current cost basis, the anticipated actions required to complete the cleanup, as well as applicable legal and/or regulatory requirements. Program management and support costs are also included in the estimates. The estimate produced is based on site-specific information and use of cost models validated in accordance with DoD Instruction 5000.61, "DoD Modeling and Simulation, Verification, Validation, and Accreditation," of May 2003. The cost estimates are developed and maintained in DON's Normalization of Data System (NORM) database. Such cost estimates are based on the current technology available.

MMRP liabilities are specific to the identification, investigation, removal, and remedial actions to address environmental contamination at ranges that were closed prior to September 30, 2002. The contamination may include munitions, chemical residues from military munitions and munitions scrap at ranges on active installations that pose a threat to human health or the environment. Cost to Complete (CTC) is not estimated until there is sufficient site-specific data available to estimate the total CTC. However, DON uses the cost of the study as the estimate until the study is completed.

The Accrued environmental restoration costs do not include the costs of environmental compliance; pollution prevention, conservation activities, contamination, or spills associated with current operations or treaty obligations, all of which are accounted for as part of ongoing operations.

Environmental Disposal for Weapons Systems Programs: This area represents environmental liabilities associated with the Nuclear Powered Aircraft Carriers and Submarines, Other Nuclear Powered Ships, Conventional Ships, and Spent Nuclear Fuel. During FY 2006, under the DON Financial Improvement Program (FIP), DON completed a review of the estimating methodology for determining the cost for disposal of ships and submarines. This review resulted in an environmental and non-environmental liability estimate that more accurately reflects the true costs of disposal. The estimating methodology is based on average cost per class of ship rather than an average applied to all ships regardless of class.

Description of the Types of Environmental Liabilities and Disposal Liabilities

Accrued Environmental Restoration Liabilities
The DoD FMR, Volume 6B, Chapter 10 requires that "any estimate produced must be based on site specific information and use cost models validated in accordance with DoD Instruction 5000.61." The DON environmental cleanup cost estimate was based on 3,919 IRP and 365 MMRP sites at 207 active installations. As of September 30, 2012, DON estimated and reported $4.5 billion for environmental restoration liabilities. This amount is comprised of $2.5 billion in Active Installations-IRP liabilities and $2.0 billion in Active Installations-MMRP liabilities.

Other Accrued Environmental Liabilities – Non-BRAC
The DON defines Non-BRAC environmental units as those sites associated with on-going operations such as solid waste management unit cleanup, landfill closure, permitted facilities, removal, replacement, retro fill, and/or disposal of PCB transformers, underground storage tank remedial investigation and closure. As part of the DON FIP efforts, the DON completed surveying, identifying, and estimating, Non-BRAC units and began recognizing the estimated environmental liability in 1st Quarter, FY 2007. At September 30, 2012 the total Other Accrued Environmental Liabilities is $1.3 billion. Of the total, the Navy portion is $1.1 billion while the Marine Corps portion is $0.3 billion.

Base Realignment and Closure Installations
BRAC environmental sites are environmental sites at DON installations that are or will be closed under the congressionally mandated BRAC process. As of September 30, 2012, DON has estimated and reported $1.6 billion for BRAC funded environmental liabilities. This amount includes $1.4 billion for IRP, $0.2 billion for MMRP, and $0.02 billion for environmental corrective action and closure requirements. MMRP includes military munitions, chemical residues from military munitions, and munitions scrap at locations on a BRAC installation.

Environmental Disposal for Military Equipment / Weapons Programs
Environmental Disposal for Weapons Systems are those estimates associated with the environmental disposal costs for DON Nuclear Weapons Programs that include Nuclear Powered Aircraft Carriers and Submarines and Other Nuclear Powered Ships, Conventional Ships, and Spent Nuclear Fuel. The DON reported an environmental disposal liability for Weapons Systems Programs of $14.2 billion in FY2012. This amount includes Nuclear Powered Military Equipment of $11.2 billion, Spent Nuclear Fuel (Other) of $2.8 billion, and Other Weapons Systems of $0.2 billion.

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

Estimated environmental liabilities are adjusted for price growth (inflation) and increases in labor rates and materials. Currently, there are no indications that any of the environmental liabilities for any category will be adjusted due to deflation. As of September 30, 2012, there are no changes to the environmental liability estimates due to changes in laws, regulations, and agreements with regulatory agencies. The DON does not have any estimates that were changed due to advances in technology.

Description of the Level of Uncertainty Regarding the Accounting Estimates used to calculate the Reported Environmental Liabilities

The environmental liabilities for DON are based on accounting estimates, which require certain judgments and assumptions that are reasonable based upon information available 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 when calculating the estimates. Liabilities can be further affected if investigation of the environmental sites reveals contamination levels that differ from the estimate parameters.

Overall, DON has a reasonable level of confidence in the estimates recognized on the financial statements. This reasonable level of confidence in the estimates is because the estimates for DERP/BRAC programs are based on the CTC module of the NORM System. A verification, validation, and accreditation were completed by a third party for CTC module of NORM, while the environmental program managers continue to validate the data.

For the Weapons systems, the environmental program managers base their environmental disposal estimates on actual costs for similar projects. The methodology used reflects the most accurate estimate of what it will cost to dispose of weapons systems. Given the fact that the planned date for opening the Department of Energy's (DOE) planned waste repository has been delayed, there is uncertainty associated with the estimate for spent nuclear fuel. As DOE's plans are solidified, DON's estimates for spent nuclear fuel will change accordingly.

The DON believes that the total current environmental liabilities for BRAC are reasonable based on information available at the time in calculating the estimates. However, as the FY 2005 BRAC closure activities are implemented over the next several fiscal years, the actual results may vary materially from the required reportable estimates. The variance will depend on additional information obtained from planned or ongoing studies of the extent and concentration of site environmental contamination and based on property disposal requirements to meet community needs. In addition to the possibility of the estimates changing on current identified sites, DON may incur additional environmental cleanup and restoration costs if new sites are identified as BRAC activities are implemented.

The DON believes that the current environmental liabilities for Other Accrued Environmental Liabilities (Non-DERP) as of September 30, 2012 are reasonable, based upon the information available at the time in calculating the estimates and completing the fence to fence survey. However, as internal controls are implemented to sustain this effort, changes to some of the estimates could occur. In addition to the possibility of some of the estimates changing for the current list of identified units, DON may incur additional units and changes to estimates as the inventory of units are reviewed annually. The BRAC Program Management Office has been notified that a status change was made in the Other Environmental Liabilities (OEL) database. BRAC is developing eligibility criteria for the reporting of these OEL units.

Note 13. Other Liabilities

As of September 30	2012		
(AMOUNTS IN THOUSANDS)	Current Liability	Noncurrent Liability	Total
1. Intragovernmental			
A. Advances from Others	$ 212,571	$ -	$ 212,571
B. Deposit Funds and Suspense Account Liability	-	-	-
C. Disbursing Officer Cash	95,170	-	95,170
D. Judgment Fund Liabilities	6,533	-	6,533
E. FECA Reimbursement to the Dept. of Labor	162,613	204,193	366,806
F. Custodial Liabilities	3,526,910	-	3,526,910
G. Employer Contribution and Payroll Taxes Payable	30,938	-	30,938
H. Other Liabilities	147,232	-	147,232
2. Total Intragovernmental Other Liabilities	$ 4,181,967	$ 204,193	$ 4,386,160
3. Nonfederal			
A. Accrued Funded Payroll and Benefits	$ 980,016	$ -	$ 980,016
B. Advances from Others	493,118	-	493,118
C. Deposit Funds and Suspense Accounts	262,812	-	262,812
D. Nonenvironmental Disposal Liabilities			
(1) Military Equipment (Nonnuclear)	151,304	26,488	177,792
(2) Excess/Obsolete Structures	66,094	525,598	591,692
E. Accrued Unfunded Annual Leave	2,940,264	-	2,940,264
F. Contract Holdbacks	73,563		73,563
G. Employer Contribution and Payroll Taxes Payable	21,557		21,557
H. Contingent Liabilities	15,364	2,610,012	2,625,376
I. Other Liabilities	6,646	-	6,646
4. Total Nonfederal Other Liabilities	$ 5,010,738	$ 3,162,098	$ 8,172,836
5. Total	$ 9,192,705	$ 3,366,291	$ 12,558,996

As of September 30	2011		
(AMOUNTS IN THOUSANDS)	Current Liability	Noncurrent Liability	Total
1. Intragovernmental			
A. Advances from Others	$ 286,402	$ -	$ 286,402
B. Deposit Funds and Suspense Account Liability	386,464	-	386,464
C. Disbursing Officer Cash	107,433	-	107,433
D. Judgment Fund Liabilities	6,605	-	6,605
E. FECA Reimbursement to the Dept. of Labor	164,436	217,859	382,295
F. Custodial Liabilities	3,501,764	-	3,501,764
G. Employer Contribution and Payroll Taxes Payable	30,004	-	30,004
H. Other Liabilities	168,220	-	168,220
2. Total Intragovernmental Other Liabilities	$ 4,651,328	$ 217,859	$ 4,869,187
3. Nonfederal			
A. Accrued Funded Payroll and Benefits	$ 398,789	$ -	$ 398,789
B. Advances from Others	550,805	-	550,805
C. Deposit Funds and Suspense Accounts	(25,423)	-	(25,423)
D. Nonenvironmental Disposal Liabilities			
(1) Military Equipment (Nonnuclear)	12,844	207,551	220,395
(2) Excess/Obsolete Structures	3,218	535,369	538,587
E. Accrued Unfunded Annual Leave	2,896,018	-	2,896,018
F. Contract Holdbacks	71,252	-	71,252
G. Employer Contribution and Payroll Taxes Payable	19,677	-	19,677
H. Contingent Liabilities	13,395	1,871,643	1,885,038
I. Other Liabilities	9,630	-	9,630
4. Total Nonfederal Other Liabilities	$ 3,950,205	$ 2,614,563	$ 6,564,768
5. Total	$ 8,601,533	$ 2,832,422	$ 11,433,955

Intragovernmental Other Liabilities (Line 1.H) consists primarily of Unemployment Compensation unfunded liabilities.

Contingent Liabilities includes $1.4 billion related to contracts authorizing progress payments based on cost as defined in the Federal Acquisition Regulation (FAR). In accordance with contract terms, specific rights to the contractors' work vests with the Federal Government when a specific type of contract financing payment is made. This action protects taxpayer funds in the event of contract nonperformance. It is Department of Defense policy that these rights should not be misconstrued as rights of ownership. The Department of the Navy (DON) General Fund (GF) is under no obligation to pay contractors for amounts greater than the amounts of progress payments authorized in contracts until delivery and government acceptance. Due to the probability the contractors will complete their efforts and deliver satisfactory products, and because the amount of contractor costs incurred but not yet paid are estimable, the DON GF has recognized a contingent liability for the estimated unpaid costs that are considered conditional for payment pending delivery and government acceptance.

Total contingent liabilities for progress payments based on cost represent the difference between the estimated costs incurred to date by contractors and amounts authorized to be paid under progress payments based on cost provisions within the FAR. Estimated contractor-incurred costs are calculated by dividing the cumulative unliquidated progress payments based on cost by the contract-authorized progress payment rate. The balance of unliquidated progress payments based on cost is deducted from the estimated total contractor-incurred costs to determine the contingency amount.

Note 14. Commitments and Contingencies

The Department of the Navy (DON) is a party in various administrative proceedings and legal actions related to claims for environmental damage, equal opportunity matters, and contractual bid protests, which may ultimately result in settlements or decisions adverse to the Federal Government. These proceedings and actions arise in the normal course of operations and their ultimate disposition is unknown. The DON has accrued contingent liabilities for legal actions where the Office of General Counsel (OGC) considers an adverse decision probable and the amount of the loss is measurable. In the event of an adverse judgment against the Government, some of the liabilities may be payable from the U.S. Treasury Judgment Fund. The DON records contingent liabilities in Note 13, Other Liabilities.

For FY 2012, DON General Fund (GF) materiality threshold for reporting litigation, claims, or assessments is $51.5 million. The DON OGC conducts a review of litigation and claims threatened or asserted involving DON GF to which the OGC attorneys devoted substantial attention in the form of legal consultation or representation.

The DON currently has 12 cases that meet the existing FY 2012 DON GF materiality threshold. DON legal counsel was unable to express an opinion concerning the likely outcome on 9 of 12 cases.

Due to the inherent uncertainties of litigation, lawyers generally refrain from expressing judgments as to outcomes except in those relatively few clear cases. In response to a Department of Defense (DoD) Inspector General Audit, "DoD Process for Reporting Contingent Legal Liabilities," DON developed a methodology to determine an estimate for contingent legal liabilities. Using this methodology, DON recognized and disclosed an estimate for contingent legal liabilities. The methodology considers the likelihood of an unfavorable outcome or potential liability and provides an overall assessment of all cases currently pending and not on an individual case basis. The likelihood of an unfavorable or potential liability was determined by using an average of the data from the current year-to-date and the preceding two years. The total dollar amount of the cases closed was divided by the total dollar amount claimed in those closed cases for each of the last two years plus current year, which were then used to calculate the average. This average is based entirely on historical data and represents the percentage that has historically been paid on claims. The merits of each individual case have not been taken into consideration. The estimate for those cases considered reasonably possible to result in an adverse judgment against DON is $246.7 million. Until sufficient historical data can be collected for the Navy Working Capital Fund, the DON GF estimate will consider all DON funding sources together.

The DON is a party in numerous individual contracts that contain clauses, such as price escalation, award fee payments, or dispute resolution, that may result in a future outflow of expenditures. Currently, DON has limited automated system processes by which it captures or assesses these potential liabilities; therefore, the amounts reported may not fairly present DON's contingent liabilities.

Note 15. Military Retirement and Other Federal Employment Benefits

As of September 30	2012			
	(AMOUNTS IN THOUSANDS)			
	Liabilities	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
1. Other Actuarial Benefits				
A. FECA	$ 1,670,271		$ -	$ 1,670,271
B. Other	489		(489)	-
2. Total	$ 1,670,760		$ (489)	$ 1,670,271

As of September 30	2011			
	(AMOUNTS IN THOUSANDS)			
	Liabilities	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
1. Other Actuarial Benefits				
A. FECA	$ 1,654,801		$ -	$ 1,654,801
B. Other	218		(218)	-
2. Total	$ 1,655,019		$ (218)	$ 1,654,801

The Department of the Navy (DON) reports an actuarial liability for the Federal Employee's Compensation Act (FECA). FECA provides federal employees injured in the performance of duty with workers' compensation benefits, which include wage-loss benefits for total or partial disability, medical benefits, and vocational rehabilitation. FECA also provides survivor benefits to eligible dependents if the injury causes the employee's death. The FECA is administered by the Office of Workers' Compensation Programs.

Actuarial Cost Method Used and Assumptions:
The DON's actuarial liability for workers' compensation benefits is developed by the Department of Labor and provided to DON only at the end of each fiscal year.

The estimate 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 ten year U.S. Treasury notes and bonds. Interest rate assumptions utilized for discounting were as follows:

Discount Rates

2.293% in Year 1

3.138% in Year 2 and thereafter

To provide more specificity 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 the charge back year (CBY) 2012 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 CBY were as follows:

CBY	COLA	CPIM
2012	N/A	N/A
2013	2.83%	3.65%
2014	2.03%	3.66%
2015	1.93%	3.72%
2016	2.00%	3.73%
2017	2.03%	3.80%

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 to economic assumptions, (2) a comparison of the percentage change in the liability amount to the percentage change in the actual incremental payments, (3) a comparison of the incremental paid losses per case (a measure of case-severity) in CBY 2012 to the average pattern observed during the most current three charge back years, and (4) a comparison thereafter of the estimated liability per case in the 2012 projection to the average pattern for the projections of the most recent three years.

Note 16. Disclosures Related to the Statement of Net Cost

Intragovernmental Costs and Exchange Revenue

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Intragovernmental Cost	$ 50,908,881	$ 50,201,170
2. Nonfederal Cost	129,385,410	131,198,281
3. Total Cost	$ 180,294,291	$ 181,399,451
4. Intragovernmental Revenue	$ (3,312,422)	$ (3,546,706)
5. Nonfederal Revenue	(7,287,485)	(8,916,321)
6. Total Revenue	$ (10,599,907)	$ (12,463,027)
7. Total	$ 169,694,384	$ 168,936,424

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the Federal Government supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity. The Department of Defense's (DoD) current processes and systems do not capture and report accumulated costs for major programs based upon the performance measures as required by the Government Performance and Results Act. The DoD is in the process of reviewing available data and developing a cost reporting methodology as required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, as amended by SFFAS No. 30, Inter-entity Cost Implementation.

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

The DON's financial management systems are unable to meet all of the requirements for full accrual accounting. Many of DON's financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of U.S. Generally Accepted Accounting Principles (USGAAP) for federal agencies. Most of DON's legacy systems were designed to record information on a budgetary basis, and do not track intragovernmental transactions by customer at the transaction level. Considering these systems limitations, DON GF is unable to accurately compare its intragovernmental costs and revenues with the corresponding balances of its intragovernmental trading partners. Buyer-side accounts payable and expenses were adjusted to match seller-side accounts receivable and revenues. This is accomplished by reclassifying amounts between federal and public cost categories, and accruing additional costs when necessary. Intradepartmental revenues and expenses are then eliminated.

In conjunction with the DoD, DON has undertaken efforts to determine the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with all elements of USGAAP. One such action is the revision of its accounting systems to record transactions based on the U.S. Standard General Ledger. Until such time as all of the DON's financial and nonfinancial feeder systems and processes are updated to collect and report financial information as required by USGAAP, DON GF's financial data will be largely based on budgetary transactions (obligations, disbursements, and collections), transactions from nonfinancial feeder systems, and adjustments for known accruals of major items such as payroll expenses, accounts payable, and environmental liabilities.

The DON's accounting systems generally do not capture information relative to Heritage Assets separately and distinctly from normal operations.

Note 17. Disclosures Related to the Statement of Changes in Net Position

Unexpended Appropriations represent the amount of spending authorized as of year-end that is unliquidated or unobligated and has not lapsed, been rescinded, or withdrawn.

Cumulative Results of Operations represents the net results of operations since inception. Included as a reduction in Cumulative Results of Operations are accruals for which related expenses require funding from future appropriations. These future funding requirements include, among others (a) accrued annual leave earned but not taken, (b) expenses for contingent liabilities, and (c) expenses for environmental liabilities.

Appropriations Received on the Statement of Changes in Net Position (SCNP) does not agree with Appropriations Received on the Statement of Budgetary Resources (SBR) due to differences between proprietary and budgetary accounting concepts and reporting requirements. The difference of $26.1 million is due to certain cash receipts recorded as "Appropriations Received" on the SBR but recognized as exchange or non-exchange revenue (usually in special and trust fund accounts) and reported on the SCNP in accordance with SFFAS No. 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting.

In the SCNP, all offsetting balances (i.e. transfers-in, transfers-out, revenue and expenses) for general fund activity between earmarked and other (non-earmarked) funds are reported on the same lines. Therefore, the Eliminations column contains all appropriate elimination entries, which net to zero within each respective line, except for intra-entity imputed financing costs.

Other Financing Sources - Other consists primarily of gains and losses associated with Military Equipment, Operating Materiel & Supplies, and Real Property.

The abnormal balances in Appropriations Used included within the Budgetary Financing Sources section are a result of the closing of the Rossmoor Liquidating Trust Settlement Account. Current Treasury posting rules require this account closing event to be treated as a return of unexpended appropriations even though these accounts are not required to treat the funds as "Unexpended Appropriations." This Treasury posting logic is being corrected in FY 2013 when Treasury includes a new U.S. Standard General Ledger account to allow a closing event such as this to be treated as a cancellation of "Revenue and Other Financing Sources" instead of as a cancellation of "Unexpended Appropriations." These abnormal balances will be self correcting in the post closing process for FY12, and will therefore no longer be abnormal beginning in FY13.

Note 18. Disclosures Related to the Statement of Budgetary Resources

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	$ 154,814,226	$ 148,297,754

Apportionment Categories for Obligations Incurred
On the Statement of Budgetary Resources (SBR): Obligations Incurred includes $185 billion of Direct Program Obligations and $9.1 billion of Reimbursable Program Obligations.

On the Report on Budget Execution (SF-133):

- Direct Obligations, Category A, amounts apportioned quarterly, are $108.0 billion.
- Direct Obligations, Category B, amounts apportioned on a basis other than quarterly, are $77.0 billion.
- Total Direct Obligations are therefore $185 billion
- Category A Reimbursable Obligations are $0.
- Category B Reimbursable Obligations are $9.1 billion.
- Total Reimbursable Obligations are therefore $9.1 billion.

Other Disclosures
The SBR includes intra-entity transactions because the statements are presented as combined.

Appropriations Received on the Statement of Changes in Net Position does not agree with Appropriations Received on the SBR due to differences between proprietary and budgetary accounting concepts and reporting requirements. The difference of $26.1 million is due to Trust Funds and Special Receipt Accounts included in the Appropriations Received line of the SBR.

Legal limitations and restrictions affect the use of the unobligated balance of budget authority based upon program and fiscal year in the applicable appropriation language or in the alternative provisions section at the end of the appropriations act.

Permanent, Indefinite Appropriations
The National Defense Sealift Fund (NDSF) is operated under the authority of 10 U.S. Code 2218, which provides for the construction (including design of vessels), purchase, alteration, and conversion of Department of Defense (DoD) sealift vessels; operation, maintenance, and lease or charter of DoD vessels for national defense purposes; installation and maintenance of defense features for national defense purposes on privately owned and operated vessels that are constructed in the United States and documented under the laws of the U.S.; research and development relating to national defense sealift; and expenses for maintaining the National Defense Reserve Fleet, including the acquisition, alteration or conversion of vessels. There was one transfer for $4.6 million into NDSF from Operation and Maintenance Defense health program as of September 30, 2012. There were no transfers out of NDSF during this period.

The Environmental Restoration, Navy (ER, N) appropriation is a transfer account that funds environmental restoration, reduction, and recycling of hazardous waste, removal of unsafe buildings and debris, and similar purposes. Funds remain available until transferred and remain available for the same purpose and same time period as the appropriations to which transferred. There were two transfers from ER, N for $0.3 billion to the Operation and Maintenance, Navy appropriation. There were no transfers into ER, N during this period.

Note 19. Reconciliation of Net Cost of Operations to Budget

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
1. Obligations Incurred	$ 194,177,904	$ 198,389,702
2. Less: Spending Authority from Offsetting Collections and Recoveries	(21,354,258)	(21,756,944)
3. Obligations Net of Offsetting Collections and Recoveries	172,823,646	176,632,758
4. Less: Offsetting Receipts	(226,131)	36,444
5. Net Obligations	172,597,515	176,669,202
Other Resources:		
6. Donations and Forfeitures of Property	1,742	652
7. Transfers In/Out without Reimbursement	(138,094)	225,126
8. Imputed Financing from Costs Absorbed by Others	816,514	881,374
9. Other	4,114,238	12,764,061
10. Net Other Resources Used to Finance Activities	4,794,400	13,871,213
11. Total Resources Used to Finance Activities	$ 177,391,915	$ 190,540,415
Resources Used to Finance Items Not Part of the Net Cost of Operations:		
12. Change in Budgetary Resources Obligated for Goods, Services, and Benefits Ordered But Not Yet Provided:		
12a. Undelivered Orders	$ (6,516,469)	$ (10,316,024)
12b. Unfilled Customer Orders	340,369	(622,769)
13. Resources That Fund Expenses Recognized in Prior Periods	(158,378)	(182,244)
14. Budgetary Offsetting Collections and Receipts That Do Not Affect Net Cost of Operations	226,131	(36,444)
15. Resources That Finance the Acquisition of Assets	(15,764,666)	(16,206,440)
16. Other Resources or Adjustments to Net Obligated Resources That Do Not Affect Net Cost of Operations:		
16a. Other	(3,977,906)	(12,989,838)
17. Total Resources Used to Finance Items Not Part of the Net Cost of Operations	$ (25,850,919)	$ (40,353,759)
18. Total Resources Used to Finance the Net Cost of Operations	$ 151,540,996	$ 150,186,656
Components of the Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Period:		
19. Increase in Annual Leave Liability	$ 7,230	$ 30,795
20. Increase in Environmental and Disposal Liability	434,868	1,891,194
21. Increase in Exchange Revenue Receivable from the Public	139,587	27,231
22. Other	203,339	283,146
23. Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	785,024	2,232,366
Components Not Requiring or Generating Resources:		
24. Depreciation and Amortization	19,679,709	19,729,331
25. Revaluation of Assets or Liabilities	(4,152,446)	(6,173,204)
26. Other		
26a. Operating Material and Supplies Used	4,125,346	5,527,002
26b. Other	(2,284,245)	(2,565,727)
27. Total Components of Net Cost of Operations That Will Not Require or Generate Resources	17,368,364	16,517,402
29. Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	$ 18,153,388	$ 18,749,768
30. Net Cost of Operations	$ 169,694,384	$ 168,936,424

The Reconciliation of Net Cost of Operations to Budget is designed to provide information about the total resources used by an entity, to explain how those resources were used to finance orders for goods and services not yet delivered, to acquire assets and liabilities, and to fund the entity's net cost of operations. It is designed to report the differences and facilitate the reconciliation of accrual-based amounts used in the Statement of Net Cost (SNC) and obligation-based amounts used in the Statement of Budgetary Resources. The computations and presentation of items in the Reconciliation of Net Cost of Operations to Budget demonstrate that the budgetary and proprietary information in an entity's financial management system agrees.

Due to the Department of the Navy (DON) financial system limitations, budgetary data does not agree with proprietary expenses and capitalized assets. Differences between budgetary and proprietary data are previously identified deficiencies. This causes a difference in net cost between the SNC and the Reconciliation of Net Cost of Operations to Budget that requires an adjustment to the Reconciliation of Net Cost of Operations to Budget. As of September 30, 2012, an adjustment of ($0.7 billion) was made to Resources that Finance the Acquisition of Assets so that proprietary accounts reconcile with the budgetary accounts.

The Reconciliation of Net Cost of Operations to Budget is presented as a consolidated statement. However, the following lines are presented as combined instead of consolidated due to interagency 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

Description of Other Lines
Resources Used to Finance Activities - Budgetary Resources Obligated contains a balance of $4.1 billion. This balance represents the data call net gains and losses recorded in relation to the capitalization of assets such as Real Property, Operating Materials and Supplies, and Military Equipment.

Resources Used to Finance Items not Part of the Net Cost of Operations contains a balance of ($4.0) billion. This balance reflects net gains and losses recorded in relation to the net change of the value of assets such as Military Construction, Ammunition, Real Property, and Shipbuilding and Conversion.

Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period contains an other balance of $0.2 billion in relation to Components Requiring or Generating Resources in Future Period. This amount consists mainly of non-environmental liabilities, contract incentives, and contingent legal liabilities. Components Not Requiring or Generating Resources contains an other balance of ($2.3) billion which is primarily comprised of a crosswalk change for CIP reporting.

Note 20. Earmarked Funds

BALANCE SHEET				
As of September 30	2012			
(AMOUNTS IN THOUSANDS)				
		Other Earmarked Funds	*Eliminations*	*Total*
ASSETS				
Fund Balance with Treasury	$	22,722	-	22,722
Investments		7,968	-	7,968
Total Assets	$	30,690	-	30,690
LIABILITIES and NET POSITION				
Other Liabilities	$	1,158	-	1,158
Total Liabilities	$	1,158	-	1,158
Cumulative Results of Operations	$	29,532	-	29,532
Total Liabilities & Net Position	$	30,690	-	30,690

STATEMENT OF NET COST				
For the period ended September 30	2012			
Program Costs	$	19,924	-	19,924
Net Cost of Operations	$	19,924	-	19,924

STATEMENT OF CHANGES IN NET POSITION				
For the period ended September 30	2012			
Net Position Beginning of the Period	$	25,545	-	25,545
Net Cost of Operations		19,924	-	19,924
Budgetary Financing Sources		23,911	-	23,911
Change in Net Position	$	3,987	-	3,987
Net Position End of Period	$	29,532	-	29,532

BALANCE SHEET				
As of September 30	2011			
(AMOUNTS IN THOUSANDS)				
		Other Earmarked Funds	*Eliminations*	*Total*
ASSETS				
Fund Balance with Treasury	$	21,541	-	21,541
Investments		9,289	-	9,289
Total Assets	$	30,830	-	30,830
LIABILITIES and NET POSITION				
Other Liabilities	$	5,285	-	5,285
Total Liabilities	$	5,285	-	5,285
Cumulative Results of Operations	$	25,545	-	25,545
Total Liabilities & Net Position	$	30,830	-	30,830

STATEMENT OF NET COST				
For the period ended September 30	2011			
Program Costs	$	26,678	-	26,678
Net Cost of Operations	$	26,678	-	26,678

STATEMENT OF CHANGES IN NET POSITION				
For the period ended September 30	2011			
Net Position Beginning of the Period	$	33,682	-	33,682
Net Cost of Operations		26,678	-	26,678
Budgetary Financing Sources		18,541	-	18,541
Change in Net Position	$	(8,137)	-	(8,137)
Net Position End of Period	$	25,545	-	25,545

Earmarked funds are financed by specifically identified revenues and are required by statute to be used for designated activities or purposes. The Department of the Navy (DON) currently has six earmarked funds, a decrease of one from FY11 due to the cancellation of the Rossmoor Liquidating Trust Settlement. Upon cancellation, the remaining unobligated balance in the account was transferred to the General Fund of the U.S. Treasury, and this account will not receive additional funds or incur additional obligations.

For the remaining six earmarked funds (three Special Funds and three Trust Funds), a brief description follows below. There have been no changes in legislation during or subsequent to the reporting period that significantly changes the purpose or that redirects a material portion of the accumulated balances of any of these six funds. Generally, revenues for DON's earmarked funds are inflows of resources to the Government.

Special Earmarked Funds

Wildlife Conservation, Military Reservations, Navy

This fund, authorized by 16 United States Code 670b, provides for the development and conservation of fish and wildlife and recreational facilities on military installations. Proceeds from the sale of fishing and hunting permits are used for these programs at DON installations charging such user fees. These programs are carried out through cooperative plans agreed upon by the local representatives of the Secretary of Defense, the Secretary of the Interior, and the appropriate agency of the State in which the installation is located.

Kaho'olawe Island Conveyance, Remediation and Environmental Restoration Fund, Navy
This fund, authorized by Public Law 103-139, 107 Statute 1418, was established to recognize and fulfill the commitments made on behalf of the United States to the people of Hawaii and to return to the State of Hawaii the Island of Kaho'olawe. Congress has found it to be in the national interest and an essential element in the Federal Government's relationship with the State of Hawaii the conveyance, clearance, or removal of unexploded ordnance, environmental restoration, control of access to the Island and future use of the Island be undertaken in a manner consistent with the enhancement of that relationship, the Department of Defense's military mission, the federal interest, and applicable provisions of law. This fund is financed by congressional appropriations.

Ford Island Improvement Account
The Ford Island Improvement fund is authorized by 10 United States Code 2814 and was established to carry out improvements to property and facilities that will deliver overall benefits to DON at the Pearl Harbor Naval Complex at Ford Island, Hawaii. Ford Island is a central feature in the Pearl Harbor National Historic Landmark. The Ford Island legislation allows DON to sell or lease properties in Hawaii and use the proceeds to develop Ford Island.

Trust Earmarked Funds

DON General Gift Fund
This trust fund is authorized by 10 United States Code 2601. Under the provisions of this statute, the Secretary of the Navy (SECNAV) may accept, hold, administer, and spend any gift, devise, or bequest of real or personal property, made on the condition that it be used for the benefit, or in connection with the establishment, operation, or maintenance of a school, hospital, library, museum, cemetery, or other institution under the jurisdiction of DON.

Ships Stores Profit, Navy
This trust fund is authorized by 10 United States Code 7220. Deposits to this fund are derived from profits realized through the operation of ships' stores and from gifts accepted for providing recreation, amusement, and contentment for enlisted members of the Navy and Marine Corps.

U.S. Naval Academy General Gift Fund
This trust fund is authorized by 10 United States Code 6973. Under the provisions of this statute, SECNAV may accept, hold, administer, and spend any gift, devise, or bequest of personal property, made on the condition that it be used for the benefit of, or in connection with, the United States Naval Academy, or the Naval Academy Museum, its collections, or its services.

Note 21. Fiduciary Activities

Schedule of Fiduciary Activities

For the period ended September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Fiduciary Net Assets, Beginning of Year	$ 32,769	$ 28,384
2. Contributions	46,803	47,803
3. Investment Earnings	2,560	2,905
4. Distributions to and on Behalf of Beneficiaries	(51,320)	(46,323)
5. Increase/(Decrease) in Fiduciary Net Assets	$ (1,957)	$ 4,385
6. Fiduciary Net Assets, End of Period	$ 30,812	$ 32,769

Fiduciary Net Assets

For the period ended September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Cash and Cash Equivalents	$ 30,812	$ 32,769

The Department of the Navy's Fiduciary Activity consists of funds in the Savings Deposit Program. Under 10, USC, §1035, and Department of Defense Financial Management Regulation (FMR), Volume 7A, Chapter 51, service members of both the Navy and Marine Corps who are on a permanent duty assignment outside the United States or its possessions can earn interest at a rate prescribed by the president, not to exceed 10 percent a year, on up to $10 thousand deposited into the program. This limitation shall not apply to deposits made on or after September 1, 1966 in the case of those members in a missing status during the Vietnam conflict, the Persian Gulf conflict, or a contingency operation. A permanent duty assignment is defined as any active duty assignment that contemplates duty in the designated area as a permanent change of station, or more than 30 days on temporary additional duty, temporary duty, or with a deployed ship or unit. As stated in the FMR, this definition of a permanent duty assignment applies specifically to this program, effective as of July 1, 1991. Interest accrual shall terminate 90 days after the member's return to the U.S. or its possessions. The deposit funds included in the balance are 17X6025 for Navy and 17X6026 for Marine Corps.

Note 22. Operating Lease Disclosure

As of September 30	2012			
	(AMOUNTS IN THOUSANDS)			
	Land and Buildings	*Equipment*	*Other*	*Total*
1. Entity as Lessee - Operating Leases				
Future Payments Due				
Fiscal Year				
2013	$ 147,865	$ 1,600	$ 7	$ 149,472
2014	150,566	1,712	8	152,286
2015	153,317	1,848	8	155,173
2016	156,120	1,978	9	158,107
2017	158,974	2,123	9	161,106
After 5 Years	162,139	2,272	10	164,421
Total	$ 928,981	$ 11,533	$ 51	$ 940,565

GENERAL FUND REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION

Department of the Navy Fiscal Year 2012 Annual Financial Report

Investments in Research and Development
Yearly Investment in Research and Development

For Fiscal Years 2008 through 2012

($ IN MILLIONS)

Categories	FY12	FY11	FY10	FY09	FY08
Basic Research	$ 554	$ 547	$ 552	$ 523	$ 452
Applied Research	738	728	752	854	748
Development					
Advanced Technology Development	761	821	859	883	752
Advanced Component Development and Prototypes	3,950	4,080	3,910	3,464	3,329
System Development and Demonstration	5,382	6,429	7,325	8,288	8,141
Research, Development, Test, and Evaluation Management Support	1,298	1,285	1,293	1,245	1,112
Operational Systems Development	4,137	4,285	4,505	4,249	3,943
Totals	**$ 16,820**	**$ 18,175**	**$ 19,196**	**$ 19,506**	**$ 18,477**

Investments in Research and Development
Investment values are based on Research and Development outlays (expenditures). Outlays are used because current Department of the Navy (DON) systems are unable to fully capture and summarize costs in accordance with standards promulgated by the Federal Accounting Standards Advisory Board.

Research and Development (R&D) programs are classified as Basic Research, Applied Research, and Development. The definition of each R&D category and subcategory is explained below.

A. Basic Research
Basic Research is the systematic study to gain knowledge or understanding of the fundamental aspects of phenomena and of observable facts without specific applications, processes, or products in mind. Basic Research involves the gathering of a fuller knowledge or understanding of the subject under study. Major outputs are scientific studies and research papers.

The following are two representative program examples for the Basic Research category.

Marine Meteorology and Space:

Navy requires the capability to predict the weather at time and space scales that support global operations, planning, and tactical operations. The Office of Naval Research's (ONR) Marine Meteorology (MM) and Space Program supports basic and applied research to understand, analyze, and predict the chaotic and nonlinear surface to space environment on all scales, including the interaction of space, ocean, ice, and land, to characterize and forecast operationally relevant aspects of the environment and its inherent uncertainty globally and regionally.

The MM program seeks to understand processes through theory and field experiments, supports model development to represent new processes numerically, and funds basic research to integrate new knowledge into prediction systems. Topics of emphasis include air-sea interaction, coupled modeling, predictability, high resolution mesoscale weather prediction, targeted observing, aerosols, tropical cyclones, and 4D data assimilation.

Major efforts include:
Tropical Cyclone Structure 2008 (TCS-08): Conducted the first major Western Pacific Operating Region airborne field experiment since 1993 to improve the understanding of storm scale processes and increase the predictability of TCS over the western North Pacific.

Coupled Ocean/Atmosphere Mesoscale Prediction System (COAMPS)-TC: Utilizing the results of TCS-08, a version of the Navy's mainstay mesoscale numerical weather prediction model was modified successfully to provide the first skillful predictions of tropical cyclone intensity by a dynamical model.

Earth System Prediction Capability: Seasonal predictions represent a bridge between climate prediction and weather prediction. Two initiatives have begun to improve the coupling, parameterizations and processes in prediction models aimed at extending skill from sub-seasonal to intra-seasonal and inter-annual timescales.

Space: The space weather research initiative focused upon triggers for ionospheric irregularities affecting communication and navigation, global assimilative ionospheric modeling, and high altitude lightning effects.

What this research will accomplish:
This research will field dynamic weather models that provide unprecedented extended range forecasting. See a video about this research and why it is important to the Navy:

http://www.youtube.com/watch?v=vht4NWLzMOk&list=UUON9qgTd6NZQmI0ev38oEKg&index=4&feature=plcp

Hydromechanics:

ONR Hydromechanics Program has contributed to ship and submarine design and performance in many respects, including measurement techniques at model and full scale, theoretical descriptions of ship and sub motion and fluid mechanics, new concepts in propulsion, and advanced computational prediction. Hydromechanics supports research in the phenomena of ship, sub, and propulsor interaction with the sea toward improvements in efficiency, robustness, and operator guidance. Focus is on extreme conditions/maneuvers, the production of a bubble wake, physics of cavitation and stratification, and new concepts in hullform and propulsion.

The goal of the program is the identification, understanding, prediction, and control of all hydrodynamics phenomena in the interaction of a ship or submarine with the sea. Observation, mathematical analysis, computational techniques, and optimization of hullform, propulsion, and operations are key to achieving the goal. Basic research forms the foundation for applied research projects toward naval application. Of particular interest is the response of ships and subs to extreme conditions such as high sea states or emergencies such as loss of a control surface or a crash-back maneuver (reverse propulsor thrust). Other important hydromechanics phenomena include the entrainment of air around a ship and the resulting bubble wake ship track, hydroacoustic noise, and ocean stratification effects. Formation of the bubble wake for a given ship is extremely difficult to predict, yet important for defense against wake-homing torpedoes.

The hydromechanics of cavitation, especially on propulsors, is also complex and is a major source of noise as well as surface erosion. Recent advances include the identification of a puzzling noise source due to vortex-interaction downstream of a propeller tip. As with the bubble wake, the presence of both gas and liquid complicate the numerical modeling of the phenomena.

What this research will accomplish:
- An understanding and proper mathematical/numerical formulation of ship and sub motion and propulsion will permit intelligent modifications to hullforms, propulsors, and control Computational shape optimization will improve the examination of design alternatives

- An understanding of the bubble wake processes, cavitation, and stratification will guide the way toward possible methods of wake and noise control and accurate prediction of hydrodynamic characteristics for vulnerability analysis

B. Applied Research

Applied Research is the systematic study to gain knowledge or understanding necessary for determining the means by which a recognized and specific need may be met. It is the practical application of such knowledge or understanding for the purpose of meeting the recognized need. This research points toward specific military needs with a view toward developing and evaluating the feasibility and practicability of proposed solutions and determining their parameters. Major outputs are scientific studies, investigations, and research papers, hardware components, software codes, and limited construction of, or part of, a weapon system to include non system specific development efforts.

The following are two representative program examples for the Applied Research category.

Advanced Power and Energy for Unmanned Undersea Vehicles (UUV):

ONR's UUV Power & Energy Program is developing component and system technologies for advanced high energy density propulsion systems enabling their operation reliably in an air-independent environment for 70+ days of continuous operation. One of the Chief of Naval Operation's priorities is to accelerate the development of long endurance UUVs to gain persistent access to areas denied to manned platforms, act as a force multiplier, and decrease platform and personnel vulnerabilities due to the frequent energy section refresh required in current UUVs. New power sources with improved energy density (5-10X times Silver Oxide-Zinc batteries), quick recharge or refueling, and operation at an acceptable cost are required.

To achieve long endurance, advanced and highly efficient power conversion technologies such as Stirling engines, Solid Oxide Fuel Cells (SOFC) and Polymer Electrolyte Membrane (PEM) Fuel Cells are coupled with high storage density reactants for both fuels and oxidizers. Fuel cell systems, in particular, have the potential to yield chemical to electrical conversion efficiencies in excess of 70% since they are not limited thermodynamically by the Carnot Cycle, and show great promise to meet both near-term and far-term UUV energy storage and power conversion requirements.

What this research will accomplish:

- Development of PEM, SOFC, and related fuel/oxidizer storage technologies
- Enables UUV energy systems to operate continuously for 70+ days without refueling (system energy densities upwards of 1000 Watt-hours/liter).

Universal Gateway:

On any Navy destroyer, cruiser or carrier today, there are two networks: one for combat systems (weapons and sensors) and one for command and control, or C2, which also encompasses intelligence, surveillance and reconnaissance. There are some 30 interconnections between the two networks, making it difficult to integrate data into a real-time common operating picture, in addition to being expensive to maintain.

In response, ONR developed the Universal Gateway, which collapses the 30 connections into a single portal, rapidly automating data integration, enhancing information assurance and reducing manpower workloads and costs. The gateway can be put between different networks, despite their classification levels, so information is available in a timely and effective way for warfighters. One example of how this will help Sailors is by automating air tasking orders. Currently, an air tasking order comes to a ship on the C2 side. The only way to link the information into a combat system—such as Aegis—is for a Sailor to download the information from the C2 network CD and then manually upload it into the combat system. The objective for the gateway is to produce a shared situation display for ships that goes beyond showing just force and unit locations—who and where—to showing a full common operating picture—who, what, when, where, why and how.

Between 2010 and 2011, ONR completed a series of limited technical evaluations that proved the gateway could integrate the various technologies that run on it. ONR also has been working on connecting data from unmanned aerial systems, which involves combat systems and surveillance information, into the gateway. This would help achieve a networked force, which is key to the DON's goals for information dominance. The next phase is to move the data into a cloud environment and add analytical capability to save time and manpower.

For another future initiative, ONR has established partnerships with the Army and Air Force to advance the Universal Gateway as means of developing a common C2 system for tracking and accessing unmanned vehicles in a joint environment. The Universal Gateway is the product of a unique rapid prototyping collaboration between ONR; Program Executive Office Integrated Warfare Systems; and Program Executive Office Command, Control, Communications, Computers and Intelligence. The partnership has been extremely successful, primarily due to increased communication, which has resulted in more rapid transitioning—quickly getting items into prototyping, experimentation and, ultimately to the Sailors and Marines.

What this research will accomplish:

- Automatically uploads data to/between ship networks
- Supports the goal of a network-centric Navy
- See a video about this research:

http://www.youtube.com/watch?v=_ni27sGS3dc&list=UUON9qgTd6NZQmI0ev38oEKg&index=2&feature=plcp

C. Development

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

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

2. Advanced Component Development and Prototypes evaluates integrated technologies in as realistic an operating environment as possible to assess the performance or cost reduction potential of advanced technology. Programs in this phase are generally system specific. Major outputs of Advanced Component Development and Prototypes are hardware and software components or complete weapon systems ready for operational and developmental testing and field use.

3. System Development and Demonstration concludes the program or project and prepares it for production. It consists primarily of preproduction efforts, such as logistics and repair studies. Major outputs are weapons systems finalized for complete operational and developmental testing.

4. Research, Development, Test, and Evaluation Management Support is support for installations and operations for general research and development use. This category includes costs associated with test ranges, military construction maintenance support for laboratories, operation and maintenance of test aircraft and ships, and studies and analyses in support of the Research and Development program.

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

The following are four representative program examples for the Development category.

Solid State Laser Maturation Program:

The Solid State Laser Technology Maturation (SSL-TM) program will develop and mature high-energy laser technologies into a prototypical weapon system for use and installation on the Navy's surface combatants. The Department of Defense (DOD) began funding research in high-energy lasers (HEL) soon after the invention of the laser in 1960 when it was thought that they might (if scalable to high power) have tremendous impact on how wars were fought. The Navy jointly built a multi-hundred-kilo-watt class laser in the 1970s, from which the Navy leveraged this technology to produce the nation's first mega-watt-class HEL weapon test bed.

The Mid-InfraRed Advanced Chemical Laser and the SeaLite Beam Director were installed and integrated at White Sands Missile Range in the mid-1980s and used for experiments by DoD. While performance of these mega-watt-class lasers was highly promising with many targets successfully engaged, the logistics and safety issues of hazardous chemicals in a shipboard environment severely hampered further development or implementation on the Navy's surface combatants.

Solid State Laser technology with weapons-level effects has been maturing rapidly and recent advancements by the scientific and commercial sectors have begun to show that a potential application on surface combatants is possible. In particular, the ONR Maritime Laser Demonstration for the first time in 2011 took a laser to sea and successfully conducted a mission scenario against a representative threat small boat, while underway. Further, support for a continuation of competitive programs continues to garner interest and generate discussion. The goal of the SSL-TM Program is to produce multiple demonstration-level events with prototypical quality systems in a competitive environment.

What this research will accomplish:

- Produce a prototypical weapon system for use on surface Navy combatants. Lasers have the capability for speed-of-light engagements, with very precise, real-time targeting and battle damage assessments

Electromagnetic Railgun:

The Electromagnetic Railgun (EM) launcher is a long-range weapon that fires projectiles using electricity instead of chemical propellants. Magnetic fields created by high electrical currents accelerate a sliding metal conductor, or armature, between two rails to launch projectiles at 4,500 mph to 5,600 mph.

The EM Railgun was initiated in 2005 as Innovative Naval Prototype (INP). The DON's science and technology corporate board chartered the INP construct to foster game-changing and disruptive technologies ahead of the normal requirements process. The goal during Phase I of EM Railgun research was a proof-of-concept demonstration at 32 mega-joule muzzle energy has been achieved. A future weapon system at this energy level would be capable of launching a 100-nautical mile projectile. This launch energy has the advantage of being able to stress many components to evaluate full-scale mechanical and electromagnetic forces.

Phase I was focused on the development of launcher technology with adequate service life, development of reliable pulsed power technology and component risk reduction for the projectile. Phase II, which started in 2012, will advance the technology for transition to an acquisition program. Phase II technology efforts will concentrate on demonstrating a rep-rate fire capability up to 10 rounds per minute. Thermal management techniques required for sustained firing rates will be developed for both the launcher system and the pulsed power system. Two industry prototypes were developed, and are being tested at the railgun facility in Dahlgren, Va. The railgun is a true warfighting game-changer. Wide-area coverage, exceptionally quick response and very deep magazines will extend the reach and lethality of ships armed with this technology.

What this research will accomplish:

- With its increased velocity and extended range, the EM Railgun will give Sailors a multi-mission capability, allowing them to conduct precise naval surface fire support, or land strikes; cruise missile and ballistic missile defense; and surface warfare to deter enemy vessels.

Autonomous Combat Casualty Care:

Expeditionary Medicine is a Science and Technology (S&T) focus area which supports Navy and Marine Corps combat forces by developing products to treat injuries. Products must not only be safe and effective but must also be small, lightweight and rugged since naval combat forces must travel light and fast.

Under development is a "system of systems" which will provide autonomous control of ventilation, fluid resuscitation, administration of drugs, sedation and analgesia, and maintenance of core body temperature through constant physiologic monitoring. The system will also have telemedicine capability.

The device is called the Autonomous Critical Care System (ACCS) and the objective is to provide appropriate intervention which will yield improved survival and outcomes. The system is based on "closed-loop-control", an example of which is a household thermostat which heats or cools a house to maintain a set temperature. The ACCS performs interventions to maintain a patient's medical condition based on changes in his/her physiology.

The ACCS can be used for patient transport, aboard ships, or in land-based medical treatment facilities to augment medical personnel. Continuous monitoring of a patient's physiology allows immediate detection of adverse changes in their medical status and thus faster interventions. The system affords appropriate intervention in the absence of a skilled caregiver and reduces manpower and logistics demand.

What this research will accomplish:

- Ability to maintain a critically injured/ill patient for minimum of 2 hrs w/o any degradation in clinical status
- The ACCS will provide the right care at the right time

Squad Electric Power Network:

The Squad Electric Power Network (SEPN) is an individually wearable, electrical-power management and distribution system that provides a universal link between worn or carried electrical devices assigned to the squad and current or future power sources.

This effort addresses the S&T Warfighter Gap PR11-39: The Marine rifle squad cannot operate persistently and effectively while dismounted due to being overburdened with electronic devices with individual power sources of multiple types. Numerous squad capabilities are dependent on sustained electrical power requiring heavy, short-life batteries.

The goal of the SEPN is to reduce the weight and logistical burden associated with electrical power requirements for individual and squad-level equipment while additionally providing a capability for individual energy sustainment in austere environments utilizing power harvesting/scavenging from available or disparate sources.

The expected, overarching benefits of the SEPN are:

1) Reduce the number and weight of spare batteries carried in dismounted operations.
2) Remove incompatibility between battery types and equipment
3) Promote electrical energy harvesting of source power at an individual level.
4) Provide mission planning tools such as data logging and state of charge indication.

Phase I prototypes have been delivered and limited technical assessments focused on human factors and electrical performance have been conducted. Phase II prototypes are expected to be delivered at the end of FY12. The Phase I prototypes successfully participated in a Limited Objective Experiment at Ft Pickett in summer 2012.

The Advanced Power Sources Program within Marine Corps Systems Command, Combat Systems Support will be the recipient of this product. This is an overarching program that addresses advanced capability in small and innovative power technologies that can be rapidly transitioned to production and fielding. The project will initiate an abbreviated Engineering and Manufacturing Development (EMD) Phase of 12-18 months to complete and mature the demonstrated technology, as well as conduct test and evaluation.

Upon completion of EMD, a production decision will be sought to procure production articles, conduct qualification testing, any required operational testing, logistics assessments, and preparation for full production and fielding in FY16.

What this research will accomplish:

- Reduced spare battery weight & bulk
- Reduced individual battery logistics
- Enable energy harvesting
- Enable state-of-charge indication

NON-FEDERAL PHYSICAL PROPERTY

The DON General Fund does not fund this type of Activity.

GENERAL FUND REQUIRED SUPPLEMENTARY INFORMATION

Department of the Navy Fiscal Year 2012 Annual Financial Report

Department of the Navy
General Property, Plant, and Equipment
Real Property Deferred Maintenance and Repair

For Fiscal Year Ended September 30, 2012

($ IN THOUSANDS)

Property Type	1. Plant Replacement Value	2. Required Work (Deferred Maintenance and Repair)	3. Percentage
Category 1: Enduring Facilities			
Navy	$ 138,796,060	$ 39,806,400	28.68%
Marine Corps	$ 43,856,876	$ 990,360	2.26%
Category 2: Excess Facilities or Planned for Replacement			
Navy	$ 1,060,550	$ 479,960	45.26%
Marine Corps	$ 1,660,951	$ -	0.0%
Category 3: Heritage Assets			
Marine Corps	$ 4,395,903	$ 99,347	2.26%

NOTE: In the table above, Navy real property deferred maintenance and repair data represent both Department of the Navy General Fund and Navy Working Capital Fund (NWCF). Similarly, Marine Corps real property deferred maintenance and repair data represent both the United States Marine Corps General Fund and NWCF-Marine Corps.

Description of Property Type categories:

- Category 1 – Buildings, Structures, and Utilities that are enduring and required to support an ongoing mission, including multi-use Heritage Assets.
- Category 2 – Buildings, Structures, and Utilities that are excess to requirements or planned for replacement or disposal, including multi-use Heritage Assets.
- Category 3 – Buildings, Structures, and Utilities that are Heritage Assets.

1. The method used to assess facilities condition is a combination of commercial Infrastructure Condition Assessment Program (ICAP) software and facilities inspection. The Navy's Quality rating (Q-rating) is calculated using the below formula:

$$Q = 1 - \left(\frac{Requirements}{PRV}\right) X\ 100$$

   The Navy models the "Requirements" value from the condition rating and configuration rating.

   The method used to assess Marine Corps facilities conditions is twofold. All buildings, paving and rail assets are inspected using the Sustainment Management Systems (SMS) methodology developed by the U.S. Army Corps of Engineers Civil Engineering Research Laboratory which provides a facilities condition index (FCI) for these assets. Other assets are assessed via facilities inspection, which categorizes buildings as Adequate, Substandard, or Inadequate. Assets inspected using the SMS methodology takes the FCI to determine the asset's Q-rating. Those assets without a direct FCI rating are converted by the Marine Corps from Adequate Substandard and Inadequate ratings to Q-ratings by assessing facilities that are rated as Adequate and less than 25 years old as Q1; facilities that are over 25 years old and rated as Adequate as Q2; facilities rated as Substandard as Q3; and Inadequate facilities as Q4.

2. The condition rating is a measure (0 -100) of an asset's physical condition at a particular point in time. The Navy uses condition modeling software to capture condition assessment data to model system/component condition ratings. The condition assessment data is supplemented by eyes-on condition assessments that capture accurate facility components and confirm as-built condition. In FY12, the condition assessment

program was expanded to include utility systems. Updated condition ratings for utility systems have caused an increase in deferred maintenance and repair backlog.

3. The configuration rating is a measure (0 - 100) of the asset's capability to support the current occupant or mission with respect to functionality. The Configuration Rating is calculated in the internet Navy Facility Assets Data Store (iNFADS) from an algorithm that weights configuration deficiency codes (code compliance, functional/space criteria, location/siting criteria or inadequate capacity/coverage) collected during Asset Evaluations. Deficiency codes identify impacts to the suitability of spaces for their intended use, including obsolescence of facility components that do not meet new standards.

4. The DON's Q-rating is represented by the bands: 100%-90% Q1; 90%-80% Q2; 80%-60% Q3; and less than 60% Q4.

5. The FY 2012 target Q-rating value representing full investment requirement for the Navy is Q1. The Department of the Navy (DON) follows the Office of the Secretary of Defense installation strategic plan goal of having facilities at a Q2 level on average as an acceptable rating. This represents an average level of 15% of Plant Replacement Value (PRV) as an acceptable level of deferred maintenance. The table above shows that deferred maintenance for the Navy is valued at 28.68%, 45.26% and 0% of PRV for categories 1 through 3, respectively. The deferred maintenance and repair estimates are based on the facility Q-ratings found in the Navy's real property inventory.

   The table above shows that deferred maintenance for Marine Corps is valued at approximately 2.26% of PRV for categories 1 and 3. Category 2 is zero because deferred maintenance backlogs are not held on facilities to be demolished.

6. The Facility Readiness Evaluation System (FRES) application was used to generate the Deferred Maintenance and Repair Report. FRES is updated with iNFADS data on a weekly basis and at the end of the fiscal year. The PRV and deferred maintenance and repair estimates for all three categories are reported for Command Navy Installations Command installations only, and only the Maintenance Fund Sources listed below are included. Facilities maintained by Bureau of Medicine and Surgery, defense agencies and Family Housing, Navy are excluded from the estimates.

   - Operation and Maintenance, Navy
   - Operation and Maintenance, Navy Reserve
   - Research, Development, Test, and Evaluation
   - Navy Working Capital Fund

7. Category 1 excludes facilities identified in Categories 2 and 3. The Navy currently identifies Category 2 facilities as follows: facilities assigned a RPA Operational Status Code of excess or surplus and RPA Interest Type Code Fee, ONST, ONFG, or Lease. Excess is defined as "property under the control of a federal agency that the head of the agency determines is not required to meet the agency's needs or responsibilities." The source for this definition is CFT Title 40 USC 102. Category 3 includes facilities that are single-use Heritage Assets. iNFADS does not identify any Navy facilities as single-use Heritage Assets; therefore, the amounts recorded for this category are zero.

Military Equipment Deferred Maintenance

For Fiscal Year Ended September 30, 2012

($ IN THOUSANDS)			
Major Category	*OP30 Amounts*	*Adjustments*	*Totals*
1. Aircraft	$209,340	$(53,029)	$156,311
2. Automotive Equipment	34,446	(34,446)	-
3. Combat Vehicles	32,280	(32,280)	-
4. Construction Equipment	6,290	10	6,300
5. Electronics and Communications Systems	14,610	531	15,141
6. Missiles	110,981	(3,179)	107,802
7. Ships	506,634	(396,052)	110,582
8. Ordnance Weapons and Munitions	20,503	(93)	20,410
9. All Other Items Not Identified Above	25,211	(15,918)	9,293
Total	$960,295	$(534,456)	$425,839

NOTE: The deferred maintenance amounts reported in the Budget Exhibit Operations (OP) Depot Maintenance (30) that accompanied the most recent President's Budget was used as the basis to identify and report amounts in the Military Equipment Deferred Maintenance. Material amounts of deferred maintenance beyond the scope of the OP-30 Budget Exhibit, that warrant reporting are in the "Adjustments" column.

Aircraft Deferred Maintenance

Four sub-categories comprise aircraft deferred maintenance: airframe rework and maintenance (active and reserve), engine rework and maintenance (active and reserve), component repair, and software maintenance. The airframe rework deferred maintenance calculation reflects year-end unfunded requirements, which represent aircraft that have reached their Fixed Induction Date or have failed an Aircraft Service Period Adjustment inspection. The engine rework deferred maintenance calculation reflects year-end actual requirements minus actual funded units. Component repair deferred maintenance represents the difference between the validated requirements minus corresponding funding.

Airframe rework and maintenance (active and reserve) is predominantly performed under the Integrated Maintenance Concept (IMC) and for a small number of aircraft under Standard Depot Level Maintenance. Currently, the AV-8B, C-130, C-2, E-2, E-6, EA-6B, F-5, F/A-18, H-1, H-46, H-53, H-60, and P-3 aircraft programs have been incorporated under the IMC concept. The IMC concept uses Planned Maintenance Intervals, performing more frequent depot maintenance, but with smaller work packages, thereby reducing out-of-service time. The goal of this program is to improve readiness while reducing operating and support costs. The Naval Air Systems Command's (NAVAIR) Industrial Strategy is to maintain the minimum level of organic capacity consistent with force levels that are necessary to sustain peacetime readiness and maintain fighting surge capability. NAVAIR works in partnership with private industry to make maximum use of industry's production capabilities and for non-core related aviation depot maintenance.

Combat Vehicles Deferred Maintenance

The combat vehicles category refers to deferred vehicle maintenance for the active and reserve Marine Corps assets. The combat vehicle category consists of weapons systems such as the M1A1 Tank, the Amphibious Assault Vehicle, the Hercules Recovery Vehicle, and the Light Armored Vehicle. The total requirement is the planned quantity of combat vehicles that require depot level maintenance in a year as determined by program managers and the operating forces with requirements validated by a modeling process. The deferred maintenance is the difference between the validated requirements and funding received for that fiscal year.

Missiles Deferred Maintenance

Four categories are used to determine missile maintenance: missiles, tactical missiles, software maintenance, and other. Deferred maintenance is defined as the difference between the total weapon maintenance requirement as determined by requirements modeling processes and the weapon maintenance that is funded in accordance with the annual budget controls for the missile maintenance program. The maintenance requirements model projects the quantity of missiles and missile components per weapon system that are required to be maintained or reworked annually.

Ships Deferred Maintenance
Fleet Type Commanders provide deferred ship maintenance data. Data is collected from the Current Ships' Maintenance Plan database, which captures maintenance actions at all levels (organizational, intermediate, depot) for active and reserve ships. Only depot level deferred maintenance is provided in the calculation of ship deferred maintenance. This includes maintenance actions deferred from actual depot maintenance work packages as well as maintenance deferred before inclusion in a work package due to fiscal, operational, or capacity constraints. Although there are some deferred maintenance actions, no ships fall into the category of "unacceptable operating condition." Any ship that would be at risk of being in unacceptable operating condition would receive priority for maintenance funding to maintain acceptable operating condition.

Ordnance Weapons and Munitions Deferred Maintenance
Ordnance weapons and munitions are part of a broader category, Other Weapons Systems. This category is comprised of ordnance, end item maintenance for support equipment, camera equipment, landing aids, calibration equipment, air traffic control equipment, target systems, expeditionary airfield equipment, special weapons, target maintenance, and repair of repairable components. Three categories define ordnance maintenance: ordnance maintenance, software maintenance, and other. Although the various programs vary in the methodology in defining requirements, all programs define deferred maintenance as the difference between validated requirements and funding.

Electronics and Communications Systems
The electronics and communications systems category refers to deferred systems maintenance for active and reserve Navy and Marine Corps assets. This category consists of maintenance performed on a variety of radar, radio, and wire and communications equipment. In part, the systems include or are associated with the Surveillance Towed-Array Sensor System (called SURTASS), P-3 Beartrap, satellite subsystems, the Multi-Band Deployable Antenna, the Multi-Mode Inter/Intra Team Radio, and a variety of radio and radar sets used within the DON. The total requirement is the planned quantity of systems and their components that require depot level maintenance in a year as determined by program managers and the operating forces. The deferred maintenance is then the difference between the validated requirements and funding received for that fiscal year.

Construction Equipment
The construction equipment category refers to deferred equipment maintenance for active and reserve Marine Corps assets. This category consists of maintenance performed on a variety of tractors and earth moving equipment. In part, the equipment includes the Aardvark Tactical, the 277C Multi-Terrain Loader, the Medium Crawler Tractor, the Armored Excavator with Brush Hog, and Bridge Erection equipment. The total requirement is the planned quantity of equipment that requires depot level maintenance in a year as determined by program managers and the operating forces. The deferred maintenance is the difference between the validated requirements and funding received for that fiscal year.

Deferred Maintenance on All Other Items Not Identified Above
This category comprises deferred maintenance for software, arrest gear, lighting and surfacing equipment, and EFTM (external fuel transfer module). The deferred maintenance is the difference between the validated requirements and funding received for that fiscal year.

Software maintenance includes the operational and system test software that runs in the airborne avionics systems (e.g., mission computer, display computer, radar) and the software that runs the ground-based support labs used to perform software sustainment (e.g., compilers, editors, simulation, configuration management).

Heritage Assets Condition Information
The methodology used to report the condition of the heritage assets was a combination of visual assessment of the objects, historic value to the DON collection, and general display and storage standards for historic collections. The overall condition of the collection objects is good.

STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES

For the periods ended September 30, 2012 and 2011

($ IN THOUSANDS)

	Research, Development, Test & Evaluation	Procurement	Military Personnel	Family Housing & Military Construction
Budgetary Resources:				
Unobligated Balance Brought Forward, Oct 1	$ 2,882,267	$ 25,089,299	$ 553,620	$ 2,683,751
Recoveries of Prior Year Unpaid Obligations	1,213,162	4,030,173	2,768,667	1,342,264
Other Changes in Unobligated Balance	(251,442)	(333,525)	56,403	(2,613)
Unobligated Balance from Prior Year Budget Authority, Net	3,843,987	28,785,947	3,378,690	4,023,402
Appropriations	17,657,584	47,106,714	47,713,857	2,404,797
Spending Authority from Offsetting Collections	174,002	896,677	376,971	1,032,290
Total Budgetary Resources	$ 21,675,573	$ 76,789,338	$ 51,469,518	$ 7,460,489
Status of Budgetary Resources:				
Obligations Incurred	$ 18,974,901	$ 52,634,970	$ 50,670,002	$ 4,858,725
Unobligated Balance, End of Year				
Apportioned	2,408,750	23,146,008	170,895	2,519,399
Unapportioned	291,922	1,008,360	628,621	82,365
Total Unobligated Balance, End of Year	2,700,672	24,154,368	799,516	2,601,764
Total Budgetary Resources	$ 21,675,573	$ 76,789,338	$ 51,469,518	$ 7,460,489
Change in Obligated Balance:				
Unpaid Obligations, Brought Forward, October 1	$ 9,503,731	$ 65,004,017	$ 1,682,639	$ 5,777,004
Uncollected Customer Payments from Federal Sources, Brought Forward, October 1	(133,936)	(245,242)	(52)	(648,533)
Obligated Balance Start of Year, Net	9,369,795	64,758,775	1,682,587	5,128,471
Obligations Incurred	18,974,901	52,634,970	50,670,002	4,858,725
Outlays, Gross	(16,995,225)	(44,519,954)	(46,922,869)	(4,045,886)
Change in Uncollected Customer Payments from Federal Sources	16,323	31,725	(5,347)	106,773
Recoveries of Prior Year Unpaid Obligations	(1,213,162)	(4,030,173)	(2,768,667)	(1,342,264)
Obligated Balance, End of Year				
Unpaid Obligations, End of Year, Gross	10,270,245	69,088,860	2,661,105	5,247,579
Uncollected Customer Payments from Federal Sources, End of Year	(117,613)	(213,517)	(5,399)	(541,760)
Obligated Balance, End of Year	$ 10,152,632	$ 68,875,343	$ 2,655,706	4,705,819
Budget Authority and Outlays, Net:				
Budget Authority, Gross	$ 17,831,586	$ 48,003,391	$ 48,090,828	$ 3,437,087
Actual Offsetting Collections	(190,325)	(928,402)	(371,624)	(1,139,063)
Change in Uncollected Customer Payments from Federal Sources	16,323	31,725	(5,347)	106,773
Budget Authority, Net	$ 17,657,584	$ 47,106,714	$ 47,713,857	$ 2,404,797
Outlays, Gross	$ 16,995,225	$ 44,519,954	$ 46,922,869	$ 4,045,886
Actual Offsetting Collections	(190,325)	(928,402)	(371,623)	(1,139,065)
Outlays, Net	16,804,900	43,591,552	46,551,246	2,906,821
Distributed Offsetting Receipts	–	–	–	–
Agency Outlays, Net	$ 16,804,900	$ 43,591,552	$ 46,551,246	$ 2,906,821

STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES

For the periods ended September 30, 2012 and 2011

($ IN THOUSANDS)

	Operations, Readiness & Support	2012 Combined	2011 Combined
Budgetary Resources:			
Unobligated Balance Brought Forward, Oct 1	$ 1,996,944	$ 33,205,881	$ 35,002,674
Recoveries of Prior Year Unpaid Obligations	3,894,749	13,249,015	14,169,439
Other Changes in Unobligated Balance	(806,574)	(1,337,751)	(1,125,467)
Unobligated Balance from Prior Year Budget Authority, Net	5,085,119	45,117,145	48,046,646
Appropriations	58,622,262	173,505,214	175,961,434
Spending Authority from Offsetting Collections	5,625,320	8,105,260	7,587,503
Total Budgetary Resources	$ 69,332,701	$ 226,727,619	$ 231,595,583
Status of Budgetary Resources:			
Obligations Incurred	$ 67,039,306	$ 194,177,904	$ 198,389,702
Unobligated Balance, End of Year			
Apportioned	206,583	28,451,635	29,803,065
Unapportioned	2,086,812	4,098,080	3,402,816
Total Unobligated Balance, End of Year	2,293,395	32,549,715	33,205,881
Total Budgetary Resources	$ 69,332,701	$ 226,727,619	$ 231,595,583
Change in Obligated Balance:			
Unpaid Obligations, Brought Forward, October 1	$ 25,510,647	$ 107,478,038	$ 101,601,676
Uncollected Customer Payments from Federal Sources, Brought Forward, October 1	(1,482,124)	(2,509,887)	(3,154,898)
Obligated Balance Start of Year, Net	24,028,523	104,968,151	98,446,778
Obligations Incurred	67,039,306	194,177,904	198,389,702
Outlays, Gross	(62,995,537)	(175,479,471)	(178,343,901)
Change in Uncollected Customer Payments from Federal Sources	(269,389)	(119,915)	645,011
Recoveries of Prior Year Unpaid Obligations	(3,894,749)	(13,249,015)	(14,169,439)
Obligated Balance, End of Year			
Unpaid Obligations, End of Year, Gross	25,659,667	112,927,456	107,478,038
Uncollected Customer Payments from Federal Sources, End of Year	(1,751,513)	(2,629,802)	(2,509,887)
Obligated Balance, End of Year	$ 23,908,154	$ 110,297,654	$ 104,968,151
Budget Authority and Outlays, Net:			
Budget Authority, Gross	$ 64,247,582	$ 181,610,474	$ 183,548,937
Actual Offsetting Collections	(5,355,931)	(7,985,345)	(8,232,514)
Change in Uncollected Customer Payments from Federal Sources	(269,389)	(119,915)	645,011
Budget Authority, Net	$ 58,622,262	$ 173,505,214	$ 175,961,434
Outlays, Gross	$ 62,995,537	$ 175,479,471	$ 178,343,901
Actual Offsetting Collections	(5,355,930)	(7,985,345)	(8,232,514)
Outlays, Net	57,639,607	167,494,126	170,111,387
Distributed Offsetting Receipts	(226,131)	(226,131)	36,444
Agency Outlays, Net	$ 57,413,476	$ 167,267,995	$ 170,147,831

Department of the Navy Fiscal Year 2012 Annual Financial Report

PROTECT THE NATION,
PROJECT POWER,
PROVIDE FREEDOM OF THE SEAS

GENERAL FUND OTHER ACCOMPANYING INFORMATION

Department of the Navy Fiscal Year 2012 Annual Financial Report

GENERAL FUND OTHER ACCOMPANYING INFORMATION

Table 1. Summary of Financial Statement Audit

Audit Opinion	Disclaimer					
RESTATEMENT	NO					
Areas of Material Weaknesses	*Beginning Balance*	*New*	*Resolved*	*Consolidated*	*Reassessed*	*Ending Balance*
Financial Management Systems	1	0	0	0	0	1
Fund Balance with Treasury	1	0	0	0	0	1
Accounts Receivable	1	0	0	0	0	1
Other Assets	1	0	0	0	0	1
Inventory and Related Property, Net	1	0	0	0	0	1
General Property, Plant and Equipment	1	0	0	0	0	1
Accounts Payable	1	0	0	0	0	1
Statement of Net Cost	1	0	0	0	0	1
Problem Disbursements	1	0	0	0	0	1
Unobligated Balances	1	0	0	0	0	1
Statement of Changes in Net Position	0	1	0	0	0	1

Table 2. Summary of Management Assurances

Effectiveness of Internal Control over Financial Reporting (FMFIA § 2)						
STATEMENT OF ASSURANCE	NO ASSURANCE					
Effectiveness of Internal Control over Operations (FMFIA § 2)						
STATEMENT OF ASSURANCE	QUALIFIED					
Material Weaknesses	*Beginning Balance*	*New*	*Resolved*	*Consolidated*	*Reassessed*	*Ending Balance*
Service Contracts	0	1	0	0	0	1
Attenuating Hazardous Noise in Acquisition & Weapon System Design	1	0	0	0	0	1
Management of Communications Security (COMSEC) Equipment	1	0	0	0	0	1
Safeguarding Personally Identifiable Information (PII)	1	0	0	0	0	1
Effective Use of Earned Value Management (EVM) Across Shipbuilding Programs	1	0	0	0	0	1
Total Material Weaknesses	4	1	0	0	0	5
Conformance with Financial Management System Requirements (FMFIA § 4)						
STATEMENT OF ASSURANCE	NO ASSURANCE					
Conformance with Federal Financial Management Improvement Act (FFMIA)						
OVERALL SUBSTANTIAL COMPLIANCE	NO ASSURANCE					

Entity Accounts

General Funds

17X0380	Coastal Defense Augmentation, Navy
17 0703	Family Housing, Navy and Marine Corps
17 0730	Family Housing Construction, Navy and Marine Corps
17 0735	Family Housing Operation and Maintenance, Navy and Marine Corps
17X0810	Environmental Restoration, Navy
17 1000	Medicare-Eligible Retiree Health Fund Contribution, Navy
17 1001	Medicare-Eligible Retiree Health Fund Contribution, Marine Corps
17 1002	Medicare-Eligible Retiree Health Fund Contribution, Reserve Personnel, Navy
17 1003	Medicare-Eligible Retiree Health Fund Contribution, Reserve Personnel, Marine Corps
17X1105	Military Personnel, Marine Corps
17 1105	Military Personnel, Marine Corps
17X1106	Operations and Maintenance, Marine Corps
17 1106	Operation and Maintenance, Marine Corps
17 1107	Operation and Maintenance, Marine Corps Reserve
17 1108	Reserve Personnel, Marine Corps
17 1109	Procurement, Marine Corps
17 1116	Operation and Maintenance - Recovery Act, Marine Corps
17 1117	Operation and Maintenance - Recovery Act, Marine Corps Reserve
17X1205	Military Construction, Navy and Marine Corps
17 1205	Military Construction, Navy and Marine Corps
17 1206	Military Construction - Recovery Act, Navy and Marine Corps
17 1235	Military Construction, Naval Reserve
17X1236	Payments to Kaho Olawe Island Conveyance, Remediation, and Environmental Restoration Fund, Navy
17X1319	Research, Development, Test, and Evaluation, Navy
17 1319	Research, Development, Test, and Evaluation, Navy
17 1320	Research, Development, Test and Evaluation - Recovery Act, Navy
17 1405	Reserve Personnel, Navy
17X1453	Military Personnel, Navy
17 1453	Military Personnel, Navy
17 1506	Aircraft Procurement, Navy
17X1507	Weapons Procurement, Navy
17 1507	Weapons Procurement, Navy
17 1508	Procurement of Ammunition, Navy and Marine Corps
17X1611	Shipbuilding and Conversion, Navy
17 1611	Shipbuilding and Conversion, Navy
17X1804	Operation and Maintenance, Navy
17 1804	Operation and Maintenance, Navy
17 1805	Operation and Maintenance - Recovery Act, Navy
17X1806	Operations and Maintenance, Navy Reserve
17 1806	Operation and Maintenance, Navy Reserve
17 1807	Operation and Maintenance - Recovery Act, Navy Reserve
17X1810	Other Procurement, Navy
17 1810	Other Procurement, Navy

Revolving Funds

17X4557	National Defense Sealift Fund, Navy
17 4557	National Defense Sealift Fund, Navy

Earmarked Trust Funds

17X8716	Department of the Navy General Gift Fund
17X8723	Ships Stores Profits, Navy
17X8733	United States Naval Academy General Gift Fund

Earmarked Special Funds

17X5095	Wildlife Conservation, etc., Military Reservations, Navy
17X5185	Kaho Olawe Island Conveyance, Remediation, and Environmental Restoration Fund, Navy
17X5562	Ford Island Improvement Account

General Fund Non- Entity Accounts

Deposit Funds

17X6001	Proceeds of Sales of Lost, Abandoned, or Unclaimed Personal Property, Navy (T)
17X6002	Personal Funds of Deceased, Mentally Incompetent or Missing Personnel, Navy (T)
17X6025	Pay of the Navy, Deposit Fund (T)
17X6026	Pay of the Marine Corps, Deposit Fund (T)
17X6434	Servicemen's Group Life Insurance Fund, Suspense, Navy
17X6705	Civilian Employees Allotment Account, Navy
17X6706	Commercial Communication Service, Navy
17 6763	Gains and Deficiencies on Exchange Transactions, Navy
17X6850	Housing Rentals, Navy
17X6999	Accounts Payable, Check Issue Underdrafts, Navy

NAVY WORKING CAPITAL FUND PRINCIPAL STATEMENTS

Department of the Navy Fiscal Year 2012 Annual Financial Report

PRINCIPAL STATEMENTS

The Fiscal Year 2012 Navy Working Capital Fund (NWCF) principal statements and related notes are presented in the format prescribed by the Department of Defense Financial Management Regulation 7000.14, Volume 6B. The statements and related notes summarize financial information for individual funds and accounts within the NWCF for the fiscal year ending September 30, 2012, and are presented on a comparative basis with information previously reported for the fiscal year ending September 30, 2011.

The following statements comprise the NWCF principal statements:

- Consolidated Balance Sheet
- Consolidated Statement of Net Cost
- Consolidated Statement of Changes in Net Position
- Combined Statement of Budgetary Resources

The principal statements and related notes have been prepared to report financial position pursuant to the requirements of the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994. The accompanying notes should be considered an integral part of the principal statements.

CONSOLIDATED BALANCE SHEET

As of September 30, 2012 and 2011

($ IN THOUSANDS)

	2012 Consolidated	2011 Consolidated
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$ 1,334,582	$ 1,247,786
Accounts Receivable (Note 4)	1,083,381	894,434
Other Assets (Note 5)	10	10
Total Intragovernmental Assets	2,417,973	2,142,230
Cash and Other Monetary Assets (Note 6)	295	2,452
Accounts Receivable, Net (Note 4)	43,326	39,995
Inventory and Related Property, Net (Note 7)	20,485,300	20,519,479
General Property, Plant, and Equipment, Net (Note 8)	2,234,480	2,340,475
Other Assets (Note 5)	1,628,448	1,021,730
TOTAL ASSETS	$ 26,809,822	$ 26,066,361
Stewardship Property, Plant and Equipment (Note 8)*		
LIABILITIES		
Intragovernmental:		
Accounts Payable (Note 10)	$ 184,615	$ 181,490
Other Liabilities (Note 12)	531,429	631,748
Total Intragovernmental Liabilities	716,044	813,238
Accounts Payable (Note 10)	3,015,987	2,799,892
Military Retirement and Other Federal Employment Benefits (Note 14)	757,427	739,256
Other Liabilities (Note 12)	1,281,831	1,174,979
TOTAL LIABILITIES	5,771,289	5,527,365
Commitments and Contingencies (Note 13)*		
NET POSITION		
Unexpended Appropriations - Other Funds	1,607	1,254
Cumulative Results of Operations - Other Funds	21,036,926	20,537,742
TOTAL NET POSITION	21,038,533	20,538,996
TOTAL LIABILITIES AND NET POSITION	$ 26,809,822	$ 26,066,361

* - Disclosure but no value required per Federal Accounting Standards.

The accompanying notes are an integral part of the statements.

CONSOLIDATED STATEMENT OF NET COST

For the Years Ended September 30, 2012 and 2011

($ IN THOUSANDS)

	2012 Consolidated	2011 Consolidated
Program Costs		
Gross Costs		
Operations, Readiness, & Support	$ 35,470,797	$ 46,240,534
Less: Earned Revenue	(33,425,738)	(54,714,590)
Net Cost of Operations	$ 2,045,059	$ (8,474,056)

The accompanying notes are an integral part of the statements.

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

For the Years Ended September 30, 2012 and 2011

($ IN THOUSANDS)

	2012 Consolidated	2011 Consolidated
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	$ 20,537,742	$ 13,283,263
Budgetary Financing Sources:		
Appropriations Used	(353)	27,267
Other Financing Sources:		
Transfers-In/Out without Reimbursement	341,583	(85,696)
Imputed Financing from Costs Absorbed by Others	538,390	578,014
Other	1,664,623	(1,739,162)
Total Financing Sources	2,544,243	(1,219,577)
Net Cost of Operations	2,045,059	(8,474,056)
Net Change	499,184	7,254,479
Cumulative Results of Operations	$ 21,036,926	$ 20,537,742
UNEXPENDED APPROPRIATIONS		
Beginning Balances	$ 1,254	$ 28,521
Budgetary Financing Sources:		
Appropriations Used	353	(27,267)
Total Budgetary Financing Sources	353	(27,267)
Unexpended Appropriations	1,607	1,254
Net Position	$ 21,038,533	$ 20,538,996

The accompanying notes are an integral part of the statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

For the Years Ended September 30, 2012 and 2011

($ IN THOUSANDS)

		2012 Combined		2011 Combined
Budgetary Resources:				
Unobligated Balance, Brought Forward, October 1	$	3,164,084	$	2,900,938
Recoveries of Prior Year Unpaid Obligations		1,870,102		564,486
Other Changes in Unobligated Balance		(1,448,900)		(329,550)
Unobligated Balance from Prior Year Budget Authority, Net		3,585,286		3,135,874
Contract Authority		8,929,539		7,218,237
Spending Authority from Offsetting Collections		21,659,085		21,688,494
Total Budgetary Resources	$	34,173,910	$	32,042,605
Status of Budgetary Resources:				
Obligations Incurred	$	30,439,413	$	28,878,521
Unobligated Balance, End of Year				
Apportioned		3,694,934		3,145,928
Unapportioned		39,563		18,156
Unobligated Balance Brought Forward, End of Year		3,734,497		3,164,084
Total Budgetary Resources	$	34,173,910	$	32,042,605

The accompanying notes are an integral part of the statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

For the Years Ended September 30, 2012 and 2011

($ IN THOUSANDS)

	2012 Combined	2011 Combined
Change in Obligated Balance:		
Unpaid Obligations, Brought Forward, October 1	$ 12,119,020	$ 12,105,212
Uncollected Customer Payments from Federal Sources,Brought Forward, October 1	(10,846,545)	(9,724,859)
Obligated Balance Start of Year, Net	1,272,475	2,380,353
Obligations Incurred	30,439,413	28,878,521
Outlays, Gross	(28,194,322)	(28,300,227)
Change in Uncollected Customer Payments from Federal Sources	(1,827,760)	(1,121,686)
Recoveries of Prior Year Unpaid Obligations	(1,870,102)	(564,486)
Obligated Balance, End of Year		
Unpaid Obligations, End of Year, Gross	12,494,009	12,119,020
Uncollected Customer Payments from Federal Sources, End of Year	(12,674,305)	(10,846,545)
Obligated Balance, End of Year	$ (180,296)	$ 1,272,475
Budget Authority and Outlays, Net:		
Budget Authority, Gross	$ 30,588,624	$ 28,906,731
Actual Offsetting Collections	(28,281,118)	(28,555,323)
Change in Uncollected Customer Payments from Federal Sources	(1,827,760)	(1,121,686)
Budget Authority, Net	$ 479,746	$ (770,278)
Outlays, Gross	$ 28,194,322	$ 28,300,227
Actual Offsetting Collections	(28,281,118)	(28,555,323)
Agency Outlays, Net	$ (86,796)	$ (255,096)

The accompanying notes are an integral part of the 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 Navy Working Capital Fund (NWCF), as required by the Chief Financial Officers (CFO) 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 NWCF in accordance with, and to the extent possible, U.S. Generally Accepted Accounting Principles (USGAAP) promulgated by the Federal Accounting Standards Advisory Board (FASAB); the Office of Management and Budget (OMB) Circular No. A-136, Financial Reporting Requirements; and the Department of Defense (DoD), Financial Management Regulation (FMR). The accompanying financial statements account for all resources for which the NWCF is responsible unless otherwise noted.

The NWCF is unable to fully implement all elements of USGAAP and OMB Circular No. A-136, due to limitations of financial and nonfinancial management processes and systems that support the financial statements. The NWCF derives reported values and information for major asset and liability categories largely from nonfinancial systems, such as inventory and logistic 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 USGAAP. The NWCF continues to implement process and system improvements addressing these limitations.

The NWCF currently has 13 auditor identified material weaknesses which are the following: (1) Financial Management Systems; (2) Fund Balance with Treasury; (3) Accounts Receivable; (4) Inventory and Related Property, Net; (5) General Property, Plant, and Equipment; (6) Accounts Payable; (7) Other Liabilities; (8) Statement of Budgetary Resources; (9) Intragovernmental Eliminations; (10) Unsupported Accounting Entries; (11) Operating Materials and Supplies (OM&S); (12) Statement of Net Cost; and (13) Reconciliation of Net Cost of Operations to Budget.

1.B. Mission of the Reporting Entity

The Department of the Navy (DON) was created on April 30, 1798 by an act of Congress (I Stat. 533; 5 U.S.C. 411-12). The overall mission of DON is to maintain, train, and equip combat-ready Navy and Marine Corps forces capable of winning wars, deterring aggression, and maintaining freedom of the seas. The NWCF provides goods, services, and infrastructure to DON and other DoD customers to help ensure our military forces are mobile, ready, and have the most advanced technology.

1.C. Appropriations and Funds

NWCF received funding to establish an initial corpus through an appropriation or a transfer of resources from existing appropriations or funds. The corpus finances operations which result in transactions that flow through the fund. The NWCF furnishes goods and services sold to customers on a reimbursable basis and maintains the corpus. Reimbursable receipts fund future operations and generally are available in their entirety for use without further congressional action. At various times, Congress provides additional appropriations to supplement the NWCF as an infusion of cash when revenues are inadequate to cover costs within the corpus. The NWCF uses these appropriations and funds to execute its mission and subsequently report on resource usage.

1.D. Basis of Accounting

The NWCF's financial management systems are unable to meet all full accrual accounting requirements. Many of the NWCF's financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of USGAAP. These systems were not designed to collect and record financial information on the full accrual accounting basis as required by USGAAP. Most of NWCF's financial and nonfinancial legacy systems were designed to record information on a proprietary basis.

The NWCF financial statements and supporting trial balances are compiled from the underlying financial data and trial balances of the NWCF sub-entities. The underlying data is largely derived from proprietary transactions from nonfinancial feeder systems, and accruals made for major items such as payroll expenses, accounts payable, Federal Employees' Compensation Act (FECA) liabilities, and revenue. Some of the sub-entity level trial balances may reflect known abnormal balances resulting largely from business and system processes. At the consolidated NWCF level, these abnormal balances may not be evident. Disclosures of abnormal balances are made in the applicable footnotes, but only to the extent that the abnormal balances are evident at the consolidated level.

The DoD is determining the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with USGAAP. One such action is the conversion of DON's legacy systems to Navy Enterprise Resource Planning (ERP) which is designed to modernize and standardize Navy's business practices. Navy ERP was developed utilizing the United States Standard General Ledger (USSGL) account structure to better comply with applicable financial management requirements. Until all NWCF financial and nonfinancial feeder systems and processes are updated to collect and report financial information as required by USGAAP, financial data will be derived from proprietary transactions, data from nonfinancial feeder systems, and accruals.

1.E. Revenues and Other Financing Sources

The NWCF's business areas include Depot Maintenance, Supply Management, Research and Development, Base Support, and Transportation. Each of the NWCF programs recognizes revenues and other financing sources in the manner described below.

Depot Maintenance NWCF activities recognize revenue according to the percentage of completion method. Supply Management NWCF activities recognize revenue from the sale of inventory items. Research and Development NWCF activities recognize revenue according to the percentage of completion method or as actual costs are incurred and billed. Base Support NWCF activities recognize revenue at the time service is rendered. Transportation NWCF activities recognize revenue on either a reimbursable or per diem basis. The majority of per diem projects are billed and collected in the month services are rendered. The remaining per diem projects accrue revenue in the month the services are rendered. For reimbursable projects, costs and revenue are recognized in the month services are rendered.

The NWCF does not include nonmonetary support provided by U.S. allies for common defense and mutual security in the amount reported in the Statement of Net Cost. The U.S. has cost-sharing agreements with countries having 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, DoD policy requires the recognition of operating expenses in the period incurred. Current financial and nonfinancial feeder systems were not designed to collect and record financial information on the full accrual accounting basis. Estimates are made for major items, such as payroll expenses, accounts payable, FECA liabilities, and revenue. Operating, Materials and Supplies (OM&S) and operating expenses are generally recognized when the items are purchased. Efforts are underway to transition to the consumption method for recognizing OM&S expenses. Under the consumption method, OM&S would be expensed when consumed. Due to system limitations, some expenditures for capital and other long-term assets may be recognized as operating expenses. The NWCF continues to implement process and system improvements to address these limitations.

1.G. Accounting for Intragovernmental Activities

Accounting standards require that an entity eliminates intra-entity activity and balances from consolidated financial statements in order to prevent overstatement for business with itself. However, the NWCF cannot accurately identify intragovernmental transactions by customer because NWCF's systems do not track buyer and seller data at the transaction level. Generally, seller entities within the DoD provide summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal accounting offices. In most cases, the buyer-side records are adjusted to agree with DoD seller-side balances and are then eliminated. The DoD is implementing replacement systems and a standard financial information structure that will incorporate the necessary elements that will enable DoD to correctly report, reconcile, and eliminate intragovernmental balances.

The Treasury Financial Manual Part 2 – Chapter 4700, "Agency Reporting Requirements for the Financial Report of the United States Government", provides guidance for reporting and reconciling intragovernmental balances. While NWCF is unable to fully reconcile intragovernmental transactions with all federal agencies, NWCF is able to reconcile balances pertaining to FECA transactions with the Department of Labor, and benefit program transactions with the Office of Personnel Management.

The NWCF'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 NWCF's financial statements do not report any public debt, interest, or source of public financing, whether from issuance of debt or tax revenues.

1.H. Transactions with Foreign Governments and International Organizations

Each year, NWCF sells defense articles and services to foreign governments and international organizations under the provisions of the Arms Export Control Act of 1976. Under the provisions of the Act, DoD has authority to sell defense articles and services to foreign countries and international organizations generally at no profit or loss to the Federal Government. Payment in U.S. dollars is required in advance.

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

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

In addition, DFAS sites and USACE Finance Center submit reports to the U.S. Treasury by appropriation on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records these transactions to the applicable Fund Balance with Treasury (FBWT) account. On a monthly basis DFAS performs a reconciliation between NWCF FBWT and the U.S. Treasury balance.

1.J. Cash and Other Monetary Assets

Cash is the total of cash resources under the control of NWCF which includes coin, paper currency, negotiable instruments, and amounts held for deposit in banks and other financial institutions. There are no restrictions on cash.

1.K. Accounts Receivable

Accounts receivable from other federal entities or the public include: accounts receivable, claims receivable, and refunds receivable. In accordance with Statement of Federal Financial Accounting Standards (SFFAS) No. 1, Accounting for Selected Assets and Liabilities, the methodology for losses due to uncollectable amounts are based on an individual account analysis and/or group analysis. The analysis is based on three years of receivable data. This data is used to determine the historical percentage of collections in each age category of receivables. The DON does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intragovernmental Business Rules published in the Treasury Financial Manual Part 2, Chapter 4700, Appendix 10, "Intragovernmental Business Rules".

1.L. Inventories and Related Property

The NWCF values approximately 95% of its resale inventory using the Moving Average Cost (MAC) method. The NWCF reports the remaining 5% of resale inventories at an approximation of historical cost using Latest Acquisition Cost (LAC) adjusted for holding gains and losses. The LAC method is used because legacy inventory systems were designed for materiel management rather than accounting. Materiel is a unique term that relates to military force management, and includes items such as ships, tanks, self-propelled weapons, aircraft, etc., and related spares, repair parts, and support equipment. Although these systems provide visibility and accountability over inventory items, they do not maintain historical cost data necessary to comply with SFFAS No. 3, Accounting for Inventory and Related Property. Additionally, these systems cannot produce financial transactions using the USSGL, as required by the Federal Financial Management Improvement Act of 1996 (P.L. 104-208). The NWCF is continuing to transition the balance of the inventories to the MAC method through the implementation of Navy ERP. Most transitioned balances, however, were not baselined to auditable historical cost and remain noncompliant with SFFAS No. 3.

Inventory available and purchased for resale includes consumable spare and repair parts and repairable items owned and managed by NWCF. This inventory is retained to support military or national contingencies. Inventory held for repair is damaged inventory that requires repair to make it suitable for sale. Often, it is more economical to repair these items rather than to procure them. The NWCF often relies on weapon systems and machinery no longer in production and held for repair. As a result, NWCF supports a process that encourages the repair and rebuilding of weapon systems and machinery. This repair cycle is essential to maintaining a ready, mobile, and armed military force. Work in process balances include (1) costs related to the production or servicing of items, including direct material, labor, applied overhead; (2) the value of finished products or completed services that are yet to be placed in service; and (3) munitions in production and depot maintenance work with its associated costs incurred in the delivery of maintenance services.

The NWCF manages only military or government-specific materiel under normal conditions. Items commonly used in and available from the commercial sector are not managed in NWCF's materiel management activities. Operational cycles are irregular and the military risks associated with stock-out positions have no commercial parallel. The NWCF holds materiel based on military need and support for contingencies. The DoD is currently developing a methodology to be used to account for "inventory held for sale" and "inventory held in reserve for future sale" under the provisions of SFFAS No. 3, Accounting for Inventory and Related Property.

Related property includes OM&S. NWCF OM&S is categorized as OM&S Held for Use. The OM&S is valued at LAC. The NWCF uses both the consumption method and the purchase method of accounting for OM&S. Items that are centrally managed and stored, such as engines, are generally recorded using the consumption method and are reported on the Balance Sheet as OM&S. When current systems cannot fully support the consumption method, NWCF uses the purchase method. Under this method, materiel and supplies are expensed when purchased. During FY 2012 and FY 2011, NWCF expensed significant amounts using the purchase method because the systems could not support the consumption method or management deemed that the item was in the hands of the end user. This is a material weakness for the DoD and long-term system corrections are in process. Once the proper systems are in place, these items will be accounted for under the consumption method of accounting.

1.M. General Property, Plant and Equipment

Property, Plant and Equipment (PP&E) consists of two categories: General PP&E, and Stewardship PP&E. Military Equipment (a classification of General PP&E), Heritage Assets and Stewardship Land (classifications of Stewardship PP&E) are reported on the financial statements of the DON's General Fund. The NWCF classifies all PP&E assets in the General PP&E category. The DoD's General PP&E capitalization threshold is $100 thousand except for real property, which is $20 thousand. The NWCF has not fully implemented the threshold for real property: therefore, NWCF is primarily using the capitalization threshold of $100 thousand for General PP&E, and most real property.

General PP&E assets are capitalized in accordance with SFFAS No. 6, as amended by SFFAS Nos. 10, 23, and 35 when an asset has a useful life of two or more years and when the acquisition cost equals or exceeds DoD's capitalization threshold. SFFAS No. 35 amends SFFAS No. 6 permitting the use of estimated PP&E values when historical cost information is not available. The DoD also requires the capitalization of improvements to existing General PP&E assets if the improvements equal or exceed the capitalization threshold for General PP&E, extend the useful life, or increase the size, efficiency, or capacity of the asset. The NWCF depreciates all General PP&E, other than land, on a straight-line basis.

When it is in the best interest of the government, the NWCF provides government property to contractors to complete contract work. The NWCF 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 meets or exceeds the DoD capitalization threshold, federal accounting standards require that it be reported on NWCF's Balance Sheet.

The DoD developed policy and a reporting process for contractors with government furnished equipment that provides appropriate General PP&E information for financial statement reporting in accordance with Federal Acquisition Regulations (FAR). The DoD requires NWCF to maintain, in their property systems, information on all property furnished to contractors. These actions are structured to capture and report the information necessary for compliance with federal accounting standards. The NWCF has not fully implemented this policy primarily due to system limitations.

1.N. Leases

In accordance with SFFAS No. 5, Accounting for Liabilities of the Federal Government, lease payments for the rental of equipment and operating facilities are classified as either capital or operating leases. When a lease is essentially equivalent to an installment purchase of property (a capital lease), and the value equals or exceeds the current capitalization threshold, NWCF records the applicable asset as though purchased, with an offsetting liability, and depreciates it. The NWCF records the asset and the liability at the lesser of the present value of the rental and other lease payments during the lease term (excluding portions representing executory costs paid to the lessor) or the asset's fair market value. The discount rate for the present value calculation is either the lessor's implicit interest rate or the government's incremental borrowing rate at the inception of the lease. The NWCF, as the lessee, receives the use and possession of leased property, for example real estate or equipment, from a lessor in exchange for a payment of funds. An operating lease does not substantially transfer all the benefits and risk of ownership. Payments for operating leases are expensed over the lease term as they become payable.

Office space and leases entered into by NWCF are the largest component of operating leases and are based on costs gathered from existing leases, General Services Administration bills, and interservice support agreements. Future year projections use the Consumer Price Index.

1.O. Other Assets

Other assets include nonfederal advances and prepayments, military and civil service employee pay advances, travel advances, and certain contract financing payments that are not reported elsewhere on NWCF's Balance Sheet.

When advances are permitted by law, legislative action, or presidential authorization, DoD's policy as prescribed in SFFAS No. 1, Accounting for Selected Assets and Liabilities, is to record advances or prepayments in accordance with USGAAP. As such, payments made prior to the receipt of goods and services should be reported as an asset on the Balance Sheet. The DoD's policy is to expense and/or properly classify assets when the related goods and services are received. The NWCF has not implemented this policy primarily due to system limitations.

The NWCF conducts business with commercial contractors under two primary types of contracts: fixed price and cost reimbursable. To alleviate the potential financial burden on the contractor that long-term contracts can cause, NWCF may provide financing payments. Contract financing payments are defined in the FAR, Part 32, as authorized disbursements to a contractor prior to acceptance of supplies or services by the Government. It is DoD policy to record certain contract financing payments as other assets. The NWCF has not fully implemented this policy primarily due to system limitations.

Advances are cash outlays made by DON GF to its employees, contractors, or others to cover a part or all of the recipients' anticipated expenses. Military pay advances are advance payments authorized for purposes intended to ease hardships imposed by the lack of regular payments when a military member is mobilized, ordered to duty at distant stations, or deployed aboard ships for more than 30 days. Civilian pay advances are payments advanced to full time DON civilians intended to finance unusual employee expenses associated with oversea assignments that are not otherwise reimbursed and to aid foreign assignment recruitment and retention. Travel advances are disbursed to employees prior to business trips. Travel advances are subsequently reduced when travel expenses are actually incurred.

Due to inconsistencies in the posting logic for Nonfederal Advances and Prepayments, NWCF is noncompliant with the Federal Financial Management Improvement Act of 1996 (FFMIA),which requires agencies to comply with the Federal financial management systems requirements, standards promulgated by the FASAB, and the USSGL at the transaction level.

1.P. 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 NWCF recognizes contingent liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. The NWCF's risk of loss and resultant contingent liabilities arise from pending or threatened litigation or claims and assessments due to events such as aircraft, ship and vehicle accidents; property or environmental damages; and contract disputes.

Other liabilities also arise as a result of anticipated disposal costs for DON NWCF assets. Consistent with SFFAS No. 6, Accounting for Property, Plant and Equipment, recognition of an anticipated environmental liability begins when the asset is placed into service. DON NWCF adheres to the DoD's policy, which is consistent with SFFAS No. 5 Accounting for Liabilities of Federal Government, and states that non-environmental disposal liabilities are recognized when management decides to dispose of an asset. The NWCF Environmental Liabilities are reported under the DON GF.

1.Q. Accrued Leave

The NWCF reports liabilities for military leave and accrued compensatory and annual leave for civilians. Sick leave for civilians is expensed as taken. The liabilities are based on current pay rates.

1.R. Net Position

Net Position consists of unexpended appropriations and cumulative results of operations. Unexpended Appropriations represent the amounts of budget 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 net difference between expenses and losses, and financing sources (including appropriations, revenue, and gains), since inception. The cumulative results of operations also include donations and transfers in and out of assets that were not reimbursed.

1.S. Undistributed Disbursements and Collections

Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to specific obligations, payables, or receivables in the source systems and those reported by the U.S. Treasury. Supported disbursements and collections may be evidenced by the availability of corroborating documentation that would generally support the summary level adjustments made to accounts payable and receivable. Unsupported disbursements and collections do not have supporting documentation for the transactions and most likely would not meet audit scrutiny. However, both supported and unsupported adjustments may have been made to the NWCF Accounts Payable and Receivable trial balances prior to validating underlying transactions required to establish the Accounts Payable/Receivable. As a result, misstatements of reported Accounts Payable and Receivables are likely present in the NWCF financial statements.

Due to noted material weaknesses in current accounting and financial feeder systems, the DoD is generally unable to determine whether undistributed disbursements and collections should be applied to federal or nonfederal accounts payables/receivables at the time accounting reports are prepared. Accordingly, the DoD policy is to allocate supported undistributed disbursements and collections between federal and nonfederal categories based on the percentage of distributed federal and nonfederal accounts payable and accounts receivable. Both supported and unsupported undistributed disbursements and collections are then applied to reduce accounts payable and receivable accordingly.

1.T. Military Retirement and Other Federal Employment Benefits

For financial reporting purposes, the DON's actuarial liability for workers' compensation benefits is developed by the Department of Labor and provided to the DON at the end of each fiscal year. Refer to Note 14 Military Retirement and Other Federal Employment Benefits for additional details and disclosures.

Note 2. Nonentity Assets

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Nonfederal Assets		
A. Accounts Receivable	$ 8,888	$ 6,513
2 Total Entity Assets	26,800,934	26,059,848
3. Total Assets	$ 26,809,822	$ 26,066,361

Nonentity assets are assets for which the Navy Working Capital Fund (NWCF) maintains stewardship accountability and reporting responsibility, but are not available for the NWCF's normal operations.

Nonentity Nonfederal Accounts Receivable (Public)

The nonentity nonfederal accounts receivable amount represents interest, penalties, fines and administrative fees that will be remitted to the U.S. Treasury.

Note 3. Fund Balance with Treasury

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Fund Balances		
A. Revolving Funds	$ 1,334,582	$ 1,247,786

Status of Fund Balance with Treasury

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Unobligated Balance		
A. Available	$ 3,694,934	$ 3,145,928
B. Unavailable	39,563	18,156
2. Obligated Balance not yet Disbursed	12,494,009	12,119,020
3. Non-FBWT Budgetary Accounts	(14,893,924)	(14,035,318)
4. Total	$ 1,334,582	$ 1,247,786

The Status of Fund Balance with Treasury (FBWT) reflects the budgetary resources to support FBWT and is a reconciliation between budgetary and proprietary accounts. It primarily consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current and future obligations.

Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations.

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

Non-FBWT Budgetary Accounts reduces the Status of FBWT. This amount is comprised of contract authority, accounts receivable, and unfilled orders without advance from customers for the Navy Working Capital Fund.

Other

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Fund Balances Per Treasury Versus Agency		
A. Fund Balance per Treasury	$ 1,334,583	$ 1,247,787
B. Fund Balance per DON	1,334,582	1,247,786
2. Reconciling Amount	$ 1	$ 1

Note 4. Accounts Receivable

As of September 30	2012		
(AMOUNTS IN THOUSANDS)			
	Gross Amount Due	*Allowance For Estimated Uncollectibles*	*Accounts Receivable, Net*
1. Intragovernmental Receivables	$ 1,083,381	$ N/A	$ 1,083,381
2. Nonfederal Receivables (From the Public)	54,760	(11,434)	43,326
3. Total	$ 1,138,141	$ (11,434)	$ 1,126,707

As of September 30	2011		
(AMOUNTS IN THOUSANDS)			
	Gross Amount Due	*Allowance For Estimated Uncollectibles*	*Accounts Receivable, Net*
1. Intragovernmental Receivables	$ 894,434	$ N/A	$ 894,434
2. Nonfederal Receivables (From the Public)	58,413	(18,418)	39,995
3. Total	$ 952,847	$ (18,418)	$ 934,429

The accounts receivable represent the Navy Working Capital Fund's (NWCF) claim for payment from other entities. Intragovernmental Receivables primarily represents amounts due from other federal agencies for reimbursable work performed pursuant to the Economy Act and other statutory authority. Refer to Note 2, Nonentity Assets, for additional information on Nonfederal Accounts Receivable. Since the Department of the Navy (DON) is at risk of not collecting on these public accounts receivable, the DON is recognizing an allowance for uncollectible amounts. The methodology used in determining the allowance amount is discussed in Notes 1.K. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules.

The DON is currently working on an effort to drive compliance with Office of Management and Budget OMB Circular A-11, Section 20.4(b)(4). Non-compliance results in unsupported departmental level adjustments which negatively impacts achievement of the DON's audit readiness goals for its Statement of Budgetary Resources. DON is partnering with its service providers to clarify guidance, resolve funding issues and standardize business practices. In addition, the DON and the Defense Finance and Accounting Service are aggressively pursuing collection mechanisms for amounts currently due from the public.

Note 5. Other Assets

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Intragovernmental Other Assets		
A. Advances and Prepayments	$ 10	$ 10
2. Nonfederal Other Assets		
A. Outstanding Contract Financing Payments	521,037	461,867
B. Advances and Prepayments	1,105,100	558,464
C. Other Assets (With the Public)	2,311	1,399
3. Total Nonfederal Other Assets	$ 1,628,448	$ 1,021,730
4. Total	$ 1,628,458	$ 1,021,740

Nonfederal Other Assets - Outstanding Contract Financing Payments

Contract terms and conditions for certain types of contract financing payments convey specific rights to the Navy Working Capital Fund (NWCF) 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 Federal Government. The Federal Government does not have the right to take the work, except as provided in contract clauses related to termination or acceptance, and NWCF is not obligated to make payment to the contractor until delivery and acceptance of a satisfactory product.

The balance of Outstanding Contract Financing Payments includes $0.5 billion in contract financing payments and an additional $26.2 million in estimated incurred but unpaid progress payments. See additional discussion in Note 12, Other Liabilities.

Nonfederal Other Assets – Advances and Prepayments

Nonfederal Other Assets - Advances and Prepayments increased primarily due to Navy Supply Management reclassification of Federal Advances and Prepayments to Nonfederal Advances and Prepayments in order to reconcile seller side trading partner data. The issue has been logged in the Navy Enterprise Resource Planning Program Management Office Quality Center and NWCF will continue to work on a resolution.

Nonfederal Other Assets – Other Assets

Other Assets (With the Public) consists of prepayments made to vendors and travel advances made to employees.

Note 6. Cash and Other Monetary Assets

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Cash	$ 295	$ 2,452

Navy Working Capital Fund Cash consists of coins, paper currency and readily negotiable instruments. There are no restrictions on cash.

Note 7. Inventory and Related Property, Net

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Inventory, Net	$ 20,308,607	$ 20,315,654
2. Operating Material & Supplies, Net	176,693	203,825
3. Total	$ 20,485,300	$ 20,519,479

Inventory, Net

As of September 30	2012			
(AMOUNTS IN THOUSANDS)	*Inventory Gross Value*	*Revaluation Allowance*	*Inventory, Net*	*Valuation Method*
1. Inventory Categories				
A. Available and Purchased for Resale	$ 8,285,011	$ (934,683)	$ 7,350,328	LAC, MAC
B. Held for Repair	13,086,366	(159,157)	12,927,209	LAC, MAC
C. Excess, Obsolete, and Unserviceable	537,735	(537,735)	-	NRV
D. Work in Process	31,070	-	31,070	AC
2. Total	$ 21,940,182	$ (1,631,575)	$ 20,308,607	

As of September 30	2011			
	(AMOUNTS IN THOUSANDS)			
	Inventory Gross Value	Revaluation Allowance	Inventory, Net	Valuation Method
1. Inventory Categories				
A. Available and Purchased for Resale	$ 9,870,424	$ 834,387	$ 10,704,811	LAC, MAC
B. Held for Repair	9,446,780	103,362	9,550,142	LAC, MAC
C. Excess, Obsolete, and Unserviceable	582,729	(582,729)	-	NRV
D. Work in Process	60,701	-	60,701	AC
2. Total	$ 19,960,634	$ 355,020	$ 20,315,654	

Legend for Valuation Methods:
LAC = Latest Acquistion Cost NRV = Net Realizable Value MAC = Moving Average Cost
LCM = Lower of Cost or Market AC = Actual Cost

General Composition of Inventory
Inventory available and purchased for resale includes consumable spare and repair parts as well as reparable items owned and managed by the Navy Working Capital Fund (NWCF). Inventory includes all material available for customer purchase. Inventory is assigned to categories based upon condition of the inventory items, or in the case of work-in-process, based upon stage of fabrication. Inventory held for repair consists of damaged materials that are not usable and are awaiting repair before they are eligible for sale. Excess inventory includes scrap materials or items that are uneconomical to repair and are awaiting disposal. Work in process includes costs related to the production or servicing of items, including direct material, direct labor, applied overhead, and other direct costs. Work in process also includes the value of finished products or completed services pending the submission of bills to the customer.

Federal Accounting Standards require disclosure of the amount of Inventory Held for Future Use. The NWCF has $0.5 and $0.5 billion reported as of September 30, 2012 and 2011 respectively, in Inventory Held for Future Sale, Net.

Inventory Valuation
Navy's inventory is reported using two methods: the approximation of historical cost method and Moving Average Cost (MAC). The approximation of historical cost is calculated by using the Latest Acquisition Cost (LAC) less the allowance for holding gains and losses. MAC is calculated each time costs are incurred for a purchase or a repairable item is remanufactured and subsequently moved to the Held for Use account by dividing the cost of total units available at the time by the number of total units available at that time. Legacy inventory systems were designed to capture materiel management information rather than accounting data. Although these systems provide visibility and accountability over inventory items, they do not maintain historical cost data necessary to comply with the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, Accounting for Inventory and Related Property. The Office of Under Secretary of Defense, Comptroller Cost of Goods Sold Model revalued inventory causing NWCF to be non-compliant with SFFAS No. 3. The Navy Enterprise Resource Planning System values inventory at MAC in accordance with U.S. Generally Accepted Accounting Principles. As of September 30, 2012, 95% of NWCF inventory was valued at MAC. The revaluation of the inventory to MAC occurred in the field accounting system to be compliant with SFFAS No. 3.

The NWCF recognizes excess, obsolete, and unserviceable inventory and Operating Materials and Supplies (OM&S) at a net realizable value of $0 pending development of an effective means of valuing such materiel.

Restrictions on Use of Inventory
There are no restrictions on the use, sale, or disposition of inventory except in the following situations:

1) Distributions without reimbursement are made when authorized by Department of Defense directives;

2) War reserve materiel in the amount of $65.9 million includes repair items that are considered restricted; and

3) Inventory, with the exception of safety stocks, may be sold to foreign, state, and local governments; private parties; and contractors in accordance with current policies and guidance or at the direction of the President.

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

Operating Materiel and Supplies, Net

As of September 30	2012			
	(AMOUNTS IN THOUSANDS)			
	OM&S Gross Value	Revaluation Allowance	OM&S, Net	Valuation Method
1. OM&S Categories				
A. Held for Use	$ 176,693	$ -	$ 176,693	LAC
2. Total	$ 176,693	$ -	$ 176,693	

As of September 30	2011			
	(AMOUNTS IN THOUSANDS)			
	OM&S Gross Value	Revaluation Allowance	OM&S, Net	Valuation Method
1. OM&S Categories				
A. Held for Use	$ 203,825	$ -	$ 203,825	LAC
2. Total	$ 203,825	$ -	$ 203,825	

Legend for Valuation Methods:
LAC = Latest Acquisition Cost

General Composition of Operating Materiel and Supplies
OM&S Held for Use consists of property that is consumed during normal operations and includes consumable spare and repair parts for use on customer work orders. NWCF only maintains OM&S Held for Use.

Federal Accounting Standards require disclosure of the amount of OM&S Held for Future Use. The NWCF reports that $0.4 and $0.0 million of OM&S is held for future use and is included in the “held for use” category as of September 30,2012 and 2011 respectively. These items are not readily available in the market and there is a more than a remote chance that they will eventually be needed.

Operating Materiel and Supplies Valuation
OM&S is valued at LAC. Using LAC involves a revaluation of OM&S balance based on standard price information available at fiscal year end. The NWCF does not use allowance accounts to report revaluations made during the fiscal year. Instead, these adjustments are presented in the financial statements through the use of gain and loss accounts.

Restrictions on Use of Operating Materials & Supplies
There are no restrictions with regard to the use, sale, or disposition of OM&S applicable to NWCF activities.

Note 8. General Property, Plant, & Equipment, Net

As of September 30	2012				
	(AMOUNTS IN THOUSANDS)				
	Depreciation/ Amortization Method	*Service Life*	*Acquisition Value*	*(Accumulated Depreciation/ Amortization)*	*Net Book Value*
1. Major Asset Classes					
A. Land	N/A	N/A	$ 31,272	$ N/A	$ 31,272
B. Buildings, Structures, and Facilities	S/L	20 or 40	6,684,421	(5,244,382)	1,440,039
C. Software	S/L	2-5 or 10	364,656	(287,331)	77,325
D. General Equipment	S/L	5 or 10	2,603,496	(2,118,744)	484,752
E Construction-in-Progress (Excludes Military Equipment)	N/A	N/A	201,078	N/A	201,078
F. Other	N/A	N/A	14	-	14
2. Total			$ 9,884,937	$ (7,650,457)	$ 2,234,480

As of September 30	2011				
	(AMOUNTS IN THOUSANDS)				
	Depreciation/ Amortization Method	*Service Life*	*Acquisition Value*	*(Accumulated Depreciation/ Amortization)*	*Net Book Value*
1. Major Asset Classes					
A. Land	N/A	N/A	$ 31,269	$ N/A	$ 31,269
B. Buildings, Structures, and Facilities	S/L	20 or 40	6,642,569	(5,095,377)	1,547,192
C. Software	S/L	2-5 or 10	402,760	(311,388)	91,372
D. General Equipment	S/L	5 or 10	2,656,854	(2,152,881)	503,973
E. Construction-in-Progress (Excludes Military Equipment)	N/A	N/A	166,657	N/A	166,657
F. Other	N/A	N/A	12	-	12
2. Total			$ 9,900,121	$ (7,559,646)	$ 2,340,475

Legend for Valuation Methods:
S/L = Straight Line *N/A = Not Applicable*

General Composition of General Property, Plant and Equipment
Navy Working Capital Fund (NWCF) General Property, Plant and Equipment (PP&E) consists of land, buildings and structures, software, general equipment and Construction-in-Progress. General PP&E, Other consists of assets awaiting disposal.

General Property, Plant and Equipment Valuation
The acquisition cost for General PP&E is captured and maintained in the applicable accountable property systems of record. There are no material amounts or types of General PP&E for which the acquisition cost is unknown. The methodology used in capitalizing General PP&E assets is discussed in Note 1.M.

Restrictions on Use of Property, Plant and Equipment
There are no known restrictions on the use or convertibility of PP&E.

Heritage assets and stewardship land are reported on the financial statements of the Department of Navy General Fund.

Note 9. Liabilities Not Covered by Budgetary Resources

As of September 30		2012		2011
(AMOUNTS IN THOUSANDS)				
1. Intragovernmental Liabilities				
A. Other	$	168,029	$	161,605
2. Nonfederal Liabilities				
A. Military Retirement and Other Federal Employment Benefits		757,427		739,256
3. Total Liabilities Not Covered by Budgetary Resources	$	925,456	$	900,861
4. Total Liabilities Covered by Budgetary Resources		4,845,833		4,626,504
5. Total	$	5,771,289	$	5,527,365

Liabilities Not Covered by Budgetary Resources are liabilities incurred which are not covered by available budgetary resources. These include liabilities resulting from the receipt of goods or services in the current or prior periods, or the occurrence of eligible events in the current or prior periods, for which revenue or other sources of funds necessary to pay the liabilities have not been made available through Congressional appropriations or earnings of the entity. Notwithstanding an expectation that the appropriations will be made, whether they in fact will be made is completely at the discretion of the Congress.

Intragovernmental Liabilities – Other consists of the unfunded portion of Federal Employees' Compensation Act (FECA) liability due to the Department of Labor and unemployment compensation due to applicable States. These liabilities will be funded by future year's budgetary resources.

Military Retirement and Other Federal Employment Benefits consist of various employee actuarial liabilities not due and payable during the current fiscal year. These liabilities represent FECA Actuarial liabilities that will be funded in future periods. Refer to Note 14, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

Note 10. Accounts Payable

As of September 30	2012					
(AMOUNTS IN THOUSANDS)						
		Accounts Payable		*Interest, Penalties, and Administrative Fees*		*Total*
1. Intragovernmental Payables	$	184,615		N/A	$	184,615
2. Nonfederal Payables (to the Public)		3,015,987		-		3,015,987
3. Total	$	3,200,602	$	-	$	3,200,602

As of September 30	2011					
(AMOUNTS IN THOUSANDS)						
		Accounts Payable		*Interest, Penalties, and Administrative Fees*		*Total*
1. Intragovernmental Payables	$	181,490		N/A	$	181,490
2. Nonfederal Payables (to the Public)		2,799,892		-		2,799,892
3. Total	$	2,981,382	$	-	$	2,981,382

Accounts Payable includes amounts owed to federal and nonfederal entities for goods and services received by Navy Working Capital Fund (NWCF). The NWCF's systems do not track intragovernmental transactions by customer at the transaction level. As a result, in the intra-governmental eliminations process, buyer-side accounts payable are adjusted to agree with supportable intra-agency seller-side accounts receivable. This is accomplished by (1) reclassifying amounts between federal and nonfederal cost categories, (2) accruing additional accounts payable and expenses, and (3) applying both supported and unsupported undistributed disbursements at the reporting entity level.

Note 11. Environmental and Disposal Liabilities

The Navy Working Capital Fund Environmental Liabilities are reported under Department of the Navy General Fund.

Note 12. Other Liabilities

As of September 30	2012		
(AMOUNTS IN THOUSANDS)	Current Liability	Noncurrent Liability	Total
1. Intragovernmental			
A. Advances from Others	$ 331,098	$ -	$ 331,098
B. FECA Reimbursement to the Dept. of Labor	73,769	94,261	168,030
C. Custodial Liabilities	8,888	-	8,888
D. Employer Contribution and Payroll Taxes Payable	23,413	-	23,413
2. Total Intragovernmental Other Liabilities	$ 437,168	$ 94,261	$ 531,429
3. Nonfederal			
A. Accrued Funded Payroll and Benefits	$ 1,039,118	$ -	$ 1,039,118
B. Advances from Others	206,870	-	206,870
C. Deposit Funds and Suspense Accounts	60	-	60
D. Contract Holdbacks	838	-	838
E. Employer Contribution and Payroll Taxes Payable	5,005	-	5,005
F. Contingent Liabilities	-	26,214	26,214
G. Other Liabilities	3,726	-	3,726
3. Total Nonfederal Other Liabilities	$ 1,255,617	$ 26,214	$ 1,281,831
4. Total	$ 1,692,785	$ 120,475	$ 1,813,260

As of September 30	2011		
(AMOUNTS IN THOUSANDS)	Current Liability	Noncurrent Liability	Total
1. Intragovernmental			
A. Advances from Others	$ 441,336	$ -	$ 441,336
B. FECA Reimbursement to the Dept. of Labor	69,616	91,988	161,604
C. Custodial Liabilities	6,513	-	6,513
D. Employer Contribution and Payroll Taxes Payable	22,295	-	22,295
2. Total Intragovernmental Other Liabilities	$ 539,760	$ 91,988	$ 631,748
3. Nonfederal			
A. Accrued Funded Payroll and Benefits	$ 910,890	$ -	$ 910,890
B. Advances from Others	232,077	-	232,077
C. Deposit Funds and Suspense Accounts	(2,502)	-	(2,502)
D. Contract Holdbacks	1,186	-	1,186
E. Employer Contribution and Payroll Taxes Payable	2,020	-	2,020
F. Contingent Liabilities	-	31,308	31,308
G. Other Liabilities	-	-	-
4. Total Nonfederal Other Liabilities	$ 1,143,671	$ 31,308	$ 1,174,979
5. Total	$ 1,683,431	$ 123,296	$ 1,806,727

Contingent Liabilities includes $26.2 million related to contracts authorizing progress payments based on cost as defined in the Federal Acquisition Regulation (FAR). In accordance with contract terms, specific rights to the contractor's work vest with the Federal Government when a specific type of contract financing payment is made. This action protects taxpayer funds in the event of contract nonperformance. It is Department of Defense policy that these rights should not be misconstrued as the rights of ownership. The Navy Working Capital Fund (NWCF) is under no obligation to pay the contractor for amounts greater than the amounts of progress payments authorized in the contract until delivery and government acceptance. Due to the probability the contractors will complete their efforts and deliver satisfactory products, and because the amount of contractor costs incurred but yet unpaid are estimable, the NWCF has recognized a contingent liability for the estimated unpaid costs that are considered conditional for payment pending delivery and government acceptance.

Total contingent liabilities for progress payments based on cost represent the difference between the estimated costs incurred to date by contractors and amounts authorized to be paid under progress payments based on cost provisions within the FAR. Estimated contractor-incurred costs are calculated by dividing the cumulative unliquidated progress payments based on cost by the contract-authorized progress payment rate. The balance of unliquidated progress payments based on cost is deducted from the estimated total contractor-incurred costs to determine the contingency amount.

Note 13. Commitments and Contingencies

A loss contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. A loss contingency is a liability when a past event or exchange transaction has occurred; a future outflow or other sacrifice of resources is probable; and the future outflow or sacrifice of resources is measurable. In addition to loss contingencies, the Department of the Navy (DON) also discloses (1) an estimate of obligations related to cancelled appropriations for which the reporting entity has a contractual commitment for payment, and (2) amounts for contractual arrangements that may require future financial obligations. Examples of claims or other contingencies include: (1) indemnity agreements –reimbursements due to licensees or contractors for losses incurred in support of federal activities; (2) claims against the federal government that are in process of judicial proceedings; (3) the unfunded portion of total liabilities to international organizations; and (4) litigation addressing claims for equity relief or non-monetary judgments whereby claimants are seeking specific actions by the DON.

The Navy Working Capital Fund is a party in various administrative proceedings and legal actions, related to claims for environmental damage, equal opportunity matters, and contractual bid protests. The DON Office of General Counsel was unable to express an opinion concerning the likely outcome on any of the cases.

Note 14. Military Retirement and Other Federal Employment Benefits

As of September 30	2012			
	(AMOUNTS IN THOUSANDS)			
	Liabilities	*Assumed Interest Rate (%)*	*(Less: Assets Available to Pay Benefits)*	*Unfunded Liabilities*
1. Other Actuarial Benefits				
A. FECA	$ 757,427		$ -	$ 757,427

As of September 30	2011			
	(AMOUNTS IN THOUSANDS)			
	Liabilities	*Assumed Interest Rate (%)*	*(Less: Assets Available to Pay Benefits)*	*Unfunded Liabilities*
1. Other Actuarial Benefits				
A. FECA	$ 739,256		$ -	$ 739,256

The Navy Working Capital Fund (NWCF) reports an actuarial liability for the Federal Employee's Compensation Act (FECA). FECA provides federal employees injured in the performance of duty with workers' compensation benefits, which include wage-loss benefits for total or partial disability, medical benefits, and vocational rehabilitation. FECA also provides survivor benefits to eligible dependents if the injury causes the employee's death. The FECA is administered by the Office of Workers' Compensation Programs.

Actuarial Cost Method Used

The NWCF actuarial liability 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. The liability for FECA benefits is developed by the Department of Labor and provided to the Department of Navy (DON) at the end of each fiscal year. The liability is distributed between the NWCF and DON General Fund based upon the number of civilian employees funded in each entity as reported in the Navy Budget Tracking System. The estimated actuarial liability is updated only at the end of each fiscal year.

Assumptions

Consistent with past practice, the projected annual FECA payments are discounted to the present value using Office of Management and Budget's economic assumptions for ten year U.S. Treasury notes and bonds.

The interest rate assumptions utilized when discounting are as follows:

Discount Rates

2.293% in Year 1
3.138% in Year 2 and thereafter

To provide more specificity concerning 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 the charge back year (CBY) 2012 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 CBYs were as follows:

CBY	COLA	CPIM
2012	N/A	N/A
2013	2.83%	3.65%
2014	2.03%	3.66%
2015	1.93%	3.72%
2016	2.00%	3.73%
2017	2.03%	3.80%

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 to economic assumptions, (2) a comparison of the percentage change in the liability amount to the percentage change in the actual incremental payments, (3) a comparison of the incremental paid losses per case (a measure of case-severity) in CBY 2012 to the average pattern observed during the most current three charge back years, and (4) a comparison of the estimated liability per case in the Discount Rates projection to the average pattern for the projections of the most recent three years.

Note 15. Disclosures Related to the Statement of Net Cost

Intragovernmental Costs and Exchange Revenue

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
1. Intragovernmental Costs	$ 4,932,504	$ 6,219,209
2. Public Costs	30,538,293	40,021,325
3. Total Costs	$ 35,470,797	$ 46,240,534
4. Intragovernmental Earned Revenue	$ (25,935,532)	$ (25,540,258)
5. Public Earned Revenue	(7,490,206)	(29,174,332)
6. Total Earned Revenue	$ (33,425,738)	$ (54,714,590)
7. Net Cost of Operations	$ 2,045,059	$ (8,474,056)

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the Federal Government that are supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity. The Department of Defense's (DoD) current processes and systems do not capture and report accumulated cost for major programs based upon the performance measures as required by the Government Performance and Results Act. The DoD is in the process of reviewing available data and developing a cost reporting methodology as required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, as amended by SFFAS No. 30, Inter-entity Cost Implementation.

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. Large balances in the Public costs and revenue lines are a result of the current process in Navy Enterprise Resource Planning. The process produces inflated gains and offsetting losses, however, the impact on Net Cost is reduced when the gains and losses are combined. The Navy is currently working to resolve the business process that results in daily postings to the gain and loss accounts for in-transit inventory.

The Navy Working Capital Fund's financial management systems do not track intragovernmental transactions by customer at the transactional level. Buyer-side expenses are adjusted to agree with internal seller-side revenues. Expenses are generally adjusted by reclassifying amounts between federal and nonfederal expenses. Intradepartment revenues and expenses are then eliminated.

Note 16. Disclosures Related to the Statement of Changes in Net Position

There is an abnormal balance in the Appropriations Used balance as of September 30, 2012. This abnormal balance occurred due to an error overstating expended appropriations associated with the War Reserve Material obligations and liquidations utilized by the United States Marine Corps.

The Statement of Changes in Net Position (SCNP) reports the change in net position during the reporting period. Net position is affected by changes to its two components: Cumulative Results of Operations and Unexpended Appropriations.

Note 17. Disclosures Related to the Statement of Budgetary Resources

As of September 30	2012	2011
	(AMOUNTS IN THOUSANDS)	
1. Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	$ 9,351,801	$ 8,931,466

Apportionment Categories of Obligations Incurred

Obligations Incurred – Direct	Category A	$0
Obligations Incurred – Reimbursable	Category B	$30.4 billion
Obligations Incurred – Reimbursable	Exempt from Apportionment	$0

Other Disclosures

The Statement of Budgetary Resources includes intra-entity transactions because the statements are presented as combined.

Note 18. Reconciliation of Net Cost of Operations to Budget

As of September 30	2012	2011
(AMOUNTS IN THOUSANDS)		
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
1. Obligations Incurred	$ 30,439,413	$ 28,878,521
2. Less: Spending Authority from Offsetting Collections and Recoveries	(31,978,984)	(30,241,496)
3. Net Obligations	(1,539,571)	(1,362,975)
Other Resources:		
4. Transfers In/Out Without Reimbursement	341,583	(85,696)
5. Imputed Financing from Costs Absorbed by Others	538,390	578,014
6. Other	1,664,623	(1,739,162)
7. Net Other Resources Used to Finance Activities	2,544,596	(1,246,844)
8. Total Resources Used to Finance Activities	$ 1,005,025	$ (2,609,819)
Resources Used to Finance Items Not Part of the Net Cost of Operations:		
9. Change in Budgetary Resources Obligated for Goods, Services, and Benefits Ordered but Not Yet Provided:		
9a. Undelivered Orders	$ (420,335)	$ (599,813)
9b. Unfilled Customer Orders	1,587,250	1,433,376
10. Resources That Fund Expenses Recognized in Prior Periods	(2,565)	(33,015)
11. Resources That Finance the Acquisition of Assets	(7,729,627)	(9,030,214)
12. Other Resources or Adjustments to Net Obligated Resources That Do Not Affect Net Cost of Operations:		
12a. Other	(2,006,205)	1,824,857
13. Total Resources Used to Finance Items Not Part of the Net Cost of Operations	$ (8,571,482)	$ (6,404,809)
14. Total Resources Used to Finance the Net Cost of Operations	$ (7,566,457)	$ (9,014,628)
Components of the Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Period:		
15. Other	$ 27,161	$ -
16. Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	27,161	-
Components Not Requiring or Generating Resources:		
17. Depreciation and Amortization	303,927	367,940
18. Revaluation of Assets or Liabilities	1,977,398	723,819
19. Other		
19a. Cost of Goods Sold	11,011,284	8,307,478
19b. Other	(3,708,254)	(8,858,665)
20. Total Components of Net Cost of Operations That Will Not Require or Generate Resources	9,584,355	540,572
21. Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	$ 9,611,516	$ 540,572
22. Net Cost of Operations	$ 2,045,059	$ (8,474,056)

The Reconciliation of Net Cost of Operations to Budget provides information about the total resources used by the Navy Working Capital Fund (NWCF). It is designed to explain how those resources were used to finance orders for goods and services not yet delivered, acquire assets and liabilities, and fund the NWCF's net cost of operations. It is intended to report the differences and facilitate the reconciliation of accrual based amounts used in the Statement of Net Cost (SNC) and obligation-based amounts used in the Statement of Budgetary Resources. The computations and presentation of items in the Reconciliation of Net Cost of Operations to Budget demonstrate that the budgetary and proprietary information in an entity's financial management system agrees.

Due to NWCF financial system limitations, budgetary data does not agree with proprietary expenses and capitalized assets. The difference between budgetary and proprietary data is a previously identified deficiency. As a result of these system limitations, resources that finance the acquisition of assets on the reconciliation of Net Cost of Operations to Budget were adjusted downward by $6.8 billion (absolute amount) as of September 30, 2012 to bring it into balance with the SNC.

The following Reconciliation of Net Cost of Operations to Budget lines are presented as combined instead of consolidated due to intra-agency budgetary transactions not being eliminated:

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

Other Components not Requiring or Generating Resources consists of overhead costs distributed to work in process, as well as costs originally recorded into another expense account that are transferred to one of three accounts: inventory work in process, internal use software in development, or completed assets. The legacy cost of goods sold increase was a result of inventory revaluation from Latest Acquisition Cost to standard price prior to conversion to Navy Enterprise Resource Planning (ERP). The Navy ERP increase was a result of the inventory revaluation from standard price to Moving Average Cost, and multiple duplicated postings with incorrect unit price values.

Note 19. Disclosures Related to Incidental Custodial Collections

Navy Working Capital Fund (NWCF) collected $11.5 million of incidental custodial revenues generated primarily from surcharges, interest, penalties, fines and administrative fees. These funds are not available for use by NWCF. At the end of each fiscal year, the accounts are closed and the balances rendered to the U.S. Treasury.

NAVY WORKING CAPITAL FUND REQUIRED SUPPLEMENTARY INFORMATION

Department of the Navy Fiscal Year 2012 Annual Financial Report

Navy Working Capital Fund
General Property, Plant, and Equipment
Real Property Deferred Maintenance and Repair

For Fiscal Year Ended September 30, 2012

The Navy Working Capital Fund real property deferred maintenance and repair information for fiscal year ended September 30, 2012 is reported with the Department of the Navy (DON) General Fund (GF) deferred maintenance and repair. See DON GF Required Supplementary Information.

NAVY WORKING CAPITAL FUND OTHER ACCOMPANYING INFORMATION

Department of the Navy Fiscal Year 2012 Annual Financial Report

Appropriations, Funds, and Accounts Included in the Principal Statements

Reporting Entity

Navy Working Capital Fund (NWCF)

Fund/Account Treasury Symbol and Title

97X4930.002

Navy Working Capital Fund Activity Group Treasury Symbol and Title

97X4930.NA1*	Depot Maintenance – Shipyards[a]
97X4930.NA2*	Depot Maintenance – Aviation
97X4930.NA4A*	Depot Maintenance – Other, Marine Corps
97X4930.NA3*	Ordnance[b]
97X4930.ND*	Transportation
97X4930.NE*	Base Support
97X4930.NH*	Research and Development
97X4930.NC*	Supply Management
97X4930.NC2A*	Supply Management, Marine Corps

Notes

* The * represents alpha or numeric characters which identify an activity or reporting segment of the activity group.

a Depot Maintenance, Shipyards became a part of the Department of the Navy (DON) General Fund (GF) in FY 2007. The Depot Maintenance, Shipyards information included in this report represents residual NWCF accounting.

b The Ordnance activity group became a part of the DON GF in FY 2000. The Ordnance information included in this report represents residual NWCF accounting for this group.

AUDIT OPINIONS

Department of the Navy Fiscal Year 2012 Annual Financial Report

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

November 9, 2012

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Independent Auditor's Report on the Department of the Navy General Fund FY 2012 and FY 2011 Financial Statements (Report No. DODIG-2013-012)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying Department of the Navy General Fund Consolidated Balance Sheet as of September 30, 2012 and 2011, and the Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, Combined Statement of Budgetary Resources, and related notes for the fiscal years then ended. The financial statements are the responsibility of the Department of the Navy management. Management is also responsible for implementing effective internal control and for complying with laws and regulations. In addition, management is responsible for implementing and maintaining financial management systems that comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA). Our responsibility is to express an opinion on the financial statements based on our audit.

We are unable to express an opinion on the Navy General Fund FY 2012 and FY 2011 Basic Financial Statements because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition, to our disclaimer, we are including the required report on Internal Control and Compliance With Laws and Regulations. This report is an integral part of our opinion report on the financial statements and should be considered in assessing the results of our work.

Disclaimer of Opinion on the Financial Statements

The Assistant Secretary of the Navy (Financial Management and Comptroller) represented to us that the Department of the Navy General Fund FY 2012 and FY 2011 Annual Financial Statements would not substantially conform to accounting principles generally accepted in the United States of America (U.S. GAAP) and that the Department of the Navy financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2012. Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to performing only those audit procedures required by generally accepted auditing standards that are consistent with the management representations made to us. Accordingly, we did not perform all the auditing procedures required by generally accepted government auditing standards and Office of Management and Budget (OMB) Bulletin 07-04, "Audit Requirements for Federal Financial Statements," September 4, 2007, as amended[1] to determine whether material amounts on the financial statements were presented fairly.

Prior audits have identified, and the Department of the Navy has also acknowledged, the long-standing material internal control weaknesses identified in the Summary of Internal Control. These material internal control

[1] OMB Memorandum M-09-33, Technical Amendments to OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statement," September 23, 2009.

weaknesses may affect the reliability of certain information contained in the annual financial statements–much of which is taken from the same data sources.[2] Therefore, we are unable to express, and we do not express, an opinion on the Basic Financial Statements.

Summary of Internal Control

In planning our work, we considered the Department of the Navy internal control over financial reporting and compliance with applicable laws and regulations. We did this to determine our audit procedures and to comply with OMB guidance, but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance with applicable laws and regulations. However, previously identified significant deficiencies, all of which are material, continue to exist in the following areas.

- Financial Management Systems
- Fund Balance With Treasury
- Problem Disbursements
- Unobligated Balances
- Accounts Receivable
- Inventory and Related Property, Net
- General Property, Plant, and Equipment
- Accounts Payable
- Other Assets
- Statement of Changes in Net Position
- Statement of Net Cost

A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a deficiency or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

Compliance With Laws and Regulations

We limited our work to determining compliance with selected provisions of applicable laws and regulations related to financial reporting because management represented that instances of noncompliance identified in prior audits continue to exist. The Assistant Secretary of the Navy (Financial Management and Comptroller) represented to us that the Department of the Navy financial management systems do not substantially comply with Federal financial management systems requirements, U.S. GAAP, and the U.S. Government Standard

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

General Ledger at the transaction level. Therefore, we did not determine whether the Department of the Navy complied with all applicable laws and regulations related to financial reporting. Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit, and, accordingly, we do not express such an opinion. See the Attachment for additional details on compliance with laws and regulations.

Other Information in the Annual Financial Statements

The Department of the Navy Management Discussion and Analysis, Required Supplementary Information, and Other Accompanying Information in the financial statements include a wide range and detailed information and do not affect our opinion on the financial statements. The information is presented for use by management and those charged with governance and should not be used for other purposes. We did not audit and do not express an opinion on the information. We compared the information with the Department of the Navy financial statements for consistency. Based on our limited work, we did not find any material inconsistencies between the information and the financial statements and applicable sections of OMB Circular No. A-136 (Revised), "Financial Reporting Requirements," August 3, 2012.

Scope and Methodology

Management is responsible for:

- preparing financial statements that conform with U.S. GAAP;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act of 1982 (FMFIA) are met;
- ensuring that the Department of the Navy financial management systems substantially comply with FFMIA requirements; and
- complying with applicable laws and regulations.

We are responsible for planning and performing the audit to obtain reasonable assurance and to provide an opinion on whether the Department of the Navy financial statements are presented fairly, in all material respects, in conformity with U.S. GAAP. We are also responsible for (1) testing whether the Department of the Navy financial management systems substantially comply with the three FFMIA requirements, (2) testing compliance with selected provisions of laws and regulations that have direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the Annual Financial Statements.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing over financial reporting and compliance to previously identified significant deficiencies, all of which are material and continue to exist. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected.

Because of the significance of the limitations on the scope of our work, we were unable to and did not perform our audit of internal control in accordance with U.S. GAAP and OMB audit guidance. We considered the limitation on the scope of our work in forming conclusions and in testing the financial statements.

We performed our audit in accordance with U.S. generally accepted government auditing standards. We believe our audit provides a reasonable basis for our opinions and other conclusions.

Agency Comments and Our Evaluation

Department of the Navy management provided comments to the draft opinion report. The comments were responsive and management generally concurred with the material weaknesses. Management is preparing corrective action plans to address the material weaknesses as part of their audit readiness effort.

This report is intended solely for the information and use of the Department's management, DoD Office of Inspector General, Office of Management and Budget, Government Accountability Office, and Congress and is not intended to be used by anyone other than these specified parties.

Lorin T. Venable

Lorin T. Venable, CPA
Acting Assistant Inspector General
DoD Payments and Accounting Operations

Attachment:
As stated

Report on Internal Control and Compliance With Laws and Regulations

Internal Control

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

Material Weaknesses

Management acknowledged that it is unable to comply with applicable reporting requirements and previously identified significant deficiencies, all of which are material, continue to exist in the following areas.

Financial Management Systems

The Department of the Navy financial management systems and feeder systems do not comply with Federal financial management system requirements, U.S. GAAP, and U.S. Government Standard General Ledger.

Fund Balance With Treasury, Problem Disbursements and Unobligated Balances - Retitled as Financial Reporting of Collections and Disbursements

> **Fund Balance With Treasury.** Deficiencies associated with Fund Balance with Treasury include undistributed disbursements, collections, and abnormal balances and the inability to reconcile the Department of the Navy General Fund records with the Department of the Treasury records and the Statement of Budgetary Resources.
>
> **Problem Disbursements.** Inaccurate or missing accounting data have resulted in unmatched disbursements and collections and an inability to reconcile the Department of the Navy General Fund records with the Department of the Treasury records.
>
> **Unobligated Balances.** Deficiencies exist in recorded unobligated amounts because financial systems are not fully integrated, and not all commands sufficiently review unliquidated obligations. Additionally, reimbursable transactions are not properly documented or reported on the Disbursing Officer Statement of Accountability.

Accounts Receivable - Retitled as Financial Reporting of Plan to Perform/Order to Cash

There are two deficiencies associated with the Accounts Receivable line: audit trails are inadequate and the accounts receivable sub-ledgers do not reconcile with the general ledger.

Inventory and Related Property, Net - Retitled as Financial Reporting of Operating Materials and Supplies

Legacy systems do not maintain the historical cost data necessary to comply with Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property." In addition, completeness issues exist because the legacy systems were not designed to provide the value of Operating Materials and Supplies using the moving average cost method and to ensure that all of the items are included in the values reported on the Balance Sheet. Some Department of the Navy commands have not used the consumption method for expensing Operating Materials and Supplies.

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General Property, Plant, and Equipment – Retitled as Financial Reporting of General Equipment, Real Property, and Military Equipment

Completeness issues may exist with recognizing internal use software and leasehold improvements. The Department of the Navy is currently working with the Under Secretary of Defense (Acquisition, Technology, and Logistics) and the Navy major commands to fully implement Statement of Federal Financial Accounting Standards No. 23, "Eliminating the Category National Defense Property, Plant, and Equipment." In addition, the Department of the Navy is working with the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, to ensure that documentation for real property is available, beginning with FY 1999; an imputed cost policy is properly implemented; and Form DD 1354, "Transfer and Acceptance of Military Property," is properly used throughout the Department of the Navy.

Accounts Payable and Other Assets - Retitled as Financial Reporting of Procure to Pay and Disbursements

Accounts Payable. The Department of the Navy intragovernmental accounts payable transactions, such as military standard requisitioning and issue procedures, fuel payables, and non-PowerTrack transportation, are not being recorded promptly, completely, or accurately. In addition, some existing Department of the Navy procedures create abnormal balances.

Other Assets. The Department of the Navy acknowledged deficiencies in contract financing progress payments that are included in the other assets line item on the balance sheet.

Statement of Changes in Net Position

The Navy accounts (such as revenue, expenses, gains, losses, and prior-period adjustments, closing to this statement) are not ready for assessment.

Statement of Net Cost

The Statement of Federal Financial Accounting Standards No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," requires agencies to provide reliable and timely information on the full cost of Federal programs, activities, and outputs. Currently, the Department of the Navy derives from budgetary accounts, and not on an accrual basis, the Intragovernmental Gross Costs and the Gross Costs with the Public, as well as Intragovernmental Earned Revenue and Earned Revenue From the Public.

Compliance With Laws and Regulations

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

Federal Financial Management Improvement Act of 1996

FFMIA requires DoD to establish and maintain financial management systems that comply substantially with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.

For FY 2012, the Department of the Navy did not fully comply with FFMIA. The Department of the Navy acknowledged that many of its critical financial management and feeder systems did not substantially comply with the Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2012.

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Page 2 of 3

Antideficiency Act

Section 1341, title 31, United States Code (31 U.S.C. § 1341) limits the Navy and its agents to making or authorizing expenditures or obligations that do not exceed the available appropriations or funds. Additionally, the Navy or its agents may not contract or obligate for the payment of money before an appropriation is made available for that contract or obligation unless otherwise authorized by law. According to 31 U.S.C. § 1351, if an officer or employee of an executive agency violates the Antideficiency Act, the head of the agency must report immediately to the President and Congress all relevant facts and a statement of actions taken. During FY 2012, the Department of the Navy General Fund reported no potential or actual Antideficiency Act violations.

Audit Disclosures

The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us that the Department of the Navy financial management and feeder systems could not provide adequate evidence supporting various material amounts on the financial statements and that previously identified material weaknesses continued to exist. Therefore, we did not perform detailed testing related to previously identified material weaknesses. In addition, we did not perform audit work related to the following laws and regulations: Government Performance and Results Act, Prompt Payment Act, Provisions Governing Claims of the United States Government (including provisions of the Debt Collection Improvement Act), Federal Credit Reform Act, Improper Payments Information Act, and the Pay and Allowance System for Civilian Employees.

Recommendations

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

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

November 9, 2012

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Independent Auditor's Report on the Department of the Navy Working Capital Fund FY 2012 and FY 2011 Financial Statements (Report No. DODIG-2013-014)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying Department of the Navy Working Capital Fund Consolidated Balance Sheet as of September 30, 2012 and 2011, and the Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, Combined Statement of Budgetary Resources, and related notes for the fiscal years then ended. The financial statements are the responsibility of the Department of the Navy management. Management is also responsible for implementing effective internal control and for complying with laws and regulations. In addition, management is responsible for implementing and maintaining financial management systems that comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA). Our responsibility is to express an opinion on the financial statements based on our audit.

We are unable to express an opinion on the Navy Working Capital Fund FY 2012 and FY 2011 Basic Financial Statements because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition, to our disclaimer, we are including the required report on Internal Control and Compliance With Laws and Regulations. This report is an integral part of our opinion report on the financial statements and should be considered in assessing the results of our work.

Disclaimer of Opinion on the Financial Statements

The Assistant Secretary of the Navy (Financial Management and Comptroller) represented to us that the Department of the Navy Working Capital Fund FY 2012 and FY 2011 Annual Financial Statements would not substantially conform to accounting principles generally accepted in the United States of America (U.S. GAAP) and that the Department of the Navy financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2012. Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to performing only those audit procedures required by generally accepted auditing standards that are consistent with the management representations made to us. Accordingly, we did not perform all the auditing procedures required by generally accepted government auditing standards and Office of Management and Budget (OMB) Bulletin 07-04, "Audit Requirements for Federal Financial Statements," September 4, 2007, as amended[1] to determine whether material amounts on the financial statements were presented fairly.

[1] OMB Memorandum M-09-33, Technical Amendments to OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statement," September 23, 2009.

Prior audits have identified, and the Department of the Navy has also acknowledged, the long-standing material internal control weaknesses identified in the Summary of Internal Control. These material internal control weaknesses may affect the reliability of certain information contained in the annual financial statements–much of which is taken from the same data sources.[2] Therefore, we are unable to express, and we do not express, an opinion on the Basic Financial Statements.

Summary of Internal Control

In planning our work, we considered the Department of the Navy internal control over financial reporting and compliance with applicable laws and regulations. We did this to determine our audit procedures and to comply with OMB guidance, but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance with applicable laws and regulations. However, previously identified significant deficiencies, all of which are material, continue to exist in the following areas.

- Financial Management Systems
- Fund Balance With Treasury
- Accounts Receivable
- Inventory and Related Property, Net
- General Property, Plant, and Equipment
- Accounts Payable
- Other Liabilities
- Statement of Budgetary Resources
- Intragovernmental Eliminations
- Unsupported Accounting Entries
- Operating Materiels and Supplies
- Statement of Net Cost
- Reconciliation of Net Cost of Operations to Budget

A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a deficiency or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

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

Compliance With Laws and Regulations

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

Other Information in the Annual Financial Statements

The Department of the Navy Management Discussion and Analysis, Required Supplementary Information, and Other Accompanying Information in the financial statements include a wide range and detailed information and do not affect our opinion on the financial statements. The information is presented for use by management and those charged with governance and should not be used for other purposes. We did not audit and do not express an opinion on the information. We compared the information with the Department of the Navy financial statements for consistency. Based on our limited work, we did not find any material inconsistencies between the information and the financial statements and applicable sections of OMB Circular No. A-136 (Revised), "Financial Reporting Requirements," August 3, 2012.

Scope and Methodology

Management is responsible for:

- preparing financial statements that conform with U.S. GAAP;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act of 1982 (FMFIA) are met;
- ensuring that the Department of the Navy financial management systems substantially comply with FFMIA requirements; and
- complying with applicable laws and regulations.

We are responsible for planning and performing the audit to obtain reasonable assurance and to provide an opinion on whether the Department of the Navy financial statements are presented fairly, in all material respects, in conformity with U.S. GAAP. We are also responsible for (1) testing whether the Department of the Navy financial management systems substantially comply with the three FFMIA requirements, (2) testing compliance with selected provisions of laws and regulations that have direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the Annual Financial Statements.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing over financial reporting and compliance to previously identified significant deficiencies, all of which are material and continue to exist. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected.

Because of the significance of the limitations on the scope of our work, we were unable to and did not perform our audit of internal control in accordance with U.S. GAAP and OMB audit guidance. We considered the limitation on the scope of our work in forming conclusions and in testing the financial statements.

We performed our audit in accordance with U.S. generally accepted government auditing standards. We believe our audit provides a reasonable basis for our opinions and other conclusions.

Agency Comments and Our Evaluation

Department of the Navy management provided comments to the draft opinion report. The comments were responsive and management generally concurred with the material weaknesses. Management is preparing corrective action plans to address the material weaknesses as part of their audit readiness effort.

This report is intended solely for the information and use of the Department's management, DoD Office of Inspector General, Office of Management and Budget, Government Accountability Office, and Congress and is not intended to be used by anyone other than these specified parties.

Lorin T. Venable

Lorin T. Venable, CPA
Acting Assistant Inspector General
DoD Payments and Accounting Operations

Attachment:
As stated

Report on Internal Control and Compliance With Laws and Regulations

Internal Control

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

Material Weaknesses

Management acknowledged that it is unable to comply with applicable reporting requirements and previously identified significant deficiencies, all of which are material, continue to exist in the following areas.

Financial Management Systems
The Department of the Navy Working Capital Fund system interfaces do not exist between the financial reporting systems, which result in unmatched disbursements and collections.

Fund Balance With Treasury – Retitled Financial Reporting of Collections and Disbursements
The Department of the Navy Working Capital Fund system interfaces do not exist between the financial reporting systems, which result in unmatched disbursements and collections.

Accounts Receivable – Retitled as Financial Reporting of Plan to Perform/Order to Cash
The Department of the Navy does not reconcile subsidiary records to corresponding general ledger accounts on a regular basis, resulting in control weaknesses and no audit trail. The Department of the Navy also posts unmatched collections to accounts receivable using journal vouchers, leaving no audit trail.

Inventory and Related Property, Net – Retitled as Financial Reporting of Inventory
The Department of the Navy Working Capital Fund supply management activities record inventory at the latest acquisition cost because the Department of the Navy does not have adequate data, processes, and methodologies to make accurate conversions. To comply with U.S. GAAP, the latest acquisition cost must be converted to an approximation of historical cost.

General Property, Plant, and Equipment – Retitled as Financial Reporting of Real Property, and General Equipment
The Department of the Navy Working Capital Fund cannot establish or support ownership and valuation of General Equipment because of the lack of supporting documentation, improper interpretation of guidance, underutilization of the accounting system of record, and system limitations. In addition, the Department of the Navy cannot substantiate that the asset records represent all General Equipment assets, including all ancillary costs to the asset, or assign a correct useful life. Further, the Department of the Navy cannot reconcile its property accountability system with its financial systems, causing its presentation and disclosure of assets to be inaccurate.

Accounts Payable and Other Liabilities – Retitled as Financial Reporting of Procure to Pay Processes

> **Accounts Payable.** The Accounts Payable line item is adversely affected by insufficient or inconsistent reconciliations and supporting documentation; undistributed disbursements; the inability to capture

Attachment
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trading partner information; and the lack of direct system interfaces, which causes matching difficulties. Unmatched disbursements are transferred to accounts payable using journal vouchers, leaving no audit trail and often causing abnormal balances.

Other Liabilities. The Department of the Navy needs to resolve unsupported, undistributed disbursements.

Statement of Budgetary Resources
Multiple deficiencies exist within the Statement of Budgetary Resources. Defense Finance and Accounting Service Cleveland staff posts adjustments to this statement based on proprietary data. The Department of the Navy needs to ensure that beginning balances are verified, reconciliation processes are established, and performance reviews are completed. The Department of the Navy needs to identify and correct all disconnects between budgetary and proprietary data.

Intragovernmental Eliminations
The Department of the Navy systems do not track intragovernmental transactions by customer or provider. Therefore, the Department of the Navy is unable to fully reconcile intragovernmental transactions with all Federal partners.

Unsupported Accounting Entries
The Department of the Navy financial feeder systems and accounting systems do not provide sufficient detail to identify Federal and non-Federal or supported and unsupported transactions.

Operating Materiels and Supplies Retitled as Financial Reporting of Operating Materials and Supplies
The Department of the Navy generally does not include Government Furnished Material in the Operating Materials and Supplies amounts reported.

Statement of Net Cost
The current Department of the Navy processes and systems do not capture and report accumulated costs for major programs based upon performance measures as required by the Government Performance and Results Act. The Department of the Navy is in the process of reviewing the available data and developing a cost reporting methodology.

Reconciliation of Net Cost of Operations to Budget
The Department of the Navy budgetary data are not in agreement with proprietary expenses and assets capitalized because of the Department of the Navy financial system limitations. The difference between budgetary and proprietary data has been previously identified as a system deficiency.

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

Attachment
Page 2 of 3

Federal Financial Management Improvement Act of 1996
FFMIA requires DoD to establish and maintain financial management systems that comply substantially with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.

For FY 2012, the Department of the Navy did not fully comply with FFMIA. The Department of the Navy acknowledged that many of its critical financial management and feeder systems did not substantially comply with the Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2012.

Antideficiency Act
Section 1341, title 31, United States Code (31. U.S.C. § 1341) limits the Department of the Navy and its agents to making or authorizing expenditures or obligations that do not exceed the available appropriations or funds. Additionally, the Department of the Navy or its agents may not contract or obligate for the payment of money before an appropriation is made available for that contract or obligation unless otherwise authorized by law. According to 31 U.S.C. § 1351, if an officer or employee of an executive agency violates the Antideficiency Act (ADA), the head of the agency must report immediately to the President and Congress all relevant facts and a statement of actions taken. During FY 2012, the Department of the Navy reported one ADA violation. Therefore, the Department of the Navy did not comply with 31 U.S.C. §§ 1341 and 1351.

DoD internal guidance limits the time from identification to reporting of ADA violations to 15 months. Our review of The Department of the Navy ADA investigations of potential violations shows that the Department of the Navy processed the one ADA violation case within 15 months.

Officials and employees of the Federal Government who violate the Antideficiency Act are subject to appropriate disciplinary action. According to DoD Regulation 7000.14-R, "DoD Financial Management Regulation," Volume 14, Chapter 7, "Antideficiency Act Report,"

November 2010, such appropriate administrative disciplinary action may include: written admonishment or reprimand, reduction in grade, suspension from duty without pay, or removal from office. However, ADA disciplinary actions taken by the Department of the Navy did not always comply with the DoD Financial Management Regulation.

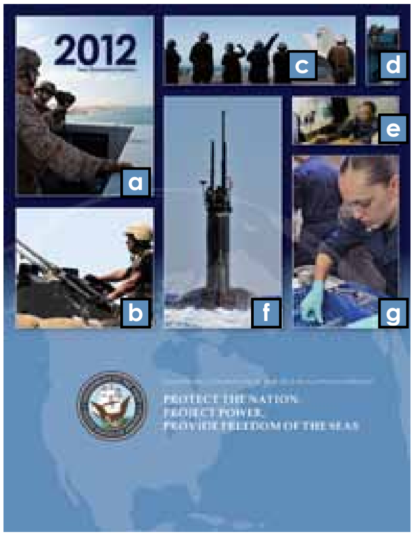
Audit Disclosures
The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us that the Department of the Navy financial management and feeder systems could not provide adequate evidence supporting various material amounts on the financial statements and that previously identified material weaknesses continued to exist. Therefore, we did not perform detailed testing related to previously identified material weaknesses. In addition, we did not perform audit work related to the following laws and regulations: Government Performance and Results Act, Prompt Payment Act, Provisions Governing Claims of the United States Government (including provisions of the Debt Collection Improvement Act), Federal Credit Reform Act, Improper Payments Information Act, and the Pay and Allowance System for Civilian Employees.

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

Attachment
Page 3 of 3

Department of the Navy Fiscal Year 2012 Annual Financial Report

PROTECT THE NATION,
PROJECT POWER,
PROVIDE FREEDOM OF THE SEAS



Cover Credits

a Marines look on as an amphibious transport dock ship transits a canal on its first operational deployment. (U.S. Navy photo by Mass Communication Specialist 3rd Class Ian Carver/Released)

b A Sailor stands watch next to a .50-caliber machine gun aboard an aircraft carrier. (U.S. Navy photo by Mass Communication Specialist 3rd Class Carlos M. Vazquez II/Released)

c Plane captains bid farewell to a launching F/A-18F Super Hornet. (U.S. Navy photo by Mass Communication Specialist 2nd Class James R. Evans/Released)

d Sailors return to the surface after searching for mines during an exercise. (U.S. Navy photo by Mass Communication Specialist 2nd Class Ernesto Hernandez Fonte/Released)

e Reviewing maintenance requests aboard an aircraft carrier. (U.S. Navy photo by Mass Communication Specialist Seaman Dean M. Cates/Released)

f An attack submarine gets underway from Souda harbor following a port visit. (U.S. Navy photo by Paul Farley/Released)

g A hospital Corpsman cleans scopes for sterilization to be used in surgery aboard a Military Sealift Command hospital ship. (U.S. Navy photo by Mass Communication Specialist 2nd Class Roadell Hickman/Released)

h Sailors assigned to an amphibious transport dock lower a rigid hull inflatable boat from the ship's boat pocket during small boat operations. (U.S. Navy photo by Mass Communications Specialist 2nd Class Zane Ecklund/Released)

i Marines conduct weapons training. (U.S. Navy photo by Mass Communication Specialist 3rd Class Fidel C. Hart/Released)

j A Quartermaster determines gyro errors by azimuth of the sun in the pilothouse aboard a multipurpose amphibious assault ship. (U.S. Navy photo by Mass Communications Specialist 3rd Class Natasha Chalk/Released)

k Civilian contractors break down the super wedge launcher after deploying a Scan Eagle unmanned aerial vehicle from the flight deck of an amphibious dock-landing ship. (U.S. Navy photo by Mass Communication Specialist 3rd Class Jonathan Sunderman/Released)

l A commanding officer of an amphibious assault ship tracks the distance to a guided-missile destroyer. (U.S. Navy photo by Mass Communication Specialist 2nd Class Tom Henderson/Released)

m A replenishment oiler conducts a replenishment-at-sea with a guided-missile destroyer as part of a multinational mission-based task force, working under the Combined Maritime Forces to conduct counter-piracy operations. (U.S. Navy photo by Mass Communication Specialist 3rd Class John Callahan/Released)

Preparation of this report cost the Department of the Navy approximately $102,000 in Fiscal Year 2012.
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FOR MORE INFORMATION

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http://www.finance.hq.navy.mil/FMC

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