United States Department of Defense

Agency Financial Report

Fiscal Year 2017

Management's Discussion and Analysis

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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 firmly committed to safeguarding the national security of the United States and to ensuring that the U.S. military remains the best prepared and most lethal warfighting force in the world.

Secretary of Defense Jim Mattis and Danish Minister of Defence Claus Hjort Frederiksen welcome Ine Eriksen Soreide, Norway's Minister of Defence, to a Global Coalition on the Defeat of ISIS meeting at Eigtveds Pakhus in Copenhagen, Denmark, May 9, 2017.

Photo by Staff Sgt. Jette Carr

Today, the United States faces a dynamic and unpredictable security environment – one that is marked by the continued provocations of rogue states, the proliferation of violent extremist organizations, and the return of competition for global power. North Korea's pursuit of nuclear weapons and the means to deliver them has increased in pace and scope, presenting a threat to all, while the actions of an assertive China and a resurgent Russian Federation have placed the international order under assault. Moreover, the breakdown of the broader Mideast order has enabled the continued rise of terrorist groups, including Al-Qaeda and the Islamic State of Iraq and Syria, and produced security vacuums that have allowed a revolutionary Iranian regime to sow violence, provoke wider Sunni-Shia confrontation, and pursue regional hegemony.

In addition to these concerning geopolitical developments, we are confronted with rapid advances in commercial technologies such as big data analytics, artificial intelligence, robotics, and additive manufacturing that will assuredly shape the character of future wars and erode the conventional overmatch to which our nation has grown so accustomed. The resultant security environment is one that is more volatile than any experienced over the last four decades. Under such circumstances, the Department of Defense cannot afford to be complacent.

Indeed, the complexities of this security environment require a thorough and deliberate examination of the U.S. military's capabilities, capacity, posture, and readiness as well as the articulation of an effective strategy to address emerging challenges and provide for the common defense. To this end, the National Defense Strategy (NDS), which the Department is currently formulating and will submit to the Congress in early 2018, will outline the Department's assessment of the threats facing our nation and serve as the key strategic document driving the Department's priorities, investments, and programmatic decisions. Consistent with the President's National Security Strategy, the NDS will guide the Department as it builds a larger, more capable, and more lethal joint force.

Despite the onerous budgetary limits imposed by the *Budget Control Act of 2011*, the Department will seek to strengthen the military by improving readiness, increasing force capacity, and enhancing key warfighting capabilities to address the known risks the United States faces as a nation while also preparing for the demands of an uncertain future. In addition, the Department will place a greater emphasis on investments in research and development, leveraging innovation from both the traditional defense industry and the commercial sector to assist us in maintaining our competitive advantage well into the future. As a result of these measures, we will be better postured to execute the National Defense Strategy and uphold critical national security objectives, in turn leaving us with a stronger, more secure America.

Marines with the 11th Marine Expeditionary Unit conduct the obstacle course during Martial Arts Instructors Course (MAIC) 1-17 aboard Marine Corps Base Hawaii, May 1, 2017. The MAIC is a three week long course that puts applicants through rigorous training designed to instill teamwork and develop leadership abilities necessary for a Marine Corps Martial Arts Program instructor to teach classes. The Makin Island Amphibious Ready Group/11th MEU is currently underway on their Western Pacific 16-2 deployment.

Photo by Cpl. Aaron S. Patterson

An MQ-9 Reaper remotely piloted aircraft from the 163d Attack Wing performs a touch and go March 24, 2017, at March Air Reserve Base, California. A week earlier, the wing made its first successful touch and go at the base, marking a milestone in the effort to relocate the wing's flight operations to March ARB from Southern California's high desert.

Photo by Airman 1st Class Crystal Housman

RESOURCES

In Fiscal Year (FY) 2017, the Department had discretionary budget authority of $606 billion. Figure 1 displays the DoD FY 2017 budget authority by appropriation type. The Department's priorities outlined in the National Security Presidential Memorandum on Rebuilding the U.S. Armed Forces were built and sustained through program and resources in the FY 2017 budget.

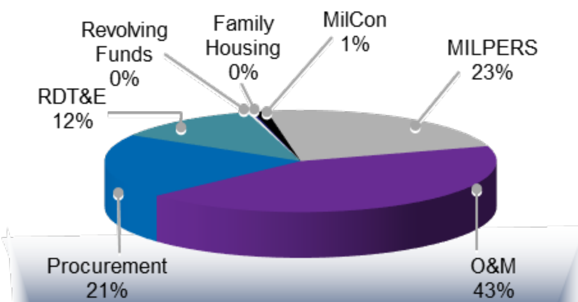
Key themes were:

- Seeking a balanced force,
- Managing enduring readiness challenges,
- Pursuing investments in military capabilities,
- Taking care of our people, and
- Supporting overseas contingency operations.

Appropriation Categories

Military Personnel – Stopped the decrease in overall troop levels by supporting increases to the three components of the Army and adding Air Force personnel in critical mission areas of intelligence, surveillance, and reconnaissance and cyber. It also supported member's ability to move between duty stations as manning levels required.

Figure 1. DoD FY 2017 Budget Authority



Budget by Appropriation	$ in Billions
Military Personnel	$139.5
Operation and Maintenance	$259.7
Procurement	$123.6
RDT&E	$73.1
Revolving Funds	$1.9
Family Housing	$1.3
Military Construction	$6.9
Total	**$606.0**

B10-17-1

Operation and Maintenance – Provided additional training and readiness options including upgrades to Opposing Force (OPFOR) equipment to enable OPFOR to replicate the tactics and capabilities of potential adversaries; provide combat support operations funds; provide maintenance, equipment, and repair parts for the Navy's expeditionary forces service in theaters of operation; increasing ship depot maintenance funding; and increasing flying hours to support tactical training.

Procurement – Included acquisition of equipment including unmanned aerial systems, Air and Missile Defense systems across the operational force, additional aircraft to replace combat worn strike fighters, ammunition, spare parts for existing equipment to maintain combat readiness, and individual personal protective gear to support the warfighter.

Research, Development, Test, and Evaluation – Provided basic and applied research to ensure the United States maintains it technological edge including the development of tools required by the Cyber Mission Force to accomplish its mission.

Family Housing – Provided funding for care and maintenance of existing housing to include support services such as refuse collection and utility services.

Military Construction – Improved existing infrastructure and to provide new and improved facilities including airfields for all services, barracks, and other buildings to support the DoD mission around the world. This includes Planning and Design funding for European Reassurance Initiative projects.

Seeking 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 the full spectrum of conflict while addressing a wide range of security challenges. In addition, the Department must sustain robust investments in science, technology, and research and development in areas most critical to meeting future challenges, including areas with the potential for game-changing advances.

Secretary of Defense James Mattis defined three lines of effort: To restore military readiness as the Department builds a more lethal force, to strengthen alliances and attract new partners, and business reforms. The FY 2017 budget reflected the choices made to achieve a modern, ready, and balanced force to meet the full range of potential military requirements. As directed in the "National Security Memorandum on Rebuilding the U.S. Armed Forces," dated January 27, 2017, the Department identified resources to (1) accelerate the defeat of the ISIS, al Qaeda, and their affiliated groups, (2) increase warfighting readiness, and (3) cover all known must-pay shortfalls. The FY 2017 budget is the vital first step in growing and maintaining a higher state of warfighting readiness in the future.

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 deployed on a periodic operational basis while ensuring strategic surge capabilities for large-scale contingencies or other unanticipated national crises. The Guard and Reserve maintained a total end strength of approximately 809,000 at the end of FY 2017. 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 the warfighting capabilities needed to maintain the military forces and to send U.S. personnel into combat with the best possible training and equipment.

Managing Enduring Readiness Challenges

The DoD recognizes the importance of and commitment to maintaining ready and capable forces. The Department continued initiatives to transition from a force largely focused on current operations to one capable of meeting a broader mission portfolio. In FY 2017, 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 the U.S. to stand as the most formidable military force in the world.

Since the enactment of the *Budget Control Act of 2011,* the Department has absorbed significant budget reductions from the FY 2012 baseline while threats against U.S. vital interests have been growing. Terrorist organizations like ISIS as well as the actions of North Korea, China, and Russia threaten the United States and its friends and allies around the world. The first step in rebuilding the U.S. Armed Forces is increasing warfighting readiness. This means ensuring that the current forces are adequately manned, trained, and equipped to fight. The request for additional appropriations covered all of these areas – manning, training, and equipping – to produce improvements in near-term warfighting readiness.

U. S. Marine Corps Capt. Geoffrey Irving, legal assistant attorney, and his wife, Anna Chou, practice their Marine Corps Martial Arts techniques during J. Wayne Day on Camp Pendleton, Calif., April 28, 2017. J. Wayne Day is an event where spouses or loved ones have a chance to participate in multiple activities such as the Marine Corps Martial Arts, Pistol Range and the Fire Crash and Rescue followed by various demonstrations and displays.

Photo by Lance Cpl. Betzabeth Y. Galvan

Pursuing Investments in Military Capabilities

The Department's research and development efforts are conducted by government laboratories, nonprofit research institutions, and defense companies both large and small. The FY 2017 resources included $13.7 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 capabilities are designed to yield a military force that achieves the nation's security objectives and ensure that the United States remains a technologically superior global force to promote peace and security. Additionally, the Department leads a continuing effort to identify and invest in unique ways to advance U.S. military superiority by incentivizing industry and government 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) leadership practices; 3) war-gaming; 4) operational concepts; and 5) business practices. The Department continues to invest in new strategic approaches and capabilities, such as advancing undersea capabilities and developing new hypersonic missiles, artificial intelligence, and autonomy and robotics, to prevent and win conflicts against 21st century threats.

Moreover, the Department is investing in innovation by developing new partnerships with the private sector and technology communities across the country through collaborative outreach efforts such as that provided by the Defense Innovation Unit-Experimental (DIUx). In FY 2017, the Department directed $60.5 million to support DIUx activities. Additional resources were provided to the Strategic Capabilities Office for their efforts to off-set the technological advances of U.S foes through the identification and development of game-changing applications of existing and near-term technology to shape and counter emerging threats.

Taking Care of Our People

America asks much of its All-Volunteer Force (AVF) and the civilians who support that force. The Department must preserve the quality of its most prized asset, the AVF, which is comprised of high quality, educated, motivated personnel who are committed to excellence in the defense of the nation. The FY 2017 budget kept faith with the men and woman in uniform and their families.

Comprising nearly half of the DoD 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); operates schools, commissaries, restaurants, and 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 MHS 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 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.

Capt. Manisha Mills, a 49th MDOS pediatrician, checks her patient's heart rate March 29, 2017 at Holloman Air Force Base, N.M. Mills' framework consists of about 20-23 appointments per day and in between those appointments, she takes walk-in clients.

Photo by Airman 1st Class Ilyana A. Escalona

Against the backdrop of a competitive military compensation and health benefit 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.

With the NDAA for FY 2016, Congress enacted the Blended Retirement System, a modified retirement system for military members that will be 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 to opt into the Blended Retirement System. Members who join the military on or after January 1, 2018 will be automatically covered by the Blended Retirement System. Although only 19 percent of military members entering service today serve the full 20 years necessary to receive a retirement benefit under the current retirement system, under the Blended Retirement System a member will have the opportunity to achieve retirement benefits that are transferable if full retirement is not reached.

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. In addition, the Department is committed to combatting suicides and sexual assaults by dedicating resources to Department-wide training and prevention programs. Despite global and fiscal challenges, the Department stands with Service members, their families, retirees, and the civilian workforce. However, 16 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 force reductions 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 the Islamic State of Iraq and Syria. Caring for the Department's people remains a top priority for the Department, Congress, and the Administration.

Supporting Overseas Contingency Operations

The Department requested $69.7 billion of OCO funds primarily to conduct Operation Freedom's Sentinel and other missions outside of Afghanistan, such as those in the Horn of Africa and Operation Inherent Resolve against ISIS. 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 FY 2017 OCO funding request to fund certain readiness requirements transferred from the base budget request, National Guard and Reserve Equipment, and improve intelligence, surveillance, and reconnaissance.

A U.S. Army M109A6 Paladin deployed in support of Combined Joint Task Force – Operation Inherent Resolve, assigned to Bravo Battery, 2-82nd Field Artillery, 3rd Brigade, 1st Calvary Division fires during training operation at Camp Manion Iraq, March 10, 2017. Bravo Battery provides base security in support of Combined Joint Task Force – Operation Inherent Resolve, the global Coalition to defeat ISIS in Iraq and Syria.

Photo by Spc. Christopher Brecht

Looking Forward

The Department's first priority is continuing to improve military readiness as it builds a more lethal force. This will be accomplished through the execution of a multi-year plan to fill in the holes caused by trade-offs made during 16 years of war, nine years of continuing resolutions, and *Budget Control Act* caps as well as to prepare for sustained future investment. This effort prioritizes a safe and secure nuclear deterrent and the fielding of a decisive conventional force, while also retaining irregular warfare as a core competency. The Department is focused on strengthening the Military Forces to ensure that the American military edge remains and endures well into this century and beyond.

The Department's second priority is strengthening and attracting new partners. Alliances and multinational partnerships, such as the North Atlantic Treaty Organization and the Defeat-ISIS Coalition, provide avenues for peace and foster the conditions for economic growth with countries sharing the same vision. Strong alliances also serve to temper the plans of those who would attack other nations or try to impose their will over the less powerful. The Department must seek to engage and collaborate with nation states choosing to be strategic competitors, such as Russia and China, while also being prepared to confront inappropriate behavior should they choose to act contrary to American interests or threaten the security of U.S. allies.

A U.S. Air Force member cooks a snake during Cope North 17 survival training at Andersen Air Force Base, Guam, Feb. 17, 2017. Cope North is a long-standing Pacific Air Forces-led exercise designed to enhance multilateral air operations between the U.S. Air Force, U.S. Navy, Japan Air Self-Defense Force and Royal Australian Air Force.

Photo by Airman 1st Class Christopher Quail

The Department's third priority is bringing business reforms to the Department of Defense. This effort focuses on instilling budget discipline and effective resource management, developing a culture of rapid and meaningful innovation, streamlining requirements and acquisition processes, and promoting responsible risk-taking and personal initiative. Examples of current and upcoming business reform initiatives include the Department's preparations for its first full-scope financial statement audit in Fiscal Year 2018, the efforts to modernize the defense travel system, and the efforts to improve the efficiency of information technology business operations. With these and other efforts, the Department demonstrates its devotion to gaining full value from every taxpayer dollar spent on defense, thereby earning the trust of the Congress and the American people.

In the pursuit of these efforts, the Department recognizes that it is critical to preserve its most enduring and competitive advantage – the Department's people. The Department is fully committed to improving the recruitment and retention of the brightest and most committed young men and women to make the Department the most rewarding environment it can be for those who choose to serve.

ORGANIZATION

The Department of Defense (DoD) maintains and uses military 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 800,000 personnel serving in the National Guard and Reserve forces, and about 750,000 civilians. The Department's military Service members and civilians operate in every time zone and in every climate. There are also approximately 2.3 million military retirees and survivors receiving retirement payments.

Secretary of Defense Jim Mattis speaks with representatives of key military and veteran support organizations at the Pentagon in Washington, D.C., April 12, 2017. To his left is Dana White, assistant to the Secretary of Defense for Public Affairs (ATSD), and to his right is U.S. Air Force Lt. Col. Kristi Beckman, director of community and public outreach for the Office of the ATSD.

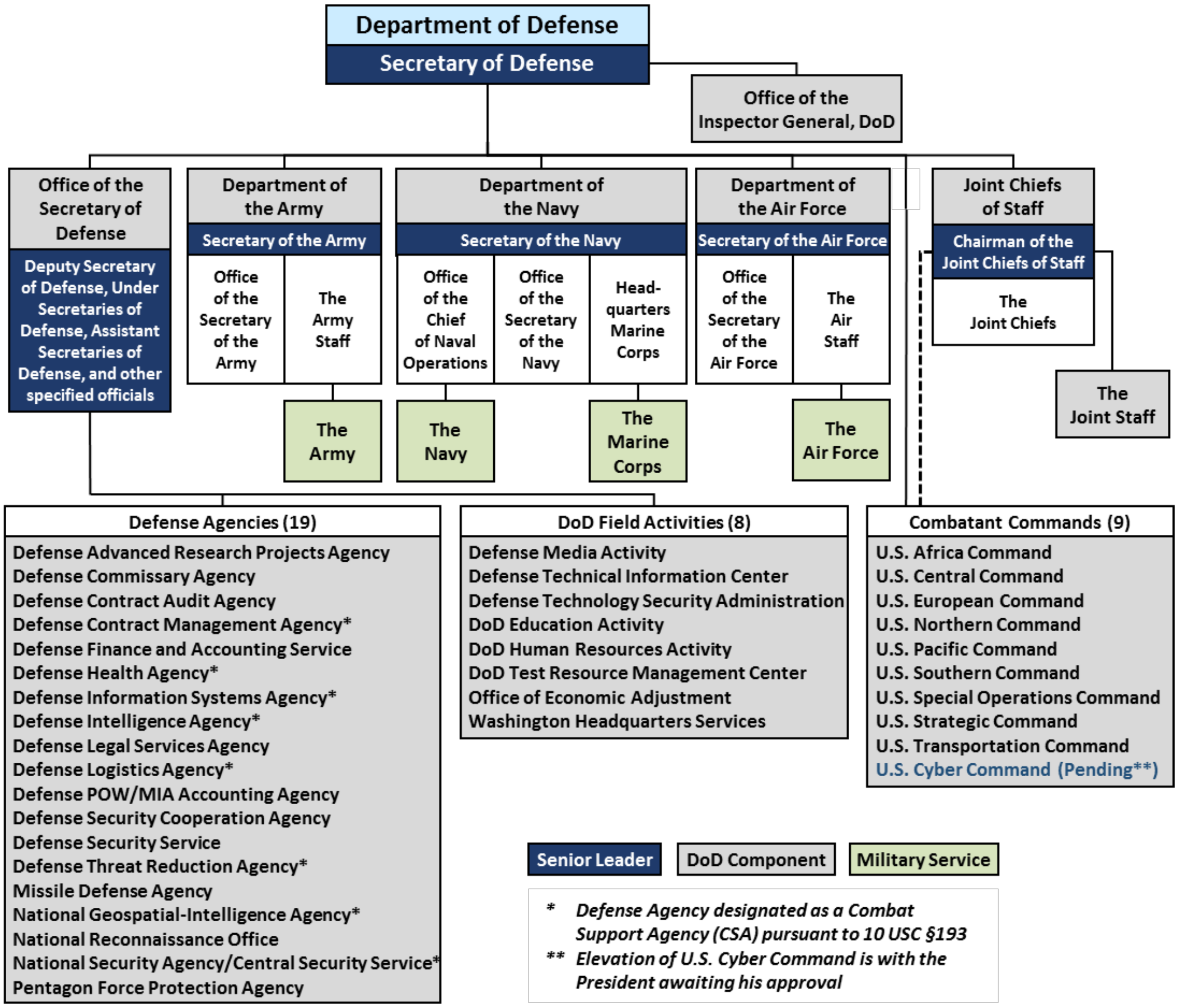
Photo by Air Force Tech. Sgt. Brigitte N. Brantley

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 568,000 facilities (buildings, structures and linear structures) located in more than 4,800 sites worldwide. These sites represent more than 27.1 million acres that individually vary in size from training ranges with over 4 million acres, such as the White Sands Missile Range, to single weather towers or navigational aids isolated on sites of less than one one-hundredth (0.01) of an acre. Of the land the Department manages, only about 31 percent is held by the Department 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 over 14,000 aircraft and approximately 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 (as seen in Figure 2) is currently composed of the Office of the Secretary of Defense (OSD), Joint Chiefs of Staff, Joint Staff, DoD Office of the Inspector General (OIG), 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

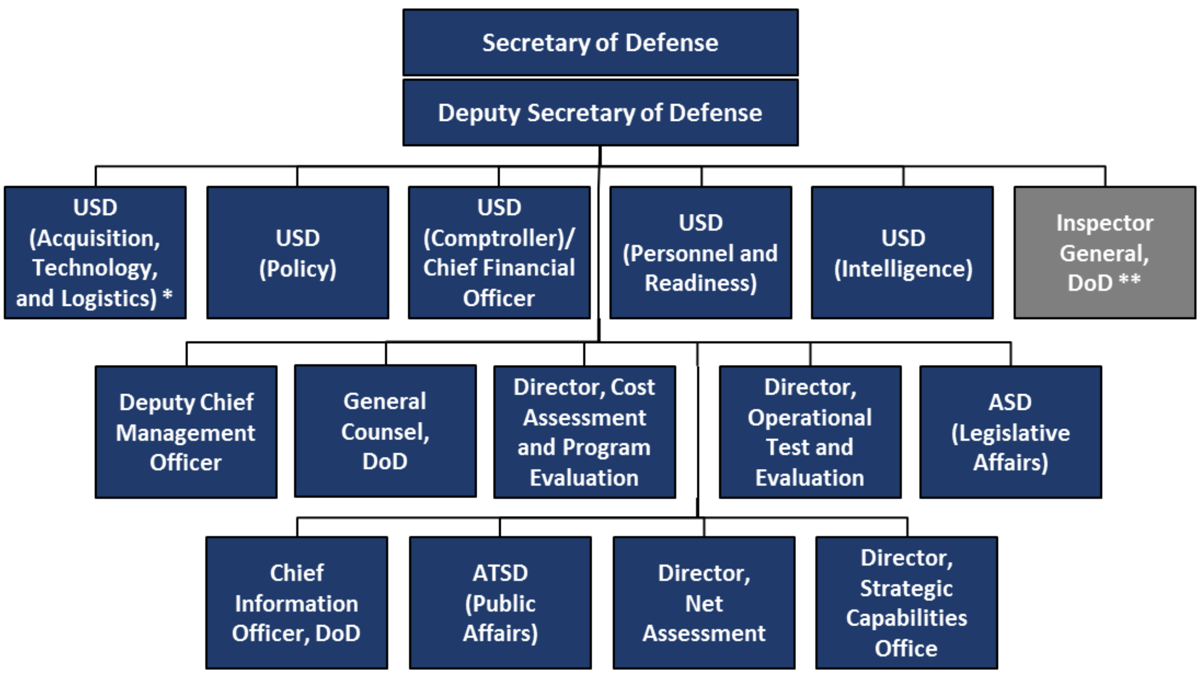


The Office of the Secretary of Defense

The function of the *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; the *Deputy Chief Management Officer*; the *Department of Defense Office of the General Counsel*; the Assistant Secretaries of Defense; the Assistants to the Secretary of Defense; the OSD Directors, and their equivalents; the Inspector General, Department of Defense; and other staff offices within OSD established by law or by the Secretary.

The OSD Principal Staff Assistants 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



** The USD for Acquisition, Technology, and Logistics is being split into two offices on February 1, 2018*

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

Acronyms: USD–Under Secretary of Defense, ASD–Assistant Secretary of Defense, ATSD–Assistant to the Secretary of Defense

The Joint Chiefs of Staff and the Joint Staff

The Joint Chiefs of Staff (*JCS*), supported by the Joint Staff under the direction of the Chairman, constitute the immediate military staff of the Secretary of Defense. The Joint Chiefs of Staff consist of the Chairman (*CJCS*), the Vice Chairman (*VCJCS*), the Chief of Staff of the Army (*CSA*), Chief of Naval Operations (*CNO*), the Chief of Staff of the Air Force (*CSAF*), the Commandant of the Marine Corps (*CMC*), and the Chief of the National Guard Bureau (*CNGB*). 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 *OIG* is an independent unit within the Department that conducts and supervises audits and investigations relating to the Department's programs and operations. The DoD Inspector General 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 four Services and the U.S. Coast Guard are collectively referred to as the U.S. Armed Forces per title 10, United States Code, *section 101(a)(4)*. The three Military Departments organize, staff, train, equip, and sustain America's military forces and are composed of four Military Services (Army, Navy, Marine Corps, and Air Force) or five when including the U.S. Coast Guard, when directed. These trained and ready forces are assigned or allocated to a Combatant Command responsible for maintaining readiness to conduct military operations.

U.S. Marines with Lima Company, 3rd Battalion, 8th Marine Regiment, take cover after setting off a donut charge for an urban assault breaching range during a deployment for training exercise at Fort Pickett, Blackstone, Va., Dec. 9, 2016. The range was an opportunity for the Marines to practice the fundamentals of their job to better prepare them for deployment.

Photo by Sgt. Clemente C. Garcia

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 Reserve Forces 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).

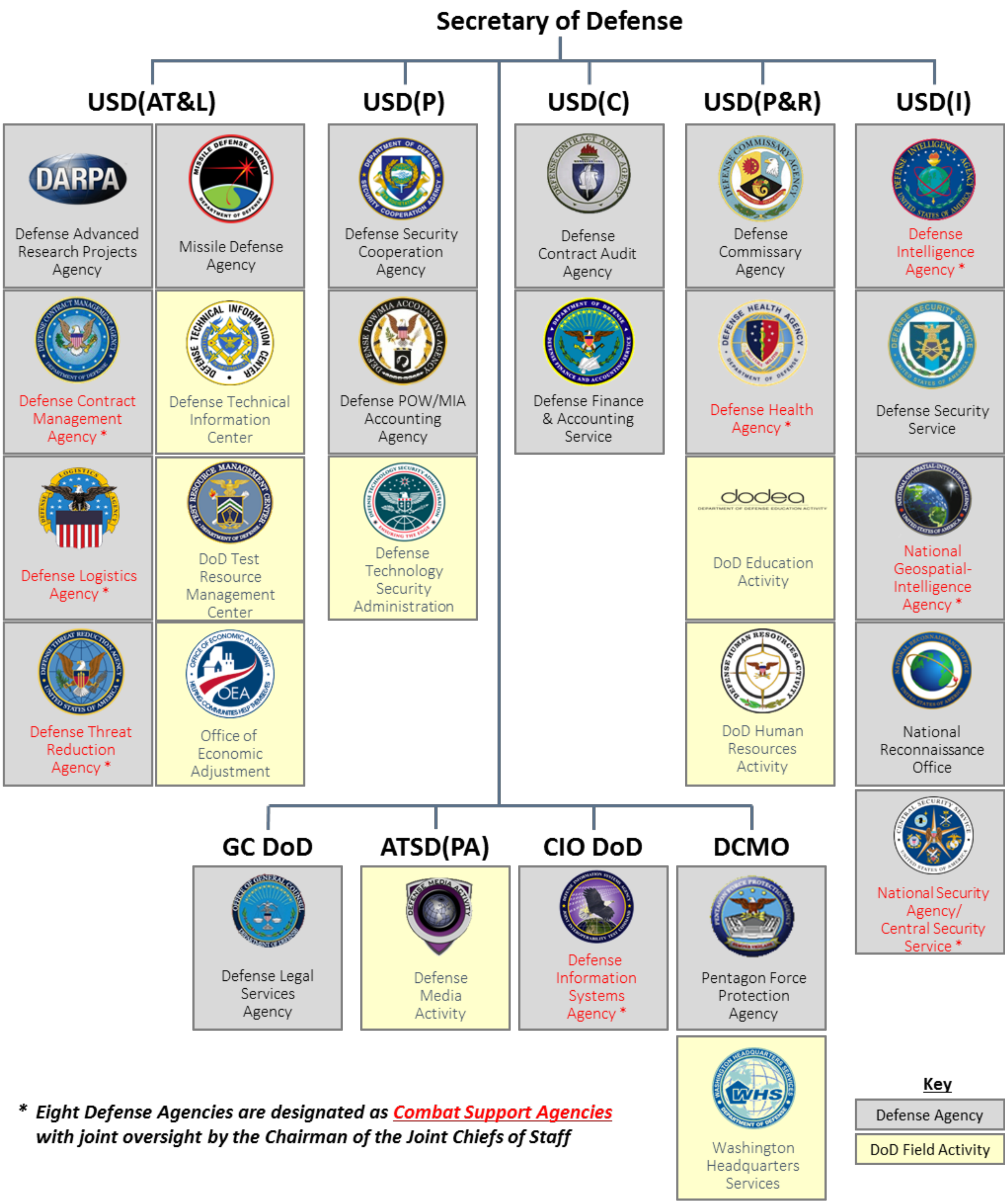
When ordered to active duty for national emergencies or other events, units of the National Guard or Reserve Forces of the Military Services are placed under operational control of the appropriate Combatant Commander or provide support to a Military Service. The National Guard and Reserve forces are 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

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 Department-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 both 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 19 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.

Figure 5. Defense Agencies and DoD Field Activities



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.

Figure 6. 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.

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.

U.S. Air Force Airman 1st Class Christian Williams, 36th Airlift Squadron loadmaster, releases cargo from a U.S. Air Force C-130 Hercules during an airdrop operation during Cope North 2017, Feb. 22, 2017. The exercise includes 22 total flying units and more than 2,700 personnel from three countries and continues the growth of strong, interoperable relationships within the Indo-Asia Pacific region through integration of airborne and land-based command and control assets.

Photo by Senior Airman Keith James

PERFORMANCE OVERVIEW

The *Deputy Secretary of Defense*, as the Department of Defense's (DoD) Chief Management Officer and Chief Operating Officer, is responsible for performance management and improvement within the Department. Each year, in accordance with the *Government Performance and Results Act of 1993* and Office of Management and Budget *Circular No. A-11*, the Department develops and tracks performance goals and measures to meet DoD strategic priorities.

The *Government Performance and Results Modernization Act of 2010* requires the development of a DoD *Agency Strategic Plan* (ASP). The Department's Fiscal Years (FY) 2015 – 2018 ASP strategic goals were:

- Strengthen and enhance the health and readiness 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.

The Department will publish and submit to Congress the FY 2018 – 2022 DoD Agency Strategic Plan with the FY 2019 President's Budget Request in February 2018. This plan will align to Secretary of Defense priorities and support the administration's management agenda.

This section provides an executive level overview of DoD's performance through Quarter 3, FY 2017, ending June 30, 2017. Complete FY 2017 results will be published in the Annual Performance Report (*APR*) section of the Department's FY 2019 President's Budget Request in February 2018.

Sailors assigned to Explosive Ordnance Disposal Mobile Unit (EODMU) 11 ascend a rope to an MH-60S Sea Hawk helicopter, from the "Eightballers" of Helicopter Sea Combat Squadron (HSC) 8, while conducting helicopter, visit, board, search, and seizure (HVBSS) training during a composite training unit exercise (COMPTUEX) with the Nimitz Carrier Strike Group in preparation for an upcoming deployment. COMPTUEX tests the mission readiness of the strike group's assets through simulated real-world scenarios and their ability to perform as an integrated unit.

Photo by Mass Communication Specialist 3rd Class Deanna C. Gonzales

Summary of Performance Results

At the end of Quarter 3, FY 2017, 50 percent of DoD quarterly performance measures were on track to meet the annual goals, while 50 percent did not meet third quarter targets and could be considered at risk of not achieving annual targets. Of the remaining performance measures, 36 measures will be reported after the close of FY 2017. A selection of Departmental successes and areas for improvement are highlighted below.

Transition to Veterans

Our Nation should provide the best support possible to those who keep our country free and strong as they transition to civilian life. The Department remains focused on how to achieve lasting success for transitioning Service members both in preparing them for careers beyond the military and ensuring a smooth transition from active duty. To effectively address these issues, the Department continues to implement policies and practices that focus on readiness and supporting Service members and their families.

The Department and other critical federal partners are working to ensure that all eligible Service members participate in an effective program of pre-separation planning and education through evidence-based learning. This support is delivered through curriculum, the "Transition GPS (Goals, Plans, Success)" within the DoD Transition Assistance Program (TAP), which is comprised of both core instructional blocks and individually selected tracks for accessing higher education, for obtaining career technical training, and for entrepreneurship. Through Quarter 3, FY 2017, more than 90 percent of known eligible active duty and Reserve Component Service members have met the TAP performance objectives.

U.S. Army veteran, David Iuli, throws a discus during the Warrior Care and Transition's Army Trials, competing for a chance to go to the Department of Defense level 2017 Warrior Games, at Fort Bliss, Texas, April 5, 2017. The Warrior Games is an annual event allowing wounded, ill and injured Service members and veterans to compete in Paralympic sports including archery, cycling, shooting, sitting volleyball, track and field, swimming and wheelchair basketball.

Photo by Spc. Fransico Isreal

Since 2007, the Department of Defense and the Department of Veterans Affairs (VA) have operated the Integrated Disability Evaluation System (IDES) to provide both DoD and VA disability benefits to Service members discharged due to medical disability. For the IDES performance goals, during Quarter 3, FY 2017, the equally weighted goal components of the average of IDES process timeliness; Service member customer service satisfaction; accuracy and consistency of Military Department IDES dispositions; and Military Department compliance with case processing administrative requirements resulted in an overall 85 percent score for DoD IDES performance measure, which exceeded the third quarter target (80 percent). The Department will continue to evaluate the Military Departments' performance against all measures that comprise the IDES Performance Goal.

Reform the DoD Acquisition Process

As the *2016 Annual Report on the Performance of the Defense Acquisition System* illustrates, cost growth for Major Defense Acquisition Programs is at a 30-year low. The Department has achieved this success by observing several key tenets: setting reasonable requirements, putting trained professionals in charge, giving them the resources that they need, and providing strong incentives for success. With some exceptions, performance requirements and schedules are generally stable across major programs and the United States continues to field the most capable warfighting systems in the world.

Since the *Weapons System Acquisition Reform Act of 2009*, major programs baselined reflect cumulative underruns in excess of $30 billion. All three Military Departments are showing net improvements across their portfolios of programs with original baselines since 2009. This result comports with analysis indicating that cost growth has improved recently and that it is the programs started before 2009 that have higher cost growth. The Department has seen success in ensuring it is paying reasonable prices by tying contractor performance and risk to profit/fee. The Department has been monitoring operating margins of prime contractors to ensure that the net effect of these efforts – combined with other issues, such as sequestration – is not undermining the health of the defense industrial base. Results for the six largest prime contractors since 2009 show that they have performed consistently or slightly better, providing evidence that our efforts have not hurt the profit margins of these companies.

The annual report also describes the Department’s significant progress in rebuilding the acquisition workforce. Congress made this success possible by enacting legislation for the Defense Acquisition Workforce Development Fund, Acquisition Demonstration Project (AcqDemo), and other special hiring authorities. The Department has rebuilt workforce size, reshaped the workforce to strengthen early and mid-career year groups, significantly improved certification and education levels, and expanded participation in the contribution-based AcqDemo personnel management system.

The Department has had many successes but will continue to review and improve work in delivering capability to the warfighter and protecting the American people. Average development timelines for major programs must be reduced to be more responsive to the force. Defense manufacturing costs continue to increase at rates greater than those of the larger economy. To some extent this is the result of the increasing complexity and performance requirements of the systems themselves, but the overall trends are unaffordable.

Innovation

U.S. Army Sgt. Justin Carrington, an unmanned aircraft system repairer with Delta Company, 9th Engineer Battalion, 2nd Brigade Combat Team, 3rd Infantry Division, prepares to launch an RQ-7 Shadow unmanned aerial vehicle (UAV) at Evans Army Airfield near Fort Stewart, Ga., Jan. 25, 2017. Soldiers with Delta Company supported the battalion field training exercises with surveillance from UAVs.

Photo by Spc. Efren Rodriguez

The Department-wide focus on technology innovation seeks to identify and invest in unique capabilities to sustain and advance the Department's military superiority for the 21st Century. The Department's research and engineering enterprise plays a vital role in maintaining the U.S. technological advantage despite the increased rate of investment in military research and development (R&D) from near-peers and easy proliferation of knowledge and technology that has eroded U.S. historic advantages. The Department's research and engineering enterprise is focused on providing the technologies to address current and future threats, reducing the cost of current systems while increasing their capability, and creating technological surprise for our adversaries. In the process of delivering capabilities into the warfighter's hands, we have leveraged all sources of innovation, both internal and external to the Department, and we used prototyping and experimentation to inform, evaluate, and accelerate technology development. The Department's continued R&D efforts contribute to the fielding of capabilities to the warfighter to ensure the Department is able to win today's fight and any future fights.

Audit and Audit Remediation

The *National Defense Authorization Act for FY 2014* mandates that the Secretary of Defense ensures a full audit is performed on the DoD financial statements beginning in FY 2018. The DoD Consolidated Audit will likely be the largest audit ever undertaken. It comprises more than 24 standalone audits and an overarching consolidated audit. The Department has notified the Department of Defense Inspector General and congressional committees that it has the necessary capabilities to start the full financial statement audit in FY 2018. The Department expects to receive a variety of audit findings and recommendations, which will help to establish the baseline and provide a benchmark against which progress can be measured.

Remediating audit findings from the full financial statement audits is at the core of the Department's audit strategy and is the most certain and cost-effective path to achieving a positive audit opinion. The audit assesses our financial process and systems and will bring to light areas where the Department can improve. Over the next year, the Department must support a number of concurrent activities, including supporting the ongoing audits, addressing issues identified in earlier audits, and planning for future audits. This all directly supports the Department's strategic priority to transform business processes.

In order to standardize how audit results are reported and tracked, the Department has developed a common tool with standardized categories of deficiencies in order to capture critical elements of audit findings to drive change and accountability and to measure progress. The tool will support accountability of remediation activities across the Components. The FY 2017 Annual Performance Plan (*APP*), which will be published as part of the Department's FY 2019 President's Budget Request in February 2018, will represent self-reported progress against performance measures identified in prior years. In FY 2018, these performance measures and targets will be changed in response to expected feedback and Notifications of Findings and Recommendations received from the audit results.

Energy

The Services and Combatant Commands have made strides in including the risks of energy disruptions in planning activities. Experiential learning through including operational energy in wargames, exercises, and operation plans allows the industrial base to bring capabilities they have developed and truly test them with the warfighter. This benefits the government-industry partnership and allows Concepts of Operation and new warfighting strategies to be developed.

The earlier we consider energy in the development process, the more we are able to effectively influence the design and capability of future systems. Underpinned by an analysis of how a system will be supported in a future warfighting scenario, the energy key performance parameter helps the Department make holistic decisions about future combat forces and the energy logistics and infrastructure needed to support those forces. The needs of the Combatant Commands will inform Department investments in people, equipment, and installations. Joint and Service wargames and scenario analyses will identify long-term risks to our combat capability that can be remedied through changes in how we consume and distribute energy in operations. These "demand signals" for operational energy improvements will then be integrated across requirements, acquisition, and innovation decision-making to quickly and effectively meet warfighter needs.

Competitively Awarded Contract Obligations

When viable, competition is, perhaps, the single best way to motivate contractors to provide the best value (i.e., the best performance at the lowest price). To this end, the Department continues to set and strives to achieve competition goals. The Military Departments each analyze projections of future acquisitions to identify opportunities and creative strategies for future competitive awards.

Competition achievement by contracting organizations varies widely based upon the missions and type of supply or service being procured. Challenges to improving competition include high-value sole-source Foreign Military Sales, large on-going shipbuilding and aviation programs, and sustainment for major weapon systems that have already moved past the stage in the lifecycle where competition is economically viable. Another challenge can be industry bid-protests of source selections results, which may require the Department to award sole-source bridge contracts for goods and services in the interim until the protests are resolved and the new contracts can be awarded.

Despite these challenges, the Department is continuing to pursue various approaches for breaking out system components for competition and take steps to increase competition for major systems by introducing competition during the sustainment phase of a product's life cycle through the use of open systems and open architectures. Beyond this kind of head-to-head competition, the Department is also expanding the types and use of other competitive environments to drive performance and cost savings. For example, the Navy's evolving Profit-Related-to-Offer techniques adjust profits and production share between two captive shipyards based on bidding and cost control. Finally, analysis is being used to continue to set goals based on what is achievable rather than on simply setting goals based on prior actuals.

U.S. Navy Flight Demonstration Squadron, The Blue Angels fly over Cinderella's Castle at Walt Disney World's Magic Kingdom en route to the Sun n' Fun Air Show in Lakeland, Florida. The Blue Angels are scheduled to perform more than 60 demonstrations across the U.S. in 2017.

Photo by Petty Officer 2nd Class Ian Cotter

Civilian Hiring End-to-End Timeline

As reflected in the establishment of this performance goal, the capacity to hire quality candidates in a timely manner is critical in the Department's ability to build a larger, more capable, and more lethal joint force. Factors both within and beyond the control of the Department have contributed to the overall increase of time to hire for the previous quarters of FY 2017. Simply, there has been no single factor that can be identified as the sole contributor.

Some areas of ongoing assessment influencing the time to hire (TTH) include inconsistency in communications across Components, differences in Human Resources (HR) Information Technology systems, lack of consistent process execution, varying degrees of interpretations of the law, HR span of control in the hiring process, budget, and/or seasonality affects. Multiple internal and external forces can complicate both analysis in understanding and determining root causes, and in implementing successful action plans.

The Department has continued to work through these challenges and uncertainties through increased engagement with the Office of Personnel Management. The buildup of analytical capabilities and competency models in USA Staffing as well as the reestablishment of a DoD TTH Civilian Hiring working group have allowed for enhanced communications, sharing of best practices, and strengthening of targeted training and professional development opportunities within the HR community. Additionally, reemphasizing the importance of communication between the HR advisors and the hiring managers will continue to be a priority effort to improve TTH processes. To ensure progress in achieving timely hiring practices, objectives and targets that contribute to program success will be captured and monitored as part of the Human Capital Operating Plan. The Department will continue to review and assess the TTH process in order to minimize negative impacting factors, while seeking to achieve its ultimate goal of timely hiring.

Summary

As outlined in the *DoD Annual Performance Report*, the Department is a performance-based organization. The Department is committed to managing towards specific, measurable goals derived from a defined mission, using performance data to continually improve operations. These measurable goals include supporting veterans transitioning into the civilian workforce; reforming the DoD acquisition process; and pursuing improvement opportunities related to audit support and remediation, encouraging competition in the contract award process, and civilian TTH. The Department looks forward to working with the Administration and Congress to meet the challenge of creating more effective and efficient operations, while delivering a high-value return for the American taxpayers in carrying out its mission of protecting the country and its interests.

FINANCIAL OVERVIEW

The preceding sections of this report provide a description of the Department of Defense's (DoD) operations in Fiscal Year (FY) 2017 and a high-level overview of the Department's performance against objectives as of Quarter 3, FY 2017. The FY 2017 final results for all Department performance measures will be reported in the Department's Annual Performance Report, which will be available in February 2018. The Financial Overview will cover financial highlights and significant financial improvement initiatives.

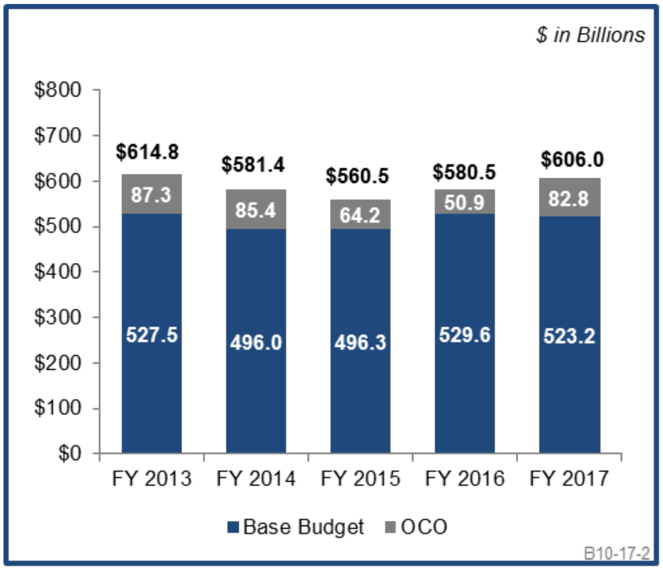
FINANCIAL HIGHLIGHTS AND ANALYSIS

The principal financial statements have been prepared to report the financial position and results of operations of the Department of Defense (DoD), pursuant to the requirements of Title 31, United States Code, *section 3515(b)*. The statements have been prepared from the accounting records of the Department in accordance with Office of Management and Budget *Circular No. A-136*, "Financial Reporting Requirements," and, to the extent possible, U.S. Generally Accepted Accounting Principles 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.

The Defense Finance and Accounting Service 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

Figure 7. Trend in DoD Budget Authority



Statement of 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 Resources section of this report and as depicted in Figure 7, the Department's Fiscal Year (FY) 2017 budget authority total is $606 billion.

In FY 2017, the Department reported $1.1 trillion in total budgetary resources (as shown in Figure 8). The total amount of "Appropriations (discretionary and mandatory" ($777.0 billion) reported on the SBR consists of appropriations enacted for the Department, contributions for DoD military retirement and health benefits made by the U.S Treasury from the U.S. Treasury's general fund, and appropriations to finance civil works projects managed by the U.S. Army Corps of Engineers. The Department also receives appropriations to finance civil work projects managed by the U.S. Army Corps of Engineers. 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 Budgetary Resources" 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 8. Composition of DoD Total Budgetary Resources

Description	FY 2017 ($ in Billions)
DoD Enacted Appropriations *	$606.0
U.S. Treasury contribution for Military Retirement and Health Benefits	94.3
Civil Works Projects executed by the USACE	5.8
Trust Fund Receipts	153.2
Trust Fund Resources Temporarily not Available	(82.3)
Total Appropriations (discretionary and mandatory) Reported on SBR	**$777.0**
Unobligated Balances from Prior Year Budget Authority	181.0
Spending Authority from Offsetting Collections	105.7
Contract Authority	76.5
Total Budgetary Resources	**$1,140.2**
* DoD FY 2017 Budget Authority from Figure 1	

Additional budgetary resources include $181.0 billion of unobligated balances stemming from prior year budget authority, $105.7 billion in spending authority from offsetting collections, and $76.5 billion of contract authority.

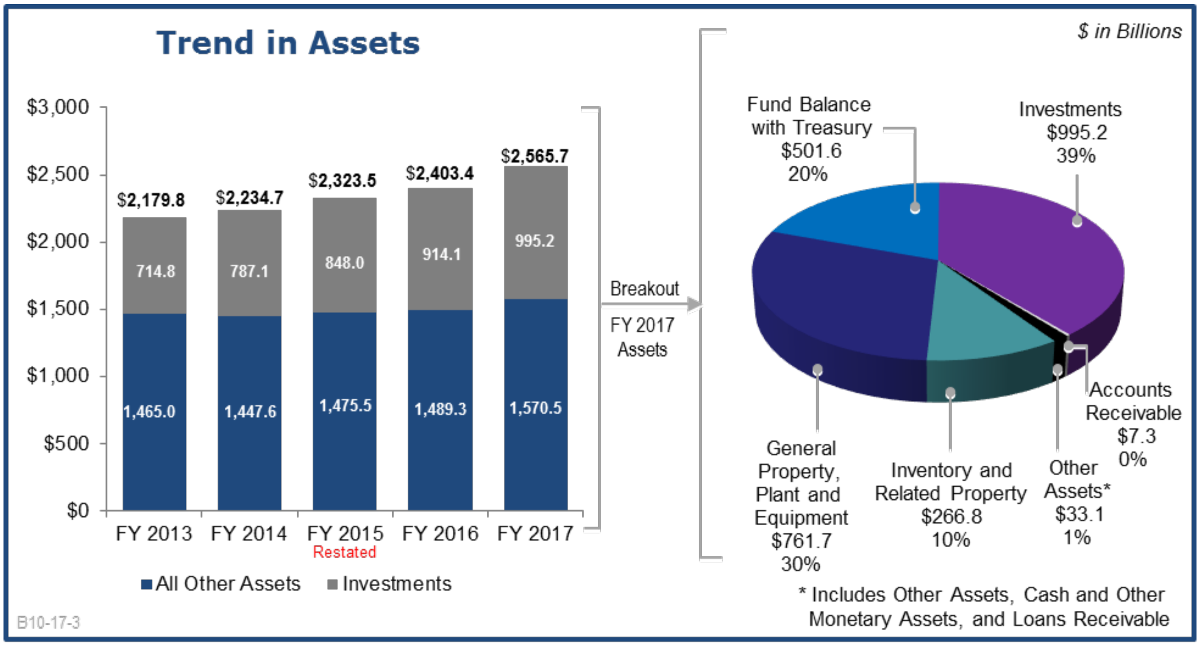
Of the $1.1 trillion in total budgetary resources, $981.5 billion was obligated and $899.8 billion of obligations were disbursed. The remaining unobligated budgetary resources balance relates primarily to appropriations available to cover multi-year investment projects, which require additional time for completion. In addition, 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, 2017, 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 $2.6 trillion in assets shown in Figure 9 represent amounts the Department owns and manages. Investments; General Property, Plant, and Equipment; and Fund Balance with Treasury represent 89 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.

Figure 9. Summary of Total Assets



Total Assets increased $162.4 billion (7 percent) from FY 2016, largely due to increases in Investments in U.S. Treasury securities ($81.1 billion) and General Property, Plant, and Equipment ($50.0 billion). As displayed in Figure 9, the Department has realized growth in Investments over the last several years. The Investments increase was primarily due to normal growth in the Military Retirement Fund that resulted 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. The increase in General Property, Plant and Equipment was the result of the Department's continued effort to establish opening balances and the revaluation of military equipment associated with the recently published Statement of Federal Financial Accounting Standards *(SFFAS) 50*, "Establishing Opening Balances for General Property, Plant, and Equipment." The Department expects additional changes in its beginning balance in future years as components continue to refine their accounting and valuation efforts in this area based on feedback from the Independent Auditors.

As seen in Figure 10, the Department's total liabilities increased $75.1 billion during FY 2017, largely due to adjustments in the estimated actuarial liability associated with military retirement benefits. This change is primarily attributable to changes in expected interest costs, normal costs, and changes in actuarial assumptions, net of benefit outlays. The Department's $2.5 trillion of liabilities reported in FY 2017 are backed by the full faith and credit of the U.S. Government.

Figure 10. Summary of Total Liabilities

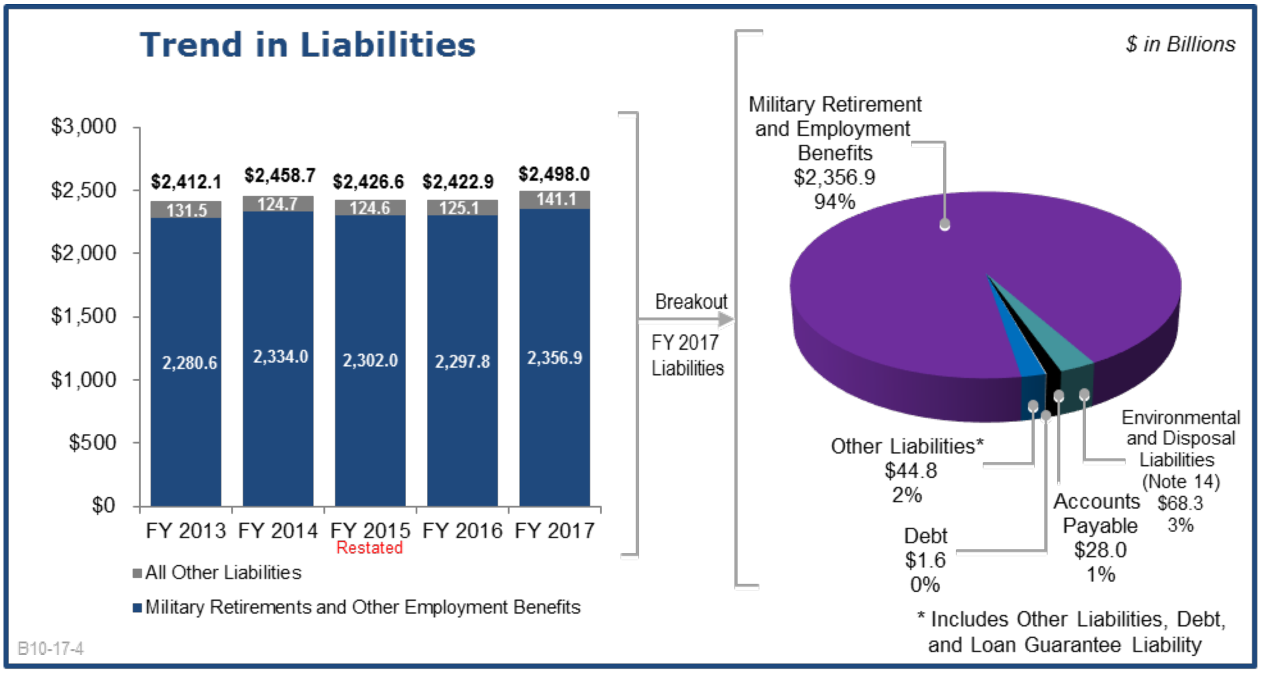
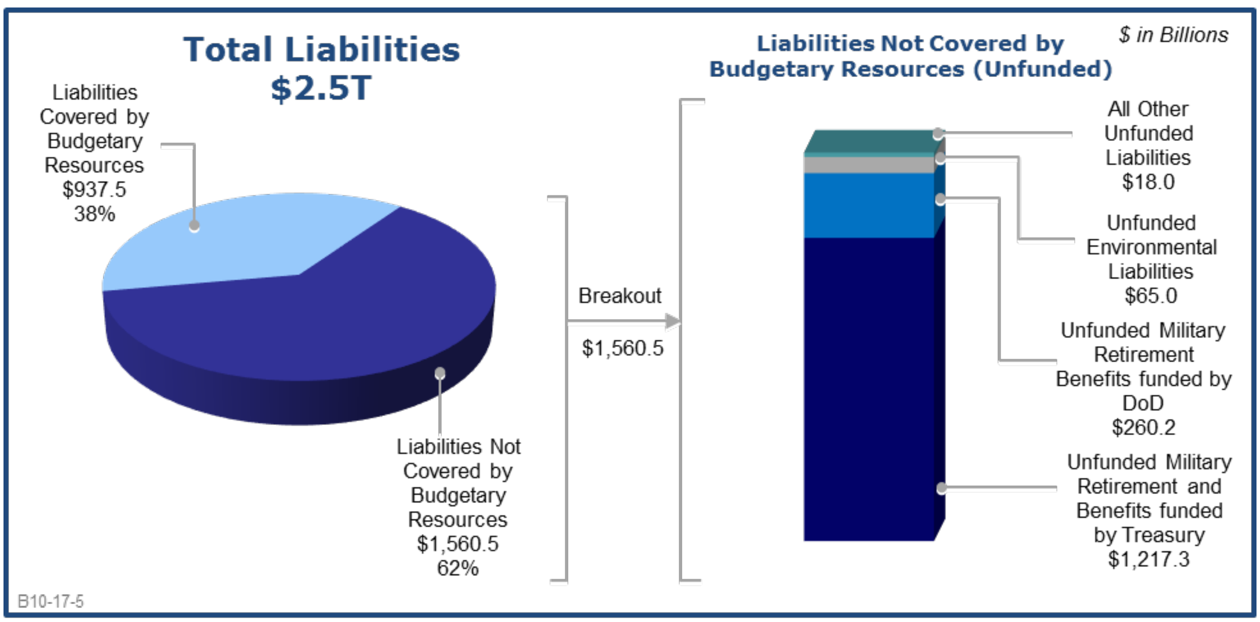


Figure 11 shows $2.5 trillion total liabilities with $1.6 trillion in liabilities not covered by budgetary resources (unfunded) that will require future resources. The U.S. Treasury is responsible for funding the $1.2 trillion actuarial liability that existed at the inception of the military retirement pension and Medicare-eligible health care programs which is approximately 78 percent of the $1.6 trillion.

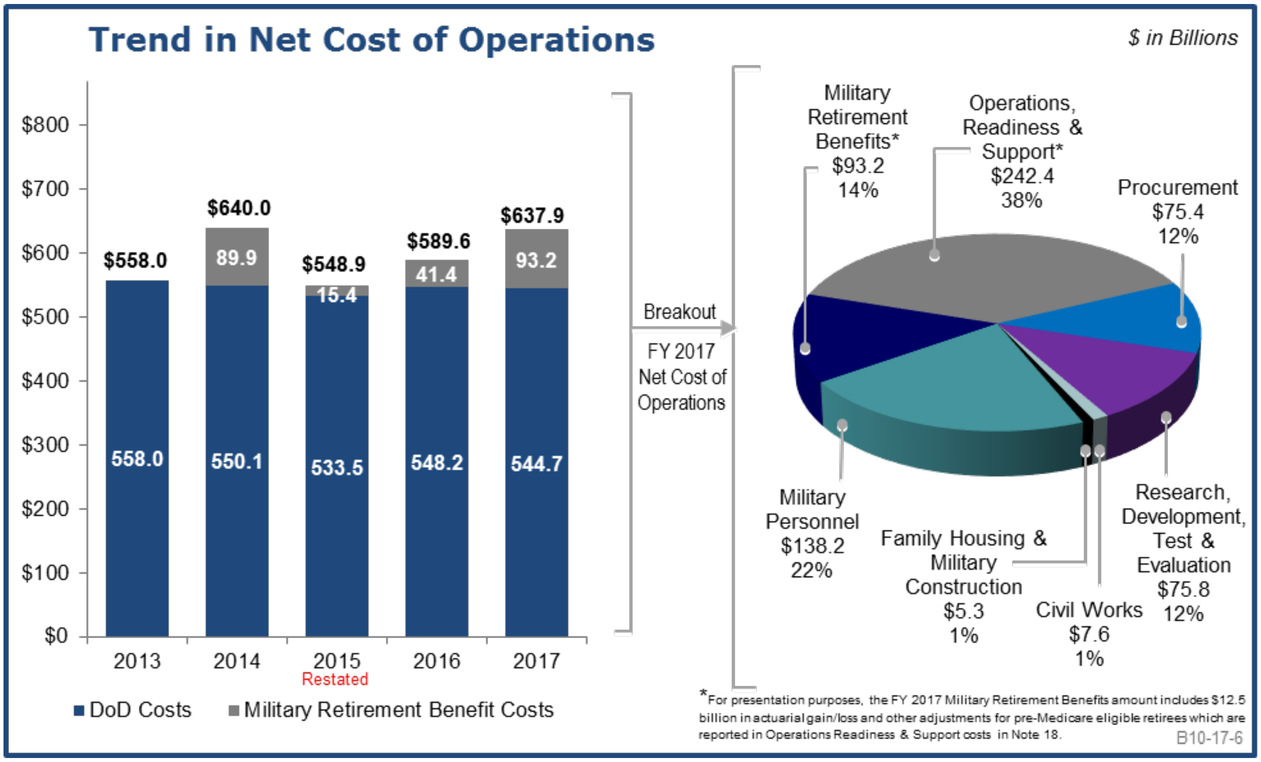
Figure 11. Liabilities Covered/Not Covered by Budgetary Resources



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 (minus) the change in 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.

Figure 12. Summary of Net Cost of Operations



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 $637.9 billion in net cost of operations during the fiscal year.

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 financial statement 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 sources financing the Department's operations. The Department's ending net position increased $87.3 billion during FY 2017. 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 are expected to continue growing to cover unfunded portions of future benefits.

Financial Performance Summary

The Department's financial performance is summarized in Figure 13. 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 variances presented in the comparative statements. Nevertheless, the data underlying the amounts is used to manage the Department's operations successfully.

Figure 13. Financial Performance Summary

Dollars in Billions	FY 2017	FY 2016	Change	% Change
ASSETS				
Fund Balance with Treasury	$ 501.6	$ 474.3	$ 27.3	5.8%
Investments	995.2	914.1	81.1	8.9%
Accounts Receivable	7.3	8.8	(1.5)	(17.0%)
Other Assets	33.1	39.2	(6.1)	(15.6%)
Inventory and Related Property, Net	266.8	255.3	11.5	4.5%
General Property, Plant and Equipment, Net	761.7	711.7	50.	7.0%
TOTAL ASSETS	**$ 2,565.7**	**$ 2,403.4**	**$ 162.3**	**6.8%**
LIABILITIES				
Accounts Payable	$ 28.0	$ 20.2	$ 7.8	38.6%
Other Liabilities	44.8	42.1	2.7	6.4%
Military Retirement and Other Federal Employment Benefits	2,356.9	2,297.9	59.0	2.6%
Environmental and Disposal Liabilities	68.3	62.7	5.6	8.9%
TOTAL LIABILITIES	**$ 2,498.0**	**$ 2,422.9**	**$ 75.1**	**3.1%**
TOTAL NET POSITION (ASSETS MINUS LIABILITIES)	**$ 67.7**	**$ (19.5)**	**$ 87.2**	**447.2%**
Total Financing Sources	$ 680.0	$ 699.4	$ (19.4)	(2.8%)
Less: Net Cost	(637.9)	(589.6)	(48.3)	8.2%
NET CHANGE OF CUMULATIVE RESULTS OF OPERATIONS	**$ 42.1**	**$ 109.8**	**$ (67.7)**	**(61.7%)**
TOTAL BUDGETARY RESOURCES	**$ 1,140.2**	**$ 1,101.3**	**$ 38.9**	**3.5%**

FINANCIAL MANAGEMENT IMPROVEMENT INITIATIVES

Financial Improvement and Audit Readiness Initiative

In Fiscal Year (FY) 2017, the Department of Defense (DoD) concluded its preparation efforts and will undergo a full financial statement audit for FY 2018. The Department has the capabilities in place to allow an auditor to scope and perform a full financial statement audit that results in actionable feedback.

Currently, nine DoD Components and funds have positive opinions on their full financial statements. Eight DoD Components and funds are sustaining positive opinions on their full financial statements, i.e., the U.S. Army Corps of Engineers – Civil Works, the Defense Commissary Agency, Defense Contract Audit Agency, Defense Finance and Accounting Service, Defense Health Agency – Contract Resource Management, Military Retirement Fund, Medicare-Eligible Retiree Health Care Fund, and the DoD Office of the Inspector General. Additionally, the Defense Information System Agency achieved a positive opinion on their financial statements for the first time.

The Army expanded the scope of its audit in FY 2017 to cover additional primary financial statements and the Air Force continued to have its schedule of budgetary activities audited. The Navy was also under limited-scope audit in FY 2017. Several defense agencies also expanded the scope of their audit readiness examinations.

In FY 2018, the Department will undergo an audit of all four of its principal financial statements (i.e., Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, and Statement of Budgetary Resources), including activity for both General Funds and Working Capital Funds. The audit of the Department's full financial statements comprises over 24 standalone audits and an overarching consolidated audit.

When full financial statement audits begin in FY 2018, the Department's focus will shift from preparing for audit to prioritizing and remediating audit findings with the goal of moving closer to a positive opinion. In order to standardize how audit findings are reported and tracked, the Department has developed a common tool with standardized categories of deficiencies in order to capture critical elements of audit findings to drive change. This tool will enable leaders to monitor completion of improvements, determine best practices, and identify common and systemic issues so that Department-wide solutions can be implemented.

Additional information on the (Financial Improvement and Audit Readiness) FIAR initiative is available in the semiannual *FIAR Plan Status Report*, available on the Under Secretary of Defense (Comptroller), Office of the Deputy Chief Financial Officer website.

Financial Management Certification Program

The Department of Defense (DoD) Financial Management (FM) Certification Program reached a steady state level of maturity in Fiscal Year (FY) 2017. The Certification Program, sponsored by the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)), was initially implemented in 2014 with the purpose of increasing the knowledge and competency level of the DoD FM workforce. As of September 30, 2017, more than 38,000 personnel achieved their required certification. This number represents 70 percent of the FM workforce, well above the FY 2017 goal of certifying 60 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 and education courses (Federal government and commercial) to FM competencies. To date, 12,789 courses (3,528 training courses and 9,261 academic courses) have been aligned.

The biannual continuing education and training (CET) requirements range from 40 CET hours for certification level 1, to 60 CET hours for level 2, and 80 CET hours for level 3. In addition to existing and prior courses, in 2012, the Comptroller team developed a new set of FM web-based training courses. At the end of FY 2017, 80 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 FM subject areas. More than 500,000 FM web-based course completions have been recorded for the 80 courses and over 63,400 of these course completions are in the Financial Improvement and Audit Readiness area. This metric indicates that the Department is achieving one of its goals of improving employee knowledge and competency level in audit readiness.

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

Institutional Reform

In the January 31, 2017, *Implementation Guidance for Budget Directives* memorandum to the Department of Defense (DoD), Secretary Mattis directed that the Department improve how it does business in order to increase the lethality, improve the readiness, and grow the capability and capacity of our forces. In support of this direction, the Department developed a comprehensive reform agenda, which will be included in the next *Agency Strategic Plan* to be published in February 2018. The focus of the reform agenda is pursuing cross-enterprise consolidation, reduction, and where appropriate, elimination of specific business activities or duplication of efforts to achieve greater efficiency, effectiveness, and savings. These efforts will free up resources for higher priority requirements that will contribute to the lethality of the Department. Implementation of the reform agenda and other Department priorities will be tracked through the DoD Agency Strategic Plan, which is based on the Secretary's priorities; the *Annual Performance Plan*, which sets out specific goals and targets; and the *Annual Performance Report*, which publishes the Department's performance results each year.

Engineering Aide 2nd Class Gabriel Jimenez, a native of Colombia assigned to Construction Battalion Maintenance Unit (CBMU) 202, high fives children from a Wayuu tribe in Mayapo, Colombia, during Continuing Promise 2017 (CP-17). CP-17 is a U.S. Southern Command-sponsored and U.S. Naval Forces Southern Command/U.S. 4th Fleet-conducted deployment to conduct civil-military operations including humanitarian assistance, training engagements, medical, dental, and veterinary support in an effort to show U.S. support and commitment to Central and South America.

Photo by Mass Communication Specialist 2nd Class Shamira Purifoy

In Fiscal Year (FY) 2017, the Department continued and expanded its reform efforts to reduce the cost of doing business. By identifying opportunities for management improvements and investments in high priority programs, the Department is striving to maximize the availability of its constrained resources for the optimal 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.

Current initiatives include service contract requirements reviews, reduction of Major DoD Headquarters Activities (MHA), leased space consolidation, information technology (IT) optimization, business optimizations including exchanges and commissaries, and military healthcare reforms.

Institutional reform will continue over the coming years as initiatives are developed through a set of cross-functional teams that have been established to champion the Department's reform agenda.

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 Office of the Secretary of Defense (OSD) staff, 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, Defense Agencies, Field Activities, via the SRRB process, were tasked with capturing savings of $1.9 billion by 2021 for reinvestment in higher priority requirements. In FY 2017, 15 senior review panels were conducted for 25 organizations, with savings of $141 million identified for FY 2017 alone. The projected savings for FY 2018 is approximately $500 million.

Major DoD Headquarters Activities

Section 346(b) of the National Defense Authorization Act *(NDAA) for FY 2016* directed a 25 percent reduction in the cost of MHA from FY 2016 baseline levels by FY 2020. In December 2015, the Deputy Secretary of Defense approved programmatic reductions of $1.39 billion and 2,350 military and civilian manpower authorizations through FY 2021 to be incorporated into the FY 2017 President's Budget request. At the end of FY 2017, the Department of Defense achieved a 20.7 percent reduction in MHA and is on track to an overall 25.9 percent reduction by FY 2020. The budget request for FY 2018 is consistent with the plan submitted in

FY 2017. As the Department implements reform activities, we will continue to seek additional cost reduction opportunities in headquarters.

The NDAA for FY 2016 additionally prescribed a new definition for MHA which included all activities of the Office of the Secretary of Defense, the Joint Staff, and the offices of the Secretaries of the Military Departments, as well as the certain headquarters elements of the Combatant Commands, major and component commands of the Military Departments, the Defense Agencies, the DoD Field Activities, and the DoD Office of the Inspector General. The new definition essentially removes smaller organizations from consideration as MHA while counting more of the staff-like activity in the major DoD Components. The definition of MHA prescribed in the NDAA for FY 2016 is that used to establish the baseline for the purposes of reporting, tracking, and managing the mandated reductions. This baseline includes manpower (military and civilian) and operating costs of headquarters, including contractor support.

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 nationwide.

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. Consolidation of defense resale is an initiative being pursued through our reform agenda which will be published with the next Agency Strategic Plan.

Information Technology Optimization

The Department continues to make progress to ongoing efforts that are projected to result in approximately $1.5 billion in IT savings in FYs 2017 – 2021. Reviews of the Military Health System IT resources have targeted more than $440 million in potential savings. An additional $1 billion in savings are expected by taking full advantage of the Department's purchasing power and aggressively identifying and pursuing opportunities to further optimize DoD's IT infrastructure, NCR and Defense Media Activity IT consolidation, enterprise licensing, and application rationalization.

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 Fourth Estate activities 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. Defense Travel Modernization is also underway and will leverage simplified and automated business rules with a projected savings of up to $450 million over five years.

Military Healthcare

The Department has proposed various ways to reform TRICARE, 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 the Department's medical force; giving the doctors, nurses, medics, and corpsmen the experience they need to be effective in their mission. These reforms have the potential to generate over $3 billion in savings over the Future Years Defense Program that can be reinvested in operational requirements without sacrificing quality, accessible health care for our people.

U.S. Soldiers, assigned to Public Health Command Europe, load a simulated causality onto a UH-60 Blackhawk, operated by U.S. Soldiers, assigned to 12th Combat Aviation Brigade, as they conduct different types of Medical Evacuations, at the 7th Army Training Command's Grafenwoehr Training Area, Germany, Mar. 20, 2017. The Soldiers conducted MEDEVAC training to develop the ability to team up with flight medics to safely transport patients by a helicopter.

Photo by Sgt. Sara Stalvey

INTERNAL CONTROLS OVERVIEW

ENTERPRISE RISK MANAGEMENT AND INTERNAL CONTROL PROGRAM

The Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) Office of the Deputy Chief Financial Officer and the Office of the Deputy Chief Management Officer, in compliance with the *Federal Managers' Financial Integrity Act of 1982*, lead the Department's effort in fulfilling the Department's Enterprise Risk Management (ERM) and Internal Control Program (ICP) responsibilities. The Department of Defense (DoD) is committed to ensuring an effective system of internal controls for business processes to provide reasonable assurance that the Department's mission is met and to support the DoD Component objectives. The DoD ERM/ICP holds both operational and financial managers accountable to ensure they are effectively managing risks and internal controls in their areas of responsibility. In accordance with the Office of Management and Budget *(OMB) Circular No. A-123*, "Management's Responsibility for Enterprise Risk Management and Internal Control," and the Government Accountability Office (GAO) Standards for Internal Control in the Federal Government ("*Green Book*"), the Department continuously strives to integrate risk management and effective internal control into existing business activities. All Components are required to conduct a robust programmatic approach to establish and assess internal controls for the conduct of all financial and non-financial mission-essential operations. DoD Components that produce stand alone financial statements are also required to provide financial reporting assurance.

U.S. Air Force Maj. Ryan Schenk, 621st Mobility Support Operations Squadron air mobility liaison officer assigned to the 101st Airborne Division at Fort Campbell, Ky., reviews the transfer of authority checklist with Capt. U.S. Army Capt. Travis Seale, a 101st Abn. Div. soldier, while waiting for the airfield to be cleared during a mobility exercise called WAREX at Joint Base McGuire-Dix-Lakehurst, N.J., March 13, 2017. AMLOs advise supported units on safe, effective use of air mobility assets from the tactical to strategic level, bridge the communication gap between supported units and U.S. Air Force air mobility command and control agencies, conduct landing zone feasibility analyses, act as landing zone safety officers, and liaison between supported units and deployed mobility forces to ensure supported unit objectives are met.

Photo by Tech. Sgt. Gustavo Gonzalez

The goal of the ICP is to support the DoD's mission by implementing appropriate operational controls to identify, prioritize, and mitigate operational and financial risk before it negatively impacts the mission. 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. Per DoD Instruction *(DoDI) 5010.40*, each DoD Component uses its leadership's mission requirements as a baseline for executing assessments of key functional, operational and financial areas. DoD Components rely upon appointed assessable unit managers for each key operational and financial area to identify and report internal control opportunities for improvement as well as deficiencies for review and comment by leadership. Another goal of ICP is to integrate the audit and remediation teams to improve the Department's ability to effectively respond and mitigate risks.

The Department's ICP works to ensure that Department-wide deficiencies are reported timely and monitors the corrective action plan efforts through the DoD Components. The status of deficiencies are aggregated and reported in the DoD Statement of Assurance. This process leverages OMB Circular No. A-123 and ensures that the Department has the appropriate oversight to prioritize and mitigate the Department's systemic, operational, and financial risks.

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 as a "management and performance challenge" by the DoD Inspector General;
- High impact of occurrence in terms of loss of dollars and/or loss of life;
- Significantly weakens established safeguards against waste, loss, unauthorized use or appropriation of funds, property, other assets, or conflicts of interest;
- Constitutes noncompliance with laws and regulations;
- Nonconformance with government-wide, financial management system requirements; or
- Identified by independent public accountants as material weaknesses.

STATEMENT OF ASSURANCE

The Department's leaders are responsible for establishing and maintaining effective internal controls to meet the Federal Managers Financial Integrity Act of 1982 (FMFIA) and the Federal Financial Management Improvement Action of 1996 (FFMIA). As the Department enters a full financial statement audit, and with several entities already sustaining positive financial statement audit opinions, considerable efforts are underway to strengthen the internal control environment. The Department will continue to improve controls over operations, financial reporting, and financial systems, and prioritize remediation of Fiscal Year (FY) 2017 material weaknesses. In FY 2018, we will leverage results from the full scope financial statement audit to assist in re-baselining the Department's material weaknesses and furthering our corrective actions.

The Department assessed its internal controls over financial reporting in accordance with the Office of Management and Budget (OMB) Circular No. A-123. While the Department continues to achieve measurable progress, the assessment found that controls in place on September 30, 2017, were not effective to provide reasonable assurance that FMFIA and FFMIA objectives were met. The Department's deficiencies, taken as a whole, in the design or operation of internal controls over financial reporting include: (1) ineffective processes and controls to post transactions to the general ledger and reconcile to the Treasury Department; (2) ineffective processes and controls to compile financial statements, reconcile data, and support entries, including journal vouchers; and (3) ineffective processes and controls to account for, value, and support Property, Plant and Equipment. Material weaknesses and corrective actions are further described in the Other Information section.

The Department assessed the effectiveness of internal controls over operations in accordance with the FMFIA and the OMB Circular No. A-123. Based on this assessment, the Department provides a modified statement of reasonable assurance that internal controls over operations are effective and efficient in ensuring compliance with applicable laws and regulations as of September 30, 2017. The Department continues to address material weaknesses with specific concerns in the areas of acquisition, contract administration, resource management, and cyber security, as well as other areas. Material weaknesses and corrective actions are further described in the Other Information section.

The Department realizes that properly planned and integrated systems, with strong internal controls, are critical to providing useful, timely, and complete financial information and achieving an unmodified audit opinion. FFMIA Section 803 (a) requires agencies to implement and maintain financial management systems that substantially comply with federal financial management system requirements, federal accounting standards, and the United States Standard General Ledger at the transaction-level. The Department conducted its evaluation of financial management systems for compliance with FMFIA in accordance with OMB Circular A-123, Appendix D. Due to various system limitations, the assessment found that the Department's financial management systems do not fully conform to the objectives of FMFIA, Section 4, and the Federal Financial Management Act of 1996.

The Department remains committed to significant and measureable improvements in its ability to provide reliable, timely, and useful financial and managerial information to support management decisions. Going under full-financial statement audit will give us the tools we need to realize these goals.

Patrick M. Shanahan
Deputy Secretary of Defense

Fiscal Year 2017 Improvements in Internal Controls

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

Intragovernmental Transactions

The Intragovernmental Transaction (IGT) Initiative implements several internal controls to allow the Department to eliminate IGTs. The Department is mandating the use of the Treasury's G-Invoicing system. The G-Invoicing system will be the front-end application for users to originate General Terms and Conditions to ensure trading partners are in agreement on buy/sell roles and responsibilities. G-Invoicing will operate as broker between trading partners for reimbursable orders, invoices, receipt and acceptance, and funds transfer. This will give the Federal Government a single source of truth for supporting documentation and allow for a common data standards between trading partners. It will ensure that all steps in the process are followed by leveraging preventative controls to reject transactions or data that do not align to requirements. Further, DoD is working hand-in-hand with the Treasury to ensure G-Invoicing requirements are incorporated into the commercial off-the-shelf (COTS) software packages. This will ensure internal controls are consistent across the Federal Government and drive down cost and time associated with implementation.

U.S. Marines fire the FGM-148 Javelin missile during a live-fire range for exercise Platinum Lion at the Novo Selo Training Area, Bulgaria, Dec. 15, 2016. The exercise brought together eight NATO Allies and partner nations for a live-fire exercise aimed to strengthen security and regional defenses in Eastern Europe.

Photo by Sgt. Michelle Reif

Critical Accounting Policies

The Department issued critical policies that represent practical and Generally Acceptable Accounting Principles-compliant solutions to address long-standing issues and to optimally position the Department for the full-scope financial audit. The policies provided standardization and consistency of reporting for the Department's various service providers. The policies also established the framework for the Department to develop an auditable, end-to-end process and streamline our efforts to improve internal controls around the supportability of transactions. During Fiscal Year (FY) 2017, the Department's policies addressed the following key areas:

- New Deposit Fund Accounts for Thrift Savings Plan (TSP) Contributions – The new deposit accounts will ensure appropriate accounting and reporting of TSP contributions and resolve the audit findings related to TSP contributions.

- Cash Accountability Initiative: Standard Processes, Systems Identification, and Data Standardization – Requires daily cash reporting with Treasury using common data standards and processes.

- U.S. Army Corps of Engineers Single Auditor Approach – Provides an efficient and effective mechanism for auditing funds sub-allotted to the U.S. Army Corps of Engineers.

- Opening Balance Valuation of Inventory and Related Property using Statement of Federal Financial Accounting Standards *(SFFAS) 48* – Addresses allowable valuation methodologies, required supporting documentation, and required accounting treatment of Inventory and Related Property and associated footnote disclosures.

- Opening Balance Valuation of General Property, Plant and Equipment using *SFFAS 50* – Addresses allowable valuation methodologies, required supporting documentation, and required accounting treatment of General Property, Plant, and Equipment and associated footnote disclosures.

- Estimating and Supporting Useful Life and Placed in Service Date for General Property, Plant, and Equipment (GPP&E) – Provides guidance on deriving and supporting Placed in Service date for GPP&E; also provides updated useful life tables that are more supportable than previous useful life guidance for the Department.

- Valuation and Reporting of Environmental Liabilities – Defines reporting responsibility, key inputs and assumptions, and validation procedures for calculating Environmental Liability Estimates, as well as revises Note 14 to achieve a more streamlined presentation.

In addition to the above policy changes developed in response to new Federal Accounting Standards Advisory Board (FASAB) Standards 48 and 50, the Department has participated in several FASAB-led working groups and Task Forces to provide input into future Accounting Standards and Technical guidance in the general area of property. The Department anticipates several FASAB pronouncements related to property in the upcoming year, and has begun the process of developing additional or updated guidance to supplement current policy.

Service Organization Integration

The Department relies on a significant number of internal (DoD) and external (commercial and other federal agency) service organizations – entities that perform a business function or process on behalf of a DoD Component. In many cases, service organizations engage other organizations, known as subservice organizations, to provide specified support services. Because service and subservice organizations collectively perform or support key parts of the Department's business processes, their internal controls have a direct and material bearing on the Department's internal control over financial reporting and financial statement audits and examinations. In turn, service organization customers, known as user entities, typically have responsibility for certain aspects of the business functions or processes performed by service organizations and must implement effective controls to address them. Controls that are in place at service organizations and subservice organizations along with the customers' own internal controls collectively comprise the DoD internal control catalogue.

To help strengthen the integration of service/subservice organization controls with DoD Components' internal controls so that the objectives of both can be achieved simultaneously, the Department issued three policy memorandums. The memorandums covered:

- Implementing ten requirements to increase the reliance and usefulness of the Service Organization Controls (SOC) 1 report for user entities and customer auditors which would reduce redundant yearly testing,
- Addressing new American Institute of Certified Public Accountants Statement on Standards for Attestation Engagements *(SSAE) 18* requirements and standards for SOC reports for Service Organizations and Subservice Organizations which links their controls with the user entities controls, and
- Establishing an infrastructure to support customer audits and examinations.

The Department continues to conduct tri-annual service organization working group meetings between service organizations and their Component customers to identify audit relevant dependencies, clarify roles and responsibilities, and report audit readiness progress, deficiencies, and corrective actions. For FY 2017, the Department achieved 12 positive opinions of service organization examinations whose controls are relevant to the customer's control environment. The Department is expanding service organization integration by:

- Helping service organizations identify and explain to Component customers the complementary user entity controls (CUECs) expected to be included in the SSAE 18 examinations so that customers can implement controls needed to rely on SOC 1 reports.
- Proactively identifying dependencies on non-DoD service organizations, including other federal agencies and commercial organizations, and integrating CUECs and Complementary Subservice Organization Controls (CSOCs) into the existing internal control framework.

- Developing templates to assist the service organizations addressing the new SSAE 18 requirements, including updating baseline control descriptions and test plans to address CUECs and CSOCs.
- 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.
- Reviewing Notifications of Findings and Recommendations (NFRs) from SSAE No. 16/18 examinations to identify common issues and areas of enterprise-wide impact.
- 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.

Treasury Index-97 Internal Control Management

The Department continues to make progress in internal controls amongst the Treasury Index (TI)-97 entities. The TI-97 entities are DoD Components, such as Defense Agencies, that execute Defense-wide appropriations rather than appropriations to and for the Military Departments. During FY 2017 the OUSD(C)/Financial Improvement and Audit Readiness (FIAR) continued testing the audit infrastructure, key supporting documentation, and internal controls for select processes on a monthly basis. OUSD(C)/FIAR also maintains a NFR tracking tool which serves as a centralized database for monitoring the progress of remediation activities and corrective action plans for TI-97 entities. The tool allows increased visibility into the Department's audit readiness progress and overall risk. To support the goal of enhancing the Department's internal controls, OUSD(C)/FIAR also continues to provide the foundation for the audit of the Department's financial statements. This groundwork includes documenting Entity-Level Controls (ELCs) in accordance with the GAO Green Book's 17 principles of internal controls. OUSD(C)/FIAR maintains an ELC matrix for Components to use in documenting ELCs as part of the OMB Circular A-123 compliance effort to highlight deficient areas, improve cross communication, share best practices/lessons learned, and drive continuous process improvements.

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

Standard Financial Information Structure and Standard Line of Accounting

The Standard Financial Information Structure (SFIS) and Standard Line of Accounting (SLOA) structure our financial data to improve financial information accuracy, transaction posting logic, general ledger balances, trial balances structure, and drive down the cost associated with audit. SFIS improves our systems' ability to interoperate through a common business language leveraging standard business rules which drive common usage, and relationships. This facilitates the reconciliation process by reducing crosswalks and removing gaps between individual

Component structures. SFIS leverages a complete internal control design by including preventative, detective, and compensating controls. SFIS provides system configuration guidance to prevent systems from supplying inaccurate data at the point of entry. It provides detective controls that validates financial data exchanges between business feeder systems and accounting systems in real-time and periodic system configuration reviews by the Joint Interoperability Test Command. Further, for legacy systems, it provides compensating control by cross-walking nonconforming data to reduce noncompliance and improve legacy systems to the maximum extent possible.

Cash Accountability (Fund Balance with Treasury)

The Cash Accountability initiative implements several internal controls for Fund Balance with Treasury. The Cash Accountability initiative standardizes the entire cash process from fund distribution through to cash reporting. Cash Accountability will move the Department to daily cash reporting to decrease the Fund Balance with Treasury differences that are the result of the current process. It will move the Department to Treasury shared services for disbursements, collections, and debt management. This ensures these processes and Treasury reporting are one in the same. This greatly reduces Fund Balance with Treasury differences. It provides common data standards for all critical information exchanges through the End-to-End Processes. Further, the Cash Accountability initiative drives down audit cost by leveraging commercial off-the-shelf software and the Treasury as a shared service provider (e.g. SSAE 16/18 costs).

U.S. Air Force 1st Lt. Brittany Trimbel, 36th Fighter Squadron pilot, secures her helmet before takeoff, Feb. 15, 2016, at Korat Royal Thai Air Force Base, Thailand. Trimbel has been flying F-16 Fighting Falcons actively since October 2015.

Photo by Staff Sgt. Amber E. Jacobs

Information Technology System Initiatives

To strengthen the IT internal controls environment and streamline the management of multiple concurrent financial statement audits/examinations and compliance assessments, the Department has taken the following actions:

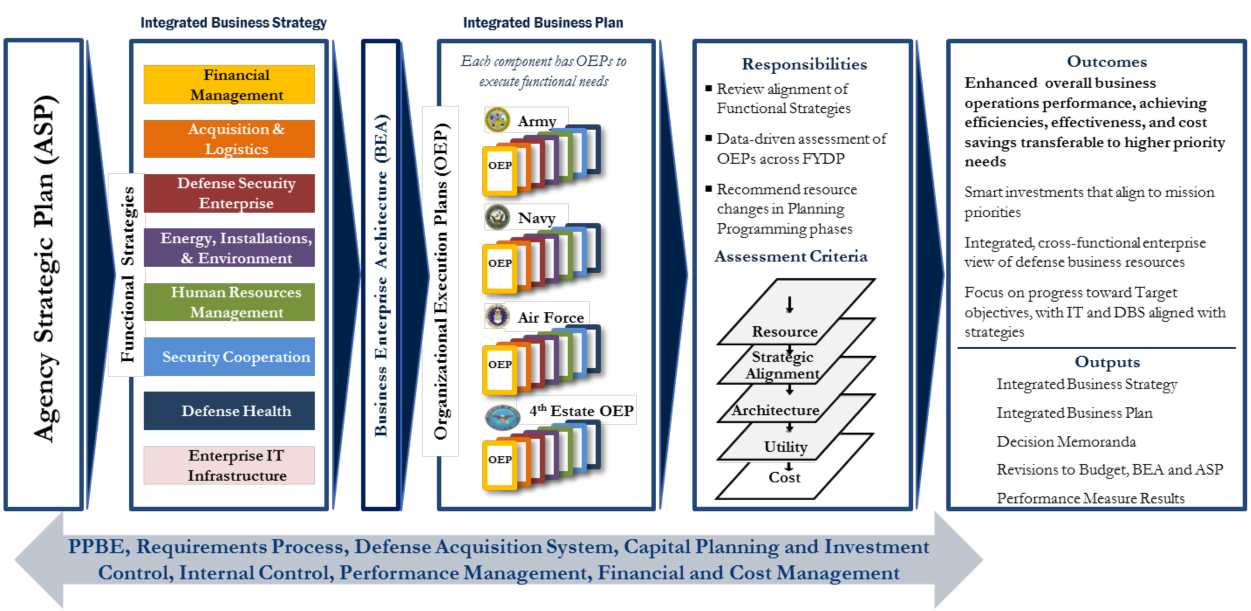
- Developed and deployed a centralized database to automate and standardize the collection and reporting of information about material IT systems, establishing a "single source of truth" about systems relevant to DoD financial statement audits and exams;
- Utilized information from the centralized database to assist the Components and non-SSAE 18 service organizations in identifying the portfolio of systems relevant to the Department's financial statement audits, enabling a thorough understanding of systems interdependencies and the internal controls that must be implemented;
- Required all Components to maintain detailed information and milestones for material IT systems in the database throughout the year to monitor and track various metrics used to measure the status of internal controls over the Department's IT systems;
- Developed a baseline rule set and guidance to address multiple audit findings about cross-application segregation of duties for 12 End-to-End business processes;
- Updated previously issued Risk Management Framework supplemental guidance to address changes to authorization and accreditation activities that impact audit and compliance requirements;
- Required Components and Service Providers to undergo SFIS Compliance Assessments for key accounting systems and DoD service provider systems;
- Implemented the Defense Agencies Initiative (DAI) at 20 Defense Agencies/Field Activities. The DAI is the target financial management enterprise resource planning system for the majority of the 4th Estate. The mission of DAI is to eliminate redundant and duplicative systems as well as to transform the budget, finance, and accounting operations for the Defense Agencies.
- Developed a Universe of Transactions (UoT) solution that is a secure big data platform that can ingest massive amounts of structured and unstructured financial data. The current scope is Defense Wide Appropriation General Fund which includes 19 accounting systems and 24 business feeder systems. Once ingested, the solution can apply business rules to standardize and tabulate the data in a format that any authorized data consumer can use. Using standard queries, visualization, or dashboards, a Component would be able to establish existence and completeness with the UoT solution and an auditor would be able to sample data for material accounts.

BUSINESS AND FINANCIAL MANAGEMENT SYSTEMS

The Department of Defense (DoD) 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.

After *section 2222 of title 10*, United States Code was amended by the National Defense Authorization Act *(NDAA) for Fiscal Year 2012*, 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 14). 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. (A legacy system has a retirement plan and date; a target system does not.)

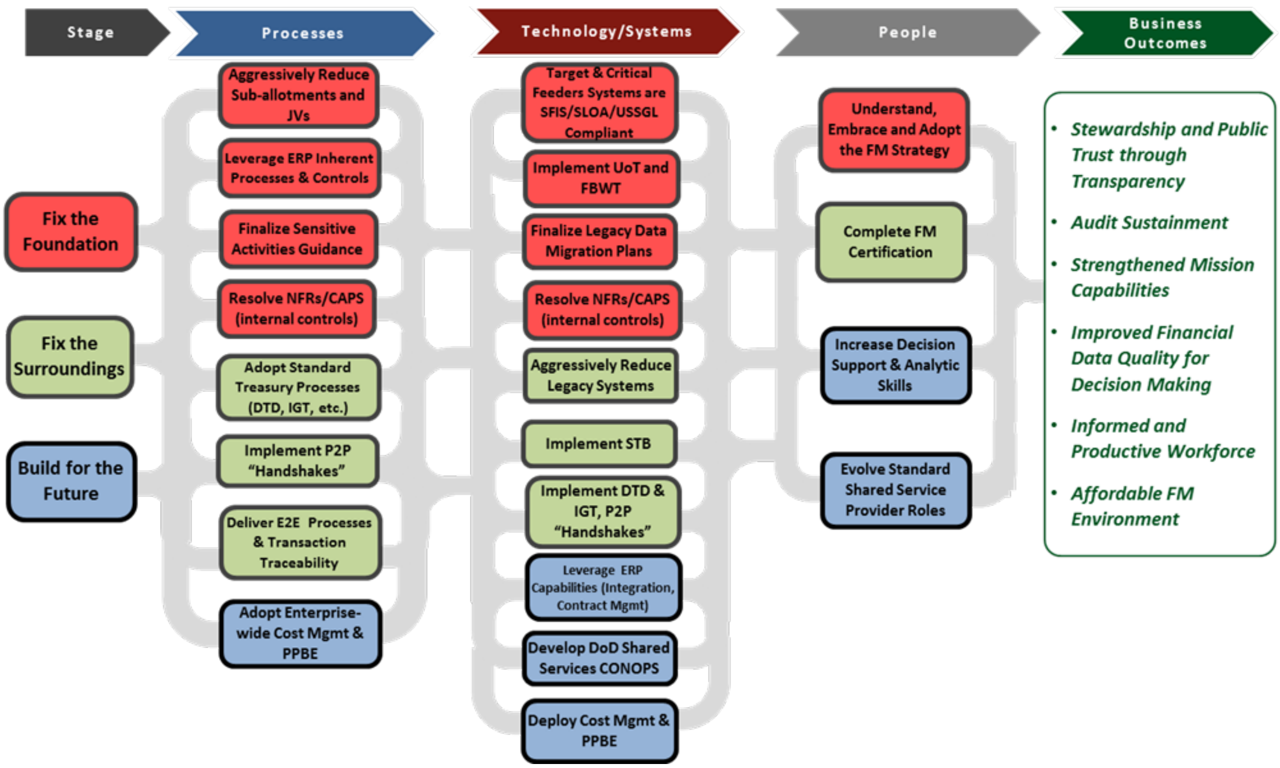
Figure 14. The Department's Integrated Business Framework



The Department's Financial Management (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 processes. The primary objectives of the FM Functional Strategy are to achieve a fully integrated environment linked by standard processes and 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 Standard Financial Information Structure (*SFIS*) the Department's first ever Standard Line of Accounting 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 Enterprise Resource Planning (ERP) systems.

Figure 15. DoD Financial Management Improvement Initiatives



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) is an acquisition system that provides enterprise-wide visibility into various logistic 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.

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. A Federal Financial Management Improvement Act of 1996 (*FFMIA*)-compliant system, AF-IPPS functionality will support audit readiness general and application controls.

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. Currently DAI provides Budget to Report, Proposal to Reward, Cost Management, Order to Cash, Procure to Pay, Acquire to Retire, and Hire to Retire capabilities for 22 of 26 Defense Agencies.

Enterprise Business System (EBS) uses a COTS product to manage the Defense Logistics Agency's (DLA) 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.

Sailors assigned to the littoral combat ship USS Coronado (LCS 4) swim in the South China Sea. Coronado is a fast and agile warship tailor-made to patrol the region's littorals and work hull-to-hull with partner navies, providing the U.S. 7th Fleet with the flexible capabilities it needs now and in the future.

Photo by Mass Communication Specialist 2nd Class Amy M. Ressler

IMPROPER PAYMENT REPORTING

The Department of Defense (DoD) Financial Management Regulation (*FMR*) 7000-14-R, *Volume 4, Chapter 14*, "Improper Payments," defines improper payments as any payment that should not have been made or that was made in an incorrect amount (i.e., overpayment or underpayment) to an eligible recipient. It also includes any payment that was made to an ineligible recipient or for an ineligible good or service, or payments for goods or services not received, or when an agency's review is unable to discern whether a payment was proper as a result of insufficient or lack of documentation.

In accordance with the Improper Payments Information Act of 2002 (*IPIA*), as amended by the Improper Payments Elimination and Recovery Act of 2010 (*IPERA*); the Improper Payment Elimination and Recovery Improvement Act of 2012 (*IPERIA*); and the Office of Management and Budget Circular No. A-123, *Appendix C*, "Requirements for Effective Estimation and Remediation of Improper Payments," DoD Components are required to report the status and recovery of improper payments to the President and the Congress in the following categories:

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

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.

Several accomplishments during Fiscal Year (FY) 2017 include: revising the Defense Finance and Accounting Service sampling plans for their Civilian Pay, Military Pay, and Travel Pay programs from simple random sample designs to stratified random sample designs; revising the United States Army Corps of Engineers sampling plans for their Commercial Pay and Travel Pay programs from simple random sample designs to stratified random sample designs; and implementing the revised Travel Pay Remediation Plan by identifying Senior Accountable Officials for travel improper payments in each of the Military Services and major defense agencies, holding quarterly progress meetings, distributing detailed travel error reports for action, and developing corrective action plans. The Department's remediation efforts resulted in a positive reduction in travel improper payments.

As the Department moves towards the congressional mandate to be audit ready by FY 2017 and undergo a full financial statement audit for FY 2018, the reduction and prevention of improper payments will help ensure the Department achieves Congress' established goal. Detailed information regarding improper payments is located in the Other Information section of this report.

Sergeant Major Matthew R. Hackett, Marine Barracks Washington D.C. sergeant major, assumes the position of attention during Friends and Family Evening Parade at the Barracks, Apr. 28, 2017. The guest of honor for the parade was the Commandant of the Marine Corps Gen. Robert B. Neller and the hosting official was the Barracks' commanding officer, Col. Tyler J. Zagurski.

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