

APPENDIX G**NOTE 1: SIGNIFICANT ACCOUNTING POLICIES**

Summarize the accounting principles and methods of applying those principles that management has concluded are the most appropriate for presenting the entity's significant assets, liabilities, equity, results of operations, cash flow, and reconciliation to the budget. Items that should be considered are a description of the reporting entity, basis of accounting, budgetary accounting practices and the policies for reporting revenues and other financing sources, funds with the U.S. Treasury and cash, foreign currency, gold and other monetary assets, loans receivable, inventories, investments, property and equipment, prepaid and deferred charges, borrowings payable to the U.S. Treasury, contingencies (including obligations related to canceled appropriations), net position, annual, sick, and other leave, and comparative data. In many cases the underlying financial systems and operations that produce these statements were not designed to generate auditable financial statements in compliance with this form and content guidance. In cases where individual line items of the financial statements cannot be obtained or a substitution is made from the requirements herein, the deficiencies will be explained and the reason for noncompliance annotated. At the discretion of the program manager, such explanation can be included in the "Overview of the Reporting Entity," individual "Notes" to the financial statements, at Note 1, "Significant Accounting Policies," or any combination thereof. A model summary of significant accounting policies follows:

NOTE 1. Significant Accounting Policies

A. **Basis of Presentation.** These financial statements have been prepared to report the financial position and results of operations of the Department of Defense (DoD), as required by the Chief Financial Officers (CFOs) Act, and other appropriate legislation. They have been prepared from the books and records of the Department in accordance with DoD Financial Management Regulation Volume 6, Chapter 6, as adopted from Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," and the applicable portions of OMB Bulletin 97-01. These statements, therefore, are different from the financial reports, also prepared by the DoD pursuant to OMB directives, that are used to monitor and control DoD's use of budgetary resources.

B. **Reporting Entity.** The Department was created on September 18, 1947, by the National Security Act of 1947. The overall mission of the Department is to organize, train, and equip forces to deter aggression and, if necessary, defeat aggressors of the United States and its allies. Fiscal year 19** represents the xxx year that the Departments of the Army, Navy, Air Force, etc., have prepared, and had audited, financial statements as required by the CFO Act and the Government Management Reform Act (GMRA).

The accompanying audited financial statements account for all funds for which the Department is responsible except that information relative to classified assets, programs, and operations has been excluded from the statement or otherwise aggregated and reported in such a

manner that it is no longer classified. The audited financial statements are presented on the accrual basis of accounting as required by DoD accounting policies.

C. Budgets and Budgetary Accounting. The Department’s major activities consist of general, working capital (revolving funds), trust, special, and deposit funds. General funds are used to record financial transactions arising under congressional appropriations. The Department manages xxx (enter actual number) general fund accounts: xxx (enter actual number) are funded by current year appropriations and xxx (enter actual number) by multi-year appropriations. Multi-year appropriations received budget authority of \$xx,xxx million in fiscal year 19**. Current year appropriations received \$xx,xxx million.

The Department expanded the use of businesslike financial management practices through the establishment of the Defense Business Operations Fund on October 1, 1991. On December 11, 1996 The Defense Business Operations Fund became the Defense Working Capital Fund. The Defense Working Capital Fund (“the Fund”) operates with financial principles that provide improved cost visibility and accountability to enhance business management and improve the decision making process. The Fund builds on revolving fund principles previously used for industrial and commercial-type activities.

The Department’s working capital funds are primarily included within the Fund and finance industrial and commercial type transactions. Supply Management and Distribution Depot funds are composed of four divisions administered by the Departments of the Army, Navy, Air Force and the Defense Logistics Agency. These activities provide supplies and inventories to Department organizations on a commercial basis. Receipts derived from resale operations are normally available in their entirety for use without further congressional action. In fiscal year 19**, these revolving funds recorded an operating profit/deficit of \$xxx million.

Supply Management and Distribution Depot
Sales, Costs of Sales and Expenses,
and Net Operating Results by Division
(in thousands)

<u>Division</u>	<u>Sales</u>	<u>Cost of Sales and expenses</u>	<u>Net Operating Results</u>
Army	\$ x,xxx	\$ x,xxx	\$x,xxx
Navy	x,xxx	x,xxx	x,xxx
Air Force	x,xxx	x,xxx	x,xxx
Defense Agencies	<u>x,xxx</u>	<u>x,xxx</u>	<u>x,xxx</u>
Total	<u>\$xx.xxx</u>	<u>\$xx.xxx</u>	<u>\$xx.xxx</u>

Amounts shown are before intraagency eliminations.

The Department’s industrial funds are also included within the Fund and are composed of four divisions: Army, Navy, Air Force and Defense Agencies. These divisions provide services to other DoD Components through buyer-seller relationships. Airlift/sealift and depot

maintenance comprise the most significant portion of fund activity accounting for xx percent of total fund revenues in fiscal year 19**. The fund recorded an operating profit/deficit of \$xx million in fiscal year 19** due to industrial fund type work.

Depot Maintenance

Revenues, Expenses, and Net Operating Results by Division
(in thousands)

<u>Division</u>	<u>Revenues</u>	<u>Expenses</u>	<u>Net Operating Results</u>
Army	\$ x,xxx	\$ x,xxx	\$ x,xxx
Navy	x,xxx	x,xxx	x,xxx
Air Force	x,xxx	x,xxx	x,xxx
Defense Agency	<u>x,xxx</u>	<u>x,xxx</u>	<u>x,xxx</u>
Total	<u>\$xx.xxx</u>	<u>\$xx.xxx</u>	<u>\$xx.xxx</u>

Amounts shown are before intraagency eliminations.

Special funds account for receipts of the government that are earmarked for a specific purpose. The Department maintains xx special funds.

Deposit fund accounts are generally used to (1) hold assets for which the Department is acting as agent or custodian or whose distribution awaits legal determination or (2) account for unidentified remittances. The Department maintains xx deposit funds.

The Department's trust funds account for gifts and bequests limited to specific purposes by the donor and/or assets held for particular purposes. The Department's Revolving Trust Fund, Commissary Stores Surcharge Collections, is the most significant of these and was established to reimburse appropriations for payments made on behalf of commissary stores for operating equipment and supplies, utilities, laundry services, and inventory losses. Surcharges provide revenue that is used to construct commissaries.

D. Basis of Accounting. Transactions are recorded on an accrual accounting basis and a budgetary basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. All known intrafund balances have been eliminated.

E. Revenues and Other Financing Sources. Financing sources for general funds are provided through congressional appropriations that are received on both an annual and a multi-year basis. Revenue for business fund activities is recognized at the point the rendered service is completed and billed or at the point inventory items are sold.

For financial reporting purposes under accrual accounting, operating expenses for general fund activities are recognized in the period incurred. Expenditures for capital and other long-term

assets are not recognized as expenses until consumed in the Department's operations. Unexpended appropriations are recorded as equity of the U.S. Government.

Certain expenses, such as annual and military leave earned but not taken, are not funded when accrued. Such expenses are financed in the period in which payment is required. Therefore, for the Department's general funds, an amount due from future financing sources (appropriations to be provided) is recognized as an offset to equity in the consolidated statement of financial position which is comprised of the accrued amount of such expenses at year-end.

F. Accounting for Intra-governmental Activities. The Department, as an agency of the federal government, interacts with and is dependent upon the financial activities of the federal government as a whole. Therefore, these financial statements do not reflect the results of all financial decisions applicable to the Department as though the agency were a stand-alone entity.

1. The Department's proportionate share of public debt and related expenses of the federal government are not included. Debt issued by the federal government and the related interests costs are not apportioned to Federal agencies. The Department's financial statements, therefore, do not report any portion of the public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

2. Financing for the construction of DoD facilities is obtained through budget appropriations. To the extent this financing may have been ultimately obtained through the issuance of public debt, interest costs have not been capitalized since the Treasury Department does not allocate interest costs to the benefiting agencies.

3. The Department's civilian employees participate in the Civil Service Retirement System (CSRS) and Federal Employees Retirement System (FERS), while military personnel are covered by the Military Retirement System (MRS). Additionally, employees and personnel covered by FERS and MRS also have varying coverage under Social Security. The Department funds a portion of and discloses the assets or actuarial data on the accumulated plan benefits or unfunded pension liabilities of its employees. Reporting pension benefits under these retirement systems is the responsibility of the Office of Personnel Management for CSRS and FERS and the Department of Defense for MRS. In fiscal year 19**, the Department contributed the following amounts to the retirement plans and Social Security:

	(in thousands)
CSRS	\$xxxx
FERS	xxxx
MRS	xxxx
Social Security	<u>xxxx</u>
	<u>\$xxxx</u>

The Department also contributed \$xx million to the FERS Thrift Savings Plan on behalf of its participating employees.

4. Most legal actions, other than contract claims, to which the Department may be a named party are covered by the provisions of the Federal Tort Claims Act and the provisions of Title 10, United States Code, Chapter 163, governing military claims. Either because payments under these statutes are limited to, amounts well below the threshold of materiality for claims payable from the Department's appropriations or because payments will be from the permanent, indefinite appropriation "Claims, Judgments, and Relief Acts" (the Judgment Fund), these legal actions should not materially affect the Department's operations or financial condition.

5. In fiscal year 19**, the Department or its Components sold assets to foreign governments under the provisions of the Arms Export Control Act of 1976. Under the provisions of the Act, DoD has authority to sell defense articles and services to foreign countries, generally at no profit or loss to the U.S. Government. Customers are required to make payments in advance to a trust fund maintained by the Department of the Treasury from which the Military Services are reimbursed for the cost of administering and executing the sales. In fiscal year 19**, the Department received reimbursements of \$xxx thousands for assets and services sold under the Foreign Military Sales program.

G. Funds with the U.S. Treasury and Cash. The Department's fund resources are maintained in U.S. Treasury accounts. Its cash receipts and disbursements are processed by the Treasury Department, and the balance with the U.S. Treasury represents the aggregate of all unexpended balances. As of September 30, 19**, the Department had \$xxxx million in funds with the U.S. Treasury.

H. Foreign Currency. The Department conducts a significant portion of its operations overseas. Gains and losses from foreign currency transactions for four general fund appropriations (operation and maintenance, military construction, family housing operation and maintenance, and family housing construction) are recognized and reported in the statement of operations. The gains or losses are computed as the variance between the current exchange rate at the date of payment and a budget rate established at the beginning of the fiscal year. In fiscal year 19**, the Department recognized a net gain/loss of \$xxx thousand due to foreign currency transactions for the four appropriations. Similar gains and losses for other appropriations are not recognized in the statement of operations. They are absorbed by budgetary transactions in which obligations are increased or decreased to reflect foreign currency fluctuations.

I. Accounts Receivable. As presented in the consolidated Statement of Financial Position, accounts receivable includes accounts, claims, and refunds receivable from other entities.

(in thousands)

<u>Division</u>	<u>Amount</u>	<u>Allowance</u>	<u>Total Net</u>
Accounts Receivable			
Government	\$ x,xxx	\$xx	\$ x,xxx
Public	x,xxx	xx	x,xxx
Refunds	x,xxx	xx	x,xxx
Claims	<u>x,xxx</u>	<u>xx</u>	<u>x,xxx</u>
Total	<u>\$xx,xxx</u>	<u>\$ xx</u>	<u>\$xx,xxx</u>

Allowances for uncollectible accounts are based upon analysis of collection experience by fund type. During fiscal year 19**, the Department wrote off approximately \$xx thousand in uncollectible receivables.

J. Loans Receivable. Loans are accounted for as receivables after funds have been disbursed. The amount of loans obligated but not disbursed are disclosed in Note 7. For loans obligated prior to October 1, 1991, loan principal, interest, and penalties receivable are reduced by an allowance for estimated uncollectible amounts. The allowance is estimated based on past experience, present market conditions, and an analysis of outstanding balances. For loans obligated on or after October 1, 1991, the loans receivable are reduced by an allowance equal to the present value of the subsidy costs (due to the interest rate differential between the loans and U.S. Treasury borrowing, the estimated delinquencies and defaults net of recoveries, the offset from fees, and other estimated cash flows) associated with these loans.

K. Inventories. Inventories, including operating supplies and nonconsumable items, are valued at Latest Acquisition Cost (LAC) as required by DoD accounting policies. Generally, LAC is determined by subtracting appropriate surcharges from the Standard Cost to arrive at the price most recently paid for a carried item. Gains and losses that result from valuation changes for inventory items are recognized and reported in the Statement of Operations and included in the calculation of the cost of goods sold. No gains or losses are recognized in the consolidated Statement of Operations as a result of changes in valuation for general fund operating supplies and materials. Such changes are reflected in the asset valuations and related invested capital as reported in the Statement of Financial Position.

L. Investments in U.S. Government Securities. Investments in U.S. Government securities are reported at cost, net of unamortized premiums or discounts. Premiums or discounts are amortized into interest income over the term of the investment. The reporting entity's intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. No provision is made for unrealized gains or losses on these securities because, in the majority of cases, they are held to maturity.

M. Property and Equipment. Valuations for weapons systems (e.g., Equipment, aircraft, missiles, and engines) are to be based on historical procurement costs, however, most of the Department's tracking systems were not designed to record and perpetuate individual acquisition costs--instead they assign standard costs to like items. Standard cost is normally the latest acquisition costs for specific federal stock categories. Engineering and modification costs incurred subsequent to approval of the basic procurement contracts are valued at the contract price of the engineering change order, value engineering, or modification which extends the life of the asset or capability of the system, and any other cost of materials or services not included in the contract cost.

Land and facilities are valued at cost. Buildings are capitalized when constructed or at the date of acquisition. Significant improvements to land and buildings normally are capitalized and depreciated over their remaining useful life. Audits of the Department's financial statements have shown that documentation to support the recorded acquisition cost of many older properties is no longer available. Obtaining appraisals for older property for which original acquisition records are no longer available is not cost effective, especially considering the number and age of many of the Department's real property assets. As a reasonable solution to this dilemma, when original records to support the acquisition cost of property are no longer available, recorded valuations of property, or other available information if the value has not been formally recorded, could be permitted for financial statement purposes when such valuation represents the best available information. When records are not available to support the original acquisition cost or value of property, the Notes to the principal statements will disclose the method of valuation and the reason for its use.

Routine maintenance and repair costs are expensed when incurred. Depreciation of property and equipment is calculated on a straight line basis. Revolving funds record depreciation on buildings and equipment. Depreciation is not required for general fund equipment and buildings.

N. Prepaid and Deferred Charges. Payments in advance of the receipt of goods and services are recorded as prepaid charges at the time of prepayment and reported as an asset on the Statement of Financial Position. Prepaid charges are recognized as expenditures and expenses when the related goods and services are received.

O. Leases. As of September 30, 19**, the Department was committed to numerous operating leases and rental agreements. Generally, these leases and agreements were for rental equipment, space, and operating facilities.

The Department owns substantially all of the facilities and real property used in its domestic operations. Capital assets overseas are purchased with appropriated funds, however; title is retained by the host country.

P. Contingencies. At any given time, the Department may be a party to various legal and administrative actions and claims brought against it. These relate primarily to tort claims resulting from aircraft, ship, and vehicle accidents, medical malpractice, property and environmental damages resulting from Departmental activities, and contract disputes.

As discussed under Note F-4, [**this reference is for cross-referencing purposes in the use of this guidance, not for inclusion in the final audited financial statement**], most legal actions, other than contract claims, to which the Department may be a named party are covered by the provisions of the Federal Tort Claims Act and the provisions of Title 10, United States Code, Chapter 163, governing military claims. Either because payments under these statutes are limited to, amounts well below the threshold of materiality for claims payable from the Department's appropriations or because payments will be from the permanent, indefinite appropriation "Claims, Judgments, and Relief Acts" (the Judgment Fund), these legal actions should not materially affect the Department's operations or financial condition.

DoD payments during fiscal year 19** for awards, compromises and settlements resulting from the legal actions discussed in the preceding paragraph amounted to \$xx (enter actual number). It is estimated that claims for payments and adjudicated claims that will be outstanding as of September 30, 19**, will be approximately \$xx (enter actual number). [As appropriate, depending on the circumstances that exist, conclude with either the sentence: "the ultimate resolution of legal actions still pending will not materially affect the agency's operations or financial condition. Therefore, no contingent liabilities have been recognized in the consolidated Statement of Financial Position" or "The ultimate resolution of legal actions still pending will materially affect the agency's operations or financial condition. These contingent liabilities have been recognized in the consolidated Statement of Financial Position."]

As of January 19**, the Department or its Components were a party to xxx (enter actual number) contract appeals before the Armed Services Board of Contract Appeals. Total value of these appeals was \$xxx (enter actual number) million. According to management, approximately xx (enter actual number) percent of appeals are successfully defended by the Department. In fiscal year 19**, contractors recovered about \$xx million from resolved claims. Such claims are funded primarily from Department appropriations.

Q. Accrued Leave. Civilian annual leave and military leave are accrued as earned and the accrued amounts are reduced as leave is taken. The balances for annual and military leave at the end of the fiscal year reflect current pay rates for the leave that is earned but not taken. Sick and other types of nonvested leave are expensed as taken. Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. To the extent appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources.

R. Equity. Equity consists of invested capital, cumulative result of operations, and unexpended appropriations less unfunded liabilities. Invested capital, as presented in the consolidated Statement of Financial Position, represents the value of the Department's capital assets as reported at average or actual costs. The portion of invested capital attributable to land and buildings represents their undepreciated cost. Increases to invested capital are recorded when capital assets are acquired or constructed or when asset valuations increase as a result of increases in average costs. Decreases occur as capital assets are depreciated or consumed in operations, or when average costs are decreased. Donated capital and trust fund balances have been included in invested capital.

Cumulative results of operations for working capital funds represents the excess of revenues over expenses since fund inception, less refunds to customers and returns to the U.S. Treasury.

Unexpended appropriations represent amounts of authority which are unobligated and have not been rescinded or withdrawn, and amounts obligated but for which neither legal liabilities for payments have been incurred nor actual payments made.

S. Aircraft/Ship Crashes. An operating loss of \$xxxx million has been recognized in fiscal year 19** for aircraft/ships which were either destroyed or damaged beyond repair due to aviation/navigation mishaps. The loss represents the book value at unit costs of those aircraft/ships either destroyed or damaged. No loss has been separately recognized for aircraft/ships which were damaged by accidents but were repairable. Costs associated with repair of such aircraft/ships are recorded as operating expenses and generally funded from operation and maintenance appropriations.

T. Treaties for Use of Foreign Bases. The DoD Components have the use of land, buildings, and other facilities which are located overseas and have been obtained through various international treaties and agreements negotiated by the Department of State. Generally, treaty terms allow the DoD Components continued use of these properties until the treaties expire. Capital investments in buildings and other facilities (for example, runways) located on the overseas bases are capitalized as stipulated in Note 1-M. The fiscal year 19** consolidated Statement of Financial Position includes \$x,xxx (enter actual number) million of buildings and facilities located in foreign countries. These fixed assets are subject to loss in the event treaties are not renewed or other agreements are not reached which allow for the continued use by the Department. Therefore, in the event treaties or other agreements are terminated whereby use of foreign bases is no longer allowed, losses will be recorded for the value of any non-retrievable capital assets after negotiations between the United States and the host country have been concluded to determine the amount due the United States for such capital investments.

As of September 30, 19**, xx overseas bases are planned to be closed within x (enter actual number) years. Negotiations are anticipated within the year with the cognizant governments regarding possible closure of the bases. Funding for closing and relocation costs will be provided through future appropriations and North Atlantic Treaty Organization (NATO)

funding. As of September 30, 19**, the Department had not finalized cost estimates regarding closing these base and relocating their activities to other bases. Operating expenses for overseas bases are included in the consolidated statement of operations.

U. Comparative Data [fill in this note as follows depending upon your situation]. Comparative data for the prior year has not been presented because this is the first year for which financial statements are prepared using the OMB prescribed format. In future years, comparative data will be presented in order to provide an understanding of changes in the financial position and operations of the Department's reporting activities-or-Comparative data from FY **** CFO financial statements is provided.

V. Undelivered Orders. The Department is obligated for goods and services which have been ordered but not yet received (undelivered orders) as of September 30, 19**. Aggregate undelivered orders amounted to \$xx,xxx (enter actual number) thousand as of September 30, 19**.