United States Department of Defense

Agency Financial Report

Fiscal Year 2016

MANAGEMENT'S DISCUSSION AND ANALYSIS

This Page Intentionally Left Blank

MANAGEMENT'S DISCUSSION AND ANALYSIS

DEPARTMENT OF DEFENSE OVERVIEW

The mission of the Department of Defense (DoD) is to provide the military forces needed to deter war and to protect the security of our country. The Department is committed to protecting the people of the United States, defending our national interests, and providing U.S. Military with the resources to accomplish its mission.

Today, we are at an inflection point in the strategic landscape. After more than a decade-long focus on long-term counterterrorism and counterinsurgency campaigns, we must contend with a renaissance of great power competition, while continuing to counter threats posed by violent extremist organizations. The advantages we have traditionally enjoyed are being challenged, and our margin of technological superiority is eroding through the rapid technological advancements enjoyed by both state and non-state adversaries. Others seek to challenge international norms by operating just short of what the international system considers to be war.

Ash Carter

Secretary of Defense

It is said that security is like oxygen: when you have enough of it you pay no attention to it; but when you don't have it, that's all you can think of. The Department maintains the finest fighting force in the world. The Department has an obligation to ensure that the men and women who choose to serve are properly trained and equipped so they can provide that oxygen, the security, that allows for stability and prosperity for the American people and our allies.

The Department sets its strategic direction through the Quadrennial Defense Review (QDR), which was provided to Congress in March 2014. The QDR is a legislatively mandated report, issued every four years, which evaluates the threats and challenges to our enduring national interests. It is the key strategic document against which the Department's priorities and requests for resources are aligned. The QDR, consistent with the President's National Security Strategy, affirms the global leadership role of the United States. and sets a course that will help bring the military resources into balance over the next decade. The QDR outlines the Department's strategic priorities, which include: rebalancing our focus and our forces to the Asia-Pacific region to preserve peace and stability; maintaining a strong commitment to security and stability in Europe and the Middle East; and sustaining a global approach to countering violent extremists and terrorist threats, with an emphasis on the Middle East and Africa. It highlights the importance of strengthening our alliances and partnerships globally.

The Asia-Pacific is a defining region for our nation's future. Half of the world's population will live there by 2050. The progress enjoyed in this region since World War II has been enabled by a peaceful security environment, which has been shaped by our enduring presence and commitments. As our allies and partners continue to experience rapid social and economic progress, we increasingly look to build their capacities to approach these global defense challenges together through a principled security network.

The rebalance to the Asia-Pacific remains a key component of the Department's strategy. Although the United States welcomes the rise of a China that is peaceful and a responsible player in international affairs, China's actions in the South China Sea are increasingly at odds with international norms and principles. Faced with North Korea's provocations, and its ballistic missile and nuclear programs, we are committed to maintaining peace and stability on the Korean Peninsula and throughout the region. The Department will maintain a robust footprint in Northeast Asia while enhancing our presence in Southeast Asia and Oceana.

Given our deep and abiding interests in a Europe that is whole, free, and at peace, Russian President Putin's continued aggressive acts towards Ukraine and illegal annexation of Crimea are unwelcome developments. The Department is working with U.S. allies and partners to promote regional security as part of a strong and balanced approach to deter Russia's aggression. We are supporting Ukraine's armed forces and have committed millions of dollars of non-lethal materiel and assistance.

The *North Atlantic Treaty Organization (NATO)* remains a cornerstone of European security. The last years have been significant in the history of the Alliance, given changing dynamics in European security. We are helping NATO turn its attention to deterring an increasingly aggressive Russia as well as addressing insecurity on NATO's southern flank after a long period of focus on Afghanistan. In light of these significant challenges, NATO leaders have agreed to powerful steps: doubling the number of military exercises in the past year, setting up new command centers, and establishing the Very High Readiness Joint Task Force. The United States has continued to participate in military exercises throughout the Baltic Republics, Poland, and other front-line states. In doing so, the United States and our allies have upheld our commitment to collective self-defense.

The Middle East is undergoing a period of great social and political turmoil. The United States, with a coalition of allies and partners, is engaging in a campaign to degrade and defeat the Islamic State of Iraq and the Levant (ISIL). Achieving a lasting defeat of ISIL requires a "whole-of-government" effort, and of the nine lines of efforts that underpin the campaign, the Department leads two: denying ISIL safe haven and building partner capacity. The Department's personnel remain committed to building the capacity of indigenous forces in both Syria and Iraq to counter ISIL. This is challenging to achieve, but ISIL's lasting defeat requires these local forces to prevail on the ground. We also continue to provide critical support to our partners in the region and around the world in an effort to bolster their defenses and enable their activities and operations aimed at countering ISIL. We are coordinating these efforts in the context of a 60-plus nation coalition.

In Afghanistan, the U.S. strategy is to continue building the capacity of the Afghan government as a reliable defense partner, and to protect U.S. national security interests in the region to ensure our gains are solidified. Afghanistan's government is now fully responsible for the security of its people and is moving ahead on a reform agenda. President Obama announced that we will maintain a continued presence of up to 9,800 military personnel before drawing down to an authorized force level of 8,400 by January 2017. We will maintain our focus on training, advising, and assisting the Afghan National Defense and Security Forces (ANDSF) as part of the NATO-led Resolute Support Mission, as well as conducting a counterterrorism mission. The Department will continue to finance the sustainment and professionalization of the ANDSF of up to 352,000 personnel through 2017.

Although our long-standing problems with Iran are far from resolved, the nuclear deal agreed upon by the international community represents a detailed arrangement to prohibit Iran permanently from obtaining a nuclear weapon. Although we welcome the positive conclusion of diplomatic negotiations, we will continue to hold Iran accountable for its actions while we ensure Israel's qualitative military edge and work with our Gulf partners to make them more capable of defending themselves against external aggression.

The FY 2017 budget reflects recent strategic threats and changes that have taken place in Asia, the Middle East, and Europe. Aggressive Russian actions, terrorism by ISIL and others, and China's island-building and claims of sovereignty in international waters all necessitate changes in our strategic outlook and in our operational commitments.

Addressing these challenges as part of DoD's mission to defend the nation requires new and innovative thinking, new operational posture in strategic regions, and new and enhanced capabilities. As we confront rising international challenges, we are seizing opportunities, developing new operational concepts, pioneering and dominating technology frontiers, reforming the defense enterprise, and building the force of the future.

Against this backdrop of emerging challenges to U.S. national interests, the Department is resetting and reconstituting the Joint Force after 15 years of war. The FY 2017 budget request strikes a prudent balance among the modernization of the Joint Force, its size, its readiness, and continues to keep faith with service members, their families and civilians. The FY 2017 President's Budget funding level will allow the Joint Force to respond to steady-state demand requirements, fulfill strategic obligations, and support the Services' readiness recovery plans.

The Department continues to make key investments in the future force, with an emphasis on restoring readiness, balancing the force, and achieving institutional reform. We are placing a greater emphasis on research and development to help us maintain our competitive edge. We are also committing to the Department's Third Offset Strategy that is designed to counter or offset the technological advances of potential U.S. adversaries. In a time where many militarily relevant technologies are driven by the commercial sector, the Department will continue drawing from the brightest innovators to find technologies that will give U.S. Military Forces an edge on the battlefield of the future.

Finally, we must maintain full accountability and demonstrate that the Department is taking effective action to make the best possible use of every taxpayer dollar. That means we must strive to manage the Defense enterprise efficiently and effectively, and reform our business and acquisition practices. If the trends hold, the geopolitical challenges ahead will only be more dynamic and fluid, and certainly no less challenging. The Department's efforts are imperative to maintain readiness on all fronts for both the geopolitical challenges we see today, and for those to come.

Marines assigned to Bravo Company, Battalion Landing Team, 1st Battalion, 6th Marine Regiment, 22nd Marine Expeditionary Unit (MEU), conduct a mass casualty training exercise aboard the amphibious assault ship USS Wasp (LHD 1) on July 28, 2016. 22nd MEU, deployed with the Wasp Amphibious Ready Group, is conducting naval operations in the 6th Fleet area of operations in support of U.S. national security interests in Europe.

Photo by Lance Cpl. Koby I. Saunders

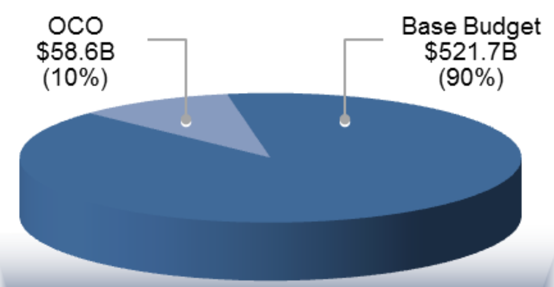
A U.S. Marine Corps MV-22B Osprey tiltrotor aircraft with Marine Medium Tiltrotor Squadron (VMM) 266, Special Purpose Marine Air-Ground Task Force-Crisis Response-Africa (SPMAGTF-CR-AF), lands onboard the French amphibious assault ship BPC Dixmude (L9015) as part of bilateral training in the Gulf of Cadiz, Spain, Aug. 6, 2016. The Dixmude served as a platform to assist SPMAGTF-CR-AF in maintaining their readiness by hosting carrier qualification training

Photo by Lt. Cmdr. Florian Edus

RESOURCES

FY 2016 budget reflected the Department's attempt to fashion a coherent defense program with the proper balance between capacity, capabilities, and current and future readiness. The DoD's FY 2016 discretionary budget authority of $580.3 billion, composed of $521.7 billion in the base budget and $58.6 billion in support of Overseas Contingency Operations (OCO). Figure 1 displays the DoD FY 2016 budget authority by appropriation. DoD priorities outlined in the 2014 QDR were sustained through programs and resources in the FY 2016 budget.

Figure 1. DoD FY 2016 Budget Authority



Budget by Appropriation	$ in Billions
Military Personnel	$138.5
Operation and Maintenance	$244.4
Procurement	$118.9
RDT&E	$69.0
Revolving Funds	$1.3
Family Housing	$1.3
Military Construction	$6.9
Total	**$580.3**

B16-17

Key themes were:

- Seek a balanced force;
- Manage enduring readiness challenges;
- Continue to focus on institutional reform;
- Pursue investments in military capabilities;
- Provide for the people;
- Support overseas contingency operations.

Despite decreasing resources, the Department must continue to maintain its decisive technological edge.

Seek a Balanced Force

The United States continues to face a rapidly changing security environment as warfare evolves across all domains. The Department must maintain ready forces with superior capabilities to deter potential adversaries and defeat attacks across full spectrum of conflict while addressing a wide range of security challenges. In addition, DoD must sustain robust investments in science, technology, research and development in areas most critical to meeting future challenges, including areas with the potential for game-changing advances.

As outlined in the January 2012 *Defense Strategic Guidance* and re-emphasized in the 2014 QDR, the FY 2016 budget reflected the choices made to achieve a modern, ready, and balanced force to meet the full range of potential military requirements. The U.S. Joint Force will be smaller and leaner, but more agile, flexible, ready to deploy, innovative, and technologically advanced. With the drawdown of U.S. Military commitments well underway in Afghanistan, the Army and the Marine Corps will no longer need to be sized to support the kind of large scale, long-term stability operations that dominated the past decade. However, as each Service reduces its end strength levels, the reductions are structured and paced to support surge, regeneration, and mobilization capabilities needed for contingencies. Both the Army and the Marine Corps made significant progress toward achieving their targeted Active Component goals of 450,000 and 182,000 end strength, respectively, while each of the other Services continue to balance and realign forces to meet global demands requiring slight increases in end strength (less than 2,000 per Service).

Reserve Components are an important element of the Total Force, and the Department is focused on optimizing the Active/Reserve force mix while sustaining readiness at appropriate levels. The reserves are trained, ready, and cost-effective forces that can be employed on a periodic operational basis while ensuring strategic surge capabilities for large-scale contingencies or other unanticipated national crises. Since the September 11 terrorist attacks, more than 933,000 Reserve Component members have been mobilized or served on active duty in support of OCO and 27,000 reservists were active at the end of FY 2016. The National Guard and Reserves consistently demonstrate their readiness and ability to make sustained contributions to national security challenges.

Maintaining this balance is essential to fund the warfighting capabilities needed to maintain the Joint Force and to send U.S. personnel into combat with the best possible training and equipment.

Manage Enduring Readiness Challenges

The 2014 QDR highlighted the importance of and commitment to maintaining ready and capable forces. The Department continued initiatives started in the FY 2014 budget to transition from a force largely focused on current operations to one capable of meeting a broader mission portfolio. In FY 2016, U.S. Military Forces were postured globally to conduct counterterrorism, stability, and deterrence operations; maintain a stabilizing presence; conduct bilateral and multilateral training to enhance U.S. security relationships; and provide the crisis response capabilities required to protect U.S. interests. Readiness investments in training technologies; force protection; command and control; and intelligence, surveillance and reconnaissance systems strengthened United States to stand as the most formidable military force in the world. The investments made in full-spectrum readiness focused on yielding a smaller but more ready and capable force.

U.S. Army Spc. Scarlett Mitchell, with U.S. Army Garrison Benelux, zeroes an M4A1 carbine in the Training Support Center's 25-meter indoor range, in Chièvres, Belgium, Aug. 24, 2016.

U.S. Army photo by Pierre-Etienne Courtejoie

Continue to Focus on Institutional Reform

In FY 2016, the Department identified concrete, measurable management reforms in areas such as Major Headquarters Activities (MHA), Service Requirements Review Board (SRRB), Business Optimization, and Financial Improvement and Audit Readiness (FIAR). This collective effort is aimed at generating savings which can be reallocated to higher priority needs such as strengthening the foundation and structure of our military and capabilities, and continuing to be careful stewards of taxpayer dollars.

In June 2015, the Department began work on the development of a consistent, defensible framework for MHA and a process for reliable tracking and reporting. The Deputy Secretary of Defense (DepSecDef) approved the framework in August 2015, and it was codified in the FY 2016 National Defense Authorization Act (NDAA). The application of the revised MHA framework to the workforce continued throughout FY 2016 and its application to the workforce required collaboration across DoD Components and the development of business rules for consistency. Baselines were developed using FY 2016 as the base year, with application of the framework accomplished by organization. A phased approach for the completion of the FY 2016 baseline was employed across the Department.

The Department continues to seek opportunities to improve efficiency and reduce the cost of managing headquarters. In FY 2016, the SRRB conducted 20 Senior Review Panels, and reviewed the results of 50 organizations within the Fourth Estate. Through this effort the SRRB improved overall performance, strengthened business operations and achieved cost savings that can be transferred to higher priority needs.

The Department continues to improve business operations and governance over defense business systems. Measuring the net benefits ratio associated with discretionary development and modernization of Information Technology (IT) investments, DoD has currently identified $241.3 million in savings for Defense Programs over FY 2017-2021. These reviews allow the Department to understand and better manage its costs associated with database systems' modernization and/or development across the Defense Business Mission Area. Furthermore, DoD enhances and implements financial policies and processes to streamline, simplify, and standardize the financial management business and systems environment to improve efficiencies and reduce costs for key end-to-end processes and data exchanges.

Pursue Investments in Military Capabilities

Better Buying Power (BBP) is the implementation of best practices to strengthen the Department's buying power, improve industry productivity, and provide an affordable, value-added military capability to the warfighters. Launched in 2010, BBP encompasses a set of fundamental acquisition principles to achieve greater efficiencies through affordability, cost control, elimination of unproductive processes and bureaucracy, and promotion of competition. The BBP initiatives also incentivize productivity and innovation in industry and government, and improve tradecraft in the acquisition of services. By placing stronger emphasis on innovation, technical excellence, and quality of products, the Services realized $6.8 billion in cost savings. Furthermore, the Space Launch Services achieved $4 billion in savings due to refined acquisition processes, and the Defense Contract Management Agency realized $225 million in savings through processing time improvement.

The Department's research and development efforts are conducted by government laboratories, nonprofit research institutions, and defense companies both large and small. The FY 2016 resources included $12.5 billion in science and technology to support groundbreaking work in the Military Services, DoD laboratories and engineering centers across the country, and the Defense Advanced Research Projects Agency to develop and advance technologies and capabilities. These investments in technologically advanced weaponry are designed to yield a military force that achieves the nation's security objectives and ensures that the United States remains a technologically superior global force to promote peace and security. Additionally, the Defense Innovation Initiative (DII) is a new Department-wide effort to identify and invest in unique ways to advance U.S. Military superiority, including investments, and incentivizing industry and government's productivity and innovation in: 1) a long-range research and development program designed to identify new technologies and their uses; and push the envelope in new technologies like data science, biotech, cyber, and electronic warfare; 2) innovative leadership; 3) war-gaming; 4) operational concepts; and 5) innovative business practices. Advancing undersea capabilities and developing new hypersonic missiles, artificial intelligence, autonomy and robotics, DoD continues to invest in new strategic approaches and capabilities to prevent and win conflicts against 21st century threats.

Staff Sgt. Nicholas Scheer, 788th Civil Engineer Squadron, explosive ordinance disposal technician briefs Geoff Daniels, Southwest Ohio Regional Representative for U.S. Sen. Sherrod Brown, on the capabilities of one of their robots during a tour of Wright-Patterson Air Force Base, Ohio, July 26, 2016. In addition to EOD, Daniels also visited the 88th Communication Squadron and other locations.

U.S. Air Force photo by Wesley Farnsworth

Moreover, DoD is investing in innovation by developing new partnerships with the private sector and technology communities across the country through collaboration of government and industry innovative technology experts that make up the Defense Innovation Unit-Experimental (DIUx). The Department directed $30 million in FY 2016 to non-traditional companies with emerging commercially-based technologies that meet the Department's military needs, channeling resources into systems that will give future warfighters a battlefield advantage, and sustain continued pursuit of investments in military capabilities such as the F-35A, the latest addition to Air Craft Carriers (ACC's) fleet of deployable and fifth-generation aircraft. The aircraft provides air superiority, interdiction, and suppression of enemy air defenses. It will provide pilots with unprecedented situational awareness of the battlespace that will be more extensive than any single-seat platform in existence.

Furthermore, FY 2016 resources advanced the Nation's commanding lead in undersea capabilities by purchasing Virginia-class attack submarines over the next 5 years. Four of those submarines will be equipped with the versatile Virginia Payload Module. The Payload Module would increase the total number of torpedo-sized weapons carried by the Virginia-class design from an estimated 37 to 65 resulting in an increase of about 76 percent.

Provide for the People

The Department's workforce, assigned or deployed worldwide, requires diverse talent from the lowest to highest grades and ranks. The Department's commitment to a generous compensation package for those individuals willing to serve their country voluntarily is evidence in an examination of the annual budget request and demonstrate by the number of initiatives and programs that support their professional development and their personal and family lives. In FY 2016, approximately $139 billion supported over 2.5 million Active and Reserve members; another $250 billion was used for operations and maintenance costs.

Comprising nearly half of DoD's budget, military and civilian personnel costs are the Department's single largest expense category. To meet the needs of our diverse workforce and mission set, the Department provides not only highly competitive monetary compensation but also manages the Military Health System (MHS) and operates schools, grocery stores, restaurants, childcare facilities, and a myriad of other programs to support service members and their families worldwide. The MHS is a complex system that incorporates health care delivery, medical education, public health, private sector partnerships, and cutting edge medical research and development. The MSH provides health care for 9.4 million eligible beneficiaries including all service members, retirees and their families, dependent survivors, and certain eligible Reserve Component members and their families.

The Department is vigilant in its efforts to ensure these costs are appropriately balanced against the Department's strategic goals. Specifically, the Department cannot allow its personnel costs to crowd out investments in the readiness and modernization that are essential to providing the training and equipment needed to accomplish the vast array of missions undertaken around the globe. Balancing resources is essential as the Department reshapes the forces needed to remain effective, and providing a robust pay and benefits package must be sustained to execute the Nation's defense strategy.

Against the backdrop of a healthy and competitive military compensation package, the Department has done a significant amount of work to explore how it can balance the rate of growth in military pay, benefit costs, and individual compensation incentives in a way that is both responsible and fair. In FY 2016, Congress accepted a presidentially determined 1.3 percent basic pay raise versus the 2.3 percent that would have occurred by operation of law. Congress authorized monthly basic allowance for housing rates to be set at 95 percent (versus 99 percent) of the median rental housing costs, phased in at 1 percent increments over 4 years.

Additionally, in the NDAA for FY 2016, Congress enacted the Blended Retirement System, a new retirement system for military members effective as of January 1, 2018. The system combines the traditional defined benefit of monthly retired pay with a defined contribution benefit through contributions to a member's Thrift Savings Plan account. While all currently serving members are grandfathered under the current retirement system, those with fewer than 12 years of service as of January 1, 2018 will have the opportunity to choose whether to remain under the current system or opt into the Blended Retirement System. Members who join on or after January 1, 2018 will automatically be covered by the Blended Retirement System. Although only 19 percent of entering military members today serve the full 20 years necessary to receive a retirement benefit under the current retirement system, under the Blended Retirement System, 85 percent of those who join will receive some form of retirement benefit if they serve at least 2 years.

The military life cycle is complex, dynamic, and key to military readiness. The Department must attract nearly 250,000 qualified new recruits to replenish the military workforce each year. Suicides and sexual assaults have also become major focus areas that require resources to combat. Despite global and fiscal challenges, the Department stands with service members, their families, retirees, and the civilian workforce. However, 15 years of war have taken a toll on the All-Volunteer Force. Multiple deployments with less respite between them, extensive use of the Guard and Reserves, and the force reductions that will take place over the next few years all contribute to a more complex and demanding environment. Declining budgets make it harder to reset the Force while sustaining the readiness needed for requirements such as deterring ISIL and responding to the Ebola outbreak. Caring for DoD's people remains a top priority for the Department, Congress, and the Administration.

U.S. Army Staff Sgt. Leonard Sims, an infantryman assigned to the 2nd Battalion, 135th Infantry Regiment, Minnesota Army National Guard, provides security for Montenegrin soldiers with the 1st Infantry Unit, Montenegro Armed Forces, crossing a bridge during react to contact drills of exercise Immediate Response, at the Croatian Armed Forces training area in Slunj, Croatia, Sept. 12, 2016. Immediate Response is a U.S. Army Europe-led combined joint tactical field training exercise designed to build interoperability between NATO

U.S. Army photo by Staff Sgt. Opal Vaughn

Support Overseas Contingency Operations

The Department received $58 6 billion of Overseas Contingency Operations (OCO) funds primarily to conduct Operation Freedom's Sentinel (OFS) and other missions outside of Afghanistan (e.g., Horn of Africa (HOA)), Operation Inherent Resolve (OIR), and post-Operation New Dawn activities. These funds were also used to train and equip Iraqi security forces and vetted Syrian opposition forces, support European partners, and respond to terrorist threats. Additionally, Congress increased the Department's OCO request to fund some readiness requirements transferred from the base budget request, National Guard and Reserve Equipment, and improve intelligence, surveillance, and reconnaissance.

LOOKING FORWARD

Beyond FY 2016, the strategic priorities identified in the *QDR 2014* remain the Department’s top priorities: rebalancing to the Asia-Pacific region, maintaining a strong commitment to security and stability in Europe and the Middle East, sustaining a global counterterrorism campaign, strengthening key alliances and partnerships, and prioritizing key modernization efforts. The Department will also continue the fight against ISIL and other terrorist networks, address North Korean provocation, Russian aggression, and address adversaries against our friends and allies in the Middle East.

As reflected in the QDR, the current strategic and budgetary environment compels us to think creatively about how we can restore the readiness of the force, while remaining globally engaged. The Department seeks to achieve full-spectrum combat readiness in the FYs 2021-2023 timeframe for the Army; for the Navy and Marine Corps it is estimated to be just outside the Future Years Defense Program (FYDP); and for the Air Force 8-10 years once conditions for recovery are set. More stable funding over the last two years has enabled measured progress, but funding alone is not sufficient for the Services to recuperate full-spectrum readiness. The Services require a combination of time, stable readiness funding profiles, and a balance between steady-state and contingency demand.

We are at a strategic turning point in the post-Cold War world. As Russia continues to act aggressively in its immediate periphery and beyond, Russia is modernizing both its nuclear and conventional military capabilities, and updating its warfighting doctrine. Although China’s rise is welcome, its increasing assertiveness in the South China Sea and elsewhere is out of step with international norms, and is increasing demand for our engagement in the Asia-Pacific region. Meanwhile, the U.S. Military’s technological edge, which we have relied upon for so long, is eroding. The resurgence of Russia and the rise of China will require that we exercise strategic muscles that we have allowed to atrophy since the end of the Cold War. The world cannot afford for U.S. leadership to waiver.

In the two years since the launch of the Defense Innovation Initiative (DII) and Third Offset Strategy, an ambitious Department-wide effort overseen by the Deputy Secretary, Robert O. Work, we are identifying and investing in innovative ways to sustain and advance U.S. Military dominance for the 21st century.

Finally, as we continue to address the challenges outlined above, we will strive to preserve our most enduring and competitive advantage – our people. Under the Force of the Future Initiative, the Department intends to improve the recruitment and retention of the brightest and most committed young men and women and make Defense the most rewarding environment it can be, for those who choose to serve.

ORGANIZATION

The Department maintains and uses armed forces to support and defend the Constitution and protect the security of the United States, its possessions, and areas vital to its interest. This mission depends on our military and civilian personnel and equipment being in the right place, at the right time, with the right capabilities, and in the right quantities to protect our national interests. This has never been more important as the United States fights terrorists who plan and carry out attacks outside the traditional boundaries of the battlefield.

The Department is one of the nation's largest employers, with approximately 1.3 million personnel in the Active Component, more than 810,000 personnel serving in the National Guard and Reserve forces, and about 750,000 civilians. Our Military Service members and civilians operate in every time zone and in every climate. There are also nearly 2.3 million military retirees, family members, and survivors receiving benefits.

Chief Master Sgt. Pete Webb, 919th Special Operations Wing, hands off the American flag to the color guard detail prior to the 9/11 Memorial Ceremony Sept. 11 at Duke Field, Fla. The flag used for the ceremony was also used during the 24-hour memorial stair climb event.

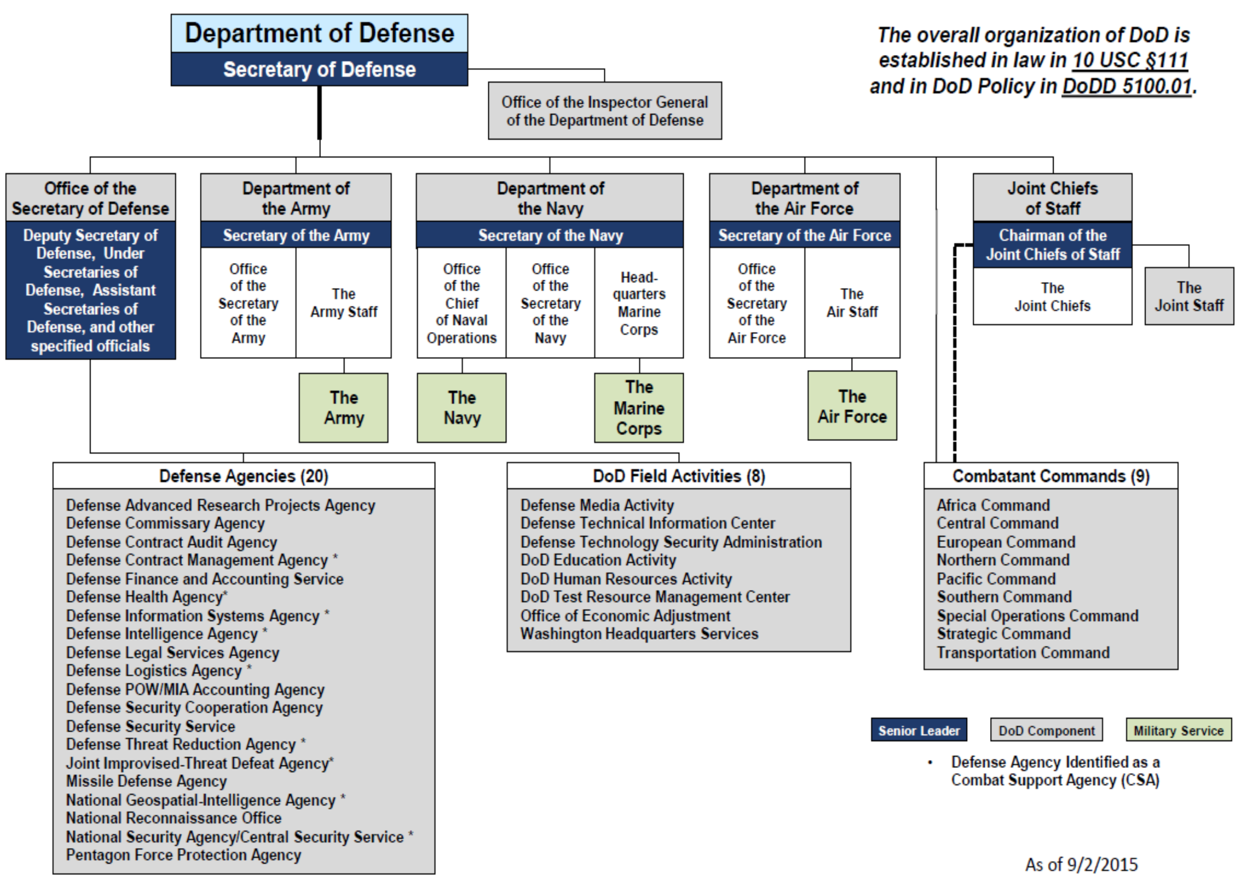
U.S. Air Force photo/Tech. Sgt. Sam King

The Department manages a worldwide real property portfolio that spans all 50 states, U.S. territories and many foreign countries. The Department's real property infrastructure includes more than 571,000 facilities (buildings, structures and linear structures) located in more than 4,903 sites worldwide. These sites represent more than 26.3 million acres that individually, range in size from training ranges to approximately 3 million acres, such as Range No.1 at Nellis Air Force Base, to single weather towers or navigational aids isolated on sites of less than one one-hundredth (0.01) of an acre. Of the land DoD manages, only 36 percent is held by DoD in fee interest. The remaining acres are controlled through other legal means such as leases, licenses, permits, public land orders, treaties, and agreements. Beyond the mission specific areas of installations such as runways, training areas, and industrial complexes, DoD installations also contain many facilities and operations found in municipalities or on university campuses such as hospital and medical facilities, public safety facilities, community support complexes, housing and dormitories, dining facilities, religious facilities, utility systems and roadways. To protect the security of the United States, the Department operates 14,140 aircrafts and 275 Battle Force ships.

The Secretary of Defense is the principal assistant and advisor to the President in all matters relating to the Department, and he exercises authority, direction, and control over the Department. The Department is currently composed of the Office of the Secretary of Defense (OSD), Joint Chiefs of Staff, Joint Staff, Office of the Inspector General of the DoD (DoD IG), Military Departments, Defense Agencies, DoD Field Activities, Combatant Commands, and other offices, agencies, activities, organizations, and commands established or designated by law, the President, or the Secretary of Defense.

The operational chain of command runs from the President to the Secretary of Defense to the Commanders of the Combatant Commands. The Chairman of the Joint Chiefs of Staff functions within the chain of command by transmitting to the Commanders of the Combatant Commands the orders of the President or the Secretary of Defense.

Figure 2. Department of Defense Organizational Structure



The Office of the Secretary of Defense

The function of OSD is to assist the Secretary of Defense in carrying out his duties and responsibilities and other duties as prescribed by law. The OSD is composed of the Deputy Secretary of Defense, who also serves as the Chief Management Officer and Chief Operating Officer; the Under Secretaries of Defense (USDs); the Deputy Chief Management Officer (DCMO); the Department of Defense Office of the General Counsel (DoD OGC); the Assistant Secretaries of Defense (ASDs); the Assistants to the Secretary of Defense; the OSD Directors, and their equivalents; the DoD IG; and other staff offices within OSD established by law or by the Secretary.

The OSD Principal Staff Assistants (PSAs) are responsible for the oversight and formulation of defense strategy, policy, and resource allocation, as well as for overseeing and managing the Defense Agencies and DoD Field Activities (Figure 3).

Figure 3. Office of the Secretary of Defense Principal Staff Assistants

** Although the IG DoD is statutorily part of OSD and is under the general supervision of the Secretary of Defense, the Office of the IG DoD (OIG) functions as an independent and objective unit of the Department of Defense.*

The Joint Chiefs of Staff and the Joint Staff

The *Joint Chiefs of Staff*, supported through the Chairman by the Joint Staff, constitute the immediate military staff of the Secretary of Defense. The Joint Chiefs of Staff consist of the *Chairman*, the *Vice Chairman*, the *Chief of Staff of the Army*, the *Chief of Naval Operations*, the *Chief of Staff of the Air Force*, the *Commandant of the Marine Corps*, and the *Chief of the National Guard Bureau*. The Joint Chiefs of Staff function as the military advisors to the President, the *National Security Council*, the Homeland Security Council, and the Secretary of Defense.

Office of the Inspector General

The *DoD IG* is an independent unit within the Department that conducts and supervises audits and investigations relating to the Department's programs and operations. The DoD IG serves as the principal advisor to the Secretary of Defense on all audit and criminal investigative matters relating to the prevention and detection of fraud, waste, and abuse in the programs and operations of the Department.

Military Departments

The Military Departments consist of the Departments of the *Army*, the *Navy* (of which the *Marine Corps* is a Component), and the *Air Force*. Upon the declaration of war, if Congress so directs in the declaration or when the President directs, the *U.S. Coast Guard* becomes a special Component of the Navy; otherwise, it is part of the Department of *Homeland Security*. The three Military Departments organize, staff, train, equip, and sustain America's military forces and are composed of the four Military Services (or five when including the U.S. Coast Guard, when directed). When the President determines military action is required, these trained and ready forces are assigned or allocated to a Combatant Command responsible for conducting military operations.

Military Departments include Active and Reserve Components. The Active Component is composed of units under the authority of the Secretary of Defense manned by active duty Military Service members. The Reserve Component includes the Reservists of each Military Service and the *National Guard*, which has a unique dual mission with both Federal and State responsibilities (Figure 4). When commanded by the Governor of each State or territory, the National Guard can be called into action during local, statewide, or other emergencies such as storms, drought, civil disturbances, and in some cases supporting federal purposes for training or other duty (non-federalized service).

When ordered to active duty for national emergencies, units of the National Guard or Reservists of the Military Services are placed under operational control of the appropriate Combatant Commander. The National Guard and Reserve forces are recognized as indispensable and integral parts of the Nation's defense and fully part of the applicable Military Department.

Figure 4. Reserve Components: Reserves and National Guard

Federal Missions

United States Army Reserve

United States Navy Reserve

United States Air Force Reserve

United States Marine Corps Reserve

United States Coast Guard Reserve

Federal and State Missions

United States Air National Guard

United States Army National Guard

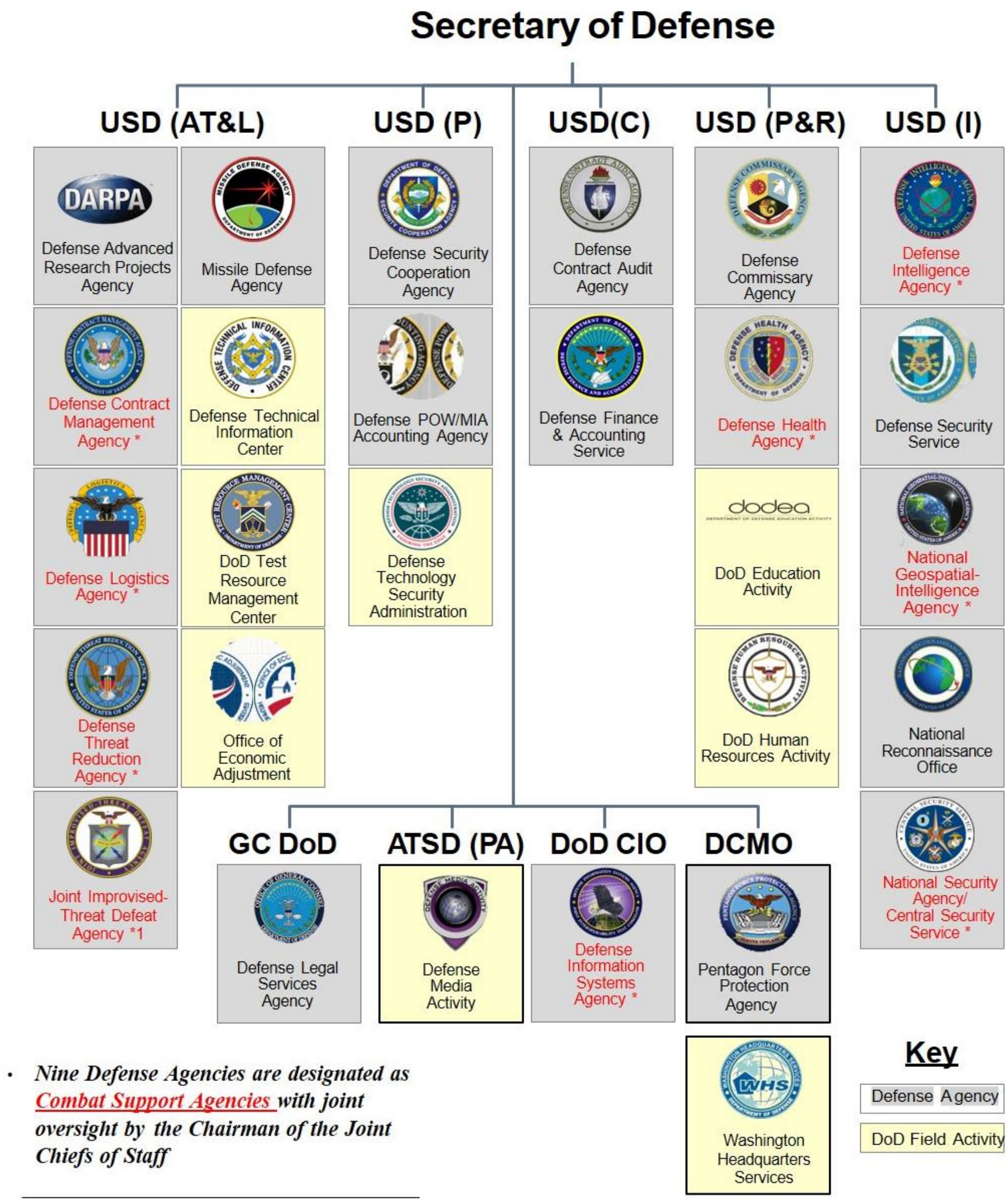
Defense Agencies and DoD Field Activities

Defense Agencies and DoD Field Activities (Figure 5) are established as DoD Components by law, the President, or the Secretary of Defense to provide, on a DoD-wide basis, a supply or service activity common to more than one Military Department when it is more effective, economical, or efficient to do so. Although Defense Agencies and DoD Field Activities fulfill similar functions, the former tend to be larger, normally provide a broader scope of supplies and services, and can be designated as Combat Support Agencies to support the Combatant Commands directly. Each of the 20 Defense Agencies and 8 DoD Field Activities operate under the authority, direction, and control of the Secretary of Defense through an OSD Principal Staff Assistant.

Women with a U.S. Marine Corps female engagement team operating in Europe interact with students at the Cambridge School of Constanta, Romania, Sept. 28, 2016. The Marines spent two weeks doing military-to-military and military-to-civilian engagements to enhance regional security and stability.

U.S. Marine Corps photo by Sgt. Michelle Reif

Figure 5. Defense Agencies and DoD Field Activities



[1] Effective at the beginning of FY 2017, JIDA is being re-aligned under DTRA.

Combatant Commands

The Commanders of the Combatant Commands (Figure 6) are responsible for accomplishing the military missions assigned to them. Combatant Commanders exercise command authority over assigned and/or allocated forces, as directed by the Secretary of Defense. The operational chain of command runs from the President to the Secretary of Defense to the Commanders of the Combatant Commands. The Chairman of the Joint Chiefs of Staff functions within the chain of command by transmitting the orders of the President or the Secretary of Defense to the Commanders of the Combatant Commands.

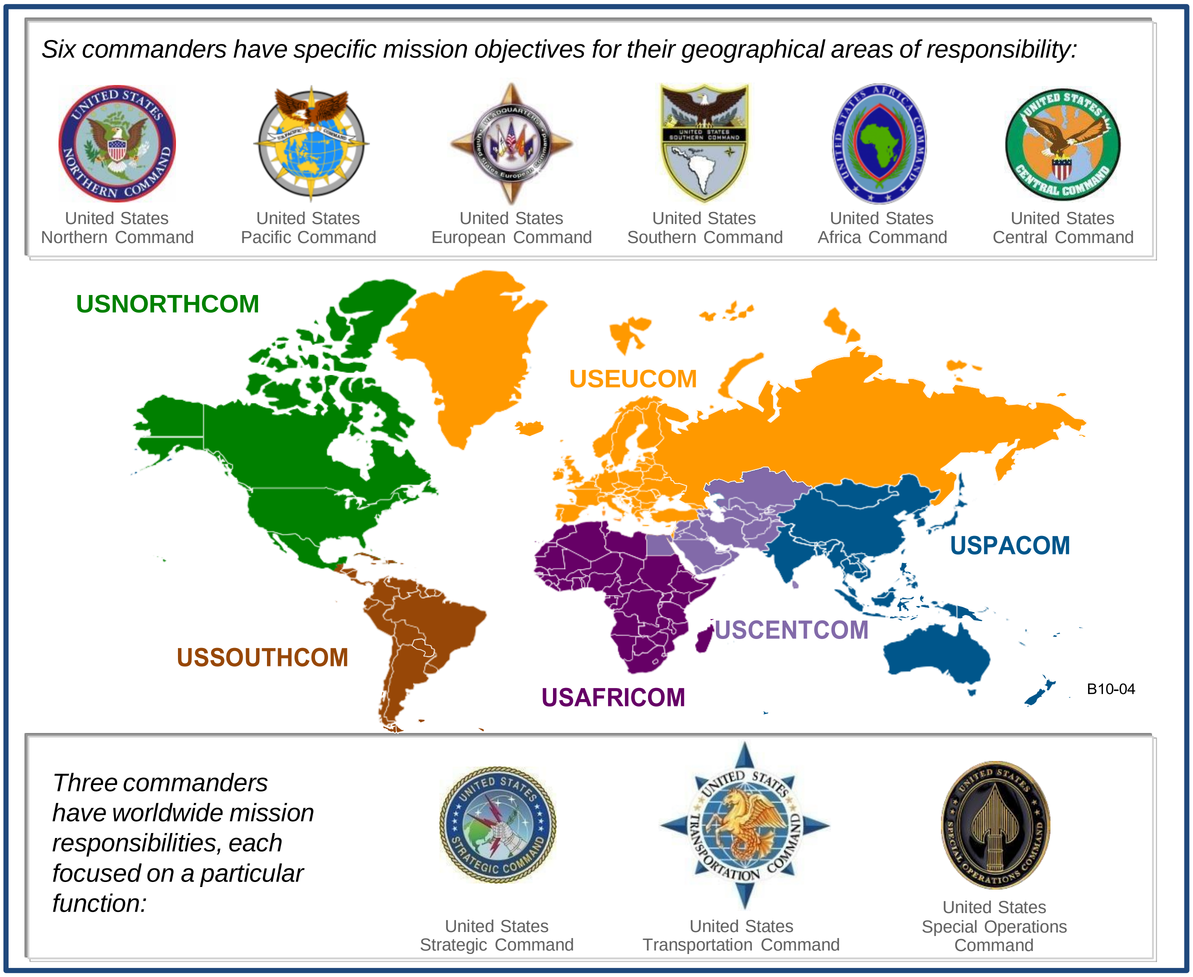
The *U.S. Strategic Command* (USSTRATCOM), *U.S. Transportation Command* (USTRANSCOM), and *U.S. Special Operations Command* (USSOCOM) are functional Combatant Commands, each with unique functions as directed by the President in the Unified Command Plan. Among Combatant Commands, the USSOCOM has additional responsibilities and authorities similar to a number of authorities exercised by the Military Departments and Defense Agencies, including programming, budgeting, acquisition, training, organizing, equipping, and providing Special Operations Forces (SOF), and developing SOF's strategy, doctrine, tactics, and procedures. The USSOCOM is reliant upon the Military Services for common support and base operating support.

Service members from various nations eat lunch together during the Non-Lethal Executive Seminar (NOLES) 2016 at Ulaanbaatar, Mongolia, Sept. 22, 2016. Eighteen nations participated in the senior military leaders' portion of the seminar. Both the United States and Mongolia have a continuing interest in strengthening their partnership with other Pacific nations, which will provide the cornerstone for security and stability in the region.

U.S. Marine Corps photo by Cpl. Jonathan E. LopezCruet

In addition to supplying assigned and allocated forces and capabilities to the Combatant Commands, the Military Departments provide administrative and logistics support by managing the operational costs and execution of these commands. The USSOCOM is the only Combatant Command directly receiving congressional appropriations.

Figure 6. Combatant Commands



PERFORMANCE OVERVIEW

The *Deputy Secretary of Defense*, as the Department's Chief Management Officer and Chief Operating Officer, is responsible for performance improvement within the Department. Each year, in accordance with public law and Office of Management and Budget (OMB) guidance[1], the Department develops and tracks performance measures to meet DoD strategic priorities.

The Department published an updated FYs 2015-2018 Agency Strategic Plan (ASP) version 2.0 in August 2016 in accordance with requirements of the Government Performance and Results Modernization Act (GPRAMA) of 2010. The Department's revised FYs 2015-2018 ASP strategic goals are:

- Strengthen and enhance the health and effectiveness of the total force;
- Defeat our adversaries, deter attacks, deny enemy objectives, and defend the Nation; and
- Achieve dominant capabilities through innovation, technical excellence, and defense institution reform.

These goals reflect the Secretary of Defense's three commitments, as outlined in the 2017 *Defense Posture Statement*, and further describe near and long-term agency priority and performance goals and the federal cross-agency priority (CAP) goals to which the Department contributes. The Department will continue to refine and mature its ASP to better inform internal and external stakeholders, enhance substance for improved decision-making, planning, alignment of actions, and resources to realize goals while also addressing requirements of GPRAMA. The Department's ASP builds from the strategic authorities and direction to align national defense efforts and resources to ultimately enable warfighter mission execution.

Sailors assigned to Coastal Riverine Squadron Two (CRS-2) prepare to deploy a Mark V Zodiac boat from a Mark VI Patrol Boat during Valiant Shield 2016 in Santa Rita, Guam, Sep. 17, 2016. Valiant Shield is a biennial U.S. Air Force, Navy and Marine Corps exercise held in Guam, focusing on real-world proficiency in sustaining joint forces at sea, in the air, on land and in cyberspace.

U.S. Navy Combat Camera photo by Mass Communication Specialist 1st Class Arthurgwain L. Marquez/Released

This section provides an executive level overview of DoD's performance through the third quarter, ending June 30, 2016, with FY 2016 end results published in the Annual Performance Report section of the Department's budget submission in February 2017.

[1] *Government Performance and Results Act of 1993 (GPRA) (Public Law 103-62)*; Government Performance and Results Modernization Act of 2010 (*GPRAMA*) (Public Law 111-352); *OMB Circular No. A-11*, Preparation, Submission, and Execution of the Budget

SUMMARY OF PERFORMANCE RESULTS

The Department has been successful in meeting many of the priority measures for third quarter, FY 2016, including those related to strengthening business operations; achieving efficiencies, effectiveness and cost savings; audit readiness; and ensuring our veterans are ready for their transition to civilian life.

At the end of the third quarter in FY 2016, 81 percent of DoD quarterly performance measures were on track to meet the annual goals, while 19 percent did not meet third quarter targets and could be considered at risk of not achieving annual targets. Of the remaining performance measures, 22 measures will be reported after the close of FY 2016. A selection of Departmental successes and areas for improvement are highlighted below.

Processing Wounded Warriors Through the Integrated Disability Evaluation System

Our Nation continues its commitment to support and care for those who keep our country safe. Providing top-quality physical and psychological care to wounded warriors and assisting with their transition to veteran status is a Department priority. In FY 2016, the Department continued its collaboration with the U.S. Department of Veterans Affairs (VA) to accelerate the transition of wounded, ill, and injured Service members into Veteran status by reducing disability evaluation processing time.

Soldiers defeat Marines to win gold in wheelchair basketball during the 2016 Department of Defense Warrior Games at the U.S. Military Academy in West Point, N.Y., June 21, 2016.

Photo by Roger Wollenberg

The Integrated Disability Evaluation System (IDES) is the mechanism the Department uses to determine if Service members coping with wounds, injuries, or illnesses that may prevent them from performing their duties are able to continue serving. IDES is a joint process established by the VA and the Department that eliminates duplicate Departmental disability examinations and ratings to provide more consistent disability determinations between Departments. IDES provides Service members more consistent access to accurate and timely information about the disability process and reduces the time Service members wait after discharge from Military Service to receive VA disability benefits and compensation.

The Department continues working with the Military Departments and the VA to improve the efficiency of the IDES which has had a distinct effect on IDES performance, most notably in reducing the time for Service members to complete the process. The Department exceeded its IDES performance measure target in support of the Agency Priority Goals (APG) for the first

(82 percent), second (86 percent), and third (84 percent) quarters of FY 2016. The performance measure combines the outcomes of timeliness for completing Department core IDES processes, service member satisfaction with DoD management of their case, the accuracy and consistency of Military Department disability determinations, and compliance with administrative processing requirements.

Reform the DoD Acquisition Process

In support of the BBP initiative, the Under Secretary of Defense for Acquisition, Technology, and Logistics (USD(AT&L)) directed the acquisition professionals in the Department to deliver better value to the taxpayer and warfighter by improving the way the Department does business. Next to supporting the Armed Forces at war, this was the President's and Secretary of Defense's highest priority for the Department's acquisition professionals. The Department is committed to procuring the critical goods and services for the U.S. Armed Forces in the years ahead in the most cost-effective manner. DoD Components have incorporated BBP concepts into their policies and practices for the acquisition of weapon systems, goods, and services by instilling a cost-conscious culture and improving the workforce's ability to adapt and apply the best approach for each situation. These efforts are enhanced by continuing analysis of Defense acquisition processes as described in the annual Performance of the Defense Acquisition System report. This report adds insight and gauges progress that results in improvements in APG measures, showing positive trends and areas for improvement. The next step in the BBP continuum is BBP 3.0, Achieving Dominant Capabilities which places an additional emphasis on innovation, technical excellence, and quality of products.

Numerous barriers have impeded the Department's efforts to increase competition rates including fewer new programs; budget constraints limiting funding for the purchase of technical data packages; extended Continuing Resolutions necessitating sole-source "bridge" contracts to avoid program disruptions; more programs past the stage where competition is economically viable; and lack of technical data packages and data rights on prior mature and aging aircraft programs.

DoD Components continue to incorporate BBP concepts into their acquisition programs, resulting in sound programs where requirements and resources are matched at program initiation.

Achieving Audit-Ready Financial Statements

The *NDAA for FY 2010*, as amended, mandated the Department have full financial statements validated as ready for audit by September 30, 2017. Accordingly, the Department has made this requirement a DoD priority goal. In FY 2017, 85 percent of the Department's total budgetary resources (both General Fund and Working Capital Fund) and 43 percent of the Department's total assets will be under audit.

The Department is continuing with the Schedule of Budgetary Activity (SBA) audits and expanding the scope to include the remaining statements by FY 2018, while sustaining a more disciplined environment, until full audit readiness is achieved. FY 2016 marks a shift in the focus from audits of the SBA to audits of all four principle financial statements, increasing the magnitude and complexity level of preparing for audit. Strategically, we have a keen focus on addressing critical capability areas which include: establishing a universe of transactions (UoT); reconciling our fund balance with the Department of the Treasury; properly supporting our journal voucher adjustments; establishing an auditable existence and completeness, and valuation baseline, and go forward process for our property assets; establishing an auditable process for identifying, valuing and recording environmental and disposal liabilities; and implementing critical information technology general and application controls for material, financially relevant systems.

The Department continues to make progress and monitor remediation activities in these critical capability areas. Progress includes issuing policies to generally enforce standards and requirements; building data repositories and processes to collect and reconcile financial data; reconciling and researching differences with Treasury; performing physical inventories for our property assets; and working with system program managers and IT communities to identify the necessary system controls and integrated processes.

The sheer size of the Department and volume of financial transactions processed daily, directly impacts the challenges we continue to face. Challenges remain to include non-standard business processes and data; disparate IT systems; lack of front-end system edit checks and controls; and the need to protect sensitive activities. The Department will continue focusing on establishing and implementing sound processes and policies in these critical capability areas, while working in parallel to resolving known deficiencies.

A U.S. Air Force C-130 Hercules from Yokota Air Base, Japan, taxies to its ramp position following the first bilateral mission of the current iteration of a rotational Air Contingent at Brigadier General Benito N. Ebuen Air Base, Lapu-Lapu City, Philippines, Sept. 26, 2016. Two C-130 Hercules aircraft and crews from 374th Airlift Wing, Yokota Air Base, Japan, the 36th Contingency Response Group from Andersen Air Force Base, Guam, and other units from across U.S. Pacific Command will conduct bilateral training missions and subject matter expert exchanges alongside their Philippine Air Force counterparts. The Air Contingent is helping to build the capacity of the Philippine Air Force and increases joint training, promotes interoperability and provides greater and more transparent air and maritime situational awareness to ensure safety for military and civilian activities in international waters and airspace. Its missions include air and maritime domain awareness, personnel recovery, combating piracy, and assuring access to the air and maritime domains in accordance with international law.

U.S. Air Force photo by Capt. Mark Lazane

Energy

Improving facility energy performance at DoD installations will lower energy costs, improve energy security, improve mission effectiveness, and reduce reliance on fossil fuels. Efficiencies will be achieved by reducing the demand for traditional energy. Legislation mandates a 3 percent annual reduction in facilities energy intensity as measured in British Thermal Units per gross square foot. The Department has pursued a facility energy investment strategy designed to reduce the energy costs and improve the energy security of our bases.

Despite falling short of the FY 2015 intensity reduction goal of 30 percent, the Department reduced its energy intensity by 19.9 percent from the FY 2003 baseline and improved by 2.2 percent over FY 2014. The FY 2015 results from the baseline for FYs 2016 – 2025 timeframe, wherein the annual goal is to reduce intensity by 25 percent or an average of 2.5 percent per year. While the Department continues to invest in cost-effective energy efficiency and conservation measures to improve goal progress, there will be challenges in future reductions. Facility energy metrics are reported on an annual basis.

Contract Obligations That Are Competitively Awarded

The BBP initiatives are aimed at achieving greater efficiencies through affordability and cost control. An element in achieving these objectives is the promotion of effective competition. For the third quarter of FY 2016, the Department achieved a competition rate of 49.8 percent. Based on current projections, the Department does not anticipate achieving the FY 2016 goal of 57 percent.

Competition achievement by contracting organizations varies widely based upon the mission and type of supply or service being procured. The Department continues to take steps to increase competition for major systems by introducing competition during the sustainment phase of a product's life cycle. DoD continues to emphasize the importance of maximizing opportunities for competitive contracting on a recurring basis at the Business Senior Integration Group meetings. In this forum, the Service Acquisition Executives discussed successes and challenges; results achieved by categories of supplies and services and/or by Program Executive Offices or Commands; strategies for introducing competitive pressures for future high dollar buys; and Contracting Enterprise Reviews.

The Defense Acquisition University's 2016 Acquisition Training Symposium included breakout sessions on the subject of competition. The Deputy Director of Contract Policy and International Contracting began each session with an overview of DoD competition policy and statistics. The Component Program Offices and Contracting Leaders gave presentations highlighting the acquisitions, programs, policies and/or initiatives to improve competition and reduce barriers to competition. Examples included the Air Force's Thule Base Maintenance Contract Competition; the Army's TACOM Warren Competition Initiatives; Marine Corps Land Systems Amphibious Assault Vehicle Competitive Acquisition Strategy; and Defense Logistics Agency's Increasing Competition efforts. Defense Procurement and Acquisition Policy plans to continue holding competition sessions and exchanges to promote knowledge sharing and best practices amongst the acquisition workforce.

Summary

The Department is a performance-based organization. As a performance-based organization, the Department is committed to specific and measurable goals based on a defined mission, using performance data to continually improve operations. The Department has maintained its commitment to veterans transitioning into the civilian workforce; and its commitment to pursuing improvement opportunities related to acquisition reform and financial audit readiness.

Rico, 2nd Security Forces Squadron Military working dog, plays with a toy after completing an explosives/narcotic detection training at Barksdale Air Force Base, La., July 19, 2016. MWD teams train about 15 hours weekly, rotating between scenarios involving explosive/narcotic detection, law enforcement, deployment and patrol exercises.

U.S. Air Force photo/Senior Airman Mozer O. Da Cunha

FINANCIAL OVERVIEW

The previous sections of this report provide a description of the Department's operations in FY 2016 and a high-level overview of the Department's performance against objectives as of the third quarter of FY 2016. The FY 2016 final results for all Department performance measures will be reported in the Department's Annual Performance Report, which will be available in February 2017.

Figure 7. DoD FY 2016 Financial Activities Processed by DFAS

Description	FY 2016
Number of Pay Transactions	$122.4 Million
Number of Commercial Invoices Paid	$11.7 Million
Number of Travel Payments	$5.8 Million
Number of General Ledger Accounts Managed	$151.8 Million
Amount Disbursed	$534.5 Billion
Intragovernmental Payments (IPAC)	$103.7 Billion
Amount of Military Retirement and Health Benefits Funds Managed	$899 Billion
Foreign Military Sales Cases Reimbursed by Foreign Governments	$479 Billion

The Department's challenges in producing auditable financial statements persist, and management is unable to provide unqualified assurance as to the effectiveness of our internal controls over financial reporting, operations, and financial management systems. The Department's unique size and mission are part of the challenge in achieving a financial statement audit. For example, Figure 7 shows the magnitude of DoD financial activities processed by the Defense Finance and Accounting Service *(DFAS)* in FY 2016, and does not include transactions processed by other DoD entities, such as the *U.S. Army Corps of Engineers* or the *Defense Health Agency*.

FINANCIAL HIGHLIGHTS AND ANALYSIS

The principal financial statements have been prepared to report the financial position and results of operations of the Department, pursuant to the requirements of *31 U.S.C. 3515 (b)*. The statements have been prepared from the accounting records of the Department in accordance with *OMB Circular No. A-136, Financial Reporting Requirements*, and to the extent possible, U.S. Generally Accepted Accounting Principles (GAAP) for Federal Entities, and the DoD *Financial Management Regulation*. The statements, in addition to supporting financial reports, are used to monitor and control budgetary resources. The statements should be read with the realization that they are for a Component of the U.S. Government, a sovereign entity.

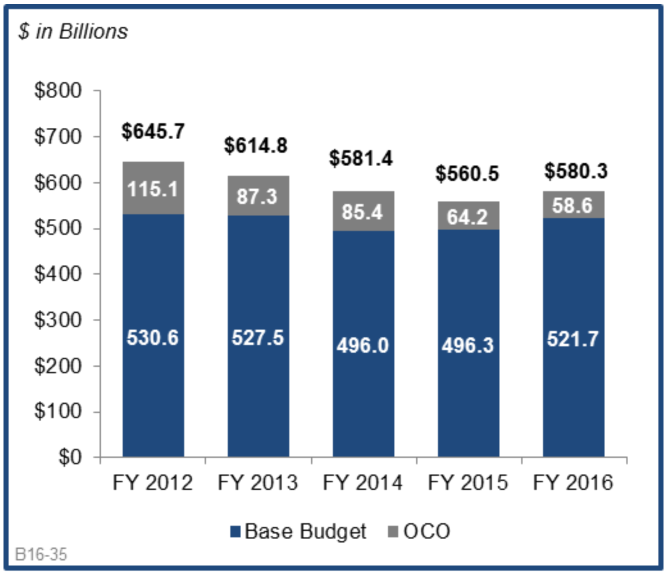
DFAS prepared the consolidated financial statements and explanatory notes, located in the Financial Information section of this report. The principal financial statements include:

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

Statement of Budgetary Resources

One of the most critical financial improvement and audit readiness priorities in the Department involves the processes, controls, and systems that support information most often used to manage the Department, namely, budgetary resources. The Statement of Budgetary Resources (SBR) presents the Department's total budgetary resources, their status at the end of the year, and the relationship between the budgetary resources and the outlays made against them. In accordance with federal statutes and implementing regulations, obligations may be incurred and payments made only to the extent that budgetary resources are available to cover such items. As discussed in the DoD Overview section of this report and as depicted in Figure 8, the Department's FY 2016 budget authority total is $580.3 billion.

Figure 8. Trend in DoD Budget Authority



In FY 2016, the Department reported $1.1 trillion in total budgetary resources (as shown in Figure 9). The total appropriations amount of $745.7 billion, reported on the SBR, consists of DoD budget authority and appropriations provided by the U.S. Treasury for DoD military retirement and health benefits. The Department also receives appropriations to finance civil work projects managed by the USACE. Current year Trust Fund receipts, including the Military Retirement Fund and the Medicare Eligible Retiree Health Care Fund, are also included in the SBR "Total Appropriations" line. Trust fund receipts, labeled "Temporarily not available," represent budget authority the Department will execute in future years to pay the current unfunded liabilities carried in these large funds.

Figure 9. Composition of DoD Total Budgetary Resources

Description	FY 2016 ($ in Billions)
DoD Enacted Appropriations *	$ 580.3
U.S. Treasury contribution for Military Retirement and Health Benefits	90.2
Civil Works Projects executed by the USACE	4.6
Trust Fund Receipts	141.2
Trust Fund Resources Temporarily not Available	(70.6)
Total Appropriations Reported on SBR	**$ 745.7**
Unobligated Balances from Prior Year Budget Authority	180.4
Spending Authority from Offsetting Collections	105.9
Contract Authority	69.7
Total Budgetary Resource	**$ 1,101.7**
* DoD 2016 Budget Authority from Figure 1	

Additional budgetary resources include $180.4 billion of unobligated balances stemming from prior year budget authority, $105.5 billion in spending authority from offsetting collections, and $69.7 billion of contract authority.

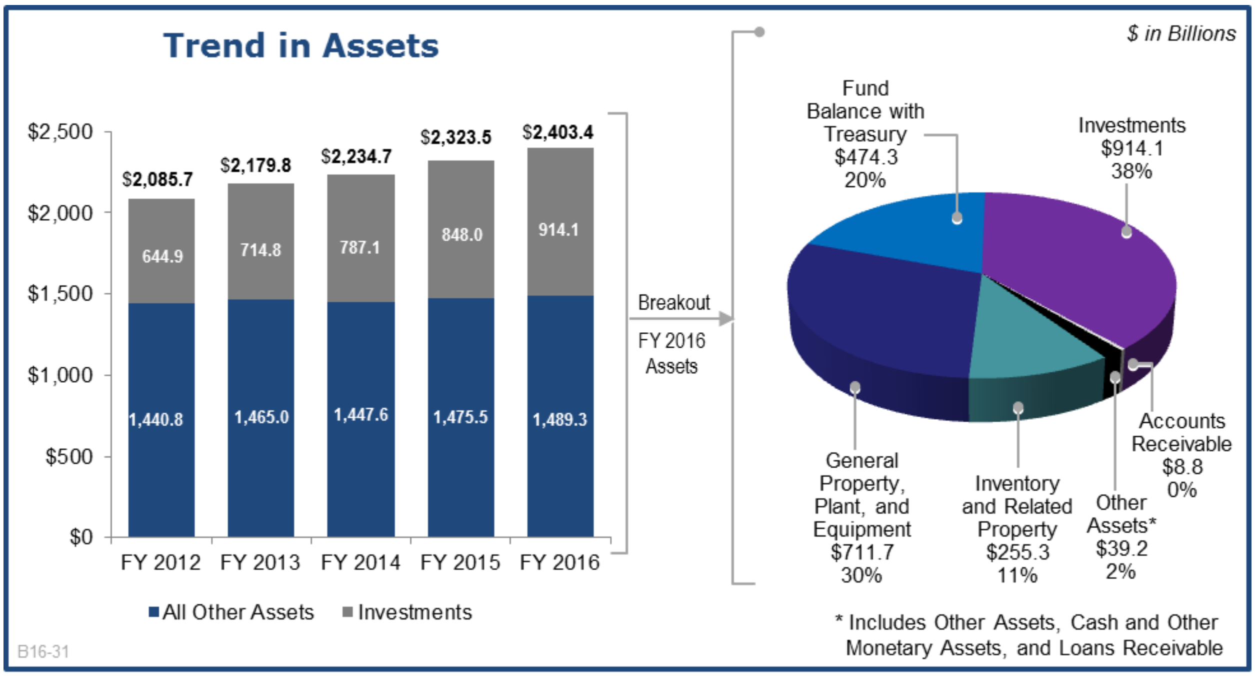
Of the $1.1 trillion in total budgetary resources, $945.7 billion was obligated and $895.6 billion of obligations were disbursed. The remaining unobligated budgetary resources balance relates to appropriations available to cover multi-year investment projects. These projects require additional time for delivery of goods and services. Expired appropriations remain available for valid upward adjustments to prior year obligations but are not available for new obligations.

Balance Sheet

The Balance Sheet, which reflects the Department's financial position as of September 30, 2016, reports probable future economic benefits obtained or controlled by the Department (Assets), claims against those assets (Liabilities), and the difference between them (Net Position).

The $2.4 trillion in assets shown in Figure 10 represent amounts the Department owns and

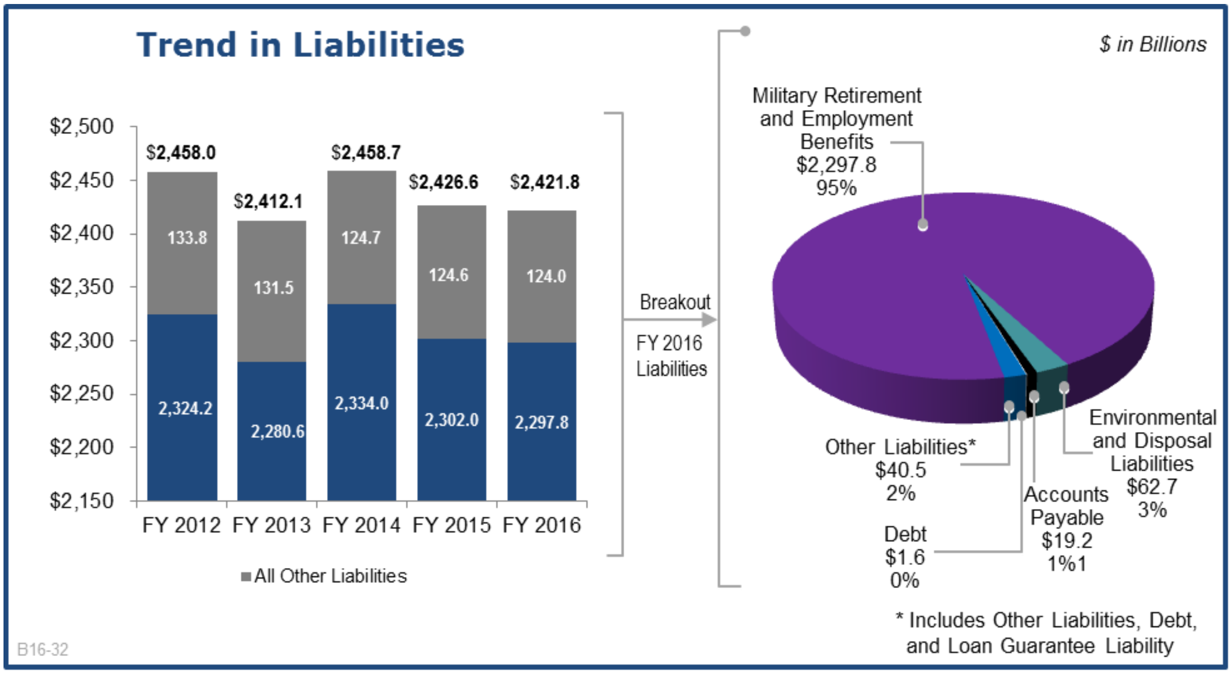
Figure 10. Summary of Total Assets



manages. Investments, General Property, Plant, and Equipment, and Fund Balance with Treasury (FBWT) represent 87 percent of the Department's assets. General Property, Plant, and Equipment is largely comprised of military equipment and buildings, structures, and facilities used to support the Department's mission requirements.

Total Assets increased $79.9 billion (3.4 percent) from FY 2015, largely due to increases in Investments in U.S. Treasury securities ($66.1 billion), General Property, Plant, and Equipment ($50.3 billion), offset by a decrease of Other Assets ($38.1 billion). The latter two are primarily the result of a reclassification of $42.0 billion of contract financing payments from Advances and Prepayments to Construction in Progress in accordance with the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) guidance. The investments increase was primarily due to normal growth in the Military Retirement Fund. As displayed in Figure 13, the Department has realized growth in investments over the last several years. The growth results from investment of contributions from the U.S. Treasury and the Uniformed Services, net of benefits paid. Under the Department's current strategy, invested balances will continue to grow to cover unfunded portions of future benefits. Funds not needed to cover current benefits were invested in U.S. Treasury Securities.

Figure 11. Summary of Total Liabilities



As seen in Figure 11, the Department's total liabilities decreased $3.7 billion during FY 2016, largely due to downward adjustments in the estimated actuarial liability associated with military retiree health care benefits. This change is primarily attributable to changes in the underlying benefit plan, actuarial assumptions, experience, and expectations used to calculate the unfunded liability. The Department's $2.4 trillion of liabilities reported in FY 2016 are backed by the full faith and credit of the U.S. Government.

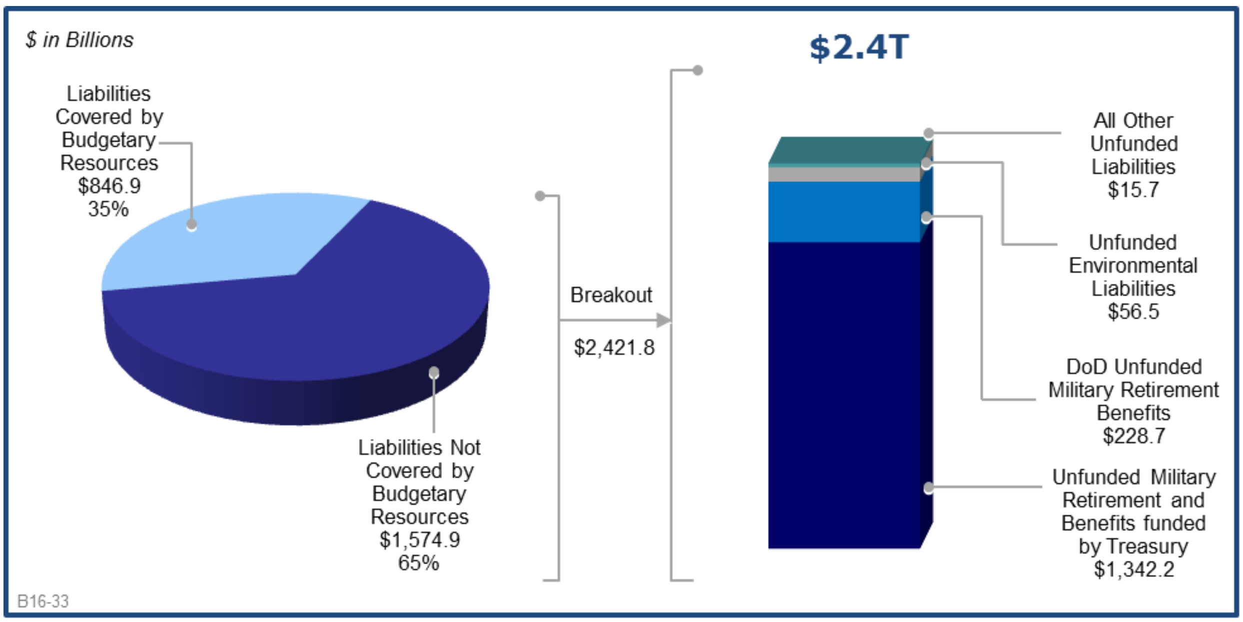
Figure 12 shows the $1.6 trillion in unfunded liabilities that will require future resources. The U.S. Treasury is responsible for funding the actuarial liability that existed at the inception of the military retirement and health care programs. This $1.3 trillion actuarial liability accounts for approximately 81 percent of the total $1.6 trillion in liabilities not covered by budgetary resources. The Department has resources available to cover approximately $795.2 billion of the remaining liabilities, primarily invested in U.S. Treasury securities. In addition, there are military pre-medicare eligible retiree health benefits actuarial liabilities of $239.7 million.

Statement of Net Cost

The Statement of Net Cost presents the net cost of all the Department's programs, including military retirement benefits. The statement reports total expenses incurred less revenues earned from external sources to finance those expenses. Generally, the resulting balance of net cost is equivalent to the outlays reported on the SBR, plus accrued liabilities, less the amount of assets purchased and capitalized on the Balance Sheet. The differences between reported outlays of the budgetary resources and reported net cost generally arise from when expenses are recognized.

The Department's costs incurred relate primarily to operations, readiness, and support activities, military personnel cost, and costs related to the Department's procurement programs. These costs were offset with investment earnings and contributions to support retirement and health benefit requirements, as well as earnings from reimbursed activities. This activity resulted in $589.6 billion in net cost of operations during the fiscal year.

Figure 12. Unfunded Liabilities



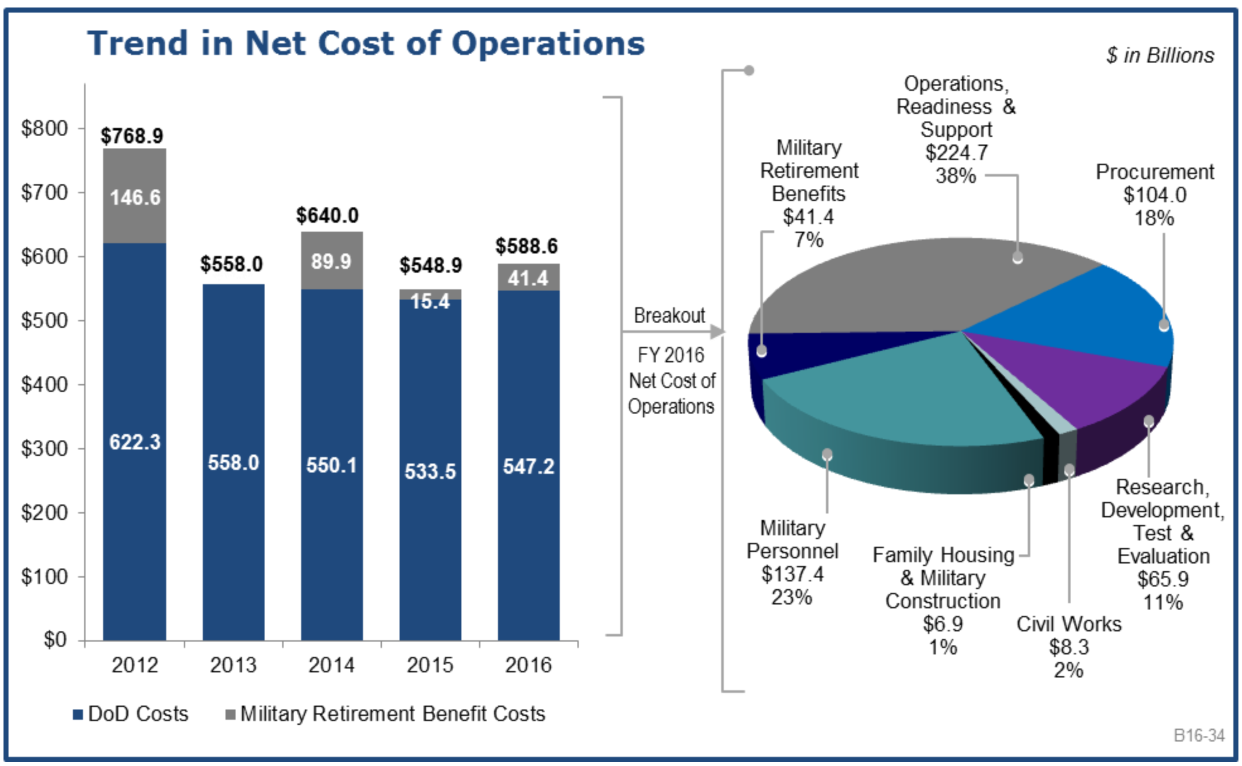
Statement of Changes in Net Position

The Statement of Changes in Net Position (SCNP) presents the total cumulative results of operations since inception and unexpended appropriations at the end of the fiscal year. The SCNP displays the components of net position separately to enable the user to better understand the nature of changes to net position as a whole. The statement focuses on how the net cost of operations as presented on the Statement of Net Cost is financed, as well as displaying the other items financing the Department's operations. The Department's ending net position increased $83.5 billion during FY 2016. The increase reflects primarily the increase in assets due to the normal growth in investments in the Military Retirement Fund. The growth results from investment of contributions from the U.S. Treasury and the Uniformed Services, net of benefits paid. Under the Department's current strategy, invested balances will continue growing to cover unfunded portions of future benefits. The Department corrected the value of General Plant, Property and Equipment, increasing the Department's ending net position by $8.3 billion. Other Financing Sources, Other consists primarily of nonexchange gains and losses necessary to reconcile the proprietary and budgetary amounts

Financial Performance Summary

The Department's financial performance is summarized in Figure 14. This table represents the Department's condensed financial position, results of operations, and budgetary resources, and includes comparisons of financial balances from the current year to the prior year. The lack of auditable financial data is a limiting factor in the ability of the Department to explain all material

Figure 13. Summary of Net Cost of Operations



variances presented in the comparative statements. Nevertheless, the data underlying the amounts is used to manage the Department's operations successfully.

Figure 14. Financial Performance Summary

Dollars in Billions	FY 2016	Restated FY 2015	Change	% Change
ASSETS				
Fund Balance with Treasury	$ 474.3	$ 467.4	$ 6.9	1.5%
Investments	914.1	848.0	66.1	7.8%
Accounts Receivable	8.8	7.7	1.1	14.3%
Other Assets	39.2	77.3	(38.1)	-49.3%
Inventory and Related Property, Net	255.3	261.7	(6.4)	-2.4%
General Property, Plant and Equipment, Net	711.7	661.4	50.3	7.6%
Total Assets	**$ 2,403.4**	**$ 2,323.5**	**$ 79.9**	**3.4%**
LIABILITIES				
Accounts Payable	$ 20.2	$ 20.3	$ (0.1)	-.5%
Other Liabilities	42.1	44.3	(2.2)	-5.0%
Military Retirement and Other Federal Employment Benefits	2,297.9	2,302.0	(4.1)	-0.2%
Environmental and Disposal Liabilities	62.7	60.0	2.7	4.5%
Total Liabilities	**$ 2,422.9**	**$ 2,426.6**	**$ (3.7)**	**-0.2%**
Total Net Position (Assets Minus Liabilities)	**$ (19.5)**	**$ (103.1)**	**$ 83.6**	**81.1%**
Total Financing Sources	699.4	677.0	22.4	3.3%
Less Net Cost of Operations	(589.6)	(548.9)	(40.7)	7.4%
Net Change of Cumulative Results of Operations	**109.8**	**128.1**	**(18.3)**	**14.3%**
Total Budgetary Resources	**$ 1,101.3**	**$ 1,067.2**	**$ (34.1)**	**3.2%**

A construction crew works on a radome as part of a multi-step project July, 25, 2016, on Buckley Air Force Base, Colo. The 460th Space Communications Squadron, Air Force Wideband Enterprise Terminals Program office, Tobyhanna Army Depot and Radome Services have been working together to replace an aging equipment on Buckley AFB in order to increase capabilities and keep up with technological advances.

U.S. Air Force photo by Airman 1st Class Gabrielle Spradling/Released Ohio

FINANCIAL MANAGEMENT IMPROVEMENT INITIATIVES

Financial Improvement and Audit Readiness Initiative

The Department's FIAR Initiative guides the Department's efforts to achieve compliance with the Chief Financial Officers Act of 1990 and undergo full financial statement audit. FIAR focuses on improving financial management, the ability to demonstrate reliable and well-controlled business processes and provide supporting documentation to auditors in a timely and consistent manner. For an organization as large and complex as DoD, achieving an audit-ready state has been a long-term, challenging endeavor. Congress and DoD stakeholders have come to fully appreciate the magnitude of this effort.

Significant audit readiness progress has been made. Beginning in FY 2015, the Military Departments moved from audit readiness into an annual audit regimen. Initial audits are helping to drive change while also giving personnel valuable real world audit experience. As a result, DoD financial managers and functional leaders better understand auditors' expectations and the higher level of consistency, discipline, and rigor that successful audits require. The auditors, in turn, are able to familiarize themselves with DoD's organization, systems, and way of doing business, allowing them to be more efficient in conducting audits. The ongoing audits maintain the Department's focus and drives progress toward an audit opinion, enhancing earlier audit readiness efforts. Operationally, audits provide objective feedback on DoD controls, processes, and systems. Audit findings and recommendations identify areas that need attention from an auditor's perspective to prioritize remediation. Audits also reveal opportunities for process improvement and resource savings.

The primary measure of audit progress is the extent to which the Department's organizations are under some form of a financial audit regimen. USACE, as well as six Defense Agencies and funds, are sustaining positive opinions on their full financial statements. In FY 2016, the Army, Navy, and Air Force each expanded their audits of current-year budgetary activity to include an additional year's appropriation. The full financial statements of the Defense intelligence agencies are all under audit. The Defense Information Systems Agency's FY 2016 full financial statements are also under audit, and in August 2016, the Defense Logistics Agency FY 2017 full financial statements went under audit. Many of our Service Providers, such as DFAS and Defense Contract Management Agency, are sustaining examinations of their controls and systems that can then be used by their Component customer financial statement auditors, saving time and money.

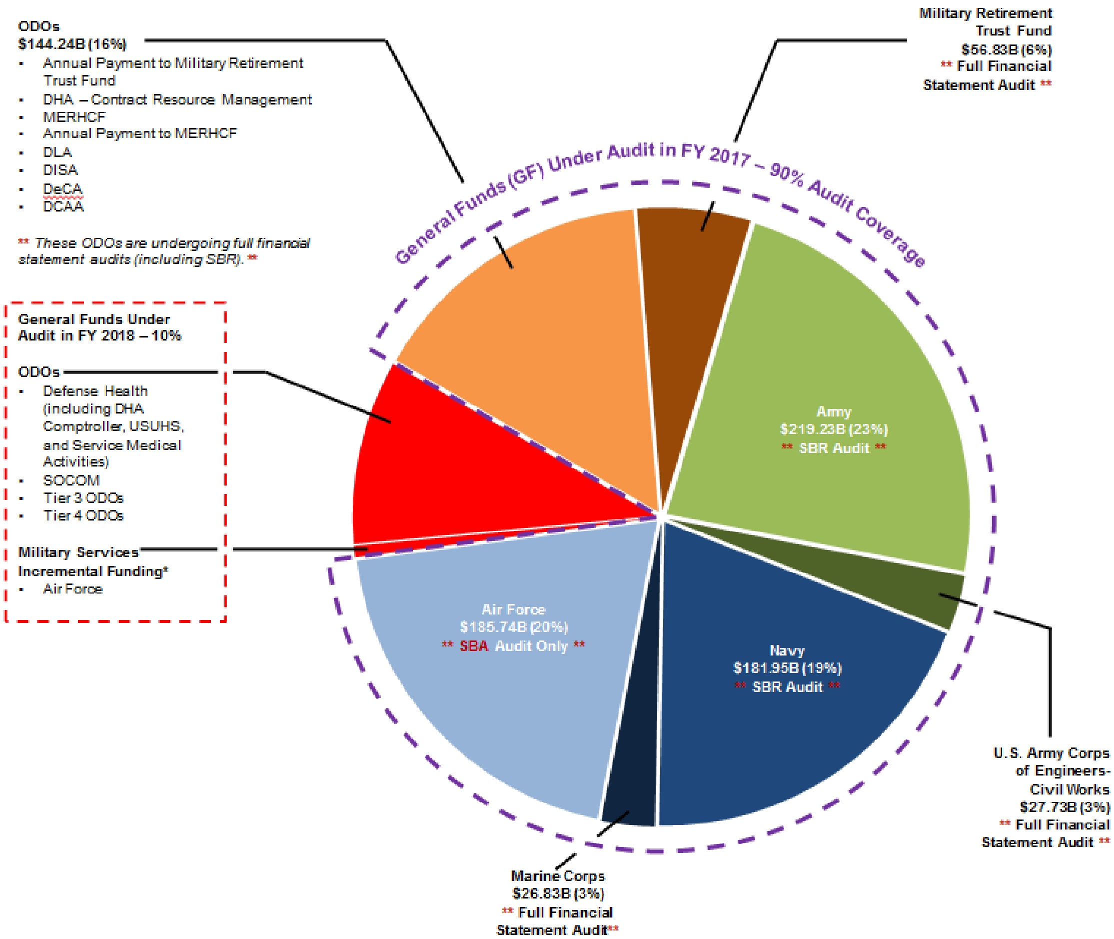
In FY 2017, 90 percent of General Fund budgetary resources and 54 percent of Working Capital Fund budgetary resources will be under audit; 43 percent of total assets will also be under audit. In FY 2017, the U.S. Marine Corps will become the first Military Service to have its full financial statements under audit. In FY 2017, the Army and Navy full SBR will be under audit; and the Air Force SBA will be audited. In FY 2017, DFAS will complete examinations of Vendor Pay and Fund Balance with Treasury for the Other Defense Organizations (ODOs). All Military Services expect to be ready for full financial statement audits in FY 2018.

A AH-1W Super Cobra with Marine Medium Tiltrotor Squadron 264 (Reinforced), 22nd Marine Expeditionary Unit (MEU), takes off from the flight deck of the amphibious assault ship USS Wasp (LHD 1) on July 28, 2016. The 22nd MEU, deployed with the Wasp Amphibious Ready Group, is conducting naval operations in support of U.S. national security interests in Europe.

U.S. Marine Corps photo by Cpl. Ryan G. Coleman)

Over the next year, the Department will continue to improve and streamline business processes and systems. Figure 15 and 16 depict the percentage of the Department's General Fund and Working Capital Fund projected to be under audit in FY 2016, FY 2017, and FY 2018. Additional information on the FIAR initiative, as well as the Department's FIAR Plan Status Reports (*FPSR*), is available on the USD(C) website.

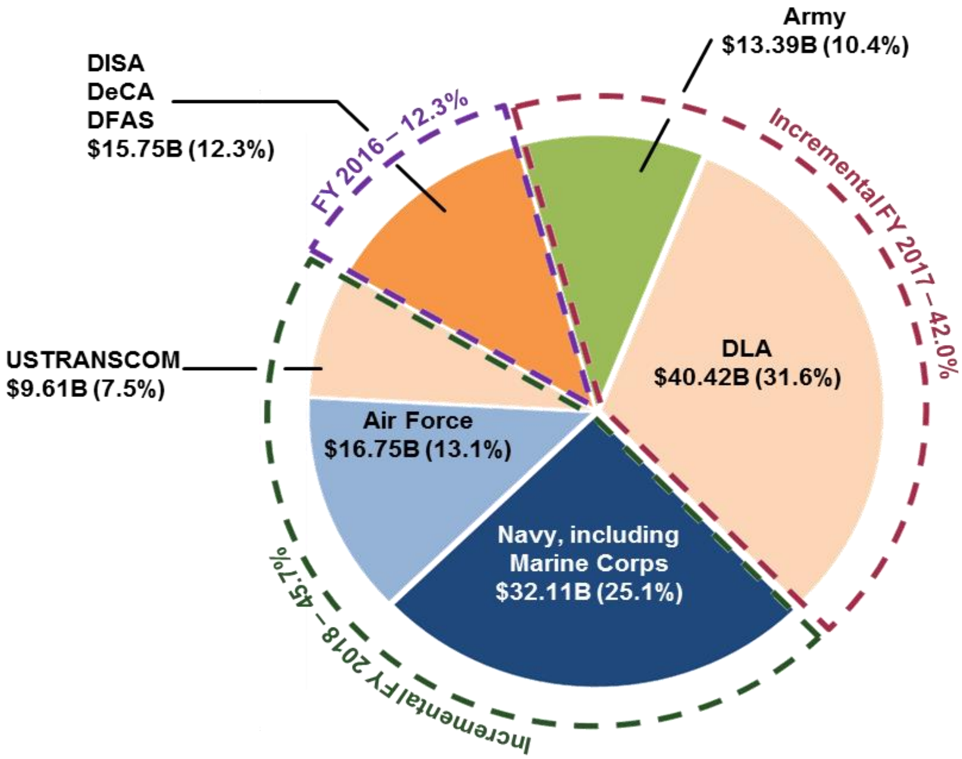
Figure 15. General Funds Projected Under Audit in FY 2016, FY 2017, and FY 2018



Based on FY 2015 Total Budgetary Resources

**Incremental Funding represents amounts received prior to FY 2015 which are not included in the FY 2016 SBA. Military Service Incremental Funding amounts are calculated using estimates based on FY 2015 Total Budgetary Resources.*

Figure 16. Working Capital Funds Projected Under Audit in FY 2016, FY 2017, and FY 2018



Based on FY 2015 Total Budgetary Resources

Financial Management Certification Program

One of the key strategic initiatives for the Department was to increase the knowledge and competency level of the DoD work force regarding financial management. The DoD Financial Management (FM) Certification Program, sponsored by the OUSD(C), was implemented in FY 2014. As of September 30, 2016, more than 35,626 personnel achieved their required certification. This number represents 65 percent of the FM workforce, well above the FY 2016 goal of certifying 55 percent of the FM workforce.

The Certification Program is course-based rather than test-based, with course hour requirements aligned to FM and leadership competencies and other specific courses, namely, audit readiness, ethics, and fiscal law. There are three levels of FM Certification, and each level includes FM experience requirements. The FM workforce must achieve certification within two years of assignment to an FM position. After meeting initial certification requirements, FM personnel must meet continuing education and training requirements every two years. The Comptroller team developed a comprehensive alignment process and aligned existing training to FM competencies. To date, 10,722 courses (3,211 training courses and 7,511 academic courses) have been aligned.

In addition to utilizing the existing FM training, the Comptroller team commenced development of FM web-based training courses in 2012. To date, 79 new courses have been developed, to support the FM certification program; and are available to the workforce, resulting in improved, cost-free access to training in key subject areas.

To date, more than 400,000 FM web-based course completions have been recorded for the 79 courses and over 54,583 of these course completions are in the FIAR area. This metric indicates that the Department is achieving one of its goals of improving employee knowledge and competency level in audit readiness.

A mature FM Certification Program will reinforce the culture of professional development within DoD, ultimately increasing proficiency in technical and leadership disciplines and enabling the FM community to keep pace with evolving warfighter needs. OUSD(C) will continue to mature its training program and provide support to warfighters globally.

Institutional Reform

FY 2016 continued the reform agenda advanced in the previous five budgets, with ever-increasing emphasis on enhancing DoD business processes. The Department must continue to reduce the "cost of doing business" to maximize the availability of its constrained resources for the optimum balance of force structure capacity and technological capabilities. This includes divesting lower priority or excess force structure and excess infrastructure as well as compensation reforms.

The Department has learned from prior draw-downs that it is impossible to generate its entire needed savings just through efficiencies. DoD prioritizes by focusing on key missions relevant to the future security environment. The Department has also identified unneeded facilities and infrastructure that must be eliminated. As DoD draws down to a smaller, more capable, agile force, it must eliminate all areas of waste, including the maintenance of unneeded facilities.

DoD continues to realize benefits generated through a series of efficiency initiatives within its overhead and mission support functions. These initiatives are identifying and realizing savings that are being made available to meet the emerging needs within the top line of the Department.

Current initiatives include reduction of MHA, service contract requirements reviews, IT optimization, leased space consolidation, military healthcare reforms, operational energy improvements, implementing more efficient logistics practices, and business optimizations including exchanges and commissaries.

Contract Management: The Department obligates over $250 billion annually to contract for goods and services, including acquisition of major weapons systems, support for military bases, implementing new information technology, and other mission areas. The Department's leadership has taken significant steps to plan and monitor progress regarding the management and oversight of contracting techniques and approaches. In FY 2016, the OSD staff and the Defense Agencies and Field Activities institutionalized a requirements review process known as Service Requirements Review Boards (SRRB), complementing similar reviews already underway in the Military Departments. SRRBs focus on assessing, reviewing, and validating service contract requirements by senior leaders. The process requires organizations to review their service contract requirements and assess opportunities for efficiencies, to include elimination of non-value added services, identification and elimination of duplicative requirements, realignment of requirements to better align to mission, and identification of strategic sourcing opportunities. In addition, the OSD staff and Defense Agencies and Field Activities, via the SRRB process, were tasked with capturing savings of $1.9 billion by 2021 to facilitate budget cuts over the FYDP. In 2016, 20 senior review panels were conducted for 50 organizations, with savings of $141 million identified for FY 2017 alone.

Major Headquarters Activities: In August 2015, the DepSecDef directed a 25 percent reduction across all appropriations for DoD MHA in the Military Departments, OSD, the Joint Staff, the Defense Agencies and Field Activities, and the Combatant Commands from FYs 2017-2020.

The NDAA directed a $10 billion cost savings by FY 2019 and 25 percent headquarters reductions for FY 2016 by FY 2020. In December 2015, the DepSecDef approved an additional reduction of $1.39 billion through FY 2021 via programmatic reductions incorporated in to the FY 2017 President's Budget. These reductions included significant civilian manpower reductions to OSD and the headquarters elements of the Defense Agencies and Field Activities, and included military manpower reductions across all headquarters of all joint activities of the Department. The Department will be eliminating approximately $7.3 billion from MHA between FYs 2015-2021.

To apply these reductions consistently, the Department adopted a new definition of MHA, which was subsequently codified in FY 2016 NDAA. The Department is now in the process of applying the new definition uniformly across the board. When fully implemented, the new definition will be built into programming and budget elements, enabling the Department to track headquarters reduction consistently across organizations and over time. The new definition and framework essentially removes smaller organizations from consideration while counting more of the staff-like activity in the major DoD Components. As of April 2016, the Department has completed the re-baselining process for OSD, the Defense Agencies and Field Activities, the Joint Staff, and the Combatant Commands. The baselining process continues with the Military Department headquarters elements.

Leased Space: In FY 2014, the Department started with a baseline of 5.4 million square feet of DoD-occupied space in the National Capital Region (NCR). The Department set forth with a plan to reduce this footprint by 1.2 million square feet prior to FY 2020. To date, the Department has eliminated 267,000 square feet of leased space used in the NCR by making better use of government space, resulting in a savings to the Department of $10 million per year beginning in FY 2016. The Department will release an additional 886,000 square feet by FY 2020 for a total saving of $43 million per year thereafter. In addition to the FY 2014 planned efforts, the Department continues to look for additional leased space savings within the NCR, and will also look into opportunities nation-wide.

Defense Resale: Recent budget proposals sought to reduce Defense Commissary Agency (DeCA) funding by more than 70 percent, or $1 billion per year, beginning in FY 2017. In order to implement a phased approach, the Department requested an alternate plan in the FY 2017 President's Budget to achieve DeCA savings of $1 billion per year by FY 2021, resulting in a total savings of $2 billion over the FYDP. A key element in the effort to achieve improved business practices in the commissaries and exchanges is the creation of a Defense Resale Business Optimization Board (DRBOB), empowered to find efficiencies and optimize the resale enterprise based on sound business practices. The DepSecDef chartered the DRBOB on February 5, 2016. The DRBOB is expected to establish a baseline of current benefits and determine costs, savings, and schedules associated with the implementation of business optimization proposals.

Information Technology Optimization: Several concurrent initiatives are contributing to $1.8 billion in savings in IT between FYs 2017-2021. Changes in Defense travel are underway with a new travel platform being implemented, resulting in savings of $520 million. Data center infrastructure improvements, circuit optimization and enterprise licensing will achieve a total savings of $715 million. Reviews of the MHS identified more than $430 million in savings and NCR IT-consolidation efforts are expected to achieve savings of $165 million.

Business Operations Improvements: The Department identified IT net benefits resulting from current Fourth Estate investments to develop, modernize, or enhance business systems. These benefits will enable a $310 million reduction of business operations costs resulting from IT modernization investments in the Fourth Estate between FYs 2017-2021. Although the net benefits analysis and findings do not currently capture any Defense health savings, the Department continues to analyze this business area to determine if additional potential savings can be achieved in the future.

Military Healthcare: The Department has proposed various ways to reform TRICARE for several years and the reforms currently reflected in the budget to give beneficiaries more simplicity and choice in how they manage their healthcare, while also incentivizing the much more affordable use of military treatment facilities. These reforms will not only save money but will also maximize the workload and readiness of our Military's medical force; giving our doctors, nurses, medics, and corpsmen the experience they need to be effective in their mission. Together, this should generate about $548 million in savings in FY 2017 and almost $7 billion over the FYDP that can be better spent in other ways without sacrificing the care of our people.

Canadian Cpl. James Sinclair, center, a medic, with the 31 Canadian Forces Health Service, works alongside U.S. Soldiers during Combat Support Training Exercise at Fort McCoy, Wis., Aug. 20, 2016.

U.S. Army photo by Staff Sgt. Debralee Best

<u>Operational Energy</u>: The Department is reducing its demand of facility energy by investing in efficiency and conservation projects on its installations. The Department continues to reduce energy costs and maximize payback in order to achieve the best return on investment. The majority of DoD investments in energy conservation are sustainment and recapitalization projects funded by the Military Departments' Operation and Maintenance appropriations. Such projects typically involve retrofits to incorporate improved lighting; high-efficiency heating, ventilation, and air conditioning systems; double-pane windows; energy management control systems; and new roofs.

In addition to using appropriated funding to improve efficiency, both in the Components' budget and the Defense-wide Energy Conservation Investment Program (ECIP), DoD Components are leveraging private capital through the use of performance-based contracts to improve the energy efficiency of existing buildings. In 2011, the President issued a memorandum calling on the Federal Government to initiate $2 billion worth of performance-based contracts. In May 2014, the President extended the goal to $4 billion to be achieved by December 2016. The Department is responsible for $2.2 billion of the Federal Government goal for performance based contracts.

The Department continues to invest in energy and water conservation, renewable and distributed energy, as well as energy resilience projects using both appropriations and third-party financing. For example, the ECIP is a $150 million annual Military Construction (MILCON) program centrally managed by OSD to fund projects that save energy or reduce Defense energy costs. It evaluates potential projects using a variety of criteria, including cost effectiveness, savings to investment ratio, and financial payback. Congressional appropriations amounting to approximately $800 million funded 1,283 projects in FY 2014. The majority, 82 percent, were energy conservation projects. The rest of the projects are renewable energy and water conservation (12 and 6 percent, respectively).

<u>Logistics</u>: "Effectiveness first--then efficiency" is the culture of the Defense Logistics Agency (DLA) Energy. DLA completed a 14-month resource management decision study for OSD that helped address a decades-old real property/audit readiness problem and identified more than $200 million in annual sustainment savings for the Department. DLA instituted right-size planning at strategic storage locations in Hawaii, Japan, and Spain that cut future construction and repair costs by 15 percent; and extended DLA's Sustainment, Restoration, and Modernization (SRM) recurring maintenance program to the Air Force to increase operational availability and lower costs, in spite of having smaller annual SRM and MILCON budgets for the year. DLA Energy also introduced a new term in the DoD lexicon: SRM repair "velocity", creating new accountability metrics and synchronizing program oversight controls which decreased requirement approval time by 66 percent, and increased the number of tanks returning to service by 64 percent for the year, which reduced repair backlogs in FY 2016 by 98 percent.

DLA continued to set the standard for world-class support and productivity by delivering 98 million barrels of fuel, 35 million cubic feet of helium and more than 58 million kilowatt hours of electricity to customers around the globe. The momentum continued in FY 2016 with a new imperative, "Global Commercial Supply Chain Velocity and Integration." The realities of near-peer capabilities, aging and vulnerable infrastructure combine to make increased commercial integration a necessary step to support warfighter requirements in an era of declining logistics investment budgets. Future mandatory increases in redundancy and resiliency thus lie in the establishment of additional commercial capabilities, new safe-haven harbors, and cooperative storage contracts with partner-nations in Australia, Japan and Eastern Europe, and new research and development capabilities to decrease reliance on fixed infrastructure. Robust supply chains in the continental United States will facilitate the elimination of intermediate storage, and the establishment of "on-call" reserves which will cut inventory holding and storage costs by $200 million per year with no decrease in warfighter capability.

DLA Energy has partnered with various energy service companies (ESCO) to complete energy savings projects for Department installations. The ESCO conducts a comprehensive energy audit and identifies improvements to save energy. In consultation with DLA Energy and the installations, the ESCO designs and constructs projects that meet the installation's needs and arranged the necessary funding for the project. The ESCO guarantees that the improvements will generate energy cost savings to pay for the project over the term of the contract (up to 25 years). For example, an investment of $133.5 million across seven installations is anticipated to yield more than $316 million in cost savings. After the contract ends, all additional cost savings accrue to the installations.

Finally, 2016 marks the beginning of DLA's pursuit of next generation alternative fuels: high volume, cost-competitive, lifecycle carbon-negative aviation and maritime products. The DLA's partnership with the White House Advanced Market Commitments Working Group focusing on emerging technologies in waste-to-energy capabilities and investment incentives, seek to spawn an indigenous U.S. industry in the next five years that better meets warfighter, environmental and cost needs for our nation.

As the DLA mission realigns with the realities facing its customers and the constraints caused by reducing budgets, each Distribution Center across the DLA network has right-sized their equipment fleets and improved their utilization rates. DLA identified 461 pieces of equipment for disposal in FY 2015 through a detailed analysis of requirements and benchmarking against the leading companies in the commercial sector. These efforts resulted in DLA's ability to turn in older assets, reducing the size of the fleet from an average age of 10 years to 8 years, creating a more modern and standard fleet, and saving the taxpayers $2.9 million.

The Department's efforts have enabled DLA Distribution to increase ocean container utilization to over 85 percent, saving taxpayers $16.4 million over the last 3 years. In addition to looking at ocean containers, DLA analyzed the cost of its scheduled truck network and found ways to increase its efficiency and effectiveness. By determining the cost break-even points for each route, DLA has been able to optimize delivery to each customer, expanding old routes and creating new routes. DLA reduced transportation costs by providing regular deliveries to warfighter concentrations. Over the past 3 years, DLA Distribution has provided $27.4 million in savings directly to its customers by utilizing its scheduled truck routes. The Department is reviewing its transportation program in order to develop a best-value solution to meet warfighter and customer needs while reducing taxpayer burden.

A United Launch Alliance Delta IV-Heavy rocket lifts off from Space Launch Complex 37B at Cape Canaveral Air Force Station, Florida, June 11, 2016, at 1:51 p.m. ET. The ULA Delta IV rocket carried a classified national security payload for the U.S. National Reconnaissance Office.

Courtesy photo by ULA

INTERNAL CONTROLS OVERVIEW

MANAGERS' INTERNAL CONTROL PROGRAM

OUSD(C) leads the Department's Federal Manager s' Financial Integrity Act *(FMFIA)* program, known as the Managers' Internal Control Program *(MICP)*. The Department is committed to ensuring effective internal management controls for all mission-essential processes. The MICP holds both operational and financial DoD managers accountable to ensure effective internal management controls in their areas of responsibility. All Components are required to conduct a robust programmatic approach to establish and assess internal management controls for all financial and non-financial mission-essential operations. Components that produce stand-alone financial statements are also required to provide financial reporting assurance.

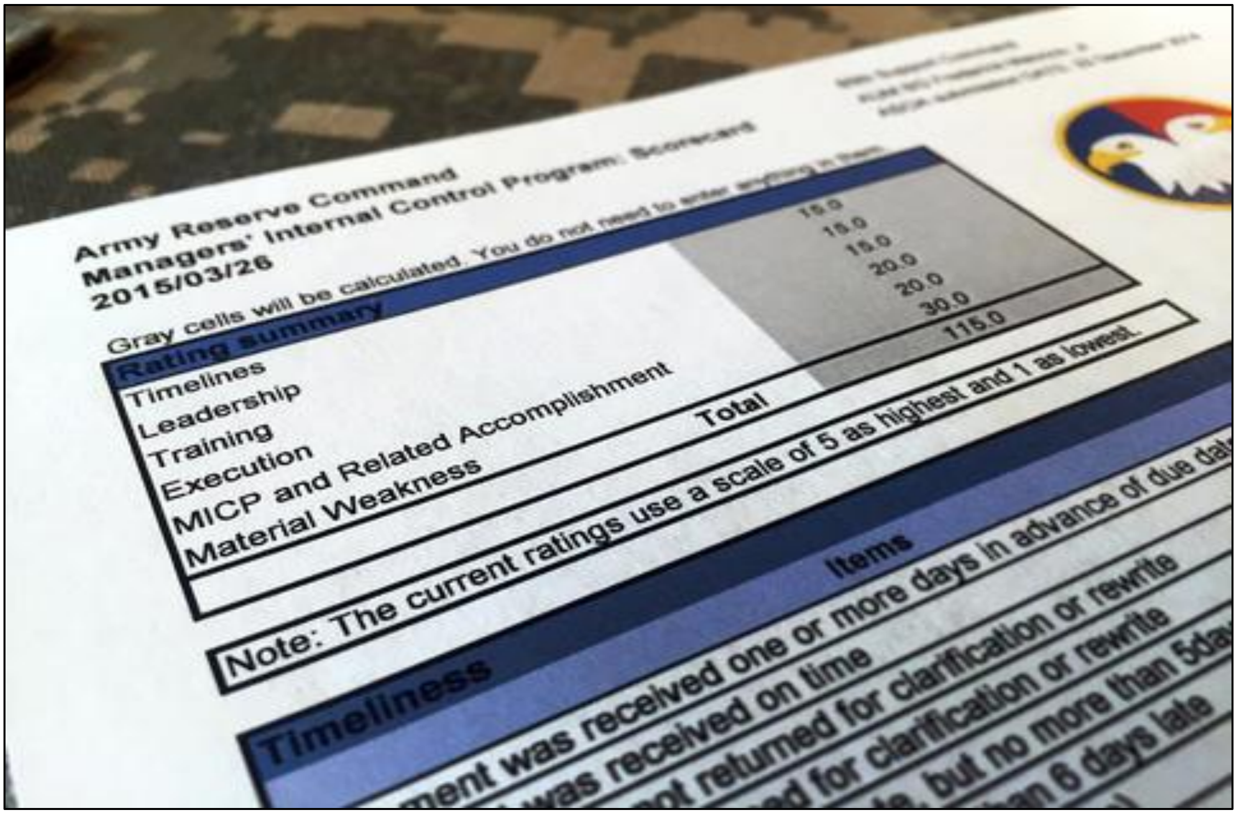
The Department advocates a "tone at the top" approach, with emphasis on the importance of the internal control program, which permeates the entire DoD culture. The purpose of the MICP is to identify, prioritize, and mitigate high operational and financial risk before it impedes the mission. Per *DoD Instruction 5010.40*, each Component uses its leadership's mission requirements as a baseline for executing assessments of key functional operational and financial areas. Instead of relying on external auditors to identify material control weaknesses, Components rely upon appointed assessable unit managers for each key operational and financial area to identify and self-report internal control deficiencies for review and comment by leadership. This process complements the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* ("Green Book") through the Department's reliance upon the Risk Enterprise Framework approach to ensure we prioritize systemic operational and financial risk for corrective action.

Types of Material Weaknesses

The Department's management uses the following criteria to classify conditions as material weaknesses:

- Merits the attention of the Executive Office of the President and the relevant Congressional oversight committees;
- Hinders management's ability to prevent or detect a material misstatement of the financial statements;
- Impairs fulfillment of essential operations or mission;
- Identified as a "high risk" by GAO or DoD IG;
- High impact of occurrence in terms of loss of dollars and loss of life;
- Significantly weakens established safeguards against waste, loss, unauthorized use or appropriation of funds, property, other assets, or conflicts of interest;
- Constitutes substantial noncompliance with laws and regulations;
- Nonconformance with government-wide, financial management system requirements; and
- Identified by independent public accountants as material weaknesses.

Based on the Department's assessment of internal controls, the DepSecDef signed the Statement of Assurance that follows on the next page.



The Army Reserve's 85th Support Command received a 100 percent passing rate, for the second year in a row, for the command's IR Annual Statement of Assurance (ASOA) report submission. The ASOA is a mandatory reporting requirement observing and assisting in the efficiency and processes of a command's staff sections. The 85th Support Command was the only command to receive the 100 percent passing rate, for a consecutive second year, across all of the Army Reserve's major subordinate commands.

U.S. Army photo by Anthony L. Taylor/Released

STATEMENT OF ASSURANCE

The leaders of the Department of Defense recognize that a key factor in improving accountability in achieving the Department's mission is to establish and maintain effective internal controls and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act of 1982 (FMFIA), the Federal Financial Management Improvement Act of 1996 (FFMIA), and related statutory and federal policy guidance. The reliance upon effective internal controls empowers leaders with timely and accurate information to assess whether the Department is achieving its goals.

The Department conducted its assessments of the effectiveness of internal controls over operations in accordance with the objectives of FMFIA. Based on this assessment, the Department provides a qualified statement of reasonable assurance that its internal controls over the effectiveness and efficiency of operations and compliance with applicable laws and regulations achieve the objectives of the FMFIA, as of September 30, 2016. The Department continues to prioritize efforts to also ensure that relevant Government Accountability Office "high risk areas" and the Department's Office of Inspector General "management challenges" are being addressed.

While several entities within the Department are sustaining positive financial statement audit opinions, DoD as an agency cannot yet produce auditable financial statements. As a result, management provides no assurance as to the effectiveness of the Department's internal controls over financial reporting in accordance with OMB Circular No. A-123, Appendix A, as of June 30, 2016. And while the Department is far from reaching an unqualified statement of reasonable assurance on its financial statements, it has made measured progress through increased senior leader emphasis on improving the quality of financial information and ultimately achieving this goal. The Department recognizes that auditable financial statements require a sound framework of internal controls and an organizational culture that promotes the identification, prioritization, and mitigation of financial reporting risk.

Closely related to efforts to improve financial reporting and achieve auditability, the Department also conducted its assessment of the effectiveness of internal controls over its integrated financial management systems. Based on the results of this assessment, and as confirmed by initial feedback from financial audits, the Department provides no assurance that its internal controls over its integrated financial management systems are compliant with FFMIA and OMB Circular No. A-123, Appendix D, as of June 30, 2016. The Department realizes that properly planned and integrated systems, with strong internal controls, are critical to providing useful, timely, and complete financial information and to achieving auditability.

Remediation of current deficiencies and weaknesses remains the priority for measuring progress against current audit goals. The Department's Financial Improvement and Audit Readiness initiative is focused upon the identification and implementation of improvements in the Department's financial processes and related internal controls. These improvements include the aggressive identification and prioritization of operational and financial risk in accordance with the Government Accountability Office's 2014 "Standards for Internal Control in the Federal Government." The Department remains committed to significant and measureable improvement in its ability to provide reliable, timely, and useful financial and managerial information to support management decisions.

Robert O. Work
Deputy Secretary of Defense

FY 2016 Improvements in Internal Controls

Strong internal controls are essential to achieving and sustaining a cost-effective audit regimen. Despite many challenges, the Department is steadily improving internal controls. Some challenges and accomplishments are highlighted below.

1. Intragovernmental Transactions: Intragovernmental transactions result when business is conducted between two federal entities. Both entities must accurately record the event so that the buying and selling documentation can be matched. Imbalances occur when the federal entities are unable to account for and reconcile differences. These differences often lack proper documentation. To address this issue, the Department is aligning how it records intragovernmental transactions by mandating the use of the Department of the Treasury's G-Invoicing system. The Department mandated the use of G-Invoicing to broker and store the general terms and conditions for intragovernmental transactions and in FY 2016 established a goal of 75 percent for new reimbursable work to be conducted using G-Invoicing. The Department created targeted working groups to focus on developing standard processes for buying and selling, defining required system and data exchanges, and standardizing data elements. The working groups also developed processes for reporting program status, generating required financial reporting, and managing training for new processes and data standards. Additionally, the Department worked with Treasury and other federal agencies to publish a government-wide data standard for intragovernmental transactions. The Department implemented internal controls in intragovernmental transactions to provide visibility of the receipt of goods and/or services as receipt and acceptance must be recorded before payment; and effectively capturing trading partner information. These process improvements increase transparency across the government and provide the ability to trace funding from initial agreement to payment.

2. Critical Accounting Policies: The Department issued several critical policies to remediate audit readiness impediments and develop practical and GAAP-compliant solutions to long-standing issues. During FY 2016, the Department's policies addressed the following key areas:
   - Financial Management Requirements for Using Sub-allotments
   - DoD Risk Management Framework
   - Accounting for Internal Funds Distributions
   - Data Standardization Memo for Accounting Systems to Comply with Data and Configuration Requirements
   - Financial Reporting Policy for Real Property Estimated Useful Lives, Land Valuation, and Accounting for Real Property Outside the U.S
   - Accounting Treatment of Long Range Ballistic Missiles
   - Strategy and Implementation Guidance for General Equipment Valuation

- Alternative Valuation Methodology for Establishing Opening Balances for Buildings, Structures and Linear Structures
- Inventory and Related Property Accounting Policy Requirements

These policies improved internal controls by establishing customer support requirements for sub-allotted funding. In addition, policies for accountability and valuation of assets include the development of methodologies for a GAAP-compliant process for allocating costs to capitalized equipment, establishing Construction in Progress opening balances, and using plant replacement values to establish and support real property opening balances.

3. Service Provider Integration: A service provider is an entity that performs a business function or process on behalf of a DoD Component. In order for service provider customers to become audit ready, a service provider's audit readiness activities must be fully integrated within its customers' audit readiness activities. The Department issued a service provider Statement on Standards for Attestation Engagements (SSAE) No. 18 (formerly SSAE 16) examination policy memorandum that requires enhancements be made to improve the reliance and usefulness of SSAE No. 18. The Department also conducted tri-annual service provider working group meetings between service providers and their Component customers to identify audit relevant dependencies, clarify roles and responsibilities, and report audit readiness progress, deficiencies, and corrective actions. Successful service provider SSAE 16/18 have improved the quality of internal controls over service providers. The Department is expanding service provider integration by:

    - Facilitating meetings where service providers identify and explain to Component customers the complementary user entity controls (CUECs) expected to be included in the SSAE 18 examinations. The Department hosted nine CUEC workshops, provided baseline / standardized control descriptions, and is developing baseline test plans to help ODOs implement effective controls to address the CUECs.
    - Developing templates to assist the service providers in addressing the new requirements.
    - Performing quality assurance reviews of service provider audit readiness deliverables.
    - Reviewing service organization control examination reports to determine whether the examination scope was sufficient or additional examinations are needed to have complete coverage of audit relevant business processes and systems.
    - Obtaining findings and recommendations from existing SSAE No. 16/18 examinations with modified opinions and tracking service provider corrective actions and testing to ensure the findings and recommendations are remediated.

4. Treasury Index-97 Internal Control Management: The Department has taken strides to improve internal controls amongst the Treasury Index (TI)-97 entities. Specifically, in FY 2016 the OUSD(C)/FIAR began testing the audit infrastructure, key supporting

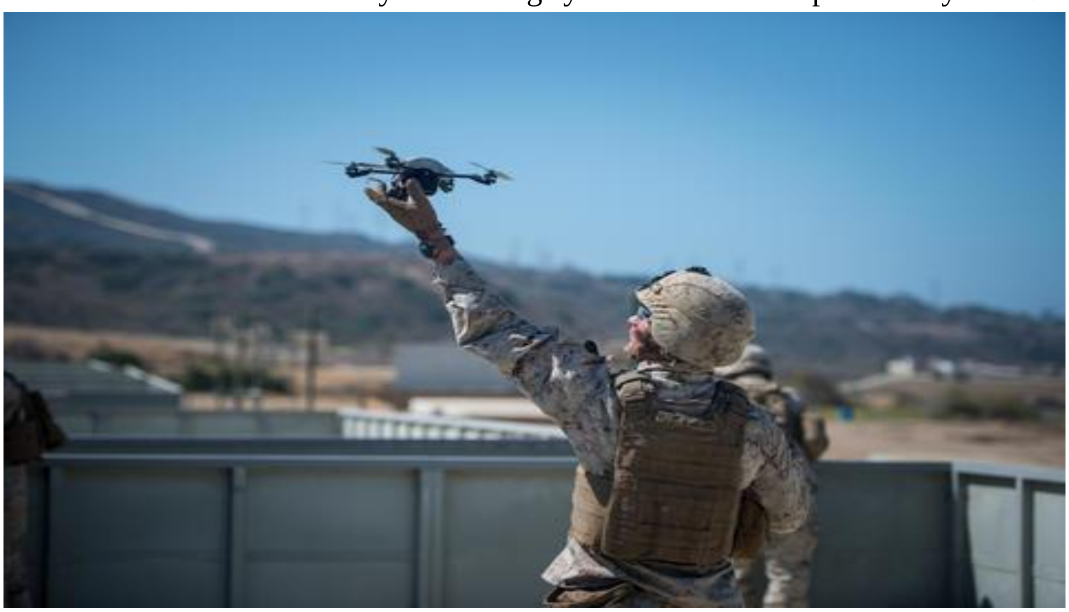
documentation, and internal controls for select processes on a monthly basis. OUSD(C)/FIAR also maintains a Notice of Findings and Recommendations (NFR) tracking tool which serves as a centralized database that provides increased visibility into the Department's audit readiness progress and overall risk. The tool also allows the Department to monitor the progress of remediation activities and corrective action plans for TI-97 entities. To support the goal of enhancing the Department's internal controls, OUSD(C)/FIAR is laying the groundwork to support the audit of the Department's financial statements. This includes documenting Entity-Level Controls (ELCs) in accordance with the GAO Green Book 17 principles of internal controls. OUSD(C) FIAR developed an ELC End State matrix for Components to use as a tool in documenting ELCs; and plans to integrate ELC with MICP to improve cross-communication, share best practices and lessons learned, and push for continuous process improvements.

The Department's efforts towards improving internal controls amongst the TI-97 entities has achieved significant milestones including remediation of issues identified during monthly testing efforts, development of end-to-end documentation, and greater accountability towards corrective action plan remediation.

5. <u>Standard Financial Information Structure and Standard Line of Accounting</u>: The Department lacked a common financial business language that standardizes data elements, business rules, and the transaction posting logic used in DoD financial management systems. To facilitate reconciliations between systems, the Standard Financial Information Structure (SFIS) and the Standard Line of Accounting (SLOA) were established for the Department's Enterprise Resource Planning Systems (ERPs)/accounting systems and key financial systems for data and interoperability standards. To verify compliance with data standards, the Joint Interoperability Test Command (JITC) began independent verifications of the ERPs/accounting systems and key financial systems to determine system compliance with SFIS, SLOA, U.S. Standard General Ledger posting logic, tie-points, and trading partner interoperability standards. Aligned with Federal Information System Controls Audit Manual general application and interface controls, the results of JITC verification provides further insight into compliance of DoD systems.

6. <u>Fund Balance with Treasury and Cash Accountability</u>: Unresolved FBWT differences between DoD and Treasury are material and jeopardize achieving a "clean" audit opinion on the financial statements. The Department endorsed a target end-state for cash accountability and reconciliations that delivers a single, auditable, enterprise-wide FBWT solution. The Department's solution also aligns with Treasury's modernization initiatives. The Department is defining data standards to improve data quality and auditability. SLOA validation service was developed for use early in the Procure-to-Pay process. This validation can also be used in other end-to-end processes, such as Orders-to-Cash, Hire-to-Retire, and Budget-to-Report. The infrastructure and data exchanges are under development and should be operational by the end of FY 2017.

7. Information Technology System Initiatives: To achieve and sustain audit readiness, the Department must develop and maintain an audit-ready IT systems environment. The Department and system owners are working hard to develop a sustainable audit ready systems environment and have implemented the following actions:
    - Required all Components to submit detailed information and milestones for material IT systems twice yearly to monitor and track audit readiness progress.
    - Conducted a series of workshops to improve reporting entities' ability to use existing SSAE 18 examination reports and identify complimentary user entity controls for which they are responsible.
    - Identified additional service provider processes and systems for which SSAE 18 examinations would support overall audit efficiency and worked with service providers to prioritize and accelerate delivery of the SSAE 18 examination reports.
    - Developed supplemental guidance to the new system certification and accreditation process that defined supplemental activities required to concurrently address audit readiness requirements.
    - Required Components and service providers to undergo SFIS Compliance Assessments for key accounting systems and service provider systems.



U.S. Marine Corps Lance Cpl. Cesar Salinas, an infantry Marine with 3rd Battalion, 5th Marine Regiment, assists his squad by providing reconnaissance with an Instant Eye at Marine Corps Base Camp Pendleton, Calif., July 13, 2016. The system is meant to increase initial visibility of the enemy before the Marines need to engage them and was built by the Marine Corps Warfighting Laboratory to assist Marines. The lab is conducting a Marine Air-Ground Task Force Integrated Experiment in conjunction with Rim of the Pacific exercise to explore new gear and assess its capabilities for potential future use. The Warfighting Lab identifies possible challenges of the future, develops new warfighting concepts, and tests new ideas to help develop equipment that meets the challenges of the future operating environment.

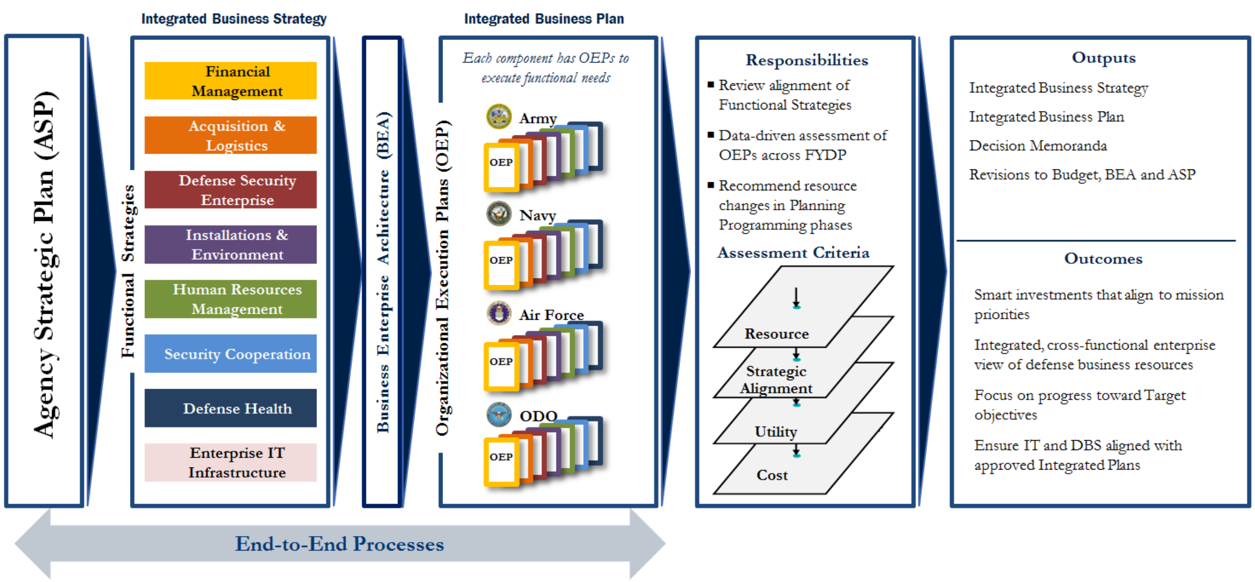
U.S. Marine Corps photo by Lance Cpl. Julien Rodarte

BUSINESS AND FINANCIAL MANAGEMENT SYSTEMS

The Department is improving its business systems to successfully achieve and sustain improvements in our internal controls, financial management, and auditable financial reports. Modernization and improved interoperability of DoD business systems is critical to efficiently respond to Warfighter needs and sustain public confidence in our stewardship of taxpayer funds.

Following enactment of section 901 of the NDAA for FY 2012[2], the Department significantly changed the requirements for investment reviews and the certification of defense business systems, which now must occur before funds are obligated (appropriated or non-appropriated). The Department's investment review process ensures that decisions on investments in business systems align with the Defense-wide integrated business strategy (Figure 17). These decisions also include retirement plans for legacy and non-target financial systems and ensure that systems eliminate redundant activity and maximize operating efficiency through streamlining business processes and the availability of timely, accurate, and useful business information.

Figure 17. The Department's Integrated Business Framework



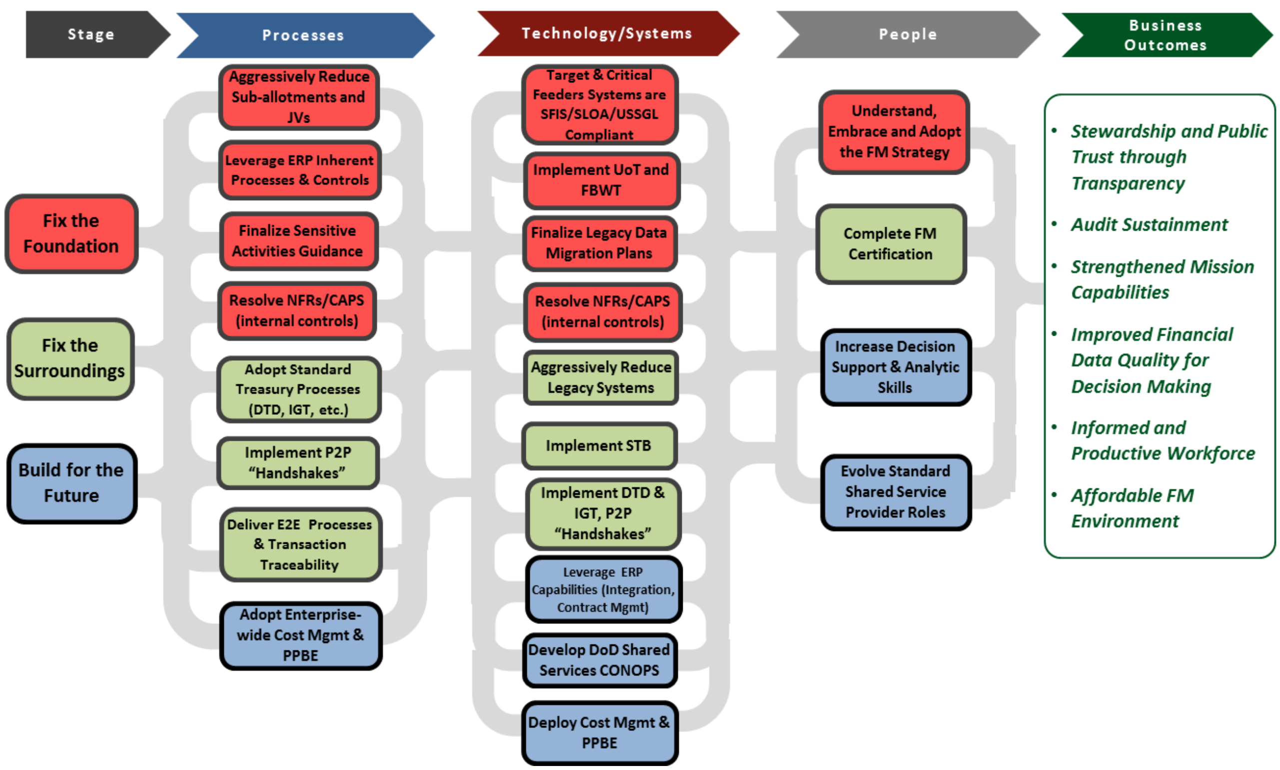
The Department's FM Functional Strategy provides the Department's vision, initiatives, goals, target environment, and expected outcomes over the next five years. The strategy is designed to ensure the Department achieves and sustains auditability and financial management improvement objectives.

The key components of the FM Functional Strategy include establishing data and data exchange standards, standard business processes, and system controls and enhancements that support improved processes, and leveraging technology across the Department's end-to-end

[2] Section 901 of the National Defense Authorization Act for FY 2012, codified at 10 U.S.C. 2222, "Defense business systems: architecture, accountability, and modernization"

processes. The primary objectives of the FM Functional Strategy are to achieve a fully integrated environment linked by standard processes, standard data, with the fewest number of systems and interfaces. Ultimately, this strategy will lead to stronger internal controls impacting financial reporting and auditability, and improve end-to-end funds traceability and linkage between budget and expenditures. Current enterprise-level initiatives include the *SFIS* the Department's first ever *SLOA* to improve funds traceability and financial reporting. The Department also participates in federal government-wide process improvement initiatives, such as the President's transparency and open government initiatives, Treasury's government-wide accounting and Direct-to-Treasury disbursing initiatives. The Department also promotes the use of business analytics and maximizing existing ERP systems.

Figure 18. DoD Financial Management Improvement Initiatives



The FM Functional Strategy also provides the plan to retire and replace legacy financial systems to simplify the FM systems environment and infrastructure. Under the legacy systems reduction plan, financial management core and feeder systems should be reduced from 327 systems at the beginning of FY 2014 to 120 systems by the end of FY 2019.

ENTERPRISE RESOURCE PLANNING SYSTEMS

The ERP systems are integral to implementing the strategic FM business process improvements, achieving the planned target environment and reductions in the number of legacy systems, and better enabling a sustainable audit environment. The ERPs provide a broad range of functionality to support DoD business operations in financial management, supply chain management, logistics, and human resource management. Some ERPs are fully fielded while others are in a state of development and deployment.

Army ERPs

General Fund Enterprise Business System (GFEBS) is the General Fund accounting, asset management, and financial system used to standardize, streamline, and share critical data across the active Army, Army National Guard, and Army Reserve. GFEBS is a web-based ERP solution that uses commercial off-the-shelf (COTS) business enterprise software to compile and share accurate, up-to-date financial and accounting data.

Logistics Modernization Program (LMP) is one of the world's largest, fully integrated supply chain, maintenance, repair and overhaul, planning, execution, and financial management systems. The LMP mission is to sustain, monitor, measure, and improve the modernized, national-level logistics support solution. By modernizing both the systems and the processes associated with managing the Army's supply chain at the national and installation levels, LMP will permit planning, forecasting, and rapid order fulfillment to supply lines. It will also improve distribution, reduce theater footprint, and ensure a warfighter who is equipped and ready to respond to present and future threats.

Global Combat Support System – Army (GCSS-A) provides enterprise-wide visibility into various logistics areas and is a key enabler for the Army in achieving auditability. The GCSS-A provides the tactical warfighter with supply, maintenance, property accountability, integrated materiel management center, management functionality, and support to tactical financial processes.

Integrated Personnel Pay System – Army (IPPS-A) is a hybrid solution using ERP software to deliver an integrated personnel and pay capability. The IPPS-A will provide the Army with an integrated, multi-component personnel and pay system that streamlines Army Human Resources processes, enhances the efficiency and accuracy of Army personnel and pay procedures, and supports soldiers and their families. The IPPS-A will improve internal controls to prevent erroneous military payments and loss of funds.

Navy ERPs

Navy Enterprise Resource Planning (Navy ERP) is an integrated business system that provides streamlined financial, acquisition, and supply chain management to the Navy's major systems commands.

Global Combat Support System – Marine Corps (GCSS-MC) is the core web-enabled, centrally managed ERP for the Marine Corps. The GCSS-MC is focused on the acquisition and implementation of the initial set of logistics capabilities to deliver improved supply and maintenance management services. As the technology centerpiece of the Marine Corps' overall logistics modernization effort, GCSS-MC will provide advanced expeditionary logistics capabilities to ensure future combat efficiency.

Air Force ERPs

Defense Enterprise Accounting and Management System (DEAMS) is an automated accounting and financial management execution system for the Air Force and U.S. Transportation Command. DEAMS is the core accounting and financial management solution for the Transportation Working Capital Fund and General Fund. It serves as the financial foundation for all enterprise business system modernization across the Department. DEAMS provides accurate and timely financial information using standardized business processes and complies with applicable federal laws, regulations, and policies. By the first quarter of FY 2017, DEAMS will have approximately 12,600 users at 131 locations across the Air Force and Combatant Commands.

Air Force Integrated Personnel and Pay System (AF-IPPS) is a comprehensive, self-service, web-based solution currently in development that integrates personnel and pay processes into one system and maintains an official member record throughout the airman's career. An FFMIA-compliant system, AF-IPPS functionality will support audit readiness general and application controls. Full deployment is projected for the fourth quarter of FY 2018.

U.S. Marines with 2nd Light Armored Reconnaissance Battalion, Bravo Company, 2nd Marine Division prepare for training exercises at Ft. Pickett, Va., Aug. 29, 2016. The Marines conducted live-fire exercises to maintain unit readiness and tactical proficiency.

U.S. Marine Corps photo by Sgt. Rebecca L. Floto, 2d MARDIV Combat Camera

Other Defense Organization ERPs

Defense Agencies Initiative (DAI) is a system dedicated to address financial management improvements through standard end-to-end business processes delivered by COTS software. DAI provides accounting, procure to payment, and time and attendance capability today; and will provide grants, financial management, and budget formulation capability in the future. By the end of FY 2017, 20 of 26 Defense Agencies will have deployed DAI.

Enterprise Business System (EBS) uses a COTS product to manage DLA's supply chain management business. EBS also includes Electronic Procurement, Real Property, Inventory Materiel Management and Stock Positioning, and Energy Convergence modules, providing DLA leadership with the tools to respond to new challenges and trends.

IMPROPER PAYMENT REPORTING

The DoD Financial Management Regulation (FMR) 7000-14-R, Volume 4, Chapter 14, defines improper payments as "any payment that should not have been made or was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements."

In accordance with the Improper Payments Information Act of 2002 *(IPIA)* (P.L. 107-300); Improper Payments Elimination and Recovery Act of 2010 *(IPERA)* (P.L. 111-204); Improper Payment Elimination and Recovery Improvement Act of 2012 *(IPERIA)* (P.L.112-248); Executive Order 13520, Reducing Improper Payments, issued November 20, 2009; and Appendix C of OMB Circular No. A-123, Defense Components are required to report the status of improper payments and recovery of these improper payments to the President and Congress in the following categories:

- Commercial Pay
- Civilian Pay
- Military Pay
- Travel Pay
- Military Health Benefits
- Military Retirements

Each DoD disbursing activity is committed to identifying the root causes of improper payments, establishing an appropriate sampling methodology, developing and implementing corrective action plans, and monitoring to ensure future improper payments are reduced and/or eliminated.

One recent success: DFAS revised the statistical sampling methodology for Defense Travel System and Integrated Automated Travel Systems for Windows and Commercial Pay improper payments. Both revisions are stratified by invoice dollar amounts and are consistent with recent GAO and DoD IG recommendations. The reports will be generated cumulatively at the end of each quarter for review. The Commercial Pay revised methodology includes two additional pay systems for a comprehensive review of all Departmental Commercial Pay programs.

As the Department moves towards the Congressional 2017 mandate to have fully auditable financial statements, the reduction and prevention of improper payments will ensure the Department achieves Congress's established goal. Towards this goal, the Department is in the process of implementing a revised Travel Pay Remediation Plan, to prevent improper payments in this high risk area. Detailed information regarding improper payments is located in the Other Information section of this report.

U.S. Airmen assigned to the 20th Force Support Squadron Honor Guard fall in line before performing a firing party ceremonial procedure at Shaw Air Force Base, S.C., June 17, 2016. Honor guardsmen perform numerous details on base to include: retirements, change of commands, and promotion ceremony details.

U.S. Air Force photo by Airman 1st Class Christopher Maldonado