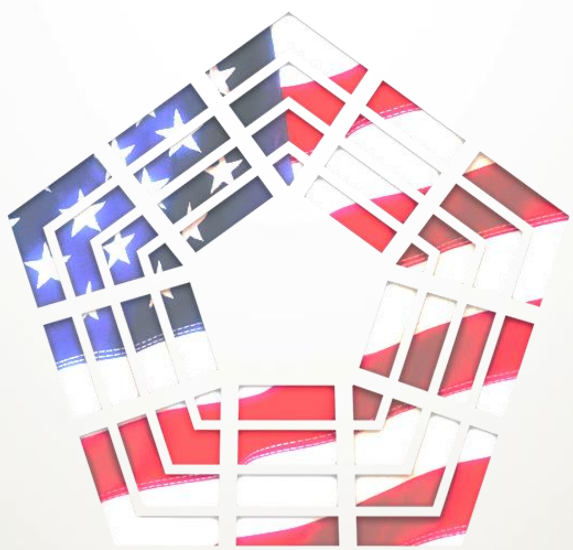
UNITED STATES DEPARTMENT OF DEFENSE

AGENCY FINANCIAL REPORT

FISCAL YEAR 2015

MANAGEMENT'S DISCUSSION AND ANALYSIS



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MANAGEMENT'S DISCUSSION AND ANALYSIS

DEPARTMENT OF DEFENSE OVERVIEW

The Department of Defense is charged with the mission to ensure the security of the United States and its citizens, or as phrased in the Constitution, to "provide for the common defense." The Department of Defense is committed to protecting the people of the United States, defending our national interests, and providing America's military with the resources to accomplish its mission.

Ash Carter

Secretary of Defense

Today, the context in which we provide this security is extremely challenging. Global disorder has increased, while some of the military advantages we have traditionally enjoyed have started to erode, for example through the rapid technological change enjoyed by both state and non-state adversaries. Violent extremist organizations continue to deny vulnerable populations their right to live in security and at peace, and some states provide support to such organizations or otherwise seek to challenge international norms.

The Department maintains a force that is second-to-none in the world and serves as a bulwark to keep the nation secure in the face of these challenges. This force exists because of the men and women who choose to serve in order to guarantee the security and the freedoms of their fellow citizens. The Department has an obligation to ensure they are properly trained and equipped.

The Department sets its strategic direction through the *Quadrennial Defense Review (QDR)*, which was provided to Congress in March 2014. The QDR is a legislatively-mandated report, issued every four years, that evaluates the threats and challenges to our enduring national interests that the nation will likely confront over the next 20 years. It is the key strategic document against which the Department's priorities and requests for resources are aligned. The QDR, consistent with the President's National Security Strategy, affirms the global leadership role of the United States and sets a course that will help bring the military into balance over the next decade. The QDR outlines the Department's strategic priorities which include: rebalancing our focus and our forces to the Asia-Pacific region to preserve peace and stability; maintaining a strong commitment to security and stability in Europe and the Middle East; and sustaining a global approach to countering violent extremists and terrorist threats, with an emphasis on the Middle East and Africa. It highlights the importance of strengthening our alliances and partnerships globally.

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

The Rebalance to the Asia-Pacific remains a key component of the Department's strategy. While a peaceful rise of China is welcome, its actions in the South China Sea are increasingly at odds with international norms. Faced with North Korea's acts of cross-border provocation, and its 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 whole, free, and at peace, President Putin's continued aggression towards Ukraine and illegal annexation of Crimea is an unwelcome strategic development. The Department is working with U.S. allies and partners to promote regional security as part of a strong and balanced approach to Russia. We are supporting Ukraine's armed forces, and have committed millions of dollars of non-lethal material and assistance.

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

In Afghanistan, the U.S. strategy is to continue building the capacity of the Afghan government as a reliable defense partner, and to protect U.S. national security interests in the region. Afghanistan's government of national unity is now fully responsible for the security of its people and is moving ahead on a reform agenda. Approximately 9,800 U.S. forces are focused on training, advising, and assisting the Afghan National Defense and Security Forces (ANDSF) as part of the NATO-led Resolute Support Mission, as well as conducting a counterterrorism mission. The Department will continue to finance the sustainment and professionalization of the ANDSF of up to 352,000 personnel through 2017.

The Middle East is undergoing a period of great social and political turmoil. The United States, with a coalition of allies and partners, is engaging in a long-term campaign to degrade and deal a lasting defeat to the Islamic State of Iraq and the Levant (ISIL). To achieve a lasting defeat of ISIL requires a "whole of government" effort, and of the nine lines of efforts that underpin the campaign, the Department leads just two: Denying ISIL Safe Haven and Building Partner Capacity. The Department's personnel remain committed to building the capacity of the Iraqi Security Forces to defend their homeland and deny ISIL safe haven. This is challenging to achieve, but ISIL's lasting defeat requires local forces to prevail on the ground. We also continue to provide critical support to our partners in the region in an effort to bolster their defenses and enable their activities and operations aimed at countering ISIL. We are doing all this in the context of a 60-plus nation coalition.

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

Against this backdrop of emerging challenges to U.S. national interests, the Department is resetting and reconstituting the Joint Force after 13 years of war. The Department continues to make key investments in the future force, with an emphasis on restoring readiness, balancing the force, and achieving institutional reform. We are placing a greater emphasis on research and development to help us maintain our competitive edge. We are also prioritizing investments in key strategic capabilities, namely nuclear deterrence; space systems; power projection; missile defense; cyber capabilities; and intelligence, surveillance, and reconnaissance.

We will also draw from the brightest innovators within the commercial sector to find technologies that will give troops an edge on the battlefield of the future, and the pace at which we have established a presence in Silicon Valley exemplifies our determination to infuse Defense with non-traditional talent and leading edge technology.

Finally we must show that we are taking effective action to make the best possible use of every taxpayer dollar. That means we must strive to manage the Defense enterprise efficiently and effectively, and to reform our business and acquisition practices. These efforts are imperative to maintain readiness on all fronts for both the geopolitical challenges we know about today, and those to come.

The USS Chung-Hoon, USS Mobile Bay and USS Russell follow the USS John C. Stennis during a show of force as they transit in the Pacific Ocean. Sailors conduct composite training and joint task force exercises as the final step in certifying to deploy.

Photo by Mass Communication Specialist 3rd Class Andre T. Richard

A soldier assigned to the California Army National Guard's Company B, 1st Battalion, 126th Aviation Regiment, observes a bambi bucket dropping water onto the Rocky Fire near Clear Lake, Calif. During the crew's 2.5-hour firefighting mission, they conducted 18 water drops.

Photo by Sgt. Jason Beal

Resources

The FY 2015 Department of 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 2015 budget were:

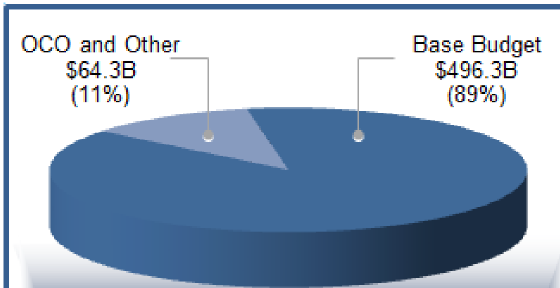
- Seek a balanced force within available resources;
- Prepare for prolonged readiness challenges;
- Continue to focus on institutional reform;
- Pursue compensation changes; and
- Pursue investments in military capabilities.

The DoD FY 2015 enacted discretionary budget authority totaled $560.5 billion, composed of $496.3 billion in the base budget, $64.2 billion in support of Overseas Contingency Operations (OCO), and $0.1 billion for other emergency funding. Figure 1 displays the DoD FY 2015 budget authority by Title.

Despite decreasing resources, the Department must continue to maintain its decisive technological edge. In FY 2015, 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 investments in modernization efforts to ensure that U.S. military forces are equipped with the most technologically innovative weapons available. For ground forces, this includes the development of the Armored Multi-Purpose Vehicle and the Joint Light Tactical Vehicle. For maritime forces, the FY 2015 request included funding for two Virginia-class fast attack submarines and two DDG-51 AEGIS destroyers, in addition to funding to continue construction of the U.S.S. John F. Kennedy and procurement of three Littoral Combat Ships. For air dominance, the budget included development and production of three different variants of the F-35 Joint Strike Fighter; the next generation aerial refueling tanker, the KC-46A; the Navy's advanced E-2D Hawkeye fleet defense aircraft; and the multi-mission P-8A Poseidon patrol aircraft. To protect the homeland and regional forces, the budget included continued development and fielding of ballistic missile defense systems. The budget also put emphasis on innovation by providing $12 billion for science and technology efforts.

Figure 1. DoD FY 2015 Budget Authority



Budget by Title	$ in Billions
Military Personnel	$140.0
Operation and Maintenance	$246.4
Procurement	$101.3
RDT&E	$63.8
Revolving Funds	$2.2
Family Housing	$1.1
Military Construction	$5.7
Total	**$560.5**

Totals may not agree due to rounding.

B15-17

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. These efficiency initiatives include reductions 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 2015 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 450,000 and 182,000, respectively.

Reserve Components are an important element of the Total Force, and the Department is focused on optimizing the active/reserve force mix and 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 members' families who give so much to defend the ideals and free institutions we often take

Two E-2D Hawkeye aircraft conduct a test flight near St. Augustine, Fla.

Photo courtesy of Northrop-Grumman

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 9.5 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

Against the unexpected geopolitical developments of Russian aggression, ISIL activism, North Korean provocation, and broader geopolitical turmoil across the Middle East region, the strategic priorities identified in the *Quadrennial Defense Review 2014* remain our Department's priorities: rebalancing to the Asia-Pacific region, maintaining a strong commitment to security and stability in Europe and the Middle East, sustaining a global counterterrorism campaign, strengthening key alliances and partnerships, and prioritizing key modernization efforts.

We are at a pivotal moment in the post-Cold War world. Russia is modernizing both its nuclear and its conventional military capabilities, and updating its warfighting doctrine. While China's rise is welcomed, its increasing assertiveness in the South China Sea is out of step with international norms and increasing demand for our engagement in the Asia-Pacific region. Meanwhile, the military's technological edge, which we have relied upon for so long, is eroding. This is a major strategic challenge facing not only the Department, but also, America's leadership in the world.

To maintain our warfighting dominance, the Department has launched the Defense Innovation Initiative and Third Offset Strategy, an ambitious Department-wide effort overseen by Deputy Secretary Work to identify and invest in innovative ways to sustain and advance America's military dominance for the 21st century.

As reflected in the QDR, the current strategic and budgetary environment compels us to think creatively about how we can restore the readiness of the force, while we remain globally engaged. The Department seeks to achieve full spectrum combat readiness by FY 2023 for the Army and the Air Force, the Navy's fleet response plan by 2020, and the Marine Corps' Force Posture Plan by 2020.

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

ORGANIZATION

The Department 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 the traditional boundaries of the battlefield.

The Department is one of the nation's largest employers, with civilians, personnel on active duty, and the Selected Reserve of National Guard and Reserve forces. Our military service members and civilians operate in every time zone and in every climate. There also are more than 2 million military retirees and family members receiving benefits.

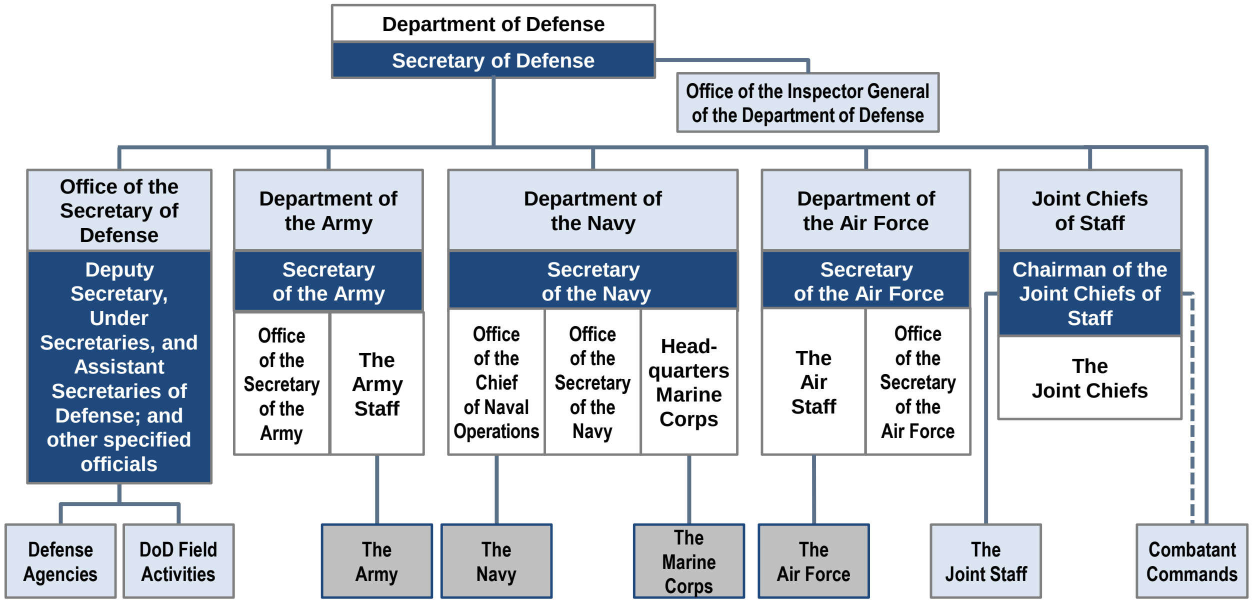
A sailor operates a tractor to carry supplies from the well deck of the amphibious dock landing ship USS Ashland onto a landing craft utility at Apra Harbor, Guam. The supplies were bound for Saipan as part of the disaster relief effort following Typhoon Soudelor.

Photo by Mass Communication Specialist 3rd Class David A. Cox

The Department's real property infrastructure includes over 562,000 facilities (buildings and structures) located on 4,800 sites worldwide covering over 24.9 million acres. To protect the security of the United States, the Department operates 14,597 aircraft and 284 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 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

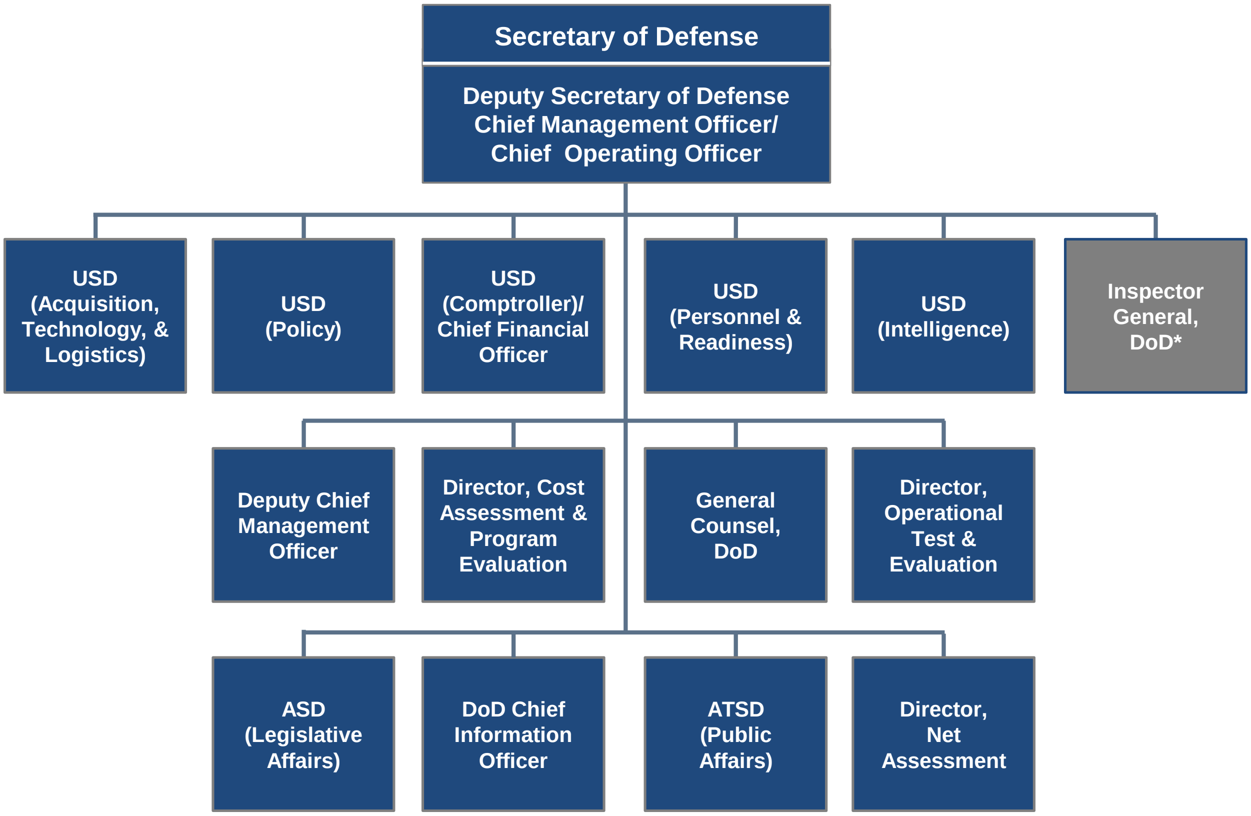


The Office of the Secretary of Defense

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; the DoD IG; and the other staff offices within OSD established by law or by the Secretary.

The OSD Principal Staff Assistants (PSAs) are responsible for the oversight and formulation of defense strategy 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**

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 the Inspector General of the 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 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, or civil disturbances, and in some cases supporting federal purposes for training or other duty (non-federalized service).

When ordered to active duty (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.

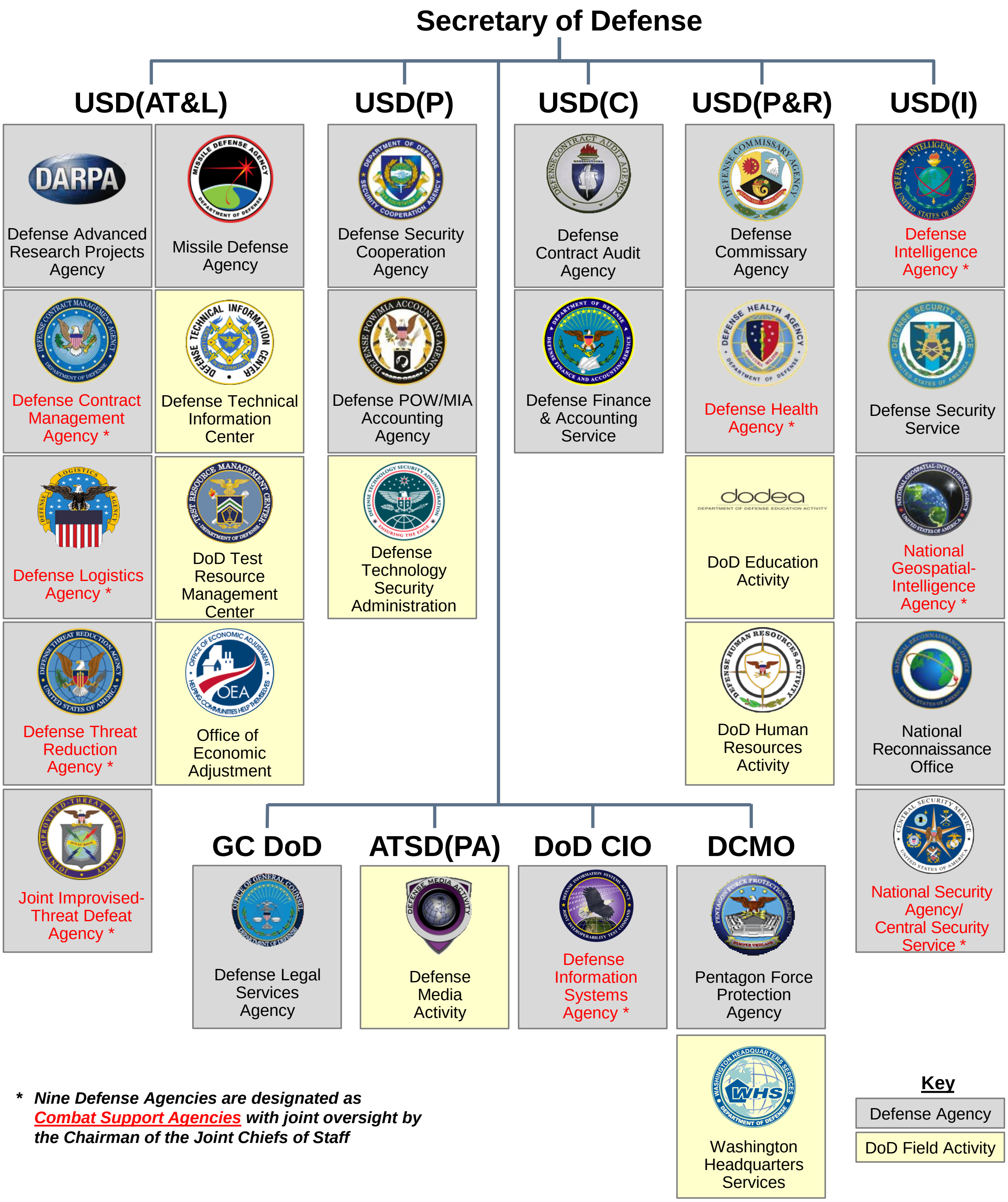
Figure 4. Reserve Components: Reserves and National Guard

Federal Missions					*Federal and State Missions*	
United States Army Reserve	United States Navy Reserve	United States Air Force Reserve	United States Marine Corps Reserve	United States Coast Guard Reserve	United States Air National Guard	United States Army National Guard

Defense Agencies and DoD Field Activities

Defense Agencies and DoD Field Activities (Figure 5) are established as DoD Components by law, the President, or the Secretary of Defense to provide, on a DoD-wide basis, a supply or service activity common to more than one Military Department when it is more effective, economical, or efficient to do so. 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 20 Defense Agencies and 8 DoD Field Activities operate under the authority, direction, and control of the Secretary of Defense through an OSD Principal Staff Assistant.

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.

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 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.

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.

The Government Performance and Results Modernization Act (GPRAMA) of 2010 requires the development of the Agency Strategic Plan (ASP). The Department's 2015-2018 ASP strategic goals are:

- Defeat our Adversaries, Deter War, and Defend the Nation;
- Sustain a Ready Force to Meet Mission Needs;
- Strengthen and Enhance the Health and Effectiveness of the Total Workforce;
- Achieve Dominant Capabilities through Innovation and Technical Excellence; and
- Reform and Reshape the Defense Institution.

The Department Agency Strategic Plan presents the strategic goals and objectives the Department aims to accomplish over Fiscal Years (FY) 2015-2018, describing near and long-term defense performance and priority goals, and the federal cross-agency priority (CAP) goals the Department contributes toward achieving. The Department will continue to mature the ASP to better inform internal and external stakeholders, enhance substance for improved decision-making, planning, alignment of actions, and resources to realize goals and deal with challenges or risks – while also addressing requirements of GPRAMA and the National Defense Authorization Act of 2008. The Department's ASP builds from the strategic authorities and direction to align national defense efforts and resources ultimately enabling warfighter mission execution.

This report provides an executive-level overview of DoD's performance through the third quarter, ending June 30, 2015, with fiscal year-end results published in the Annual Performance Report in the Department's budget submission in February 2016.

Marines with the 31st Marine Expeditionary Unit depart the amphibious assault ship USS Peleliu (LHA 5) to participate in the ground phase of Amphibious Landing Exercise (PHIBLEX) 15 in Subic Bay, Philippines. PHIBLEX is a bilateral training exercise designed to improve the interoperability, readiness, and professional relationships between the U.S. Marine Corps and partner nations.

Photo by Mass Communication Specialist 3rd Class Dustin Knight

[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*

SUMMARY OF PERFORMANCE RESULTS

At the end of the third quarter, 67 percent of the Department's quarterly performance measures were on track to meet the annual goals, while 33 percent did not meet third quarter targets and are considered "at risk" of not achieving their annual targets.

Successes

The Department has been successful in meeting most of the priority measures for third quarter, FY 2015, including those related to acquisition reform and providing high quality care to wounded, ill, or injured service members. 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.

Processing Wounded Warriors through the Integrated Disability Evaluation System (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 2015, the Department continued its work with the *U.S. Department of Veterans Affairs* (VA) to accelerate the transition of *Wounded, Ill, and Injured* Service members into Veteran status by reducing the disability evaluation processing time.

U.S. and British athletes compete in the 100-meter sprint at the 2015 Department of Defense Warrior Games on Marine Corps Base Quantico, Va., June 23, 2015.

Photo by Lance Cpl. Terry W. Miller Jr.

IDES is used to determine if Service members coping with wounds, injuries, or illnesses that may prevent them from performing their duties are able to continue serving. IDES is a joint process established by the VA and the Department that includes a single set of medical examinations and disability ratings. The goal is to reduce the gap between separation from active duty and receipt of VA benefits and compensation.

In the area of information technology enhancements, the Department is acquiring a DoD Disability Evaluation System Information Technology (IT) solution, with a targeted Initial Operating Capability in FY 2017. This will leverage existing IT capabilities where appropriate, and include new capabilities to support end-to-end case management, tracking, and reporting, and to enhance electronic IDES case file transferability within the Military Departments and interoperability between the Department and VA.

Despite numerous cross-agency challenges, the Department exceeded its IDES performance measure target in support of the Agency Priority Goals (APG) for the second

(85 percent), third (87 percent) and fourth (87 percent) quarters of FY 2015. The performance measure combines the outcomes of timeliness for completing Department core IDES phases, Service member satisfaction with the process, the accuracy and consistency of Military Department disability determinations, and compliance with administrative processing requirements.

Reform the DoD Acquisition Process

In the Better Buying Power (BBP) initiative announced in September 2010, and re-emphasized in the November 2012 memorandum introducing BBP 2.0, the Under Secretary of Defense for Acquisition, Technology and Logistics (USD(AT&L)) directed the acquisition professionals in the Department to deliver better value to the taxpayer and warfighter by improving the way the Department does business. Next to supporting the Armed Forces at war, this was the President's and Secretary of Defense's highest priority for the Department's acquisition professionals. USD(AT&L) pointed out its continuing responsibility to procure the critical goods and services U.S. Armed Forces need in the years ahead without having ever-increasing budgets to pay for them. DoD Components have incorporated Better Buying Power concepts into their policies and practices for the acquisition of weapon systems, goods and services, instilling a cost-conscious culture and improving the workforce's ability to adapt and apply the best approach for each situation. These efforts are informed by ongoing analysis of numerous aspects of defense acquisition in the annual reports on the Performance of the Defense Acquisition System. These reports add insight and gauge progress that result in improvements in APG measures, showing positive trends and areas for further work. On April 9, 2015, USD(AT&L) announced the next step in the BBP continuum, BBP 3.0, Achieving Dominant Capabilities through Technical Excellence and Innovation. BBP 3.0 places an additional emphasis on innovation, technical excellence, and quality of products.

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

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

Areas for Improvement

The Department did not meet 33 percent of its third quarter targets for the APG measures, indicating these are at risk for not achieving annual performance goals. There are improvement opportunities related to achieving audit-ready financial statements, improving energy performance, and competitive contracting.

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.

Fiscal Year 2015 was a pivotal year for the Department. Each Military Department began an Independent Public Accountant (IPA) audit of its General Fund Schedule of Budgetary Activity (SBA) FY 2015 appropriations. Additionally, most of the material other Defense organizations (ODO) went under SBA examination or completed mock audits of their current year budgetary activities. Going under IPA audit or examination is an essential part of the DoD strategy to achieve full audit readiness and is consistent with the feedback received from the Government Accountability Office, the DoD Office of the Inspector General, and some members of Congress. While the Department is in the process of prioritizing the corrective action plans to address the audit findings, it will continue to focus on preparing the remaining financial statements for audit.

The Department is currently focused on four principal financial statements: Statement of Budgetary Resources (SBR), Balance Sheet, Statement of Net Cost, and Statement of Changes in Net Position. To support auditability of the Balance Sheet, the Department established audit readiness of Mission Critical Assets as a priority. The Mission Critical Assets audit readiness strategy focuses on financial statement assertions for Existence and Completeness, Valuation, Presentation and Disclosure, and Rights and Obligations. Resolving existence and completeness issues is an essential first step to valuing assets and reporting them on the Balance Sheet. The Department did not meet the Mission Critical Assets target goal due to outstanding policy issues in establishing an appropriate valuation baseline. The Department is working with the Federal Accounting Standards Advisory Board to establish a valuation baseline. Fund Balance with Treasury (FBWT), a material line item on the Balance Sheet, is another indicator as to whether the Department's full financial statements will be audit ready by FY 2017. The Department did not meet the FBWT target due to audit findings related to one Military Service. The SBR is also an indicator of whether the Department's full financial statements will be audit ready by FY 2017. The Department did not meet the SBR target due to audit findings related to supporting balances for open obligations from prior year funds.

For the purposes of the above indicators, audit readiness is defined as an individual reporting entity's management audit readiness assertions for FBWT, Existence and Completeness of Mission Critical Assets, Valuation of Mission Critical Assets, and SBR to enable more meaningful and achievable goals when establishing FY 2016 goals. The Department is committed to resolving the audit findings and achieving and sustaining audit-ready financial statements.

U.S. sailors and Marines man the rails as they pull into their first port call of their summer deployment on the amphibious dock landing ship USS Ashland in Bunbury, Australia, June 29, 2015. The Ashland is patrolling in the U.S. 7th Fleet area of operations.

Photo by U.S. Navy Petty Officer 2nd Class David Co

Energy

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

Despite falling short of the FY 2014 intensity reduction goal of 27 percent, the Department reduced its energy intensity by 17.6 percent from the FY 2003 baseline and improved by 0.4 percent from FY 2013. While the Department continues to invest in cost-effective energy efficiency and conservation measures to improve goal progress, there will be challenges in future reductions. Facility energy metrics are reported on an annual basis.

A Navy F/A-18E Super Hornet launches at sunset from the flight deck of the aircraft carrier USS Ronald Reagan in the Pacific Ocean off the coast of Southern California, July 10, 2015. The aircraft is assigned to Strike Fighter Squadron 137.

Photo by Petty Officer 2nd Class Chase C. Lacombe

Contract Obligations That Are Competitively Awarded

The Better Buying Power initiatives advanced by the Under Secretary of Defense for Acquisition, Technology and Logistics are aimed at achieving greater efficiencies through affordability and cost control. A principal element in achieving these objectives is the promotion of effective competition. For the third quarter FY 2015, the Department achieved a competition rate of 52.4 percent against the third quarter target of 56 percent. Based on current projections, the Department does not anticipate achieving the FY 2015 goal of 59 percent.

However, USD(AT&L) continues to emphasize the importance of maximizing opportunities for competitive contracting on a quarterly basis at the Business Senior Integration Group meetings. In this forum, the Service Acquisition Executives have shared best practices by describing the approach employed by program executive officers to identify targets of opportunity.

Looking ahead to next fiscal year, USD(AT&L) will emphasize a transition from targeted goals based primarily on the percentage increase over prior year actuals, to a forecast model that projects competition opportunities a year in advance to account for anomalies, such as the purchase of a nuclear powered aircraft carrier. The Director of Defense Procurement and Acquisition Policy, with Component input, will examine differing circumstances and projected competitive opportunities to enable more meaningful and achievable goals when establishing FY 2016 goals.

Summary

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

A soldier assigned to the 982nd Combat Camera Company, rappels down a cliff during Fleet Combat Camera Pacific's Quick Shot 2015 combined joint field training exercise in the Angeles National Forest near Azusa, Calif., Aug. 6, 2015. Quick Shot is a semiannual field exercise designed to train combat camera personnel to operate in a combat environment.

Photo by Mass Communication Specialist 2nd Class Anthony R. Martinez

A MESSAGE FROM THE CHIEF FINANCIAL OFFICER

It is a privilege for me to present the fiscal year (FY) 2015 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.

This year marked a turning point for the Department. In January 2015, independent public accounting firms began auditing the Military Departments' General Fund Schedules of Budgetary Activity for their FY 2015 appropriations. Although a number of organizations and some of the Department's largest funds have already been sustaining full financial statement audit opinions, moving the Military Departments and many of the components into an annual audit routine represents a major cultural change for the Department.

No one feels the impact of this shift more than the over 53,000 members of the defense financial management workforce. Our financial management workforce must be prepared to work with auditors and respond to their requests, while also completing extensive and challenging audit readiness work for the remaining statements. Additionally, as we increase emphasis on the correct financial account treatment of business transactions to our current budgetary focus, the workforces in our business areas will become more involved. Personnel in areas such as acquisition, human resources, logistics, maintenance, and facilities management are being called upon to strengthen their internal controls, processes, and systems while also supporting the warfighter. Our workforce exemplifies the Department's commitment to the Financial Improvement and Audit Readiness initiative.

Furthermore, we continue to improve the skills of the Department's financial management workforce. Our course-based certification program for the financial management workforce emphasizes certain courses and ensures that proper training occurs at each point in an employee's career. To date, over 11,000 members have achieved their required certification, instilling a culture of continual professional development.

We also have continued our improvement and consolidation of our financial related systems and instituted additional internal controls over our financial reporting and operations. Many financial management issues that cut across the Department remain—future milestones critical to audit readiness will be a challenge for all components to meet. Regardless of these challenges and the amount of audit readiness work to be completed, I remain confident that with sustained emphasis and commitment from DoD leaders, the DoD workforce, and Congress, we will continue making progress toward our goals.

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 2015 and a high-level overview of how the Department met its performance goals and objectives as of the third quarter of FY 2015. The FY 2015 final results for all Department performance measures will be reported in the Department's Annual Performance Report, which will be available in February 2016.

As noted, the Department's issues in producing auditable financial statements persist, and management cannot provide unqualified assurance as to the effectiveness of our internal controls over financial reporting, operations, and financial management systems. Part of the challenge in successfully passing a financial statement audit lies with the Department's unique size and mission. For example, Figure 7 shows the magnitude of financial activities processed only by the Defense Finance and Accounting Service (DFAS) in FY 2015, and does not include transactions processed by other DoD entities, such as the U.S. Army Corps of Engineers or the Defense Health Agency.

Figure 7. DFAS Statistics FY 2015

Description	FY 2015
Number of Pay Transactions	135.7 million
Number of Commercial Invoices Paid	11.8 million
Number of Travel Payments	5.7 million
Number of General Ledger Accounts managed	190.6 million
Amount Disbursed	$477 billion
Amount of Military Retirement and Health Benefits Funds Managed	$834 billion
Foreign Military Sales Cases Reimbursed by Foreign Governments	$455 billion

Despite our complexities, we continue to make strides in our efforts towards producing auditable financial statements. Notably, the Army, Navy, Air Force, and multiple Defense Agencies underwent audit in FY 2015 of their Schedules of Budgetary Activity (SBA), a precursor to audits of their Statements of Budgetary Resources (SBR). Also, several DoD Components have continued to maintain audit opinions on their full financial statements.

The Department's Financial Improvement and Audit Readiness (FIAR) Initiative guides the Department's efforts to improve our financial management and ability to demonstrate reliable and well-controlled business processes and provide supporting documentation to auditors in a timely and consistent manner. Through the Managers' Internal Controls Program, we continue to identify and fix gaps in business practices, policies, and procedures that could leave room for errors or weaknesses. Additionally, we continue to replace, update, and consolidate outdated and redundant information technology systems. New data standards are in place to improve data quality and systems interoperability. These initiatives are detailed further in this report.

With continued improvements in systems and business processes, the Department can more readily achieve and sustain the reliability of reported financial information to meet the timeliness, reliability, and accuracy standards of an independent auditor. Although the Department has yet to achieve full auditability, we are 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.

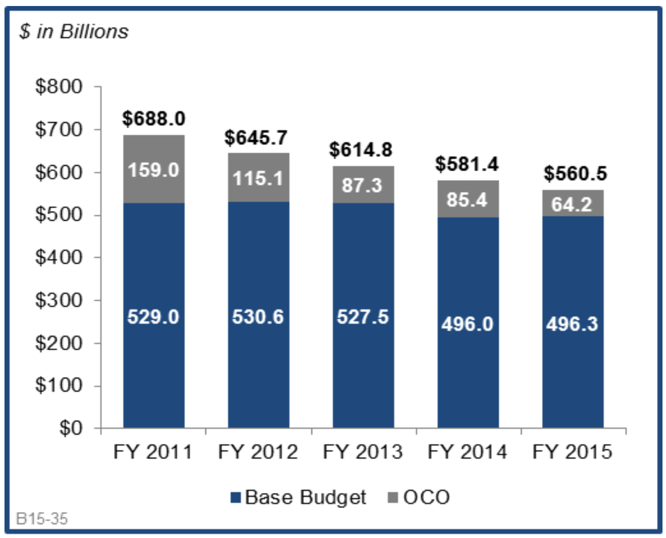
The Defense Finance and Accounting Service (DFAS) prepared the consolidated financial statements and explanatory notes, located in the Financial Information section of this report. The principal financial statements include the:

- Statement of Budgetary Resources;
- Balance Sheet;
- Statement of Net Cost; and
- 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 8. Trend in DoD Budget Authority



As discussed in the DoD Overview Section of this report and as depicted in Figure 8, the Department's FY 2015 budget authority total is $560.5 billion. The change in FY 2015 budget authority from FY 2014 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 9, the Department reported $1.1 trillion in FY 2015 total budgetary resources. The total appropriations amount of $720.5 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 9. Composition of DoD Total Budgetary Resources

Description	FY 2015 ($ in billions)
DoD Budget Authority	$ 560.5
U.S. Treasury contribution for Military Retirement and Health Benefits	86.4
Civil Works Projects executed by the USACE	4.1
Trust Fund Receipts	123.7
Trust Fund Resources Temporarily not Available	(54.2)
Total Appropriations Reported on SBR	**$ 720.5**
Unobligated Budget Authority Brought Forward from Prior Year	176.0
Spending Authority from Offsetting Collections	102.4
Contract Authority	68.3
Total Budgetary Resources	**$ 1,067.2**

Additional budgetary resources include $176.0 billion of unobligated balances stemming from prior year budget authority, $102.4 billion in spending authority from offsetting collections, and $68.3 billion of contract authority.

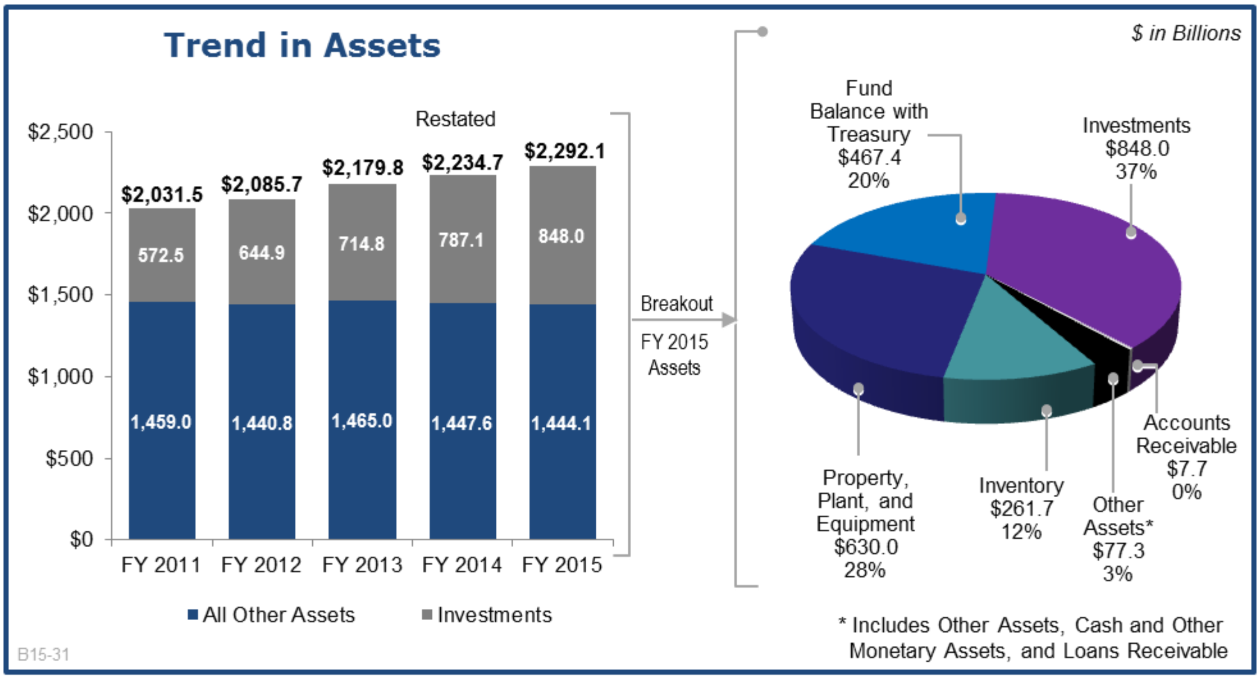
Of the $1.1 trillion in total budgetary resources, $917.8 billion was obligated and $887.8 billion of obligations were disbursed. The remaining unobligated budgetary resources balance relates to appropriations available to cover multi-year investment projects. These projects require additional time for delivery of goods and services. Expired appropriations remain available for valid upward adjustments to prior year obligations but are not available for new obligations.

Balance Sheet

The Balance Sheet, which reflects the Department's financial position as of September 30, 2015, 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 $2.3 trillion in assets shown in Figure 10 represent amounts the Department owns and manages. Investments, General Property, Plant, and Equipment, and Fund Balance with Treasury (FBWT) represent 85 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 10. Summary of Total Assets



Total Assets increased $57.4 billion (2.6 percent) from FY 2014, largely due to a $60.9 billion increase in Investments in U.S. Treasury securities. Investments increased primarily due to normal growth in the Military Retirement Fund. As displayed in Figure 13, the Department has realized growth in investments over the last several years. The growth results from investment of contributions from the U.S. Treasury and the Uniformed Services, net of benefits paid. Under the Department's current strategy, invested balances will continue to grow to cover unfunded portions of future benefits. Funds not needed to cover current benefits were invested in U.S. Treasury Securities.

As seen in Figure 11, the Department's total liabilities decreased $32 billion during FY 2015, due to downward adjustments in the estimated actuarial liability associated with military retiree health care benefits. This change is primarily attributable to changes in the underlying benefit plan, actuarial assumptions, experience, and expectations used to calculate the unfunded liability. The Department's $2.4 trillion of liabilities reported in FY 2015 are backed by the full faith and credit of the United States Government.

Figure 11. Summary of Total Liabilities

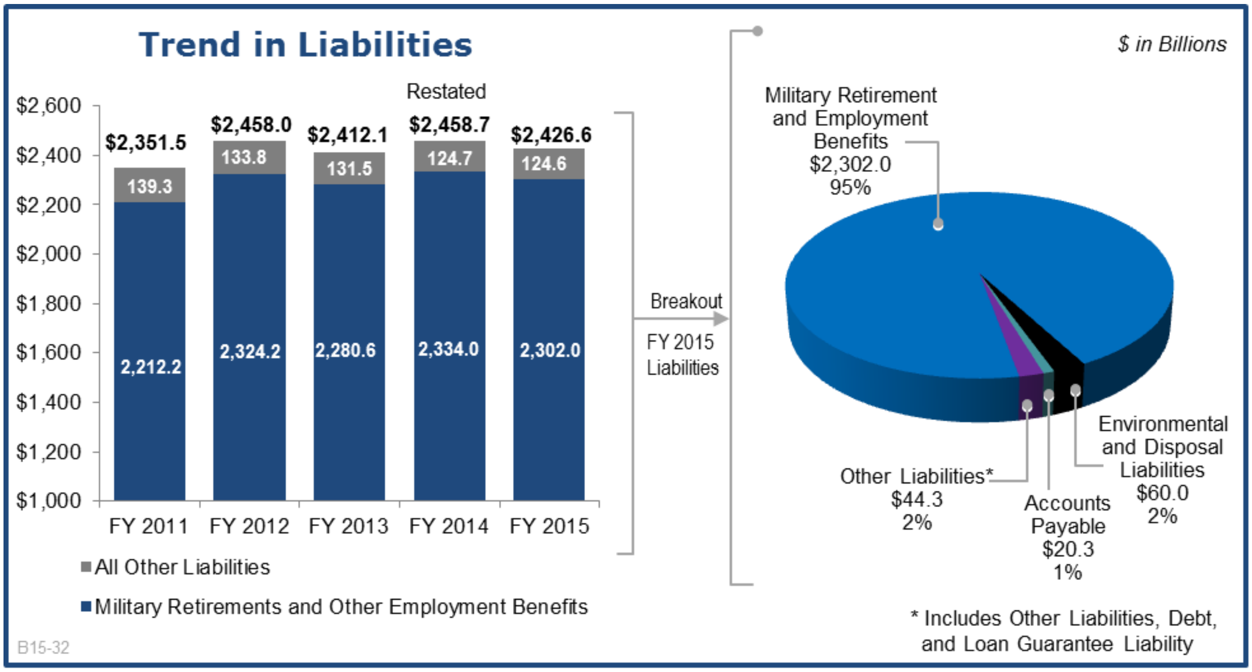
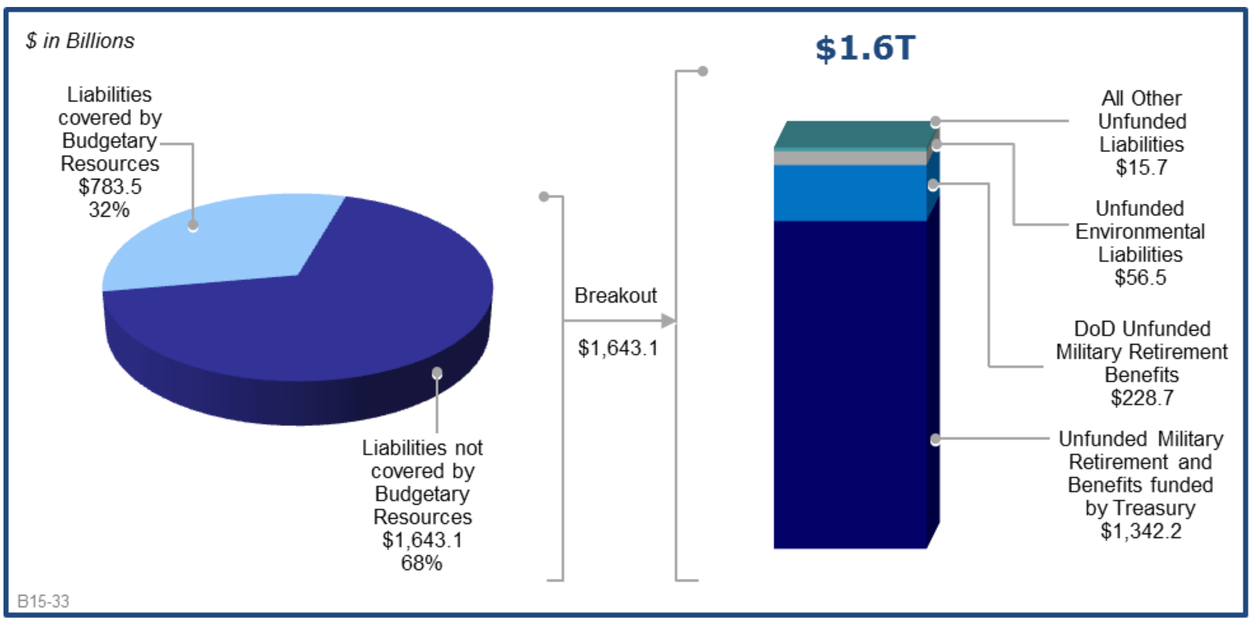


Figure 12 shows the $1.6 trillion in unfunded liabilities that will require future resources. The U.S. Treasury is responsible for funding the actuarial liability that existed at the inception of the military retirement and health care programs. This $1.3 trillion actuarial liability accounts for approximately 82 percent of the total $1.6 trillion in liabilities not covered by budgetary resources. The Department has resources available to cover approximately $724.6 billion of the remaining liabilities, primarily invested in U.S. Treasury securities. In addition, there are Military Pre-Medicare eligible retiree health benefits actuarial liabilities of $235.3 million.

Figure 12. Unfunded Liabilities



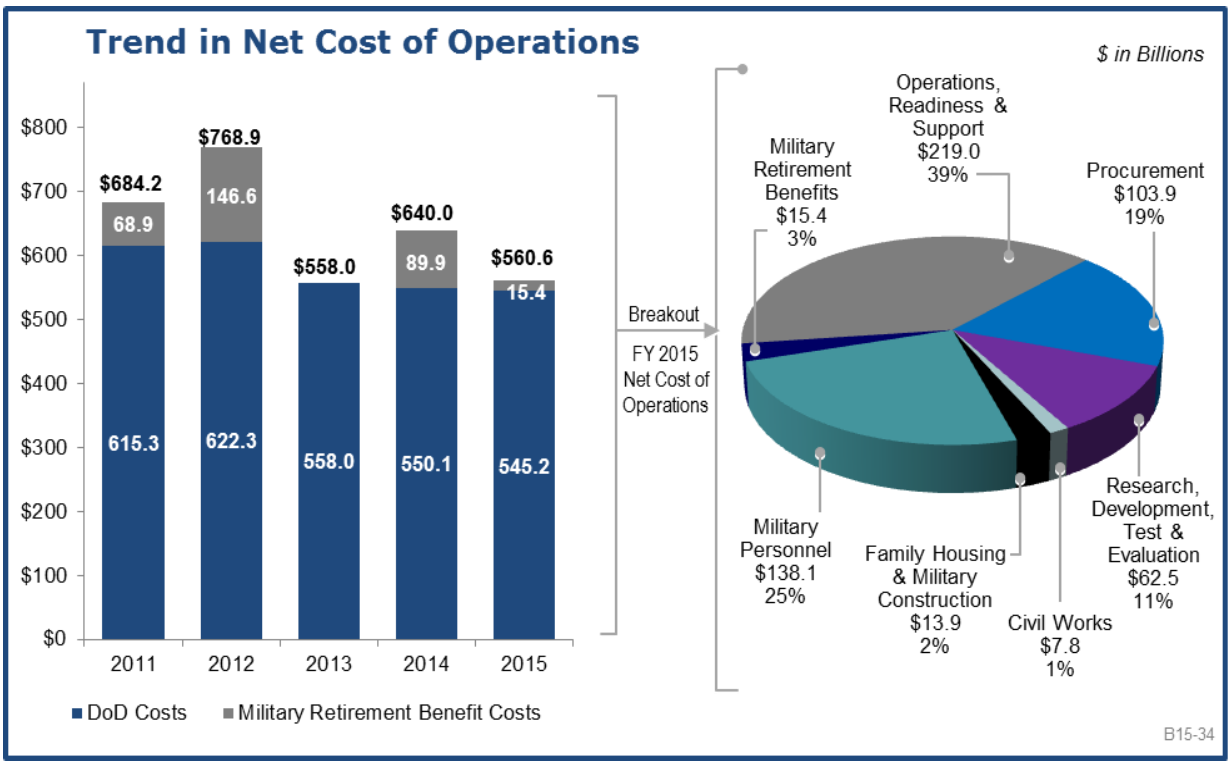
Statement of Net Cost

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 $560.6 billion in net cost of operations during the fiscal year.

As depicted in Figure 13, the $560.6 billion in net cost of operations represents a $79.4 billion decrease (12 percent) from FY 2014 reported net cost. Approximately $74.5 billion of the decrease is related to the cost for future military retirement and health care benefits, largely driven by plan amendments, changes in actuarial assumptions, and other actuarial gains and losses.

Figure 13. 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 $89.5 billion during FY 2015. The increase reflects primarily the effect of the change in projected military retirement and health care benefits.

Financial Performance Summary

The Department's financial performance is summarized in Figure 14. This table represents the Department's condensed financial position, results of operations, and budgetary resources, and includes comparisons of financial balances from the current year to the prior year.

Management also relies on information that describes the economic conditions of the Department that cannot be expressed in the basic financial statements. Required supplementary stewardship information includes the Department's investments in nonfederal physical property and investments in research and development.

Nonfederal Physical Property investments support the purchase, construction, or major renovation of physical property owned by state and local governments. In addition, Nonfederal Physical Property investments include federally-owned physical property transferred to state and local governments. Examples include expenditures supporting the design, build, and construction services/management for the missions of commercial navigation, flood/storm damage reduction, hydropower, regulatory, environmental, recreation, and water supply. Investments in transferred and funded assets for FY 2015 totaled over $1.3 billion.

The Department also invests in research and development to maintain its technological advantage over potential adversaries, improve the health and welfare of military personal and their families, and make operational improvements to increase the Department's overall efficiency and effectiveness. During FY 2015 the Department made investments in research and development of over $61 billion, which included investments in basic research, applied research, and development. Examples of research and development programs included lightweight energy efficient materials, night vision, global weather patterns, experimental and operational ships, planes, vehicles, and medical advances for the care and treatment of wounded warriors and their families.

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 is used to manage the Department's operations successfully.

Figure 14. Financial Performance Summary

Dollars in Billions	FY 2015	Restated FY 2014	Change	% Change
ASSETS				
Fund Balance with Treasury	$ 467.4	$ 480.4	$ (13.0)	-2.7%
Investments	848.0	787.1	60.9	7.7%
Accounts Receivable	7.7	8.0	(0.3)	-3.8%
Other Assets	77.3	78.9	(1.6)	-2.0%
Inventory and Related Property, Net	261.7	261.5	0.2	0.1%
General Property, Plant and Equipment, Net	630.0	618.8	11.2	1.8%
Total Assets	**$ 2,292.1**	**$ 2,234.7**	**$ 57.4**	**2.6%**
LIABILITIES				
Accounts Payable	$ 20.3	19.9	$ 0.4	2.0%
Other Liabilities	44.3	46.2	(1.9)	-4.1%
Military Retirement and Other Federal Employment Benefits	2,302.0	2,334.0	(32.0)	-1.4%
Environmental and Disposal Liabilities	60.0	58.6	1.4	2.4%
Total Liabilities	**$ 2,426.6**	**$ 2,458.7**	**$ (32.1)**	**-1.3%**
Total Net Position (Assets Minus Liabilities)	**$ (134.5)**	**$ (224.0)**	**$ 89.5**	**40.0%**
Total Financing Sources	677.0	646.5	30.5	4.7%
Less Net Cost of Operations	(560.6)	(640.0)	79.4	-12.4%
Net Change of Cumulative Results of Operations	**116.4**	**6.5**	**109.9**	**1,690.8%**
Total Budgetary Resources	**$ 1,067.2**	**$ 1,084.4**	**$ (17.2)**	**-1.6%**

An F-16 Fighting Falcon aircraft sits on the flightline before morning sorties on Tyndall Air Force Base, Fla., Sept. 18, 2015. The aircraft is assigned to the Ohio Air National Guard's 180th Fighter Wing.

Ohio National Guard photo by Air Force Senior Master Sgt. Beth Holliker

FINANCIAL MANAGEMENT IMPROVEMENT INITIATIVES

Financial Improvement and Audit Readiness Initiative

The Financial Improvement and Audit Readiness (FIAR) initiative is the Department's strategy for achieving and validating audit readiness of all financial statements by September 30, 2017. Audit readiness means the Department has strengthened internal controls and improved financial practices, processes, and systems so there is reasonable confidence the information can withstand an audit by an independent auditor.

Fiscal year (FY) 2015 was a pivotal year for the Department. Each Military Department began an Independent Public Accountant (IPA) limited-scope audit of its General Fund Schedule of Budgetary Activity (SBA) for its FY 2015 appropriations. Additionally, most of the material other Defense organizations (ODO) went under SBA examination or completed mock audits of their current year budgetary activities. Going under IPA audit or examination is an essential part of the DoD FIAR strategy and is consistent with the feedback received from Government Accountability Office (GAO), the DoD Office of the Inspector General (DoD IG), and some members of Congress. Audits highlight dependencies between organizations and remaining deficiencies so corrective actions can be implemented and full audit readiness can be achieved. Going under audit also means an important culture change is underway, requiring both military and civilian personnel across the Department to learn and understand the business of being audited.

During FY 2015, about 90 percent of the total DoD General Fund appropriations were under audit. The remaining General Fund appropriations not currently under audit are undergoing examinations or audit readiness activities.

U.S Marines and sailors clear a fallen tree during a community service project at an elementary school in Saipan in the aftermath of Typhoon Soudelor in Garapan, Saipan, Aug. 14, 2015. The Marines are assigned to 31st Marine Expeditionary Unit, and the sailors are assigned to the USS Ashland.

Photo by Petty Officer 3rd Class David A. Cox

Soldiers help extinguish a small fire while battling the Rocky Fire near Clear Lake, Calif., Aug. 12, 2015. The soldiers are California National Guardsmen assigned to the 578th Brigade Engineer Battalion and the 1st Battalion, 18th Cavalry, 79th Infantry Brigade Combat Team.

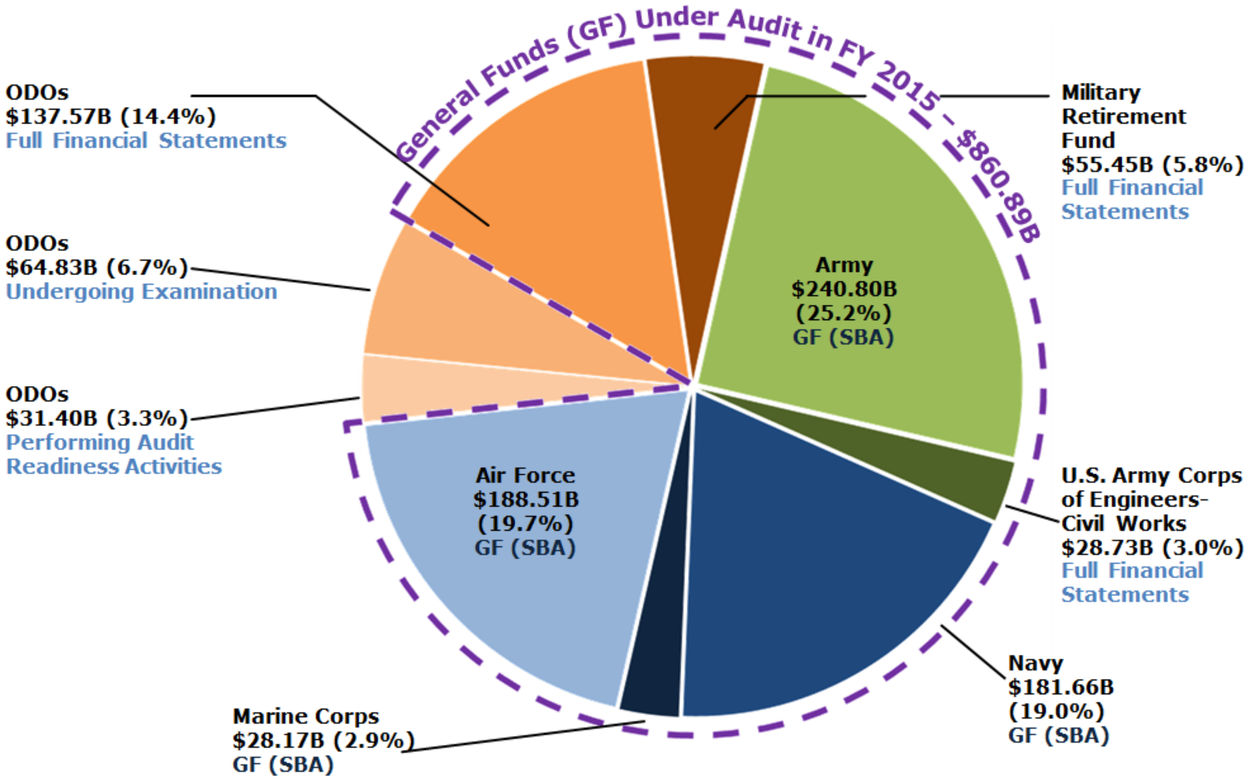
California Army National Guard photo

Over the next two years, the Department will continue to expand the scope of audits, while sustaining a stronger, more disciplined environment, until full audit readiness is achieved. Lessons learned from other federal agencies suggest that the first years of auditing the full financial statements will not result in a positive opinion, but the Department is committed to resolving all issues until a positive opinion can be achieved and sustained.

Figure 15 identifies the Components that were under audit in FY 2015 and their percentage of the total DoD General Funds (based on FY 2014 total).

Additional information on the FIAR initiative, as well as the Department's FIAR Plan Status Reports, is available on the Under Secretary of Defense (Comptroller) website.

Figure 15. General Funds Under Audit in FY 2015



Based on FY 2014 Total Budgetary Resources.

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. As of September 2015, over 8,000 members achieved their required certification. The FM personnel in the Reserve Components 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, 68 of these courses are available to the workforce, resulting in improved, cost-free access to training in key, substantive subject areas.

To date, over 181,000 FM web-based course completions have been recorded and over 29,000 of these course completions are in the Financial Improvement and Audit Readiness (FIAR) area. This metric’s results indicate that the program 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; consolidating unintentionally duplicative efforts; reducing management headquarters staffs; 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 $93 billion in cost reductions from fiscal year (FY) 2015 through FY 2019 in the Department's Future Year's Defense Program (FYDP) supporting the FY 2015 President's Budget request compared to the FYDP supporting the FY 2014 President's Budget. The savings include:

- Streamlining Business Practices and Support Services. The Department reduced $38 billion from the FYDP by streamlining business practices and support services such as installation and administrative functions, contracting, staffing, and by implementing initiatives to reduce costs in the health care sector.
- Contracting Efficiencies. The Department eliminated $30 billion from the FYDP by reducing contract support levels commensurate with reductions in force structure, and by implementing better buying power initiatives in procurement activities.
- Terminating or Restructuring Weapons Programs. The Department reduced $9 billion from the FYDP by identifying and terminating programs in which the most important capabilities could be met by other means, and restructuring or protracting of timelines that will still permit the Department to meet the most important strategic needs.
- Manpower or Force Restructuring. The Department eliminated $8 billion across the FYDP by reducing the civilian workforce commensurate with reduced force structure levels and reduced workload at depot maintenance activities.
- 20 Percent Headquarters Reductions. The Department reduced the FYDP by $5 billion by implementing the Department's institutional reform efforts to prioritize and consolidate duplicative efforts and thereby reduce management headquarters staffs.
- Restructuring and Delaying Military Construction Projects. The Department eliminated $4 billion across the FYDP by funding only the most critical facility requirements and ensuring construction projects are sized to support requirements needed for the reduced force structure.

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.

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 is committed to ensuring effective internal management controls for all mission-essential processes. The MICP holds both operational and financial DoD managers accountable to ensure effective internal management controls in their areas of responsibility. All Components are required to conduct a robust programmatic approach to establish and assess internal management controls for all financial and non-financial mission-essential operations. Components that produce standalone financial statements are also required to provide financial reporting assurance.

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

Types of Material Weaknesses

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

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

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

STATEMENT OF ASSURANCE

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

The Department conducted its assessments of the effectiveness of internal controls over operations in accordance with the objectives of FMFIA. Based on this assessment, the Department provides a qualified statement of reasonable assurance that its internal controls over the effectiveness and efficiency of operations and compliance with applicable laws and regulations achieve the objectives of the FMFIA, as of September 30, 2015. The Department continues to prioritize efforts to also ensure that relevant Government Accountability Office "high risk areas" and the Department's Office of Inspector General "management challenges" are being addressed.

While several entities within the Department are sustaining positive financial statement audit opinions, the Department as an agency cannot produce auditable financial statements. As a result, management provides no assurance as to the effectiveness of the Department's internal controls over financial reporting in accordance with Office of Management and Budget (OMB) Circular No. A-123, Appendix A, as of June 30, 2015. While the Department has much work to do to assert an unqualified statement of reasonable assurance on its financial statements, it has made measured progress through increased senior leader emphasis on improving the quality of financial information and ultimately achieving this goal. The Department recognizes that auditable financial statements require a sound framework of internal controls and an organizational culture that promotes the identification, prioritization, and mitigation of financial reporting risk.

Closely related to efforts to improve financial reporting and achieve auditability, the Department also conducted its assessment of the effectiveness of internal controls over its integrated financial management systems. Based on the results of this assessment, and as confirmed by initial feedback from financial audits, the Department provides no assurance that its internal controls over its integrated financial management systems are compliant with FFMIA and OMB Circular No. A-123, Appendix D, as of June 30, 2015. The Department realizes that properly planned and integrated systems, with strong internal controls, are critical to providing useful, timely, and complete financial information and to achieving auditability.

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

Robert O. Work
Deputy Secretary of Defense

FY 2015 Improvements in Internal Controls

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

1. Intragovernmental Transactions: Intragovernmental transactions result when business is conducted between two federal entities. Both entities must accurately record the event so that the buying and selling documentation can be matched. Imbalances occur when the federal entities are unable to account for and reconcile differences. These differences often lack proper documentation. To address this issue, the Department is aligning how it records intragovernmental transactions by mandating the use of the Department of the Treasury's Invoice Processing Platform (IPP). The Department developed standard intragovernmental data exchange maps to be used by DoD financial systems, creating a common intragovernmental financial transaction set. Additionally, the Department worked with the Department of the Treasury and other federal agencies to create a government-wide data standard for intragovernmental transactions.

2. Charge Card Programs: Stronger controls help the Department identify, correct, and minimize fraud, waste, and abuse of charge cards. Additionally, limiting the number of cards in use reduces the number of cards that can be stolen or compromised. The total number of purchase cards issued in the Department of Defense was reduced by 20,505 this year. Much of this reduction was a direct result of the Army's implementation of the Purchase Card Online System (PCOLS), which assisted in the identification of underutilized cards to remove from operational use. The Department also aggressively provided oversight of the Purchase Card program, and as a result recorded 3,325 personnel actions for potential misuse or abuse of purchase cards.

3. Service Provider Integration: A service provider is a DoD Component that performs a business function or process on behalf of another Component. In order for service provider customers to become audit ready, a service provider's audit readiness activities must be fully integrated with its customers' audit readiness activities. Statement on Standards for Attestation Engagements (SSAE) No. 16 examinations are being used to validate the effectiveness of service provider internal controls. Results of the SSAE No. 16 examinations can then be used by Component customer financial statement auditors, improving Department-wide efficiency, and saving time and money. Because successful service providers' SSAE No. 16 examinations are essential to their Component customers' success, the Office of the Under Secretary of Defense (Comptroller) is expanding service provider integration. DFAS has begun an SSAE No. 16 for Fund Balance with Treasury (FBWT) and will continue sustainment of clean opinions on its service provider SSAE No. 16 examinations to include Civilian Pay, Contract Pay, and Disbursements. In addition, the Defense Logistics Agency (DLA) received a clean opinion on its Defense Agency Initiative (DAI) SSAE No. 16 examination.

4. Standard Line of Accounting (SLOA): The Department has lacked a common financial business language that standardizes data elements, business rules, and the transaction posting logic used in DoD financial systems. To facilitate reconciliations

between systems, the Joint Interoperability Test Command (JITC) began independent verifications of the Department's ERPs and key financial systems to determine system compliance with Standard Financial Information Structure/Standard Line of Accounting (SFIS/SLOA) data element configuration, United States Standard General Ledger (USSGL) posting logic, tie-points, and trading partner interface interoperability standards. Aligned with Federal Information System Controls Audit Manual (FISCAM) general application and interface controls, the results of JITC verification provides further insight into the audit readiness status of DoD systems and findings to remediate as part of audit preparations.

5. Fund Balance with Treasury and Cash Accountability: Unsupported journal vouchers and unresolved FBWT differences between the Department and the Department of the Treasury (Treasury) are material and jeopardize achieving audit ready financial statements. The Department has endorsed a single, auditable enterprise-wide FBWT solution that aligns with Treasury's modernization initiatives. The standardized process was tested with select DoD accounts in the last half of FY 2015. Results of those tests are being evaluated, and the process is being refined.

A Marine fires a Javelin at a simulated enemy tank during Operation Lava Viper at Pohakuloa Training Area, Hawaii, May 29, 2015. The Marines are assigned to Weapons Company, 1st Battalion, 3rd Marine Regiment.

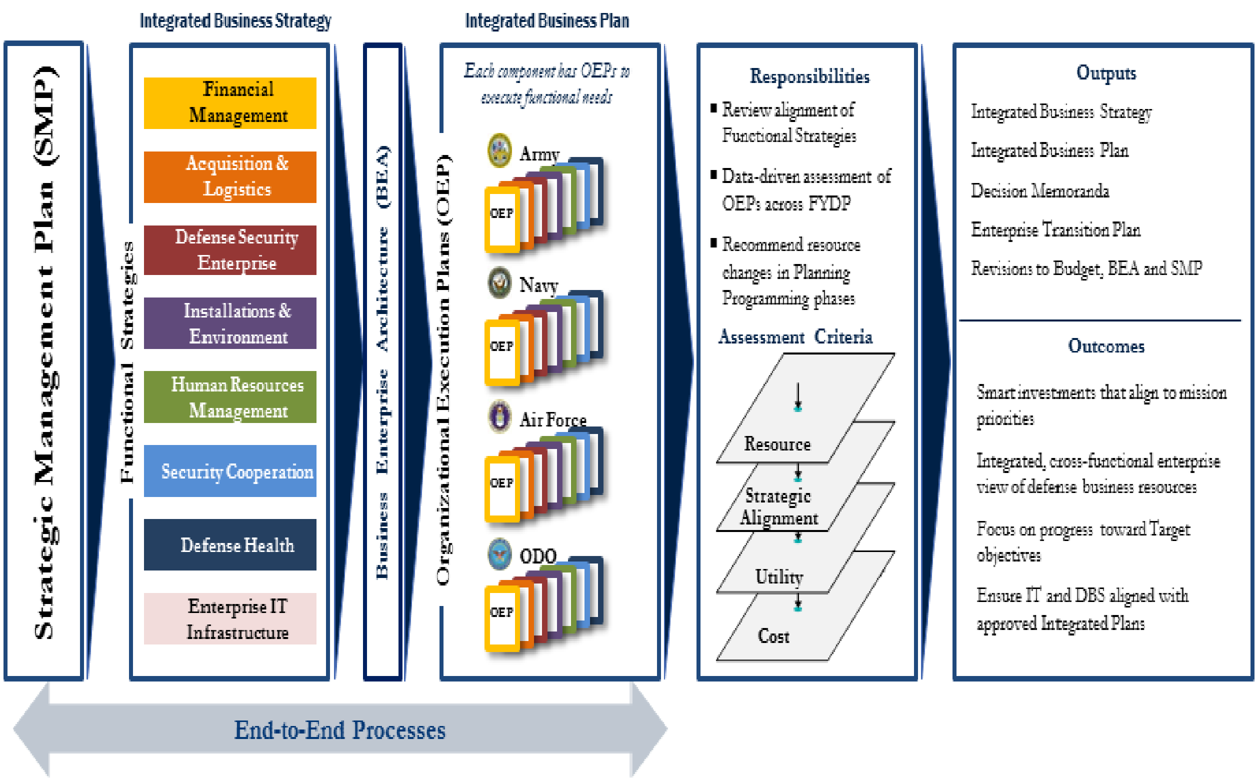
Photo by Cpl. Ricky S. Gomez

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[2] 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 16). These decisions also include retirement plans for legacy and non-target financial systems and ensure that systems eliminate redundant activity and maximize operating efficiency through streamlining business processes and the availability of timely, accurate, and useful business information.

Figure 16. The Department's Integrated Business Framework



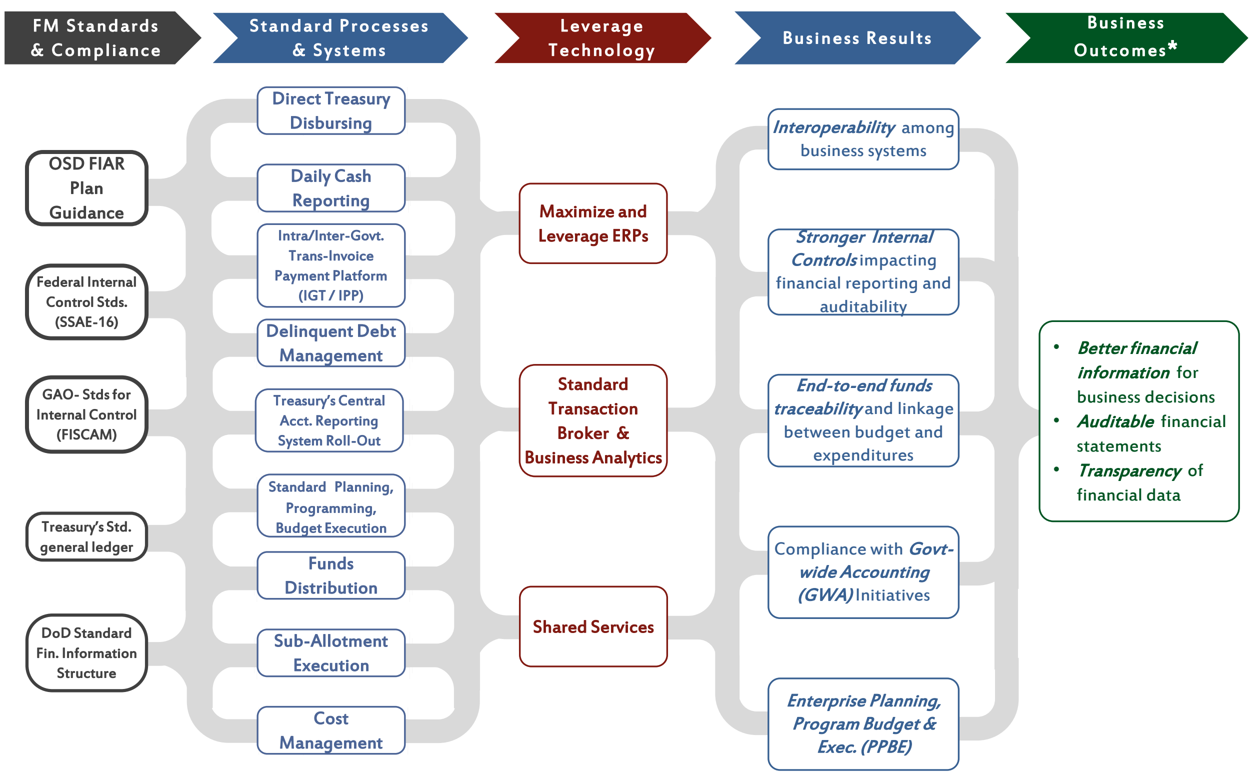
The Department's Financial Management (FM) Functional Strategy provides the Department's vision, initiatives, goals, target environment, and expected outcomes over the next five years. The strategy is designed to ensure the Department achieves and sustains

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

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, 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*, the Department's first-ever *Standard Line of Accounting* to improve funds traceability and financial reporting. The Department also participates in Federal-wide process improvement initiatives, such as compliance with the President's transparency and open government initiatives, the Department of the Treasury's Government-wide accounting and Direct-to-Treasury disbursing initiatives, as well as promoting the use of business analytics and maximizing existing Enterprise Resource Planning (ERP) systems.

Figure 17. DoD Financial Management Improvement Initiatives



The FM functional strategy also provides the plans 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

The 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 creates an Air Force enterprise financial data view by providing an integrated accounting and finance solution to manage appropriated and working capital funds.

The 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 (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. By the end of FY 2017, 22 of 26 Defense Agencies will have deployed DAI.

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.

Soldiers conduct a raid at an urban terrain training site on Fort Pickett, Va., Aug. 20, 2015. The Virginia National Guard ran the 14-day long exercise aimed at teaching infantry skills to non-combat military occupational specialties.

Photo by Sgt. Sean Brady

IMPROPER PAYMENT REPORTING

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

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

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

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

- Defense Finance and Accounting Service revised the statistical sampling methodology for Commercial Pay improper payments. The revised sampling methodology is more complex and produces statistically valid improper payment estimates. The population is separated into quarters and samples are selected from each quarter for review. The sampling methodology is stratified by dollar amounts consistent with both Government Accountability Office and DoD IG recommendations.

As the Department moves towards the Congressional 2017 mandate to have fully auditable financial statements, the reduction and elimination of improper payments will ensure the Department achieves Congress' established goal.