United States Department of Defense

Agency Financial Report

Fiscal Year 2014

Management's Discussion and Analysis

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MANAGEMENT'S DISCUSSION AND ANALYSIS

DEPARTMENT OF DEFENSE OVERVIEW

One of the core responsibilities of the United States government is to protect the life and liberty of the American people, or as phrased in the Constitution, to "provide for the common defense." The *Department of Defense* (DoD) plays a critical role in defending and advancing the safety and security of American citizens and interests.

Today, the nation faces a rapidly changing security environment with dynamic and unpredictable threats around the world. Unrest and violence persist, creating a lack of stability and sectarian conflict, and threatening U.S. citizens. Following more than a decade of war, and with potential adversaries across the world continuing to develop significant capabilities, the Department of Defense is committed to protecting the American people, defending the national interest, and providing America's military with the resources to accomplish its mission.

Chuck Hagel
Secretary of Defense

Building on the *Defense Strategic Guidance* published in 2012, the Department delivered the *Quadrennial Defense Review (QDR) 2014* to Congress in March 2014. The QDR is a legislatively-mandated report, issued every four years, that evaluates the threats and challenges the nation will likely confront over the next 20 years. This QDR describes the tough choices the Department makes during this time of fiscal austerity to ensure our Armed Forces retain the capability to execute a wide range of missions to secure our nation's interests, now and in the future.

The Department's strategic priorities include rebalancing our focus and our forces to the Asia-Pacific region to preserve peace and stability; maintaining a strong commitment to security and stability in Europe and the Middle East; and sustaining a global approach to countering violent extremists and terrorist threats, with an emphasis on the Middle East and Africa. We will invigorate efforts to build innovative partnerships and strengthen our alliances, all while pursuing lower-cost, resourceful approaches.

Rebalancing to Asia-Pacific remains a key component of the defense strategy. The United States seeks to preserve peace and stability in a region that is increasingly central to U.S. political, economic, and security interests. Faced with North Korea's pursuit of long-range missiles and weapons of mass destruction, we are committed to maintaining peace and stability on the Korean Peninsula. The Department will maintain a robust footprint in Northeast Asia while enhancing our presence in Oceania and Southeast Asia.

Given our deep and abiding interests in a Europe that is free and at peace, the Department works with U.S. allies and partners to promote regional security. We are supporting Ukraine's Armed Forces in their current engagements in Eastern Ukraine, and have committed millions of dollars of non-lethal material and assistance.

U.S. Army Stryker armored vehicles convoy during operations in support of Steadfast Javelin II, a NATO-led exercise.

Photo by Airman 1st Class Jordan Castelan

More broadly, the Department is reinforcing our [North Atlantic Treaty Organization]() (NATO) allies and upholding our commitment to collective self-defense. The Department participates in military exercises throughout the Baltic republics and Poland, with American aircraft flying Baltic air policing missions and American ships increasing patrols in the Black Sea.

The Department continues its responsible drawdown of U.S. forces in Afghanistan. With the projected end of the *International Security Assistance Force* (ISAF) combat mission, there will be 9,800 U.S. troops serving in Afghanistan at the end of calendar year 2014. These troops will focus on training, advising, and assisting the Afghan forces as part of the NATO Resolute Support Mission, as well as conducting limited counterterrorism operations. The Department also continues to finance the sustainment and professionalization of the Afghan National Security Forces (ANSF).

A U.S. Special Forces Soldier watches after a clearing operation in which two suspected insurgents were detained and IED materials were destroyed.

Photo by Pfc. David Devich

A U.S. Army National Guard Lieutenant guides vehicles in preparation for retrograde support mission at Camp Marmal, Afghanistan.

Photo by Staff Sgt. Peter Sinclair

The U.S. and our allies and partners seek to degrade and ultimately destroy the threat posed by the Islamic State of Iraq and the Levant (ISIL). In the last few months, the world has seen ISIL's barbarity up close, as its fighters advanced across western and northern Iraq and Syria and slaughtered thousands of innocent civilians. The DoD personnel in Iraq remain committed to building the capacity of the Iraqi Security Forces to defend their homeland. The DoD's "Advise and Assist" role will help the Iraqis take back territory lost to ISIL.

U.S. Air Force F-15E Strike Eagle aircraft flies over northern Iraq after conducting airstrikes in Syria.

Photo by Senior Airman Matthew Bruch

The last 12 years have reinforced the importance of the Military Services operating as a Joint Force, specifically in terms of combined intelligence, surveillance and reconnaissance, cyber operations, and unmanned aerial vehicles. In FY 2014, the Military Services actively participated in the Combatant Command-sponsored large Joint Force exercises, as well as innovative, low-cost, and small-footprint engagements across the globe. The Department invested in exercises and engagements across all Combatant Commands as a cost-effective way to provide U.S. presence and reassure allies.

The Department is focused on preparing for the future by rebalancing defense efforts in a period of increasing fiscal constraint. Our strategic priorities protect and advance U.S. interests and sustain America's leadership; responsibly and realistically take steps to rebalance major elements of the Joint Force, given the changing fiscal environment; and continue our efforts to control costs and improve use of resources in a period of fiscal austerity. Our sustained attention and engagement will be important in shaping emerging global trends.

Resources

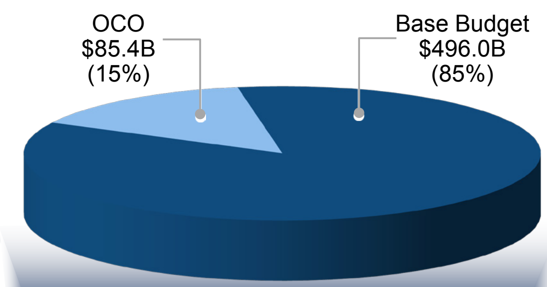
The FY 2014 Defense budget balanced capacity, capability, and readiness to protect the security interests of the United States within the funding constraints of the *Bipartisan Budget Agreement*. The key themes in the FY 2014 budget were to achieve a deeper alignment of our future force structure with resource availability, to maintain a mission-ready force, to emphasize institutional reforms by being even better stewards of taxpayer dollars, and to take care of our people and their families.

The DoD FY 2014 budget authority totaled $581.4 billion, composed of $496 billion in the base budget, and $85.4 billion in support of the Overseas Contingency Operations (OCO). Figure 1 displays the DoD FY 2014 budgetary authority by appropriation.

Despite decreasing resources, the Department must maintain its decisive technological edge. In FY 2014, the Department invested in emerging military capabilities, such as new and expanded cyber capabilities, nuclear deterrence, space, precision strike, and operationally responsive and persistent intelligence, surveillance, and reconnaissance assets.

The Department also continued its modernization efforts by funding three variants of the Joint Strike Fighter; a shipbuilding program that included two Virginia-class submarines, one Aegis destroyer, and four littoral combat ships; various unmanned aerial systems, such as the Reaper; development of the KC-46A tanker and procurement of P-8A aircraft; and a multi-faceted missile defense program.

Figure 1. DoD FY 2014 Budget Authority



Budget by Appropriation	$ in Billions
Military Personnel	$144.0
Operation and Maintenance	$262.5
Procurement*	$99.7
RDT&E	$62.9
Military Construction	$8.4
Family Housing	$1.4
Revolving Funds	$2.5
Total	**$581.4**

* Procurement includes $225M Iron Dome(P.L. 113-145)

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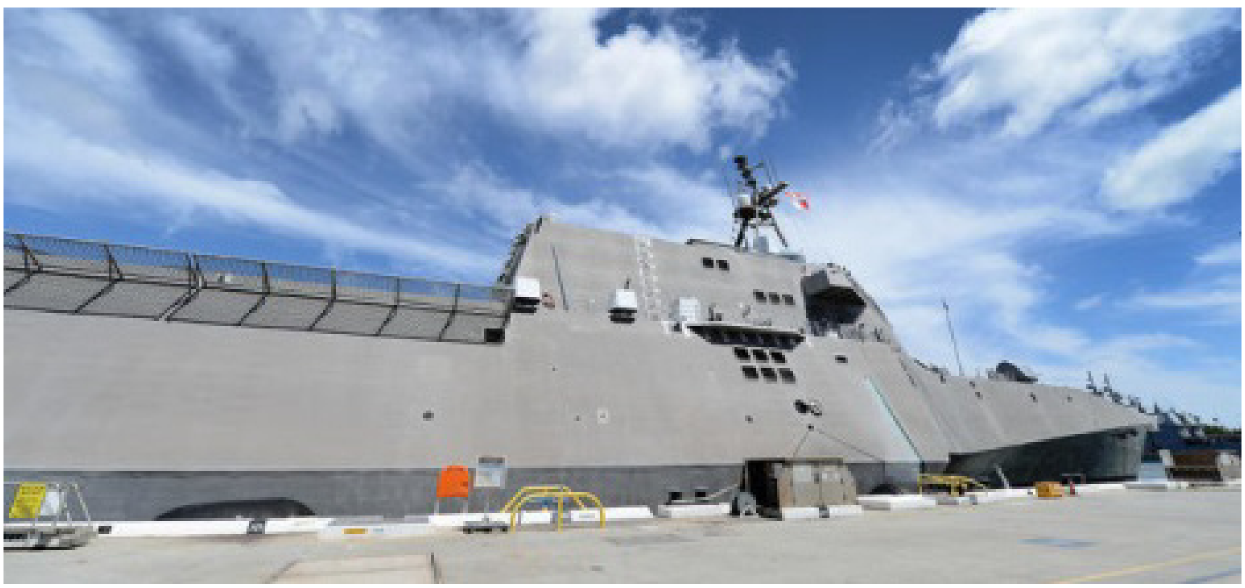


The littoral combat ship USS Independence at Joint Base Pearl Harbor-Hickam, Hawaii, during RIMPAC 2014 exercise. RIMPAC is a U.S. Pacific Fleet-hosted biennial multi-national maritime exercise to foster international cooperation and security on the world's oceans.

Photo by Mass Communication Specialist 1st Class Shannon E. Renfroe

We continue to pursue institutional reforms to reduce the cost of doing business. By controlling support costs and generating efficiencies, we have prioritized spending on combat power. Recently, the Department announced a 20 percent reduction in Headquarters budgets across the Department, beginning with the Office of the Secretary of Defense. We also have implemented acquisition reform efforts, most notably through the *Better Buying Power* initiatives that seek to achieve affordable programs by controlling costs, incentivizing productivity and innovation in industry and government, eliminating unproductive bureaucracy, promoting effective competition, and improving the professionalization of the acquisition workforce.

The force structure reductions that began with the FY 2013 budget continue. In accordance with the revisions to the January 2012 *Defense Strategic Guidance*, the FY 2014 budget reflected the choices made to achieve a modern, ready, and balanced force to meet the full range of potential military requirements. The Army and Marine Corps, in particular, made progress toward achieving their targeted active end states of 440,000 – 450,000 and 182,100 respectively.

Paratroopers from the United States, France, Germany, the United Kingdom and the Netherlands participate in a mass parachute jump in Chef-du-Pont, France, to mark the 70th anniversary of D-Day.

Photo by SPC Joshua E. Powell

Reserve Components are an important element of the Total Force, and the Department is focused on optimizing the active/reserve force mix, sustaining their readiness at appropriate levels. The reserves are trained, ready, and cost-effective forces that can be employed on a periodic operational basis while ensuring strategic surge capabilities for large-scale contingencies or other unanticipated national crises.

We recognize the demands that continue to be placed on the all-volunteer force and their families who give so much to defend the ideals and free institutions we often take for granted. Their dedication reminds us that preserving America's liberties often comes with a heavy cost.

We keep faith by supporting a variety of Military Family Assistance programs designed to improve military life, such as child care, non-medical counseling and Morale, Welfare and Recreation programs. The military healthcare system provides services to 9.6 million beneficiaries, including military retirees and their families, dependent survivors, and certain eligible Reserve Component members and their families. We seek to control healthcare costs and reasonable health care benefit reform as part of a balanced approach to cost containment, which is essential to fund the warfighting capabilities needed to maintain the Joint Force and to send our personnel into combat with the best possible training and equipment.

LOOKING FORWARD

Turmoil around the world continues, ranging from the threat presented by ISIL in Iraq and Syria to the potential of an Ebola pandemic. As reflected in the [*Quadrennial Defense Review 2014*], the current strategic and budgetary environment compels us to think creatively and develop new ways to manage and employ the Joint Forces as we engage with the world. Force readiness decisions made today will continue to have an impact for years to come.

The Department is continually developing and refining comprehensive plans for both resetting and rebalancing the total force, which includes all Reserve Component forces, in the most effective and efficient manner possible. During these times of fiscal austerity, particularly with the potential to return to the [*Budget Control Act of 2011*] reduced funding levels, balancing between readiness, force structure sizing, and threats will remain a high priority.

U.S. Marines and Sailors prepare to board a Marine Corps KC-130J Super Hercules aircraft to deploy to West Africa in support of Operation United Assistance.

Photo by 1st Lt. Gerard R. Farao

U.S. Airmen board a C-17 Globemaster III aircraft to Monrovia, Liberia, carrying a modular medical treatment center and supplies in support of Operation United Assistance.

Photo by Senior Airman Kayla Newman

Operation United Assistance, a USAFRICOM-led operation, provides command and control, logistics, training, and engineering support to the U.S. government's efforts to contain the Ebola virus outbreak.

ORGANIZATION

The Department of Defense maintains and uses armed forces to support and defend the Constitution and ensure 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 America fights terrorists who plan and carry out attacks outside of the traditional boundaries of the battlefield.

The Department is one of the nation's largest employers, with approximately 1.3 million personnel on active duty, 756,000 civilians, and 824,000 men and women in the Selected Reserve of National Guard and Reserve forces. Our military service members and civilians operate in every time zone and in every climate, and more than 450,000 of our employees

U.S. Sailors and civil service mariners on the joint high-speed vessel USNS Spearhead maneuver a rigid-hull inflatable boat into the water during Africa Partnership Station (APS) 2014 in the Gulf of Guinea. APS is an international security cooperation initiative facilitated by the Commander, U.S. Naval Forces Europe-Africa.

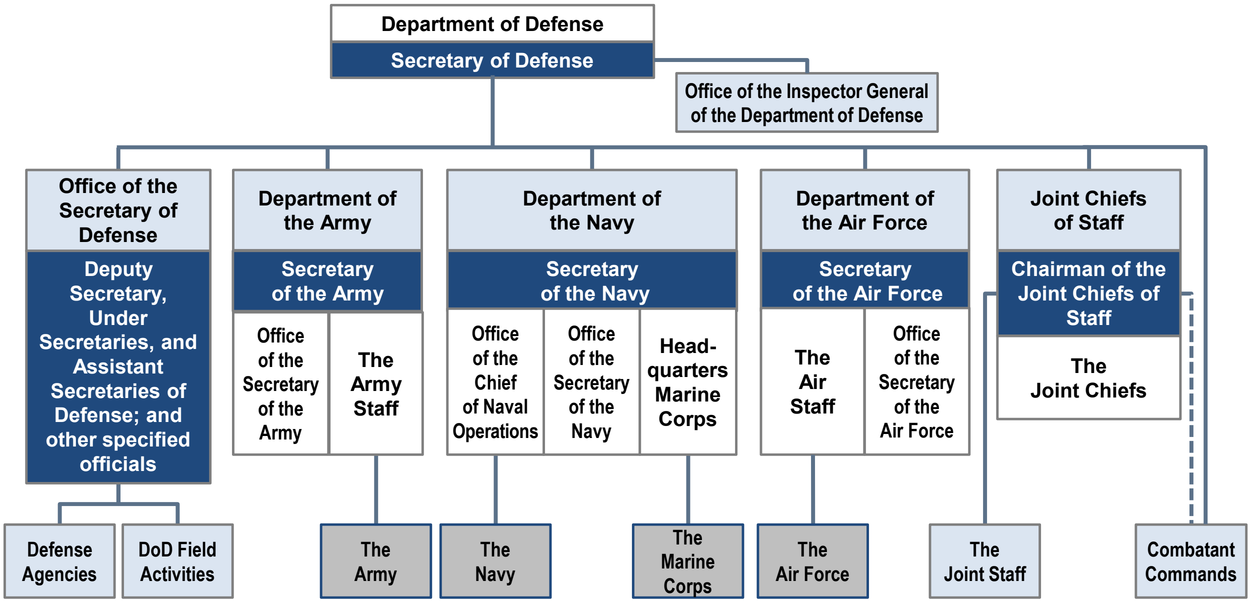
Photo by Mass Communication Specialist Seaman Justin R. DiNiro

serve overseas. There also are more than 2 million military retirees and family members receiving benefits.

The Department's real property infrastructure includes over 526,000 facilities (buildings and structures) located on 4,800 sites worldwide. These sites represent over 24.7 million acres that individually range in size from training ranges of approximately 3 million acres, such as Range No.1 at Nellis Air Force Base, to single weather towers or navigational aids isolated on sites of less than one one-hundredth (0.01) of an acre. To protect the security of the United States, the Department operates approximately 17,580 aircraft and 630 ships.

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

Figure 2. Department of Defense Organizational Structure



The Office of the Secretary of Defense

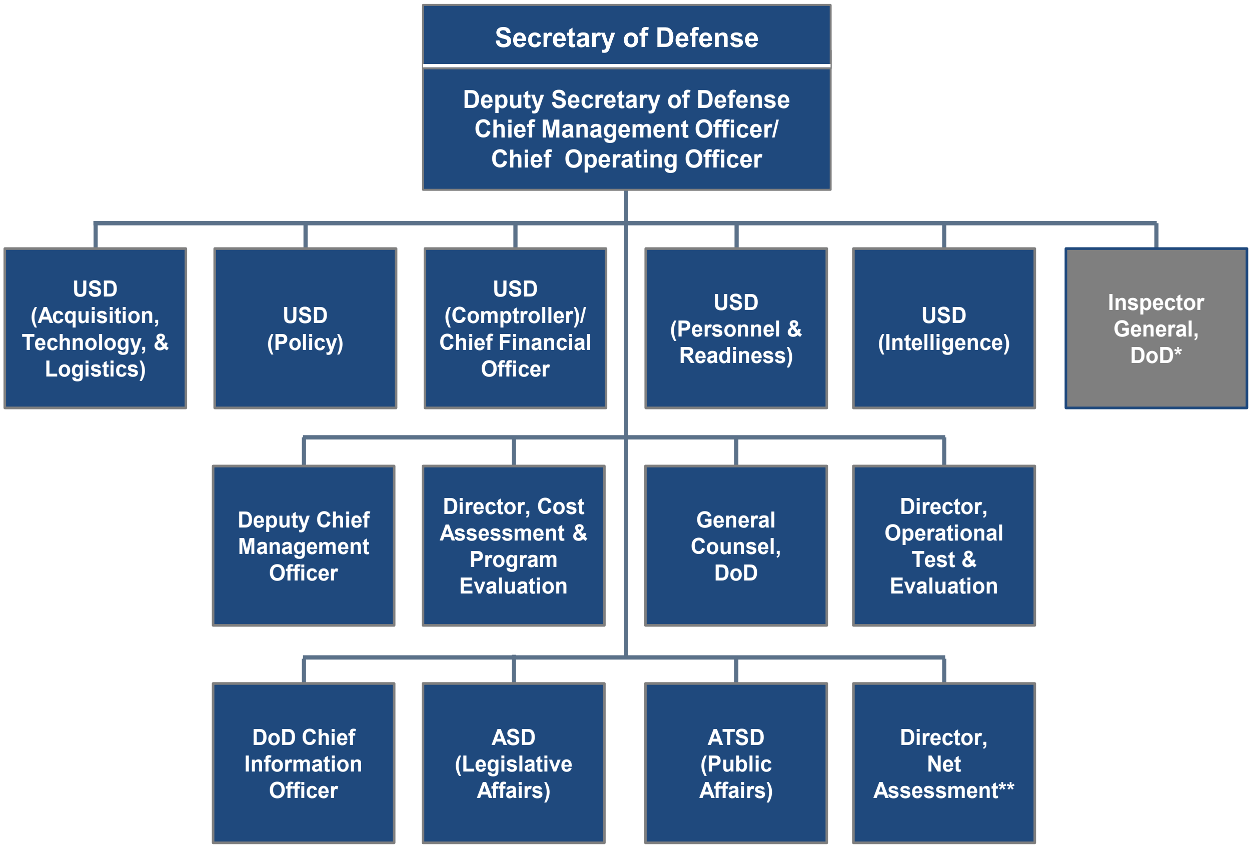
The function of OSD is to assist the Secretary of Defense in carrying out his duties and responsibilities and other duties as prescribed by law. The OSD is comprised of the Deputy Secretary of Defense, who also serves as the Chief Management Officer and Chief Operating Officer; the Under Secretaries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

President Barack Obama, right, Defense Secretary Chuck Hagel, center, and Army Gen. Martin Dempsey, chairman of the Joint Chiefs of Staff, salute the American flag as the national anthem plays during the ceremony to commemorate 9/11 at the Pentagon, Sept. 11, 2014.

Photo by Master Sgt. Adrian Cadiz

The OSD Principal Staff Assistants (PSAs) are responsible for the oversight and formulation of defense strategy and policy (Figure 3).

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



** Although the IG DoD is statutorily part of OSD and is under the general supervision of the Secretary of Defense, the Office of the IG DoD (OIG) functions as an independent and objective unit of the Department of Defense*
*** Alternative organizational placements are being considered for the Director, Net Assessment*

The Joint Chiefs of Staff and the Joint Staff

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

Office of the Inspector General

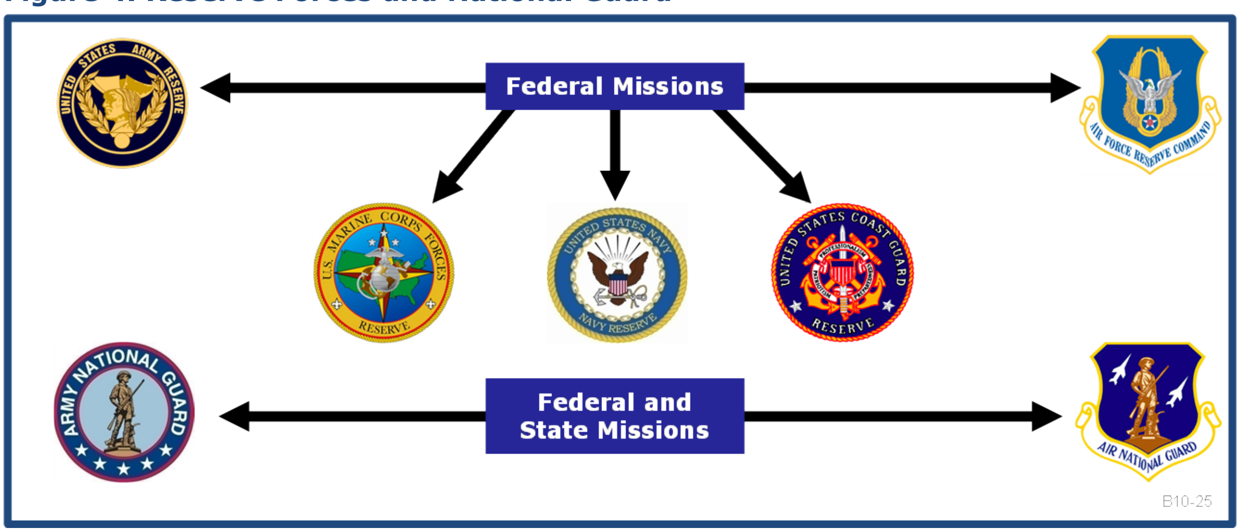
The *Office of Inspector General, DoD* is an independent unit within the Department that conducts and supervises audits and investigations relating to the Department's programs and operations. The *DoD IG* serves as the principal advisor to the Secretary of Defense on all audit and criminal investigative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

Military Departments

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

Military Departments include Active and Reserve Components. The Active Component is composed of units under the authority of the Secretary of Defense manned by active duty Military Service members. The Reserve Component includes the Reservists of each 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, or civil disturbances (non-federalized service).

Figure 4. Reserve Forces and National Guard

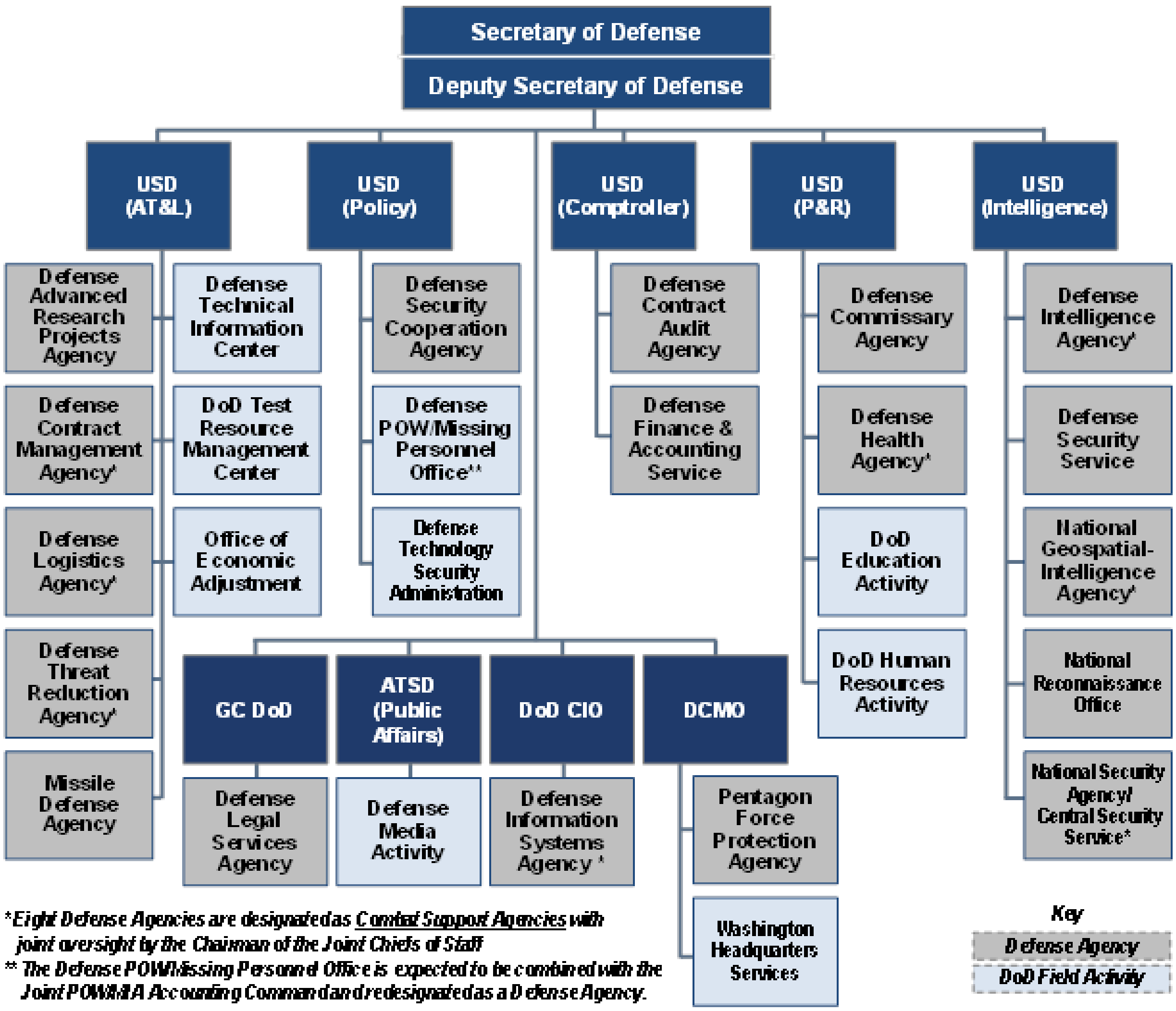


When ordered to active service or called into federal service for national emergencies, units of the Guard are placed under operational control of the appropriate Combatant Commander. The Guard and Reserve forces are recognized as indispensable and integral parts of the Nation's defense and fully part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

Defense Agencies and DoD Field Activities

Defense Agencies and DoD Field Activities (Figure 5) are established as DoD Components by law, the President, or the Secretary of Defense to provide, on a DoD-wide basis, a supply or service activity common to more than one Military Department when it is more effective, economical, or efficient to do so. While 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 directly support the Combatant Commands. Each of the 18 Defense Agencies and 9 DoD Field Activities operate under the authority, direction, and control of the Secretary of Defense through an OSD Principal Staff Assistant (PSA).

Figure 5. Defense Agencies and DoD Field Activities



*Eight Defense Agencies are designated as Combat Support Agencies with joint oversight by the Chairman of the Joint Chiefs of Staff

** The Defense POW/Missing Personnel Office is expected to be combined with the Joint POW/MIA Accounting Command and redesignated as a Defense Agency.

Combatant Commands

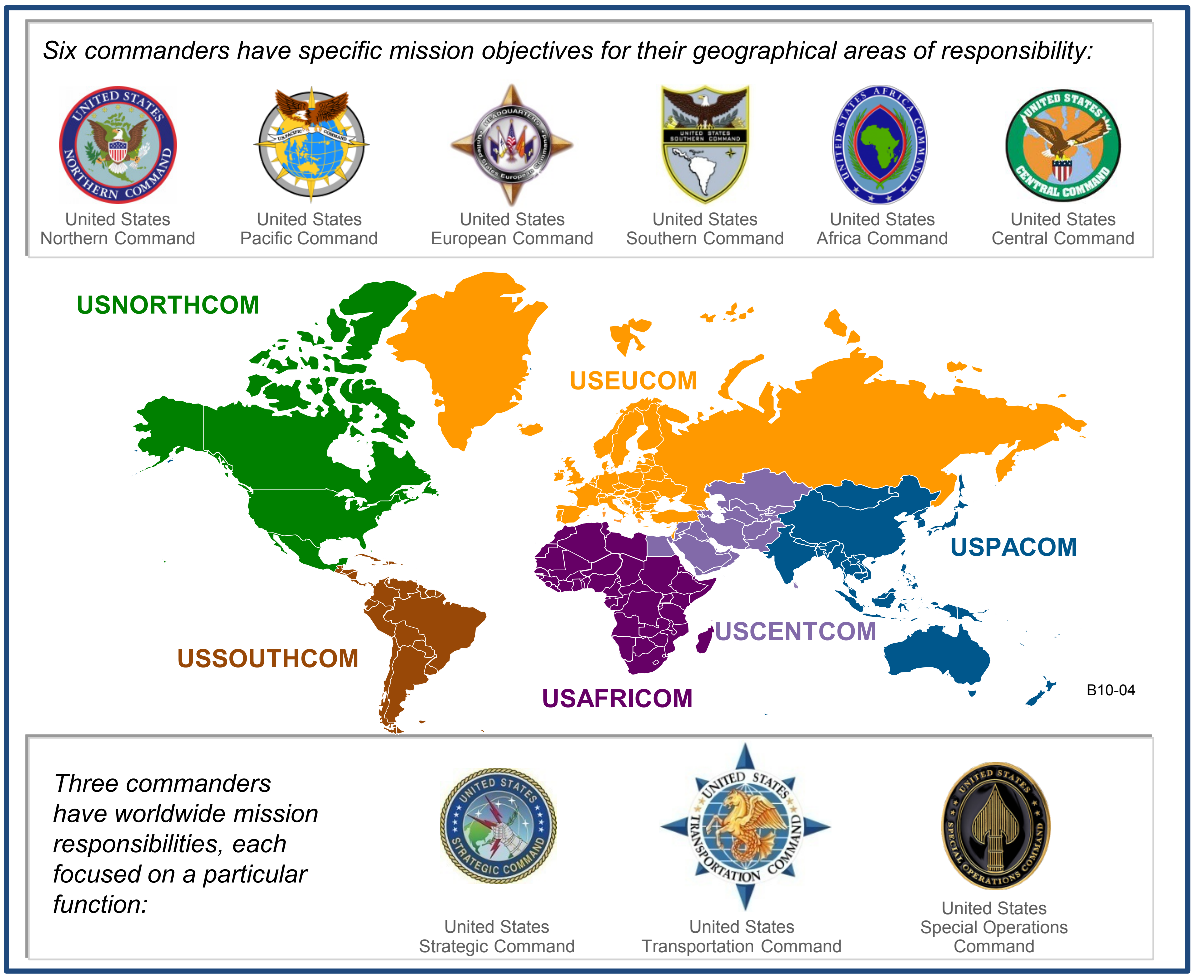
The Commanders of the Combatant Commands (Figure 6) are responsible for accomplishing the military missions assigned to them. Combatant Commanders exercise command authority over assigned and/or allocated forces, as directed by the Secretary of Defense. The operational chain of command runs from the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

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

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

Figure 6. Combatant Commands



PERFORMANCE OVERVIEW

The *Deputy Secretary of Defense*, as the Department's Chief Management Officer and Chief Operating Officer, is responsible for performance improvement in the Defense Department. Each year, in accordance with public law and OMB regulations[1], the Department develops and tracks performance measures to meet DoD Strategic priorities. For FY 2014, the Department continued to follow the *Quadrennial Defense Review (QDR) Report 2010* priorities. The *Quadrennial Defense Review 2014* was issued in March of 2014, and new performance measures associated with the most recent QDR are under development. The current performance measures were shaped by the following strategic goals:

1. Prevail in today's wars.
2. Prevent and deter conflict.
3. Prepare to defeat adversaries and succeed in a wide range of contingencies.
4. Preserve and enhance the all-volunteer force.
5. Reform the business and support functions of the Defense enterprise.

U.S. Marines leave the well deck of the amphibious dock landing ship USS Germantown in a combat rubber raiding craft during Amphibious Landing Exercise (PHIBLEX) 15 in Manila Bay, Philippines. PHIBLEX is a bilateral training exercise designed to improve the interoperability, readiness, and professional relationships between the USMC and partner nations.

Photo by Mass Communication Specialist Seaman Patrick Dionne

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

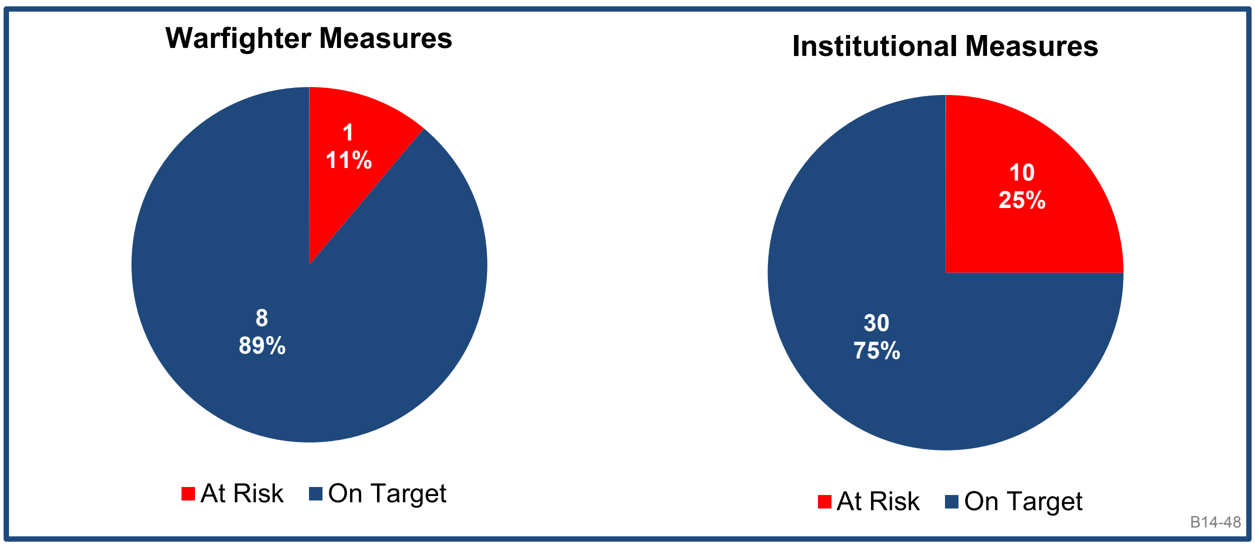
The Department's strategic priorities serve as the foundation for the strategic objectives, performance goals, and performance measures outlined in the Department's *Annual Performance Plan* (APP). The OSD Principal Staff Assistants are responsible for creating the performance measures, which are published each year in the *DoD Budget Request*. These performance measures encompass activities related to both the Department's warfighting mission and business (institutional) operations to create a holistic annual performance plan and budget submission.

This report provides an executive-level overview of DoD's performance through the third quarter, ending June 30, 2014, with fiscal-year end results published in the Annual Performance Report (APR) in the Department's budget submission in February 2015.

Summary of Performance Results

At the end of the third quarter, 89 percent of Warfighting measures were on track to meet the annual goals, while 11 percent did not meet third quarter targets and are considered "at risk" of not achieving their annual targets. Similarly, 75 percent of the Institutional measures are on track while 25 percent are at risk of not achieving their annual targets. However, the Department is currently re-evaluating those performance measures to conform to new strategic priorities identified in the *Quadrennial Defense Review 2014*, released in the Spring of 2014.

Figure 7. Performance Measure Results, Third Quarter FY 2014



Successes

The Department has been successful in meeting most of the key measures for third quarter, FY 2014, including those related to mission readiness and providing high quality care to wounded warriors. The Department has maintained its commitment to taking care of its people and has made considerable improvements in processing wounded warriors in a timely and effective manner.

Mission Readiness

Despite a challenging fiscal environment, the Department has remained committed to ensuring that our Nation's military remains ready to train, advise, and assist foreign security forces and their sustaining institutions to operate with or in lieu of U.S. forces. To that end, the Department requires that annually, 95 percent of General Purpose Force (GPF) units/teams deployed to support Combatant Command (COCOM) security force assistance (SFA) requirements receive focused SFA training. As of the end of the third quarter, FY 2014, 100 percent of GPF deployed to support SFA requirements receive focused SFA training, ensuring that warfighters in Afghanistan and elsewhere around the globe were trained and prepared to build partnership capacity.

In FY 2014, the Department took three priority actions with regard to the *Defense Institutional Reform Initiative*, a program that develops effective, accountable, professional and transparent partner defense establishments in partner countries that can manage sustain and employ national forces.

(1) Established a larger pool of advisors and technical experts, cohesively trained and employed, to meet growing engagement demand.

(2) Worked with DoD Components for exceptions to hiring freezes to improve program capacity.

(3) Worked more closely with Commands and Security Officers to improve defense institutions.

U.S. Air Force, U.S. Navy, Japan Air Self-Defense Force, and Royal Australian Air Force aircraft fly in formation over the Pacific Ocean in support of Cope North 2014. Cope North is an annual air combat tactics, humanitarian assistance and disaster relief exercise designed to increase the readiness and interoperability of the U.S. Air Force, Japan Air Self-Defense Force, and Royal Australian Air Force.

Photo by Tech. Sgt. Henry Hoegen

Achieving Audit-Ready Financial Statements

The *National Defense Authorization Act of 2010* mandated that the Department have audit-ready financial statements by 2017; accordingly, the Department made this requirement a priority goal. Achieving audit readiness means that the Department has strengthened internal controls and improved financial practices, processes, and systems so there is reasonable confidence the information can withstand review by an independent auditor.

The Department is currently focused on two Statement of Budgetary Resources (SBR) line items, "Obligations Incurred" and "Outlays," which closely relate to current year activity, or the "Schedule of Budgetary Activity" (SBA). For Quarter 3, the Department set a target of having 25 percent of the SBR "Obligations Incurred" line item validated as audit ready, and we achieved 51 percent.

Processing Wounded Warriors through IDES

Our Nation continues to be committed to the care and support of those who keep our country free and strong. Providing top-quality physical and psychological care to wounded warriors and assisting with the transition to veteran status is a Department priority. In FY 2014, the Department continued its work with the *U.S. Department of Veterans Affairs* (VA) to accelerate the transition of *Wounded, Ill, and Injured* (WII) Service members into Veteran status by reducing the disability evaluation processing time.

Athletes dive into a pool during the 2014 Warrior Games in Colorado Springs, Colo. 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 Airman 1st Class Scott Jackson

The Integrated Disability Evaluation System (IDES) is used to determine if Service members coping with wounds that may prevent them from performing their duties are able to continue serving. IDES is a joint process established by the VA and DoD that includes a single set of medical examinations and disability ratings. The goal is to close the gap between separation from active duty and receipt of VA benefits and compensation.

Despite numerous cross-agency challenges, the Department was able to meet its IDES goal. One indicator used to assess the efficiency and effectiveness of the IDES system is the percentage of Service members who meet DoD's core IDES time and Service member satisfaction goals. In the third quarter of FY 2013, just 26 percent of Service members being processed through IDES met time and satisfaction goals; a year later, in the third quarter of FY 2014, the percentage rose to 79 percent. The Department is on track to achieve the fourth quarter goal of 80 percent.

Areas for Improvement

The Department successfully achieved 89 percent of its Warfighting measures, meeting or exceeding third quarter targets, indicating that they are on track to achieve their annual performance goals. However, the Department did not meet 25 percent of its third quarter targets for Institutional measures, indicating they are at risk for not achieving annual performance goals. There are improvement opportunities related to human intelligence and veterans transitioning into the civilian workforce.

Human Intelligence (HUMINT) Training

The Department set a target that by the third quarter, 62 percent of funded training seats at the HUMINT Joint Center of Excellence for Military Source Operations, Interrogation, and HUMINT-enabling training activities would be filled through student enrollments. However, only 45 percent of funded training seats were filled. Several factors that have limited the desired performance in FY 2014 – lingering restrictions based on the *Budget Control Act of 2011*, to include sequestration, the government shutdown, and an overall overstated training requirement based on uncertainty with continued operations in Afghanistan, Iraq, and Africa.

To gain efficiencies, the Department began to transition courseware to a distributed learning environment online. The first transition, for the Joint Source Validation Course, was not completed in the third quarter due to technical difficulties, which negatively impacted course enrollments. Once the course is fully transitioned to an online platform, 100 percent of the validated training requirement can be met. In addition to the online learning environment, the Department is establishing Mobile Training Teams to make training more accessible.

Career Readiness and Pre-Separation Training for Veterans

Our Nation can and should provide the best support possible to those who keep our country free and strong as they transition to civilian life. The Department is partnering with other federal agencies to ensure that all Service members participate in an effective program of pre-separation planning and education.

To this end, Service Members must complete a set of clear, comprehensive career preparation activities prior to leaving Active Duty status to be considered “career ready.” These Career Readiness Standards (CRS), an integral component of the *Transition Assistance Program* (TAP), help to ensure Service members have the training and skills needed to succeed in civilian life. Completion of CRS activities is mandatory for all Service members retiring, separating, or being released after 180 days or more of Active Duty. The Commanders verify CRS completion during a mandatory event called "Capstone," no later than 90 days prior to transition.

U.S. Soldiers and civilians participate in the Morale, Welfare and Recreation's 9th Annual 5k Down and Dirty Mud Run, at Joint Base Lewis-McChord, Wash. The run consisted of 14 obstacles and is part of the Morale, Welfare and Recreation's efforts to promote healthy activities.

Photo by Sgt. Cody Quinn

For third quarter, the Department set a goal that 85 percent of eligible Service members would meet CRS prior to their separation. The Department did not meet this goal, verifying that only 26.4 percent of Service members had met CRS prior to separating.

Data gathering processes for this measure are immature and continue to evolve. Capstone, the process used to verify CRS by Commanders or Commanders' designees, was launched in October 2013 for some Military Services, but was not fully implemented until March 2014. The Department expects reported performance to improve as Capstone and improved data collection processes are implemented across installations to provide complete and timely data.

Another performance measure used to gauge how well the Department prepares Service members to transition to veteran status is the following: Verified percent of Service members who have separated and attended (a) pre-separation counseling, (b) a Department of Labor employment workshop, and (c) VA benefits briefings prior to their separation. This performance measure tracks the attendance rate to three specific classes/information briefings in accordance with the *Vow to Hire Heroes Act of 2011* (known as the VOW Act), while the CRS measure takes into account a broader spectrum of activities to achieve career readiness prior to separation. To calculate the results for the VOW Act performance measure, the *Defense Manpower Data Center* (DMDC) queries a TAP database for each separation reported to determine whether or not course completion and counseling session records are present for the Service member.

For third quarter, the Department set a goal of achieving 85 percent validation, but only 59.3 percent were validated. Data collection processes for these new measures are immature and continue to evolve. The Department is actively working with the Military Departments and DMDC to ensure that required TAP services are being delivered, identify the causes of data gaps, and enable Service TAP offices to more easily and accurately report completion of pre-separation counseling and course attendance. Progress is being made as a result of these efforts.

In summary, the Department's focus on mission readiness over the past year has resulted in success on 89 percent of its "warfighting" measures, including that 100 percent of General Purpose Force units/teams deployed to support Combatant Command security force assistance (SFA) requirements had received focused SFA training. Most importantly, the Department has maintained its commitment to caring for Service Members and their families who have borne the burden of more than a decade of war. While the Department did not meet 25 percent of its third quarter targets for Institutional measures, we have identified improvement opportunities related to human intelligence and veterans transitioning into the civilian workforce. The Department plans on building on the momentum of the successes of the past year to improve performance related to those and other measures.

A MESSAGE FROM THE CHIEF FINANCIAL OFFICER

It is a privilege for me to present the fiscal year (FY) 2014 financial statements for the Department of Defense. The information contained in this report reflects the Department's continued emphasis on responsible stewardship of taxpayer dollars and our commitment to providing transparent financial information to the public.

The 2014 fiscal year will be best remembered for beginning with a government-wide shutdown, for efforts to recover from the effects of sequestration, and for the funding constraints of the Bipartisan Budget Act of 2013. These circumstances presented significant challenges to the men and women entrusted with the Department's sacred mission to ensure the security of the United States.

But there is more to the story. Despite significant obstacles, FY 2014 will also be remembered for significant achievements in financial management. Despite diminishing funds, the Department skillfully realigned resources needed to support emerging global contingencies and counter threats to America's security. For example, in western Africa we set up isolation units and provided equipment in support of public health workers surging in from around the world to fight Ebola.

Also this year, for the first time in history, a military service – the U.S. Marine Corps – achieved a clean audit opinion on its Schedule of Budgetary Activity (SBA) for FY 2012, which reported on the receipt and use of FY 2012 funds. Following the Marine Corps' audit readiness approach, the Military Departments and many of the Defense Agencies also asserted audit readiness, and beginning in January 2015, over 90 percent of the Department's current year appropriations will be under audit or internal examination. This is a major achievement for the Department, thanks in large measure to DoD's commitment in implementing the Financial Improvement and Audit Readiness (FIAR) plan.

Setting the stage for additional gains across the board, we also took concrete action to improve the skills of the Department's financial management workforce. Until now, the Department lacked a framework that enabled us to emphasize certain courses and to ensure that proper training occurs at each point in an employee's career. Our new course-based certification program for the financial management (FM) workforce meets that need. It has been endorsed by Congress. And to date, approximately 47,000 DoD financial managers have launched their continuing education through the program – more than 98 percent of the financial management DoD Civilians and Active Duty military.

These improvements, and others, are reflected in the pages of this report. To be sure, much remains to be done, but the record contained here is a measure of just how far we have come. It's a record that the American people can view with confidence that their tax dollars are being responsibly managed.

Michael McCord

Michael McCord
Under Secretary of Defense (Comptroller)/
Chief Financial Officer

FINANCIAL OVERVIEW

The previous sections of this report provide an overview of the Department's operations in FY 2014 and a high-level overview of how the Department's met its performance goals and objectives as of the third quarter of FY 2014. The FY 2014 final results for all Department performance measures will be reported in the Department's Annual Performance Report, which will be available in February 2015.

The Department continues to make strides in its efforts towards producing auditable financial statements, as evidenced by the upcoming audits of the Army, Navy, and Air Force Schedules of Budgetary Activity (SBA) and the planned audit readiness assertion on the SBA by some of the Other Defense Agencies. Also, several DoD Components have received and maintained audit opinions on their full financial statements, some for many years.

Department-wide, we continue to replace, update, and consolidate outdated and redundant information technology (IT) systems, with plans to reduce the number of financial management systems from 327 to 120 by FY 2019. New data standards have been put in place to improve data quality and systems interoperability. Additionally, through the Managers' Internal Controls Program, the Department continues to identify and fix gaps in business practices, policies, and procedures that could leave room for errors or weaknesses.

With fewer systems and improved business processes, the Department can more readily achieve and sustain the reliability of reported financial information that meets the timeliness, reliability, and accuracy standards of an independent auditor.

A U.S. Soldier conducts fire phobia training as part of Steppe Eagle 2014, an annual exercise between the U.S. and several Central Asian partner nations designed to train participants in peace support operations.

Photo by Pfc. Lloyd Villanueva

At present, the Department cannot produce auditable financial statements and management cannot provide unqualified assurance as to the effectiveness of our internal controls over financial reporting. The Department currently lacks the ability to prove reliable and well-controlled business processes and consistently provide supporting documentation to auditors in a timely manner. The Department's Financial Improvement and Audit Readiness (FIAR) Initiative, which is briefly discussed later in this report, guides the Department's efforts to improve our financial management.

Figure 8. DFAS Statistics FY 2014

Description	FY 2014
Number of Pay Transactions	150.2 Million
Number of Commercial Invoices Paid	11.5 Million
Number of Travel Payments	5.8 Million
Number of General Ledger Accounts managed	228.6 Million
Amount Disbursed	$572 Billion
Amount of Military Retirement and Health Benefits Funds Managed	$772 Billion
Foreign Military Sales Cases Reimbursed by Foreign Governments	$424 Billion

Part of the challenge in successfully passing a financial statement audit lies with DoD's unique size and mission. For example, Figure 8 shows the magnitude of financial activities processed only by the *Defense Finance and Accounting Service* (DFAS) in FY 2014, and does not include transactions processed by other DoD entities, such as the *U.S. Army Corps of Engineers* or the *Defense Health Agency*. Although we have yet to achieve full auditability, the Department is confident that we know how taxpayer funds are spent, that employees and vendors are paid timely and appropriately, and that our overall financial operations are managed soundly in our efforts to protect and defend the nation.

FINANCIAL HIGHLIGHTS AND ANALYSIS

The principal financial statements have been prepared to report the financial position and results of operations of the Department, pursuant to the requirements of *31 U.S.C. 3515 (b)*. The statements have been prepared from the accounting records of the Department in accordance with *OMB Circular No. A-136*, Financial Reporting Requirements, and to the extent possible, U.S. Generally Accepted Accounting Principles (USGAAP) 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.

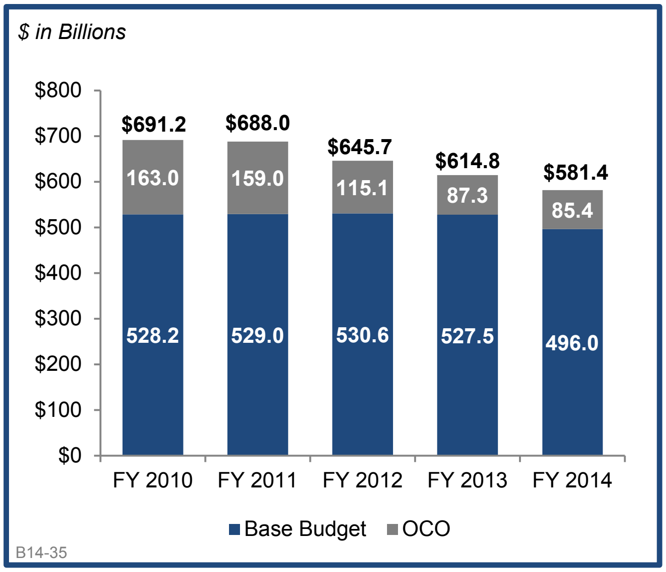
The Defense Finance and Accounting Service (DFAS) prepared the consolidated financial statements and explanatory notes, located in the Financial Information section of this report. The principal financial statements include:

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

Statement of Budgetary Resources

One of the most critical financial improvement and audit readiness priorities in the Department involves the processes, controls, and systems that support information most often used to manage the Department, namely, budgetary resources. The Statement of Budgetary Resources (SBR) presents the Department's total budgetary resources, their status at the end of the year, and the relationship between the budgetary resources and the outlays made against them. In accordance with Federal statutes and implementing regulations, obligations may be incurred and payments made only to the extent that budgetary resources are available to cover such items.

Figure 9. Trend in DoD Budget Authority



As discussed in the DoD Overview Section of this report and as depicted in Figure 9, the Department's FY 2014 budget authority total is $581.4 billion. The change in FY 2014 budget authority from FY 2013 is mostly attributable to sequestration actions required by the [Budget Control Act of 2011](#) and the Bipartisan Budget Agreement of 2013.

As shown in Figure 10, the Department reported $1.1 trillion in FY 2014 total budgetary resources. The total appropriations amount of $737.6 billion, reported on the Statement of Budgetary Resources, consists of DoD budget authority and appropriations provided by the U.S. Treasury for DoD military retirement and health benefits. The Department also receives appropriations to finance civil work projects managed by the [U.S. Army Corps of Engineers](#) (USACE). Current year Trust Fund receipts, including the Military Retirement Fund and the Medicare Eligible Retiree Health Care Fund, also are included in the SBR "Total Appropriations" line. Trust fund receipts, labeled "Temporarily not available," represent budget authority the Department will execute in future years to pay the current unfunded liabilities carried in these large funds.

Figure 10. Composition of DoD Total Budgetary Resources

Description	FY 2014 *($ in billions)*
DoD Budget Authority	$581.4
U.S. Treasury contribution for Military retirement and health benefits	84.3
Civil works projects executed by the USACE	4.3
Trust Fund Receipts	136.1
Trust Fund Resources Temporarily Not Available	(68.5)
Total Appropriations Reported on SBR	**$737.6**
Unobligated Balances from Prior Year Budget Authority	175.9
Spending Authority from Offsetting Collections	100.3
Contract and Borrowing Authority	70.6
Total Budgetary Resources	**$1,084.4**

Additional budgetary resources include $175.9 billion of unobligated balances stemming from prior year budget authority, $100.3 billion in spending authority from offsetting collections, and $70.6 billion of contract authority.

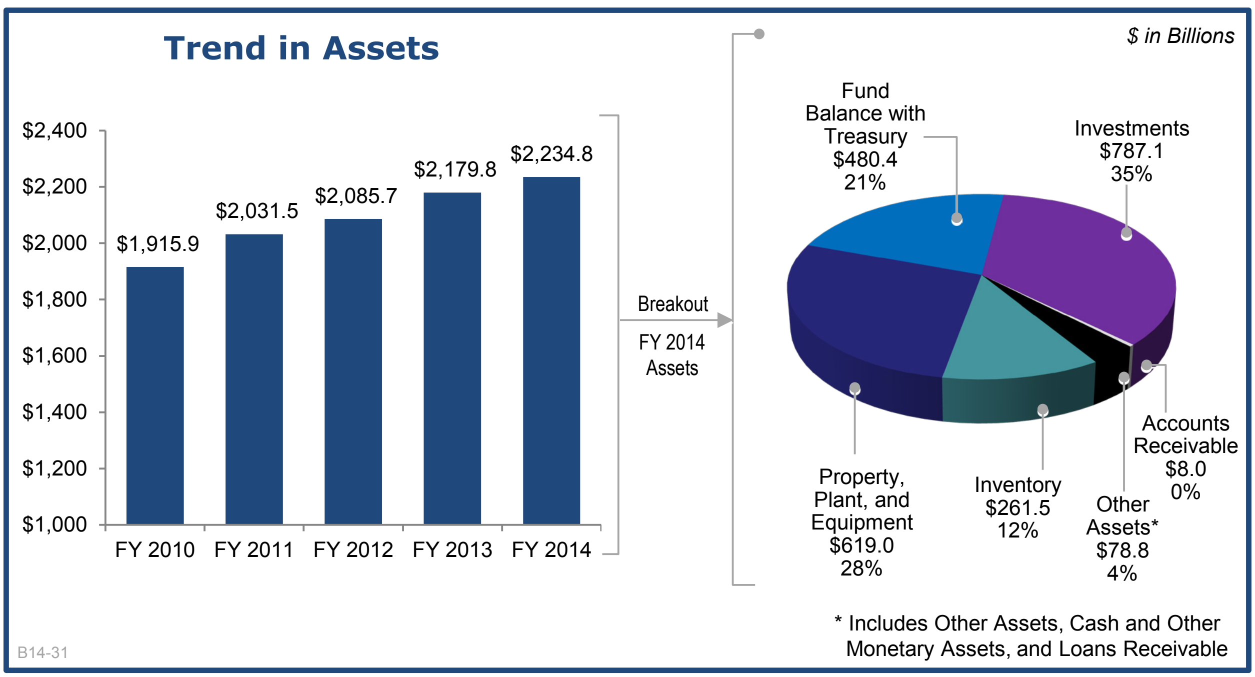
Of the $1.1 trillion in total budgetary resources, $933.7 billion was obligated and $891.1 billion of obligations was disbursed. The remaining unobligated budgetary resources balance relates to appropriations available to cover multi-year investment projects. These projects require additional time for delivery of goods and services. Expired appropriations remain available for valid upward adjustments to prior year obligations but are not available for new obligations.

BALANCE SHEET

The Balance Sheet, which reflects the Department's financial position as of September 30, 2014, reports amounts available to provide future economic benefits (Assets) owned or managed by the Department, amounts owed (Liabilities) requiring use of available assets, and the difference between them (Net Position).

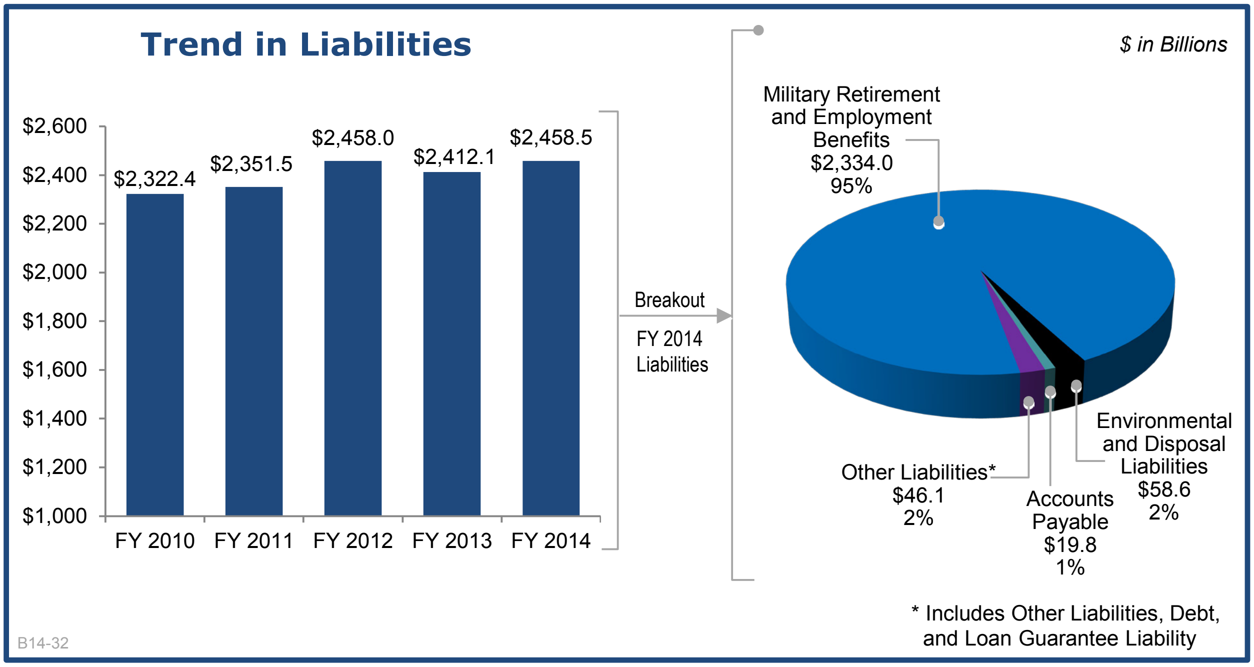
The $2.2 trillion in assets shown in Figure 11 represent amounts the Department owns and manages. Investments, General Property, Plant, and Equipment, and Fund Balance with Treasury (FBWT) represent 84 percent of the Department's assets. General Property, Plant, and Equipment is largely comprised of military equipment and buildings, structures, and facilities used to support the Department's mission requirements.

Figure 11. Summary of Total Assets



Total Assets increased $55 billion (3 percent) from FY 2013, largely due to a $72.3 billion increase in Investments in U.S. Treasury securities offset by a $20.6 billion decrease in General Property, Plant, and Equipment. Investments increased by $72.2 billion due to the $83.5 billion deposit of additional funds from the U.S. Treasury and military services to cover the normal growth of future military retirement and health benefits. Funds not needed to cover current benefits were invested in U. S. Treasury Securities. The $20.6 billion decrease in the Department's General Property, Plant, and Equipment is primarily the result of the ongoing audit readiness efforts to validate existence and completeness and improve the valuation of its assets.

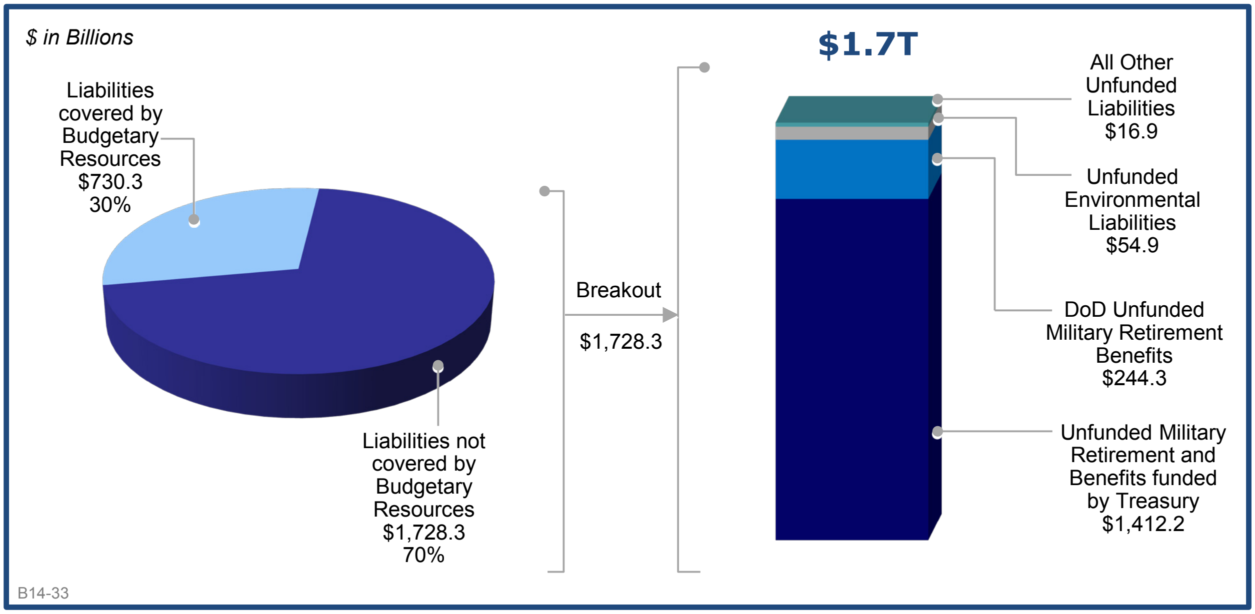
Figure 12. Summary of Total Liabilities



As seen in Figure 12, the Department's total liabilities increased $46.4 billion during FY 2014, almost exclusively due to upward adjustments in the estimated actuarial liability associated with military retirement pension and health care benefits. The Department's Office of the Actuary revised the cost basis for the estimate by $46.6 billion. The Department's $2.5 trillion of liabilities reported in FY 2014 are backed by the full faith and credit of the United States Government.

Figure 13 shows the $1.7 trillion in unfunded liabilities that will require future resources. The U.S. Treasury is responsible for funding the actuarial liability that existed at the inception of the military retirement and health care programs. This $1.4 trillion actuarial liability accounts for approximately 82 percent of the total $1.7 trillion in liabilities not covered by budgetary resources. Additionally, the Department has resources available to cover approximately $670.9 billion of the remaining liabilities, primarily invested in U.S. Treasury securities.

Figure 13. Unfunded Liabilities



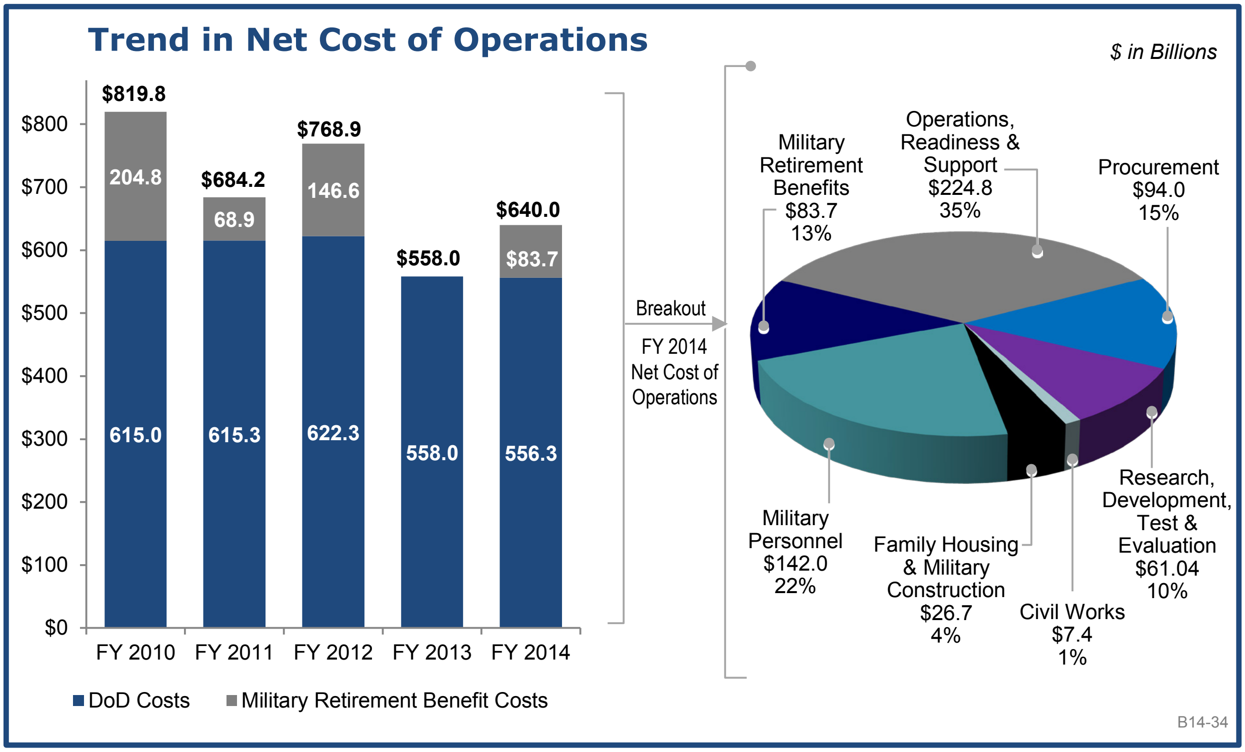
Statement of Net Cost

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 Statement of Budgetary Resources (SBR), plus accrued liabilities, less the amount of assets purchased and capitalized on the Balance Sheet. The differences between reported outlays of the budgetary resources and reported net cost generally arise from when expenses are recognized.

The Department's costs incurred relate primarily to operations, readiness, and support activities, military personnel cost, and costs related to the Department's procurement programs. These costs were offset with investment earnings and contributions to support retirement and health benefit requirements, as well as earnings from reimbursed activities. This activity resulted in $640 billion in net costs of operations during the fiscal year.

As depicted in Figure 14, the $640 billion in net cost of operations represents an $82 billion increase (15 percent) from FY 2013 reported net cost. A $69.7 billion change to the actuarial assumptions used to estimate and record accruals for future payments of military retirement and health care benefits increased the overall net cost of operations. The change resulted in a loss on the net cost of operations and also has the effect of increasing the liabilities on the Balance Sheet.

Figure 14. Summary of Net Cost of Operations



Statement of Changes in Net Position

The Statement of Changes in Net Position (SCNP) presents the total cumulative results of operations since inception and unexpended appropriations at the end of the fiscal year. The SCNP displays the components of net position separately to enable the user to better understand the nature of changes to net position as a whole. The statement focuses on how the net cost of operations as presented on the Statement of Net Cost is financed, as well as displaying the other items financing the Department's operations. The Department's ending net position increased $8.6 billion during FY 2014. The increase reflects primarily the impact of the change in actuarial liability estimates, offset by the impact of the decrease in the value of property, plant, and equipment during FY 2014.

Financial Performance Summary

The Department's financial performance is summarized in Figure 15 on the following page. 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. As noted, 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 can be and is used to manage the Department's operations successfully.

Figure 15. Financial Performance Summary

Dollars in Billions	FY 2014	FY 2013	Change	% Change
ASSETS				
Fund Balance with Treasury	$ 480.4	$ 482.7	($ 2.3)	-0.5%
Investments	787.1	714.8	72.3	10.1%
Accounts Receivable	8.0	11.7	(3.7)	-31.6%
Other Assets	78.8	77.0	1.8	2.3%
Inventory and Related Property, Net	261.5	254.0	7.5	3.0%
General Property, Plant and Equipment, Net	619.0	639.6	(20.6)	-3.2%
Total Assets	**$ 2,234.8**	**$ 2,179.8**	**$ 55.0**	**2.5%**
LIABILITIES				
Accounts Payable	$ 19.8	$ 21.7	($ 1.9)	-8.8%
Other Liabilities	46.1	51.5	(5.4)	-10.5%
Military Retirement and Other Federal Employment Benefits	2,334.0	2,280.6	53.4	2.3%
Environmental and Disposal Liabilities	58.6	58.3	0.3	0.5%
Total Liabilities	**$ 2,458.5**	**$ 2,412.1**	**$ 46.4**	**1.9%**
Total Net Position (Assets Minus Liabilities)	**($ 223.7)**	**($ 232.3)**	**$ 8.6**	**3.7%**
Total Financing Sources	646.5	727.2	(80.7)	-11.1%
Less Net Cost of Operations	640.0	558.0	82.0	14.7%
Net Change of Cumulative Results of Operations	**6.5**	**169.2**	**(162.7)**	**96.2%**
Total Budgetary Resources	**$ 1,084.4**	**$ 1,097.8**	**($ 13.4)**	**-1.2%**

FINANCIAL MANAGEMENT IMPROVEMENT INITIATIVES

Financial Improvement and Audit Readiness Initiative

As Secretary Hagel reported to Congress and told the men and women serving in the Department of Defense, getting our financial house in order is one of the Department's top priorities. Deputy Secretary Work has echoed *Secretary Hagel's message* and recently challenged leaders of the Defense Agencies and activities to be champions for Financial Improvement and Audit Readiness (FIAR) – to demand compliant processes and systems, to incorporate audit readiness in employee performance plans, and to be prepared to move out of audit readiness and into the business of being under continuous audit. The message is clear: The DoD leadership team is serious about improving financial management processes and controls over DoD resources.

Audit readiness is critically important for the Department of Defense. "Audit ready" means the Department has reasonable assurance about the effectiveness of its internal controls and financial practices, processes, and systems and their ability to withstand audit by an independent auditor. Financial statement auditability is not only required by law[2], but will demonstrate that the Department properly manages and is a good steward of taxpayer dollars.

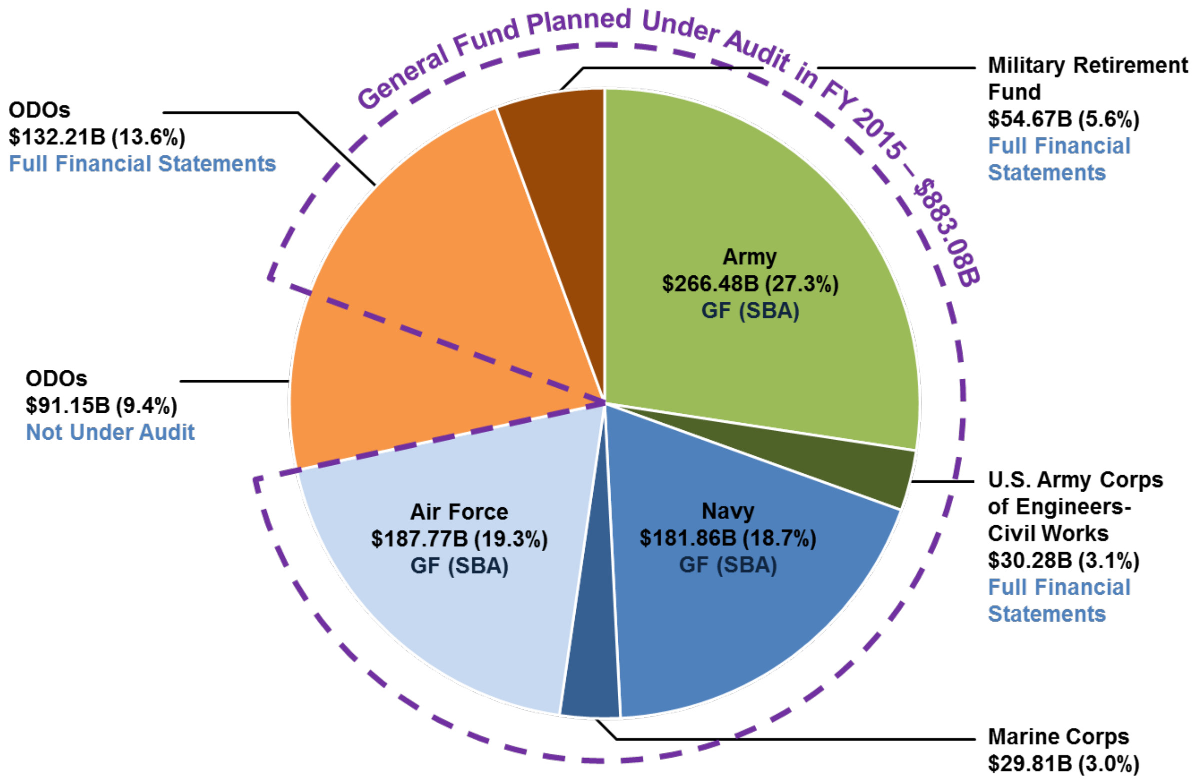
This year, the Department made substantial progress. The *U.S. Marine Corps* became the first Military Service to achieve an unmodified ("clean") opinion on its Schedule of Budgetary Activity (SBA) for FY 2012, which reported on the Marine Corps' receipt and use of funds in FY 2012. Achieving an opinion on the SBA shows that the Marine Corps' budgetary processes, controls, and systems, which are the same used in reporting both current and expired funds in the Statement of Budgetary Resources (SBR), can meet audit standards.

Following the Marine Corps' audit readiness approach, the Military Departments and many of the other Defense organizations (ODOs) asserted audit readiness on their FY 2015 appropriations, to be reported on a Schedule of Budgetary Activity (SBA). Beginning in January 2015, over 90 percent of the Department's current year appropriations will be under audit. Most of the other ODOs not under audit will begin SBA examinations or mock audits in FY 2015. All remaining ODOs will continue audit readiness activities and not be audited until the DoD Consolidated Financial Statements are audited in FY 2018.

[2] *Chief Financial Officers Act of 1990* ("CFO Act") (Public Law 101-576), as amended by the *Reports Consolidation Act of 2000*; the *Government Management Reform Act of 1994* (GMRA) (Public Law 103-356); *National Defense Authorization Act of 2010* (Public Law 111-84)

Figure 16 identifies the DoD Components that will be under audit in FY 2015 and their percent of the total DoD General Funds. The DoD Components have now expanded the audit readiness focus from budgetary data to all financial transactions to achieve the full goal of auditing full financial statements in FY 2018. Several DoD Components that have received and sustained audit opinions on their full financial statements, such as the U.S. Army Corps of Engineers Civil Works, will continue to prepare stand-alone financial statements.

Figure 16. General Funds Under Audit in FY 2015



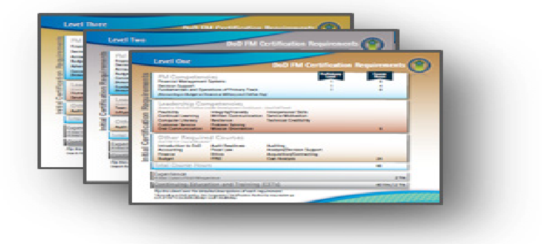
Note: Based on FY 2013 Total Budgetary Resources.

In terms of our strategic warfighting mission and the size of the Department's annual budget and quantity of worldwide physical assets, no organization in the world can compare with the complexity of the U.S. Department of Defense. As the Department continues to emphasize improvements in its business processes and more and more of the DoD Components achieve audit readiness and complete audits successfully, the Department will demonstrate its effective stewardship of taxpayer dollars. Additional information on the Department's *Financial Improvement and Audit Readiness* Initiative, as well as the latest FIAR Plan Status Report, is available on the Under Secretary of Defense (Comptroller)'s public website.

Financial Management Certification Program

The DoD Financial Management (FM) Certification Program, sponsored by the Office of the Under Secretary of Defense (Comptroller), hit full stride in FY 2014. Ninety-eight percent of Active-Duty Military and Civilian FM personnel have transitioned into the program, and over 725 members have already achieved their required certification. The FM personnel in the Reserve Components will be transitioned in FY 2015, and we expect the wave of certifications awarded will increase steadily throughout the upcoming fiscal year.

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 members 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.



When we recognized that the inventory of FM courses would not be adequate to support a course-based certification program, the Comptroller team began to develop FM web-based training courses in 2012. Currently, 38 of these courses are available to the workforce, resulting in improved, cost-free access to training in key, substantive subject areas.

To date, over 38,000 FM web-based course completions have been recorded and over 6,000 of these course completions are in the Financial Improvement and Audit Readiness (FIAR) area. This metric's results indicate that the Program already is achieving one of its goals, which is to improve employee knowledge and skills in audit readiness.

As the FM Certification Program matures, the culture of continual professional development and training for all FM workforce members will become ingrained, proficiency in technical and leadership subject areas will increase, and support to the warfighters will keep pace with their needs.

More Disciplined Use of Resources

Continuing the reform agenda advanced in previous budgets, the Department reviewed all budgetary areas for potential savings in its "More Disciplined Use of Resources" campaign. Strategies to realize savings included restructuring the civilian workforce to meet key needs with fewer personnel; better leveraging of the reserve components; restructuring military treatment facilities; controlling health care costs by taking advantage of lower prices for private care; and restructuring or terminating weapons programs and military construction projects to focus on the most critical capabilities.

As a result of these efforts, the Department proposed approximately $37 billion in additional cost reductions over the period of FY 2014 through FY 2018 (Future Years Defense Program) from the amount of funds requested in the Department's FY 2014 President's Budget. The savings include:

- Streamlining Business Practices and Support Services. The Department saved $19 billion by streamlining business practices and support services, such as installation and administrative functions, contracting, and staffing.
- Terminating or Restructuring Weapons Programs. The Department saved $14 billion by identifying and terminating programs where the most important capabilities could be met by other means.
- Restructuring and Delaying Military Construction Projects. The Department saved $4 billion by funding only the most critical facility requirements and ensuring construction projects only support requirements after force structure adjustments.

The Department remains committed to performing its mission while operating efficiently, reducing costs, and effectively managing taxpayer dollars. As the military force structure draws down, the Department will continue to examine other opportunities to streamline installation support and management overhead to match capacity to the new force structure.

U.S. Sailors assigned to Naval Mobile Construction Battalion 11 pour concrete for a project at Camp Lemonnier, Djibouti.

Photo by Mass Communication Specialist 1st Class Jonathan Carmichael

INTERNAL CONTROLS OVERVIEW

MANAGERS' INTERNAL CONTROL PROGRAM

The Office of the Under Secretary of Defense (Comptroller) leads the Department's *Federal Managers' Financial Integrity Act* (FMFIA) program, known as the *Managers' Internal Control Program* (MICP). The Department's management has a fundamental responsibility to develop and maintain effective internal controls to provide reasonable assurance that obligations and cost are in compliance with applicable laws; funds, property, and other assets are safeguarded against waste, loss, and unauthorized use or misappropriation; revenues and expenditures are properly recorded and accounted for; and programs are efficiently and effectively executed in accordance with applicable laws and management policies. This is accomplished, in part, through leadership's strong, clear, and consistent "tone-at-the-top" that includes the empowerment and regular interface with subject matter experts embedded in each of a Component's key functional areas.

The MICP is dependent upon the shaping of an organizational culture that proactively implements continuous business process improvements to ensure timely, accurate, and complete financial and operational information. This continuous business process improvement methodology complements and relies upon stakeholders' understanding, documentation and assessment of their assigned functional areas. A comprehensive MICP also provides leadership the latitude to address related operational and financial risk before the mission is adversely impacted.

All Components are required to implement a robust program to establish and assess internal controls for all mission-essential operations. Components identified in the Department's *FIAR Guidance* are required to include assurances over the internal controls related to financial reporting and financial systems.

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 previously as a "high risk" area.
- High impact of occurrence in terms of loss of dollars and loss of life.
- Significantly weakens established safeguards against waste, loss, unauthorized use or appropriation of funds, property, other assets, or conflicts of interest.
- Constitutes substantial noncompliance with laws and regulations.
- Nonconformance with government-wide, financial management system requirements.

Based on the Department's assessment of internal controls, the Secretary of Defense has signed the following Statement of Assurance.

STATEMENT OF ASSURANCE

The leaders of the Department of Defense (the Department) recognize the importance of establishing and maintaining effective internal controls and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA), the Federal Financial Management Improvement Act (FFMIA), and Office of Management and Budget (OMB) Circular A-123, Appendix D, "Compliance with the Federal Financial Management Improvement Act of 1996." The Department continues to focus on strengthening its Managers' Internal Control Program so that it can meet program objectives.

At present, the Department cannot produce auditable financial statements, and management cannot provide unqualified assurance as to the effectiveness of our internal controls over financial reporting. To improve its financial management and reinforce public confidence in its stewardship of taxpayer funds, the Department is committed to achieving financial auditability. Auditable financial statements require a sound framework of internal controls and an organizational culture that promotes the identification, prioritization, and mitigation of risks to financial reporting.

The Department conducted an assessment of the effectiveness of internal controls over financial reporting as required by OMB Circular A-123, Appendix A. This assessment determined that, while the Department continues to achieve measurable progress, it cannot provide reasonable assurance that internal controls over financial reporting were effective as of September 30, 2014. In addition, as of September 30, 2014, the Department's financial systems are not all in compliance with the FFMIA and OMB Circular A-123, Appendix D. Details of the material weaknesses are available in Other Information.

The Department conducted its assessment of the effectiveness of internal controls over operations per OMB Circular A-123, "Management's Responsibility for Internal Control." Based on this assessment, the Department provides qualified assurance that its internal controls over the effectiveness and efficiency of operations and compliance with applicable laws and regulations achieved the objectives of the FMFIA, as of September 30, 2014. Details of identified material weaknesses are available in Other Information. The Department continues to prioritize efforts to address relevant Government Accountability Office high risk areas as well as management challenges identified by the Department of Defense Office of Inspector General, focusing attention on opportunities to strengthen internal controls.

Improvements in the Department's financial processes remain the focus of the Department's Financial Improvement and Audit Readiness initiative and systems modernization efforts. The Department remains fully committed to establishing and sustaining a culture centered on an effective control environment.

Robert O. Work
Deputy Secretary of Defense

FY 2014 Improvements in Internal Controls

Despite significant challenges, the Department achieved important improvements in internal controls, which will better enable our ability to meet strategic priorities. A few of our accomplishments are highlighted below.

- Security. The *United States Special Operations Command* (USSOCOM) established a security professionals working group and created a single location to report, track, and archive all security incidents and violations. The single archive location will enable the working group to review previous incidents and violations and use the active archived reports to identify trends, patterns, and emerging threats to the Command's security program. The working group will adjust the Command's security education to address identified threats and vulnerabilities, from review of metrics of previous incidents.
- Financial Reporting. Independent public auditors performed attestation engagements (Statement on Standards for Attestation Engagement No. 16) and issued unqualified opinions, with no material weaknesses identified, on the effectiveness of select DFAS internal controls for Military Pay and Disbursing Operations, Civilian Pay and Disbursing Operations, and Contract Pay and Disbursing Operations.
- Charge Card Programs. The Department implemented new safeguards and controls to supplement oversight and legal compliance[3] in use of the Government travel charge card. Cardholders are now required to formally document and acknowledge their understanding of the DoD government travel charge card policy. Commanders and Agency Heads are responsible for periodic reviews of the effectiveness of the internal controls in their travel card program. Also this year, the Department issued the "Government Charge Card Guidebook for Establishing and Managing Purchase, Travel and Fuel Card Programs," which highlights important controls to identify, correct, and minimize fraud, waste, and abuse of charge cards.
- Standard Line of Accounting. This year, the Department began to implement the standard line of accounting (SLOA) in accounting systems. The SLOA is comprised of standard data elements that will allow different financial management systems to better interoperate. The SLOA is comprised of a subset of data elements in the DoD Standard Financial Information Systems language, and will be used to report financial information to OMB and the Department of the Treasury. The SLOA will improve the completeness and accuracy of financial information that is traded between different accounting systems and improve the reliability of financial reporting.

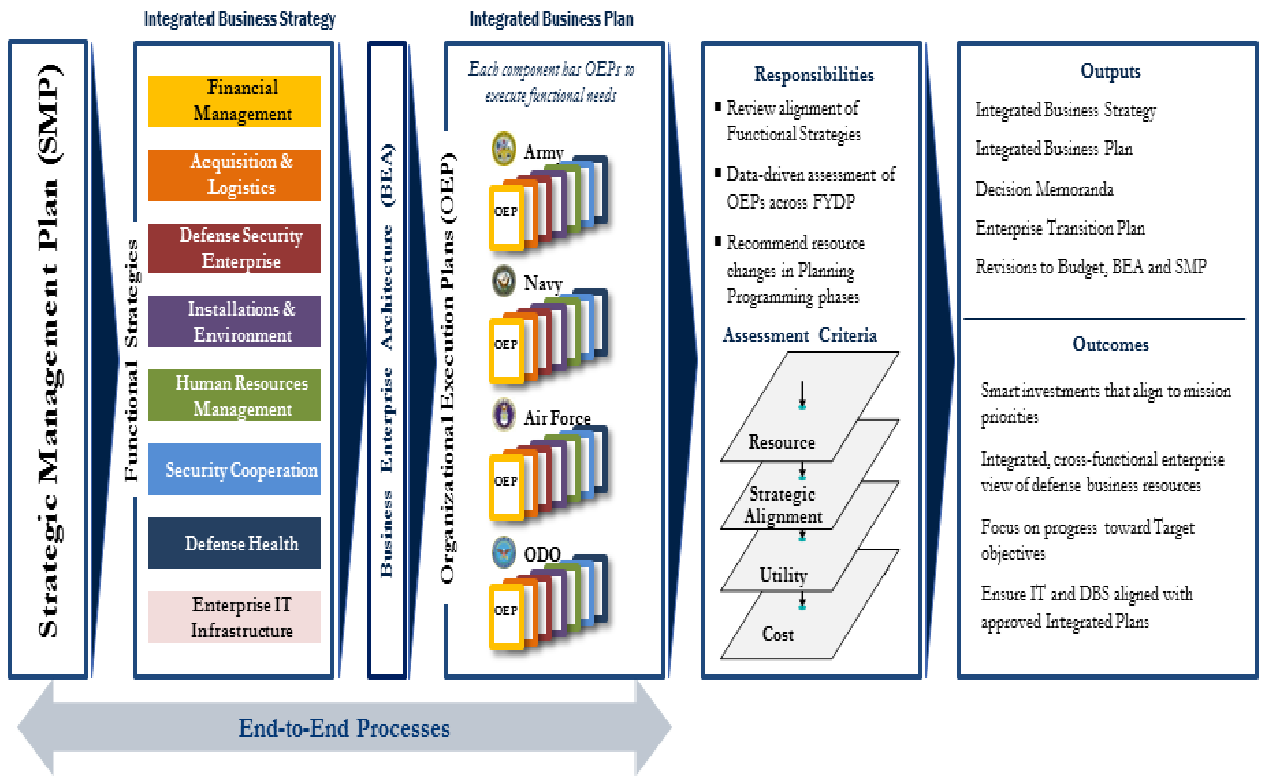
[3] *Government Charge Card Abuse Prevention Act of 2012* (Public Law 112-194)

Business and Financial Management Systems

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

Following passage of section 901 of the National Defense Authorization Act[4] for FY 2012, the Department significantly changed the requirements for investment reviews and the certification of defense business systems, which now must occur before funds (appropriated or non-appropriated) are obligated. The Department's investment review process ensures that decisions on investments in business systems align with the Defense-wide integrated business strategy (Figure 17). These decisions also ensure that systems eliminate redundancy and maximize operating efficiency through streamlining business processes and the availability of timely, accurate and useful business information.

Figure 17. The Department's Integrated Business Framework

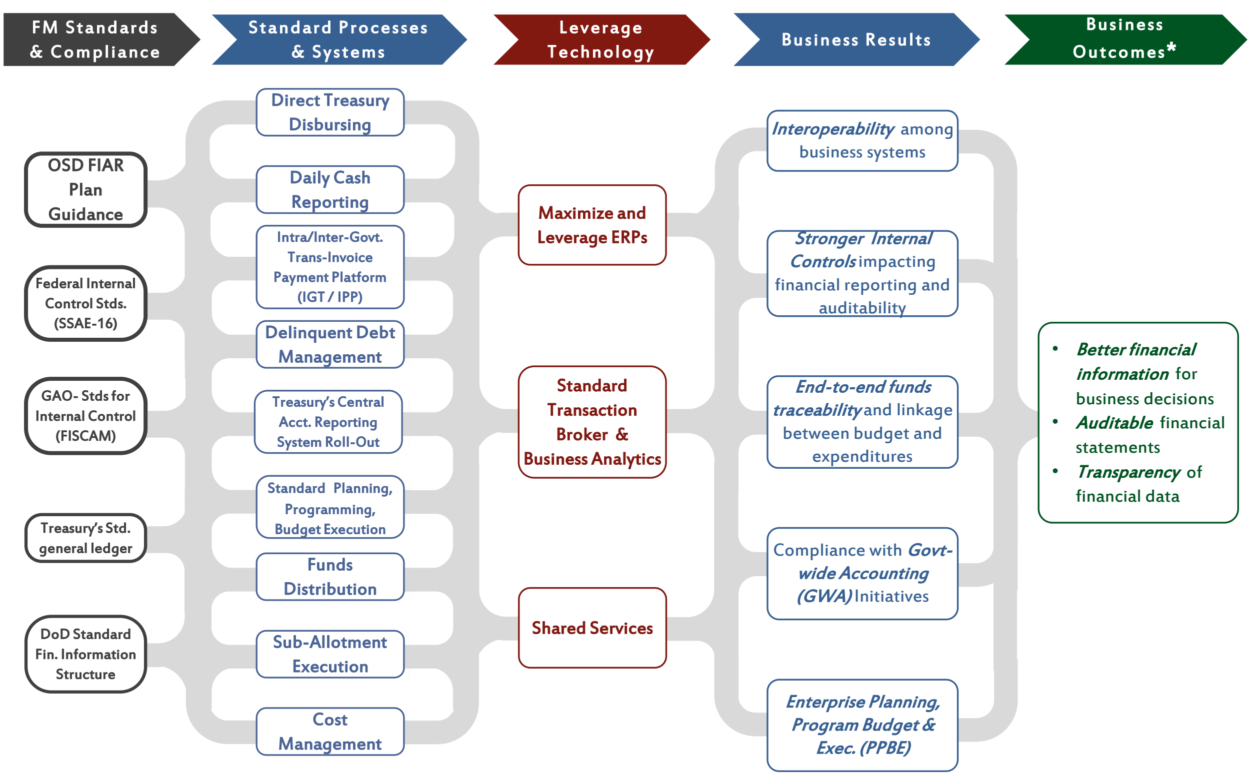


[4] Section 901 of the National Defense Authorization Act for FY 2012, codified at 10 U.S.C. 2222, "Defense business systems: architecture, accountability, and modernization"

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 strategy include setting data standards, process and system improvements, and leveraging technology throughout the FM community. Current enterprise-level initiatives include the Standard Financial Information Structure, the Department's first-ever Standard Line of Accounting to improve transaction quality. The Department also participates in Federal-wide process improvement initiatives, such as compliance with the President's transparency and open government initiatives, the U.S. Treasury Department's Government-wide accounting initiative, and direct-to-Treasury disbursing, as well as promoting the use of business analytics and maximizing existing enterprise resource planning (ERP) systems.

Figure 18. DoD Financial Management Improvement Initiatives



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

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. The 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, improved distribution, a reduced theater footprint, and a warfighter who is equipped and ready to respond to present and future threats.

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

Integrated Personnel Pay System – Army (IPPS-A) is a hybrid solution using ERP software to deliver an integrated personnel and pay capability. The IPPS-A will provide the Army with an integrated, multi-Component personnel and pay system which 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. The DEAMS creates an Air Force enterprise financial data view by providing an integrated accounting and finance solution to manage appropriated and working capital funds.

Air Force Integrated Personnel and Pay System (AF-IPPS) is a comprehensive, self-service, web-based solution 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 (FFMIA)-compliant system, AF-IPPS functionality will support audit readiness general and application controls. Full deployment is not projected until the fourth quarter of FY 2018.

Other Defense Organization ERPs

Defense Agency Initiative (DAI) is a system dedicated to address financial management improvements through standard end-to-end business processes delivered by commercial off-the-shelf (COTS) software. The DAI provides accounting, procure to payment, and time and attendance capability today, and will provide grants financial management and budget formulation capability in the future.

Deputy Secretary of Defense Bob Work addresses DoD leadership during the ODO FIAR Conference. He discussed budgetary concerns and the Department's way ahead.

Photo by
Mass Communication Specialist 2nd Class Sean Hurt

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

Improper Payment Reporting

The Federal government disburses more than $2 trillion in payments to individuals and other entities each year. Beginning in 2002, Congress enacted legislation to help ensure Federal entities have strong financial management controls in place to pay the correct amount to the appropriate recipient and to better detect and prevent improper payments.

In accordance with legislation[5] (collectively referred to in this report as IPERA) and Office of Management and Budget (OMB) Circular No. A-123, the Department reports on its improper payments, and the recovery of these payments, to the President (via OMB) and Congress in the following categories:

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

The Department continually looks for opportunities to improve our improper payment methodologies. The Department is implementing recommendations reflected in the DoD IG's April 2014 review[6] of our improper payment program, as well as the recommendations identified by the Government Accountability Office (GAO) in its May 2013 report[7]. For example, based on GAO recommendations, DFAS enhanced the sampling methodology used in the Commercial Pay category to stratify the universe of payments by invoice dollar amount, in addition to stratifying by site and system. The Defense Health Agency (DHA) also modified its statistical sampling plan pursuant to the GAO's recommendation related to calculating underpayments. The DHA may award a recovery auditing contract in FY 2015 to recapture outstanding credit balances from vendor and contractor accounts.

As part of the Department's efforts to become fully auditable by FY 2017, each DoD disbursing activity is diligently reviewing and reporting on all payments that are subject to IPERA and ensuring the processes used are compliant with laws and regulations. Until all DoD disbursements can be reconciled with the amount reported on the Statement of Budgetary Resources, the Department cannot demonstrate that all payments subject to IPERA have been reviewed. The Department's efforts to achieve an auditable SBR by FY 2017 will increase the public's confidence in the Department's stewardship of taxpayer dollars and the integrity of the DoD improper payments program.

Refer to the Other Information section of this report for detailed reporting on improper payments and recoveries.

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[5] *Improper Payments Information Act of 2002* (IPIA) (P.L. 107-300); *Improper Payments Elimination and Recovery Act of 2010* (IPERA) (P.L. 111-204); *Improper Payment Elimination and Recovery Improvement Act of 2012 (IPERIA)* (P.L. 112-248); *Recovery Auditing Act* (Section 831, Defense Authorization Act, for FY 2002) (P.L. 107-107)
[6] *DoD Efforts to Meet the Requirements of the Improper Payments Elimination and Recovery Act in FY 2013*
[7] *Significant Improvements Needed in Efforts to Address Improper Payment Requirements*

U.S. Sailors assigned to the amphibious assault ship USS Bataan rescue people in the Mediterranean Sea June 6, 2014. The Bataan and the guided missile frigate USS Elrod rendered assistance and provided food, water, medical attention and temporary shelter to 277 people after receiving a report that an Italian military marine patrol aircraft sighted six small vessels, one of which was sinking.

Photo by Mass Communication Specialist Seaman Apprentice Michael J. Lieberknecht

A U.S. Army UH-60 Black Hawk helicopter assigned to the Oklahoma Army National Guard releases water from a helicopter bucket May 5, 2014, near Guthrie, Oklahoma. Black Hawk crews assisted firefighters in battling wildfires that burned more the 6,000 acres and numerous homes in less than 24 hours.

Photo by Maj. Geoff Legler