UNITED STATES DEPARTMENT OF DEFENSE

FISCAL YEAR 2007
PERFORMANCE & ACCOUNTABILITY HIGHLIGHTS

Defending Our Freedom

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The amounts presented in subsequent pages have been rounded and may not match the Agency Financial Report.

Message From The Deputy Secretary Of Defense

DEPUTY SECRETARY OF DEFENSE
1010 DEFENSE PENTAGON
WASHINGTON, DC 20301-1010

November 15, 2007

Enclosed is the fiscal year 2007 Agency Financial Report for the Department of Defense. This report has become the annual centerpiece for reporting on the Department's financial execution, plans and accomplishments. While the Department's focus during the past year has been the war against terror, much progress has also been made to improve the financial management of the public assets that are entrusted to the Department.

The men and women of the Department of Defense are committed to success in the war effort. These Soldiers, Sailors, Airmen and Marines are heavily engaged throughout the world:

- In Afghanistan, U.S. forces are working with local and coalition forces to strengthen governmental structures train indigenous forces and apply the rule of law.
- In Iraq, our forces are working to restore stability, provide security for economic development, defeat extremists, and deny extremists places to plan, train, and operate.
- In the Horn of Africa, the Philippines, and a host of other places, our forces are working to ameliorate the conditions that foster extremism.
- At home, service members are securing our borders, responding to natural disasters, and guarding against – and preparing for – terrorist attacks.

The Department has a responsibility to provide accurate and timely accounting of the financial resources that we manage. We take this responsibility seriously. While the challenge is large and much work remains to be done, progress continues and the enclosed report provides a status of improvement efforts and a summary of our financial position.

The report describes the challenges and presents the financial management and business transformation accomplishments of the Department of Defense during fiscal year 2007. The report supports the Defense Department's participation in the Office of Management and Budget pilot financial reporting initiative for all federal agencies and contains the most complete financial information available.

This letter is an excerpt from the FY 2007 Agency Financial Report

Message From The Chief Financial Officer

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

November 15, 2007

We are pleased to present the fiscal year (FY) 2007 Agency Financial Report of the Department of Defense. The Department's leadership considers its financial stewardship responsibility to be an integral part of its mission to defend our Nation.

The Department's financial management professionals have worked hard to improve the quality, accuracy and reliability of our financial information. As of FY 2006, roughly one-third of the Department's $3.3 trillion in combined assets and liabilities have achieved an unqualified audit opinion. By following the roadmap we have laid out, the Department expects to increase its overall audit readiness to two-thirds by the end of FY 2009.

During FY 2007, efficiency gains in financial management operations allowed us to return savings to the warfighter of almost $100 million in projected overhead costs. We also reduced the amount of outstanding debt owed to the Department by $1.2 billion over the last two years through better monitoring and collection efforts.

Our monitoring of costs in the procurement contract area led to over $2.4 billion in savings. In addition, the Department investigated and collected over $225 million in fraudulently billed costs. These efforts have stretched the warfighter dollar and increased the Department's purchasing power.

We continue to improve our financial stewardship by strengthening internal controls. A recently concluded audit of the Department's civilian payroll system, which pays over 795,000 federal employees, found no weaknesses in the design of the system internal controls. This year, the Department's Management Internal Control Program, which identifies reports and corrects material internal control weaknesses, reduced the number of uncorrected weaknesses from 35 to 19.

We acknowledge that the journey before us is challenging, but supporting our warfighters and prudent stewardship of taxpayer resources demands nothing less. We are all deeply grateful to our soldiers, sailors, airmen and marines who defend our freedom each and every day. Those of us in the financial community are proud to do our part to support them.

Tina W. Jonas

This letter is an excerpt from the FY 2007 Agency Financial Report

Highlights Overview

The Department of Defense (DoD) Fiscal Year (FY) 2007 Agency Financial Report (AFR) Highlights document provides a high level analysis of the Department's financial performance information for FY 2007. It provides a summary of the Department's FY 2007 performance goals, objectives, and results. In addition, it provides basic information on various financial trends such as revenues, expenses, and also an assessment of the Department's financial solvency. The purpose of this report is to provide highlights of the detailed information found in DoD's AFR and should not be viewed as a substitute. The goal of this document is to increase agency and program accountability for performance by making the financial and performance information more transparent and accessible.

The AFR Highlights coveers the following sections:

- Overview
- Performance
- Financial

The DoD FY 2007 AFR was provided to the President, the Congress, other Federal departments and agencies, and the American public on November 15, 2007. It provides an overview of the Department's financial condition. This report is similar to the private sector's annual report to stockholders. The AFR covers the 12-month period ending September 30, 2007, and can be found at *http://www.dod.mil/comptroller/afr*.

Department of Defense Year in Review

From the mountains of South America to the deserts of the Middle East to the tropical forests of the Pacific Rim, members of the Department of Defense (DoD) continue their work to safeguard the American people. Wars in Iraq and Afghanistan garner much attention, but the nation continues to pursue violent extremists wherever they seek to hide. Humanitarian work and partnership building have become mainstream endeavors. And while heavily engaged against today's threats, the Department looks to future risks and challenges to ensure our dominance over any threat that may arise.

Around the globe, military forces are working closer than ever before with members of other U.S. Departments. Provincial Reconstruction Teams, staffed by partners from the State and Justice Departments, U.S. Agency for International Development (USAID) and others, are partnering with Coalition forces to rebuild infrastructure and give local citizens a chance to free themselves from destitute conditions. In the Horn of Africa, the Philippines and elsewhere, American forces are cooperating with over a dozen nations who work together in the Gulf of Arabia, share intelligence, and plan operations to fight as one force against enemies ranging from terrorists to pirates.

Efforts to strengthen national partnerships during military exercises have been matched by efforts to build friendships at a local level. Through much of the history of U.S. forces, humanitarian efforts have been relegated to a tertiary role. Forces filled this role mostly in response to large natural disasters such as a tsunami or hurricane. Today, members of the military are serving as humanitarians with increased frequency and effectiveness. Air Force physicians have provided surgeries and care to citizens of Vietnam. Soldiers built a school complex in Uganda. Two Navy ships, Comfort and Peleliu, provided a myriad of services to citizens across the globe.

While the Department is focused on today's challenges, threats of the future cannot be overlooked. The government of Iran continues to cause concern as its members promote violence and instability throughout the Mideast region. The United States has increased cooperation with countries like Russia and China. But a lack of transparency, combined with aggressive statements from government leaders, calls into question the direction of our associations. And the United States, along with many nations, continues to guard against the threat of nuclear proliferation from North Korea.

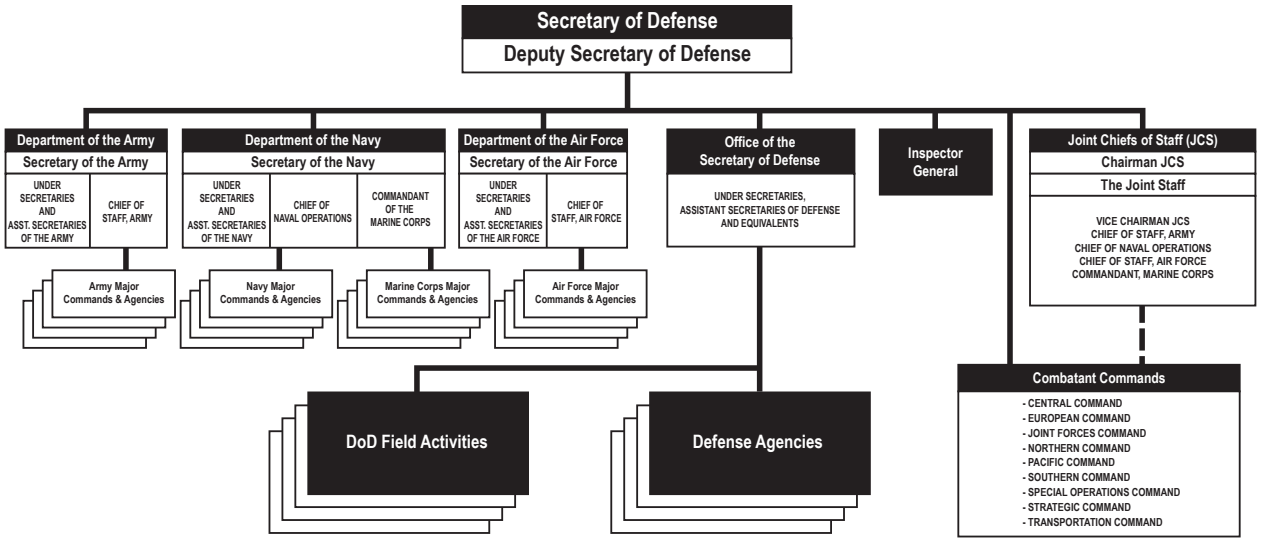
The Department is developing a host of platforms and shifting mindsets to meet whatever challenges may arise. The "peace dividend" many hoped for during the 1990s is giving way to the reality of today's world defined by instability and crisis. The Department's mission is to protect the citizens of the nation. But the Department also serves those undertaking that mission. To meet those requirements, the Department continues to bolster its forces and support systems to ensure continued success around the globe.

As always, the remarkable achievements of the Department could not be possible without the heroic efforts of those in uniform. Each has sworn an oath to serve and protect. They do so with the utmost professionalism and skill. Their service is greatly appreciated.

Mission and Organization

The mission of the United States Armed Forces is to provide the military forces needed to deter war and to protect the security of the country. Since the creation of America's first army in 1775, the Department has evolved to become a global presence, with individuals stationed in more than 140 countries dedicated to defending the United States and its interests around the world. The Department embraces the core values of leadership, professionalism, and technical knowledge. Its employees are dedicated to duty, integrity, ethics, honor, courage, and commitment.

The chart below shows how the Department is structured.



2007 Performance Goals, Objectives, and Results

The management of performance is being pursued throughout every level of the DoD. Tied to various accountability measures, performance is being advocated so that every soldier, sailor, airman, marine, and DoD civilian is keenly aware of the impacts that their individual role has on the mission of the Department.

Several initiatives have been established to emphasize sustainable performance within the Department. One such initiative, known as the Performance Improvement Initiative (PII), is focused on re-emphasizing and implementing all the statutory provisions of the Government Performance Results Act of 1993. As a result of this improvement initiative, the Department unveiled its most recent strategic plan in 2006 which outlined the way ahead for the next 20 years.

The plan acknowledges that the Department has been and is transforming along a path that shifts emphasis from the 20th to the 21st century. It also acknowledges that everything done in the Department must contribute to joint warfighting capability.

The Performance Budget Hierarchy displays the foundational principles upon which the strategic goals are built. This hierarchy indicates that every level of the DoD is accountable for measuring performance and delivering results at multiple tiers of the organization that support the Department's strategic goals and objectives. Performance accountability cascades to the appropriate management level with performance targets advocated at all echelons.

Performance Budget Hierarchy

With that concept in mind, the 2006 strategic plan sets the basis for five overarching goals that represent a judicious balance between present needs and future capabilities. For additional details regarding the Department's strategic plan, go to http://www.defenselink.mil/qdr.

Strategic Goals

These goals, emanating from the foundation built by the Department's strategic plan, helped form seventeen objectives, which were further broken down into 49 enterprise-level performance targets for FY 2007. Forty five targets have been evaluated and results for the remaining four will be available in March 2008. Interim results reflect an overall success rate of 69% by meeting or exceeding 31 performance results. Thirty-one percent (or fourteen performance targets) were not achieved. Of particular note, the Department achieved all of its FY 2007 performance targets associated with:

- Iraq and Afghanistan transition (Strategic Objective 1.1)
- Homeland defense (Strategic Objective 2.1)
- Force restructuring (Strategic Objective 2.2)

Additional details on FY 2007 DoD performance results are provided in the DoD FY 2009 Budget Request Summary justification at http://www.defenselink.mil/comptroller/budget.html.

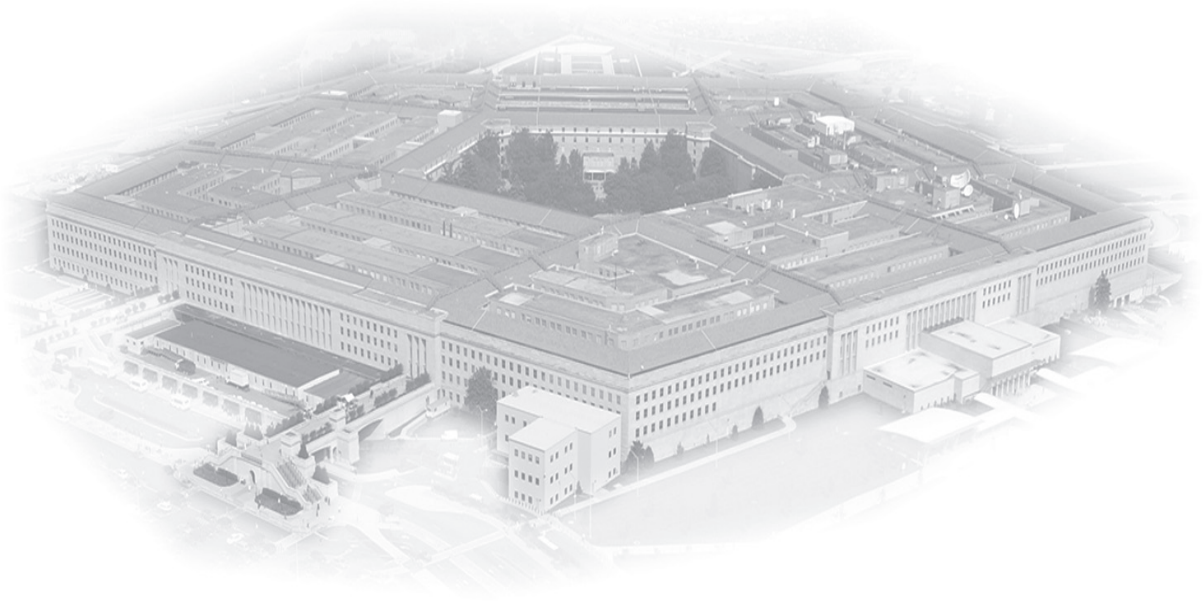
DoD Strategic Goals and Objectives

STRATEGIC GOAL	OBJECTIVES
1. Fight the Long War on Terrorism	1.1: Conduct a large-scale, potentially long-duration irregular warfare campaign that includes counterinsurgency, security, stability, transition, and reconstruction operations.
2. Reorient Capabilities and Forces	2.1: Deter or defeat direct attacks to the U.S. homeland and its territories and contribute toward the nation's response to and management of the consequences of Weapons of Mass Destruction (WMD) or other catastrophic event; improve ability to respond to Chemical, Radiological, Biological, Nuclear, and Explosive (CRBNE) attacks and improve the capability of interagency partners to contribute to our nation's security.
	2.2: Deter and defend against transnational terrorists attacks and globally distributed aggressors and shape the choices of countries at strategic crossroads, while postured for a second, nearly simultaneous campaign.
	2.3: Operationalize and strengthen intelligence.
	2.4: Enhance security and reduce vulnerabilities.
3. Reshape the Defense Enterprise	3.1: Improve acquisition processes and execution to support warfighter requirements.
	3.2: Focus research and development to address warfighting requirements.
	3.3: Implement improved logistics operations to support joint warfighting.
	3.4: Maintain capable, efficient, and cost-effective installations to support the DoD workforce.
	3.5: Improve financial management and budget and performance integration to support strategic decisions and improve financial stewardship to the taxpayer.
	3.6: Make information available on a network that people depend on and trust.
4. Develop a 21st Century Total Force	4.1: The "All Volunteer" military force is available and ready to meet the steady-state and surge activities of the DoD.
	4.2: DoD remains competitive for needed talent by sustaining workforce satisfaction.
	4.3: Provide effective and efficient human resources management to DoD customers.
	4.4: Improve workforce skills to meet mission requirements.
5. Achieve Unity of Effort	5.1: Build capacity of international partners in fighting the war on terrorism.
	5.2: Improve strategic communications process to link information issues with policies, plans, and actions and improve primary communications supporting capabilities.

In addition, lower-level performance targets at the program level augment enterprise-level performance. Some of these performance targets reflect the DoD Program Assessment Rating Tool (PART) input. The PART is a standardized diagnostic tool to measure program performance across the federal government. To date, PART diagnostics have been applied to 54 DoD unclassified program areas listed on the following page. As a result, 48 programs have been assessed at the adequate level or higher as summarized below. While every PART assessment has a plan that includes process improvements for FY 2009, not all program areas project quantifiable outcome improvements based on mission priority and fund availability. Based on this input, 19 of 54 unclassified PARTed areas project incremental performance improvements between FY 2008 and FY 2009. Additional details on PART information are provided at *http://www.whitehouse.gov/omb/expectmore/agency/007.html*.

DoD PART Rating Summary

PART Rating	Number of DoD Programs
Effective	19
Moderately effective	19
Adequate	10
Ineffective	0
Results not demonstrated (RND)	6
Total PARTs Completed	54



DoD PART Program Rating

Program	Score
Air Combat Program	Moderately Effective
Air Force Aircraft and Weapons Readiness	Effective
Air Force Base Operations & Support	Results Not Demonstrated
Air Force Combat-Related Readiness	Effective
Air Force Depot Maintenance	Effective
Airlift Program	Moderately Effective
Army Air Readiness	Moderately Effective
Army Base Operations & Support	Moderately Effective
Army Depot Maintenance	Effective
Army Land Forces Readiness	Effective
Chemical Demilitarization	Adequate
Cooperative Threat Reduction	Effective
Defense Advanced Technology Development Program	Results Not Demonstrated
Defense Air Transportation System	Moderately Effective
Defense Applied Research Program	Moderately Effective
Defense Basic Research	Effective
Defense Civilian Education and Training	Adequate
Defense Commissary Agency	Moderately Effective
Defense Communications Infrastructure	Results Not Demonstrated
Defense Contract Audit Agency	Effective
Defense Contract Management Agency	Effective
Defense Health Care	Adequate
Defense Housing	Moderately Effective
Defense Small Business Innovation Research/Technology Transfer	Results Not Demonstrated
Department of Defense Depot Maintenance: Ship	Effective
Department of Defense Education Activity	Moderately Effective
Department of Defense Facilities Sustainment, Restoration, Modernization, and Demolition	Adequate
Department of Defense Recruiting	Moderately Effective
Department of Defense Training and Education Programs – Accession Training	Moderately Effective
Department of Defense Training and Education Programs – Basic Skills and Advanced Training	Effective
Department of Defense Training and Education Programs – Voluntary Training	Moderately Effective
Depot Maintenance – Naval Aviation	Effective
DoD Unmanned Aircraft Systems (UAS)	Moderately Effective
Energy Conservation Investment	Effective
Future Combat Systems/Modularity Land Warfare	Moderately Effective
Junior Reserve Officer Training Corps	Moderately Effective
Marine Corps Base Operations & Support	Results Not Demonstrated
Marine Corps Depot Maintenance	Effective
Marine Corps Expeditionary Warfare	Moderately Effective
Marine Corps Ground Forces Readiness	Effective
Military Construction Programs	Moderately Effective
Military Force Management	Effective
Missile Defense	Adequate
National Security Space Weather Programs	Adequate
Navy Base Operations & Support	Adequate
Navy Ship Readiness	Effective
Navy Shipbuilding	Adequate
Navy/Marine Corps Air Readiness	Effective
Precision Weapons Programs	Moderately Effective
Rotary Wing Programs	Adequate
Space Launch	Adequate
Space-based Communications Programs	Moderately Effective
Strategic Offensive Capabilities	Effective
Test & Evaluation Programs	Results Not Demonstrated

Financial Position of the Department of Defense for 2007

The information in this report provides an overview of the financial position of the Department for 2007. In addition, it gives basic information on various financial trends such as revenues, expenses, and also an assessment of the Department's financial solvency. This report is intended to provide highlights of the detailed information found in DoD's FY 2007 Agency Financial Report and should not be viewed as a substitute.

A proper approach to determining the financial health of an organization is a matter of broad interpretation. In the case of a governmental organization the size and complexity of the DoD, several financial indicators are necessary and conclusive answers are somewhat elusive. However, appropriate financial indicators can be used to help assess the ability to meet current and future financial obligations while executing a balanced budget as approved by the Congress.

DoD's financial management environment is complex and diverse. The vast degree of complexity is illustrated by the fact that the Department's assets exceed the combined assets of the top six Fortune 500 companies. Comparatively, gross costs exceed only the top two Fortune 500 Companies.

As can be seen in this report, the financial statements for the Department reflect short-term solvency (ability to satisfy current requirements). Due to the nature of its business, the Department incurs significant long-term liabilities and commensurate levels of risk. While addressing future requirements, continued work on a wide variety of financial improvements are being designed to yield increased efficiencies, updated financial systems, and business processes that will vastly improve long-term financial management within the Department.

As a result of systems and process improvements, the Department's financial processes and internal management controls are becoming stronger. Vastly improved accuracy, reliability, and completeness of financial information is the standard.

Department-Wide Financial Information

The financial statements of the Federal government are fundamentally unique from any private sector financial statement with requirements contained within the U.S. Constitution. The Constitution states "No money shall be drawn from the Treasury but in Consequence of Appropriations made by Law." It goes on to say "A regular Statement and Account of the receipts and Expenditures of all public Money shall be published from time to time." In response to this mandate, the Department compiles four principal statements, including a consolidated Balance Sheet along with statements of Net Cost, Changes in Net Position, and Budgetary Resources. Each is described in the table below. These statements reflect the Department's financial position and changes in both proprietary (analogous to the manner in which a business accounts for its assets, liabilities, revenues, and expenses) and budgetary activities. Comparatively, these statements are similar to a corporate Balance Sheet, Income Statement, Stockholders' Equity, and Statement of Cash Flow. The number of DoD's principal financial statements was reduced from six in prior years by eliminating the Statement of Financing and discontinuing use of the Statement of Custodial Activity. Information on these areas is now presented in notes to the financial statements.

Financial Statements

Statement	What Information It Provides
Balance Sheet	Reflects the Department's ongoing financial position. Assets are the amount of future economic benefits owned or managed by the Department. Liabilities are amounts owed by the Department. The net position (equity) is the difference between the assets and liabilities.
Statement of Budgetary Resources	Provides information about budgetary resources received as well as their status at the end of the period.
Statement of Net Cost	Presents the components of the net cost of the Department's operations for the reporting period. Net cost is the gross cost of the agency less revenue reimbursed for its activities.
Statement of Changes in Net Position	Reports changes in equity based on Cumulative Results of Operations and Unexpended Appropriations (e.g. all funding provided to the agency less net cost for all years).

The financial statements ending September 30, 2007 are presented in their entirety in the Department's Agency Financial Report for FY 2007, representing the financial and budgetary position. The Department is a large and an extraordinarily complex institution with more than three million military and civilian employees and nearly 580,000 facilities located in every state of the Nation and several areas around the world. The FY 2007 financial statements reported $1.5 trillion in assets and nearly $2.1 trillion in liabilities. The following chart provides a comparison of financial information over a five year period.

Balance Sheet

	2007	2006	Restated 2005	Restated 2004	Restated 2003
Assets					
Fund Balance with Treasury	$ 407,167.0	$ 329,045.1	$ 290,657.1	$ 289,598.9	$ 252,062.0
Investments and Related Interest	335,123.3	300,351.0	263,972.8	231,476.2	205,593.8
Accounts Receivable, Net	8,882.3	10,805.9	8,906.8	8,546.1	8,366.5
Other Assets	37,458.6	29,118.3	25,341.2	22,498.2	21,834.6
Cash and Other Monetary Assets	15,028.0	2,199.8	2,072.7	2,178.1	1,534.9
Loans Receivable	3,207.1	3,855.1	75.6	70.7	64.0
Inventory and Related Property, Net	224,948.7	231,823.2	222,573.3	220,505.6	205,544.6
General Property, Plant and Equipment, Net	474,530.5	465,439.5	452,541.4	440,898.6	446,308.9
Total Assets	**$1,506,345.5**	**$1,372,637.9**	**$1,266,140.9**	**$1,215,772.4**	**$1,141,309.3**
Liabilities					
Loan Guarantee Liability	$ 25.0	$ 36.8	$ 41.1	$ 34.4	$ 25.9
Accounts Payable	31,585.5	28,938.2	30,633.4	30,197.4	27,965.2
Debt	3,242.3	3,697.8	467.1	591.8	698.2
Environmental and Disposal Liabilities	72,489.9	69,985.1	65,027.6	64,367.2	61,490.6
Other Liabilities	68,704.7	44,765.8	41,136.2	45,218.1	39,893.1
Military Retirement and Other Federal Employment Benefits	1,874,679.5	1,815,769.5	1,736,057.8	1,569,704.7	1,429,565.5
Total Liabilities	2,050,726.9	1,963,193.2	1,873,363.2	1,710,113.6	1,559,638.5
Net Position					
Unexpended Appropriations - Earmarked Funds	8.1	11.4	-	-	-
Unexpended Appropriations - Other Funds	380,510.0	309,521.1	271,493.6	243,813.9	218,869.5
Cumulative Results of Operations - Earmarked Funds	(1,280,107.2)	(1,271,684.5)	-	-	-
Cumulative Results of Operations - Other Funds	355,207.7	371,596.7	(878,715.9)	(738,155.1)	(637,198.7)
Total Net Position	(544,381.4)	(590,555.3)	(607,222.3)	(494,341.2)	(418,329.2)
Total Liabilities and Net Position	**$1,506,345.5**	**$ 1,372,637.9**	**$1,266,140.9**	**$1,215,772.4**	**$1,141,309.3**

Overall, the majority of the changes in the Department's assets and liabilities over the past five years can be attributed to inflationary growth coupled with health and military pension cost growth.

In summary:

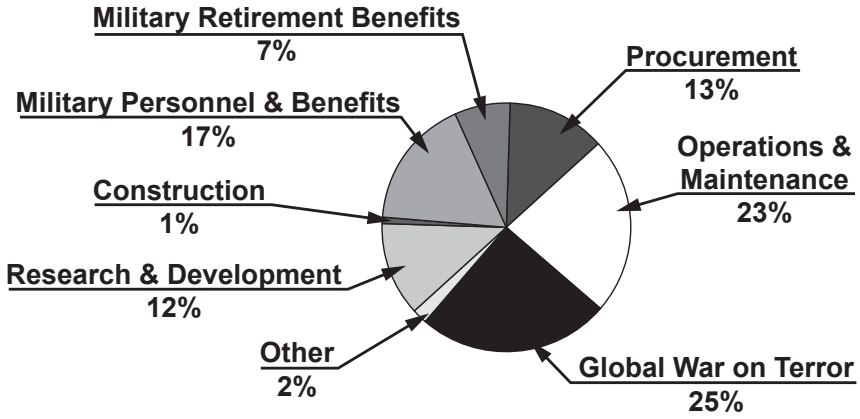
- A portion of DoD's growth in assets and liabilities can be attributed to a 13% increase in inflation.[1]
- Assets grew $365 billion since 2003, the result of increased cash and investments from increasing contributions that are required to cover future commitments.
- Liabilities grew $491 billion since 2003, primarily the result of increased actuarial costs of health and pension benefits. The standard assumptions include inflationary growth of 3% each year for pensions and health care cost.
- The Department's net position has improved $63 billion since 2005 due primarily to the growth in military equipment. The Department continues to validate the asset base and improve its accuracy and reliability in this area.

[1] *Historical Consumer Price Index, (accessed 22 January 2008) available from http://inflationdata.com/inflation/Consumer_Price_Index/HistoricalCPI.aspx*

Revenue

The Department has a variety of funding sources. The primary sources are the series of DoD appropriations (public monies provided by the Congress for Defense use), revenue from work performed, and interest earned on investments. During FY 2007, the Department received $659 billion* in appropriations and invested these resources in key areas as shown on the chart. The Department is the Federal government's single largest agency receiving more than half of the discretionary Federal budget.

FY 2007 Resource Allocation



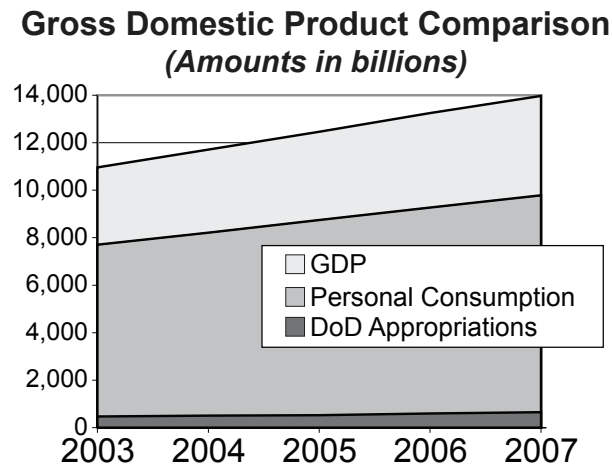
The following information was summarized from our detailed statement of Budgetary Resources and indicates budgetary resources and amounts remaining available.

Budgetary Resources

	2007	2006	2005	2004	2003
Total Budgetary Resources	$1,055,261.0	$ 902,645.7	$ 846,089.3	$1,014,657.2	$ 928,751.7
Less Obligations Incurred	943,270.0	816,541.3	777,499.8	720,712.7	669,710.2
Subtotal	111,991.0	86,104.4	68,589.5	293,944.5	259,041.5
Less Unobligated Balances Not Available	12,354.8	10,260.1	8,656.9	51,825.3	23,285.3
Total Budgetary Resources Available	$ 99,636.2	$ 75,844.3	$ 59,932.6	$ 242,119.2	$ 235,756.2

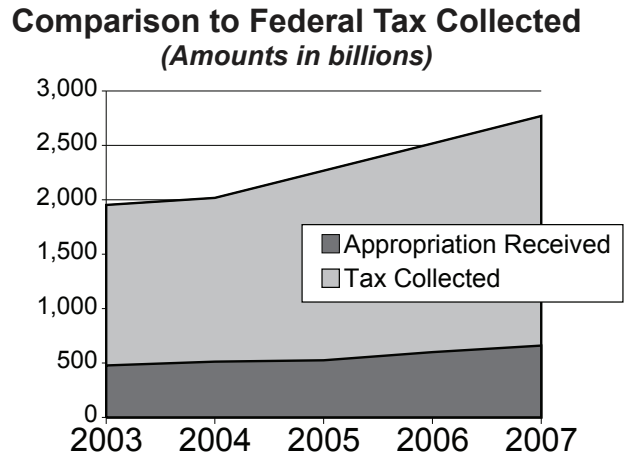
** This amount includes DoD direct appropriations and funds separately appropriated for military retiree health and pension benefits, the Civil Cemeterial expenses of the Army, the Civil Works of the Army Corps of Engineers, and a DoD managed program on behalf of the Executive Office of the President.*

As the largest Federal agency, the Department's share of the Gross Domestic Product (GDP) was only 4% between 2003 and 2007. In comparison, Americans spent an average of 70% of the GDP on personal consumption items during the same period (Personal consumption refers to food, clothing, fuel, motor vehicles and parts, furniture and household equipment, housing, household operations, transportation, medical care, and recreation).[2]



For further comparison, the Department receives approximately 24% of the Federal taxes collected, equating to approximately $2,000 per American citizen.[3] In return the Department provides:

- Protection of the country
- Presence in foreign nations
- Protection from terror
- Protection of allies and political interests around the world.



[2] *"Current-dollar and GDP" (accessed 23 January 2008) available from http://www.bea.gov/National/Index.htm*
[3] *"Summary of Internal Revenue Collections and Refunds, by Type of Tax" (accessed 23 January 2008) available from http://www.irs.gov/pub/irs-soi/*

Expenses

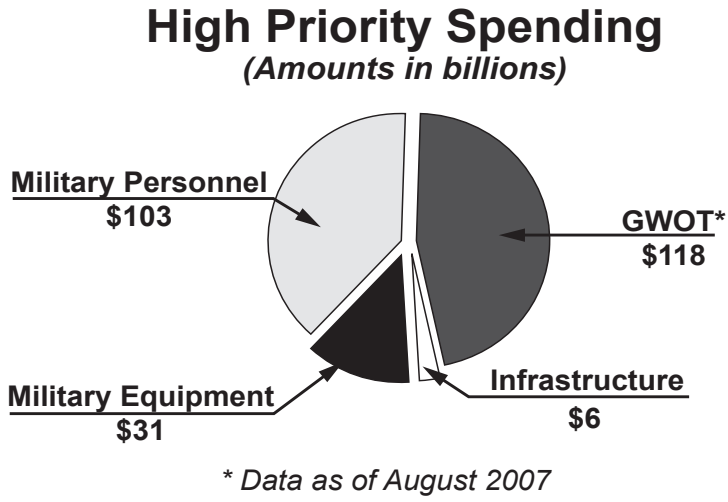
The Department expensed $668 billion during FY 2007. This amount consisted of items that helped achieve the President's goals, objectives, and priorities for items such as capital investments, sustaining on-going operations, and infrastructure. Financial data reflecting our spending can be used to evaluate program priorities and, compared to revenue and appropriations received, helps measure the Department's ability to support continuing programs. By making investments in people, infrastructure, operations and technologies, DoD continues its success in defending national interests and priorities.

The following table provides a summary of the Department's Net Cost of Operations which shows gross costs of the agency less reimbursable revenue.

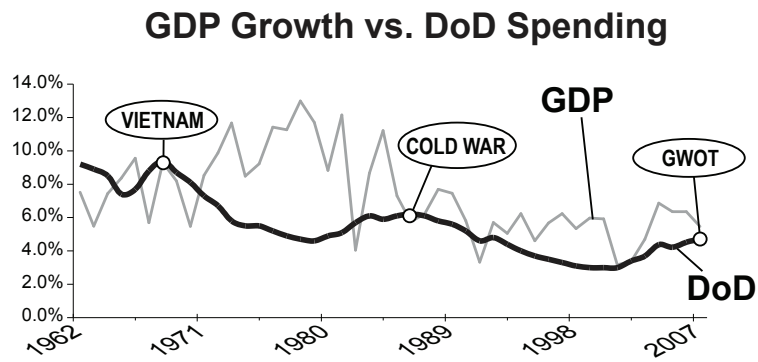
Net Cost of Operations

	2007	2006	2005	2004	2003
Program Costs					
Gross Costs	$ 668,138.4	$ 634,544.0	$ 680,086.6	$ 643,148.3	$ 538,036.7
Less: Earned Revenue	(45,686.4)	(48,495.7)	(45,207.1)	(37,783.4)	(25,746.1)
Net Cost of Operations	**$ 622,452.0**	**$586,048.3**	**$ 634,879.5**	**$ 605,364.9**	**$ 512,290.6**

As its highest priority in 2007, the Department spent approximately $118 billion for Global War on Terror. In addition, $6 billion was spent on infrastructure, $31 billion on military equipment, and $103 billion on military personnel costs.

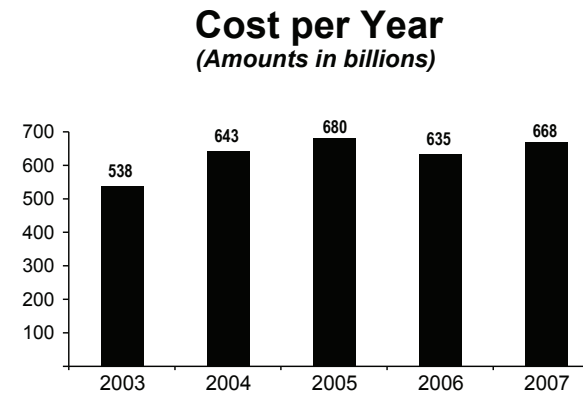


The current share (4%) of the Gross Domestic Product spent on Defense is much less in comparison to 10% during the Vietnam War and the 6% during the Cold War.[4]

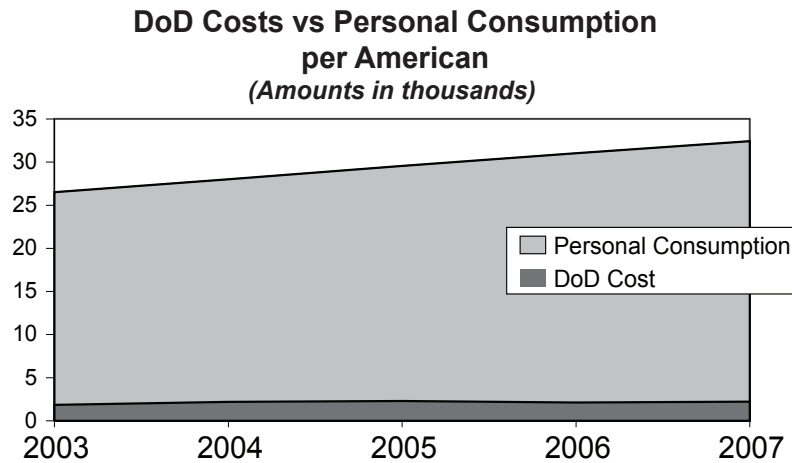


A complete picture of the Department's financial information indicates several trends and insights on the financial health of the organization.

- Gross costs increased $130 billion, which is consistent with asset and liability growth. The Department's gross costs include all operational costs as well as those related to expected future benefits earned in the current year.
- Current year expenses include items such as benefits earned for retirement and health care. These expenses totaled $668 billion in 2007, an increase of $34 billion (5%) from the prior year. These expenses over the last five years have increased 24 percent.



The Department's costs represent about $2,000 per American. Comparatively, Americans spend an average of $30,000 for personal consumables. In other words, the Department spends approximately 7% of the amount that Americans spend for consumables.[5]

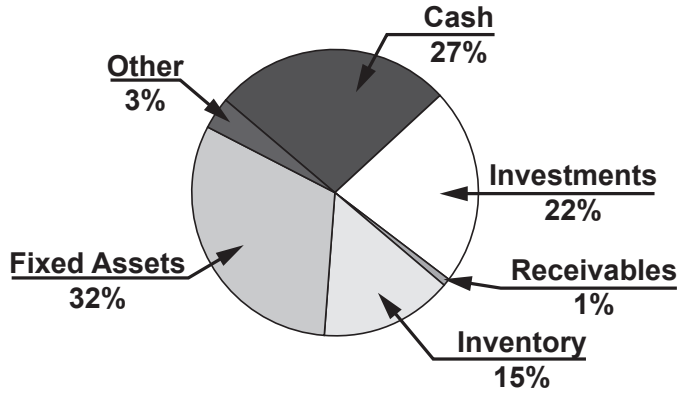


[4] *"Current-dollar and GDP" (accessed 23 January 2008) available from http://www.bea.gov/National/Index.htm*
[5] *"Current-dollar and GDP" (accessed 23 January 2008) available from http://www.bea.gov/National/Index.htm*

Assets

Assets of the Department total $1.5 trillion consisting primarily of cash, investments, inventory, and fixed assets and reflect a 32% growth since 2003. This increase is primarily attributable to growth in cash and investments required to cover current obligations and future military pensions and health benefits. It is notable that managing assets in the Federal government differs from the management of private sector assets. For example, in the private sector, assets can be sold and proceeds used to buy down corporate debt. This can be an important part of corporate financial strategy as assets are employed and debt is managed to drive the bottom line. Alternatively, government agencies are unable to use the proceeds from the sale of assets as they are generally returned to the U.S. Treasury, and therefore are not available to help offset debt. This is a significant difference in the financial structure of the Department when compared to the financial flexibilities of the private sector.

DoD Assets

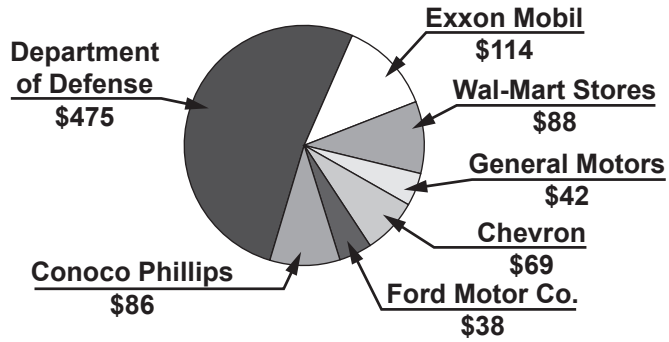


Assets

	2007	2006	Restated 2005	Restated 2004	Restated 2003
Fund Balance with Treasury	$ 407,167.0	$ 329,045.1	$ 290,657.1	$ 289,598.9	$ 252,062.0
Investments and Related Interest	335,123.3	300,351.0	263,972.8	231,476.2	205,593.8
Accounts Receivable, Net	8,882.3	10,805.9	8,906.8	8,546.1	8,366.5
Other Assets	37,458.6	29,118.3	25,341.2	22,498.2	21,834.6
Cash and Other Monetary Assets	15,028.0	2,199.8	2,072.7	2,178.1	1,534.9
Loans Receivable	3,207.1	3,855.1	75.6	70.7	64.0
Inventory and Related Property, Net	224,948.7	231,823.2	222,573.3	220,505.6	205,544.6
General Property, Plant and Equipment, Net	474,530.5	465,439.5	452,541.4	440,898.6	446,308.9
Total Assets	**$1,506,345.5**	**$1,372,637.9**	**$1,266,140.9**	**$1,215,772.4**	**$1,141,309.3**

The Department is heavily invested in fixed assets including property, plant, leasehold improvements, and equipment. The values of fixed assets on the Balance Sheet are shown net of accumulated depreciation. As of year-end 2006, the Department's fixed assets of $475 billion exceed the sum of the net fixed assets for the top six Fortune 500 Companies, demonstrating the immensity of the Department.[6]

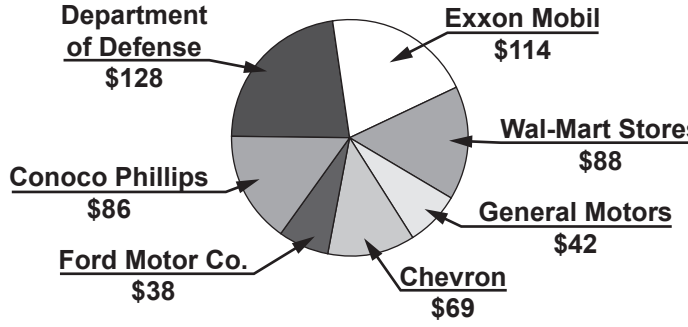
Net Fixed Assets
(Amount in billions)



The Department's investment in fixed assets is largely in military equipment. Valued at $346 billion, military equipment makes up approximately 73% of the Department's general property, plant and equipment and is the single largest item on the Balance Sheet. Overall, it represents approximately one-quarter of total assets. Military equipment is comprised of items such as weapon systems and other equipment designed to be used to carry out battlefield missions. When it was first added to the Balance Sheet in 2003, systems and processes were inadequate to properly value the equipment, or track its depreciation. As a result, the Department overstated the value on the Balance Sheet for several years. Valuation methodology has been corrected and systems are being put into place to properly account for values. Prior to requirements implemented as a result of the Chief Financial Officers (CFO) Act of 1990, accountability reporting was based on a different set of standards. Since the Department has many assets that precede the new Generally Accepted Accounting Principles (GAAP) requirements, many historical records supporting fixed asset costs are simply lacking. Reasonable estimates will continue to be a factor in the fixed asset valuation.

Even without military equipment, the Department's fixed assets are greater than those of the top Fortune 500 Companies, to include Exxon Mobil (the entity with the largest fixed assets on the Fortune 500 list).

Net Fixed Assets Excluding Military Equipment
(Amounts in billions)



[6] *"Fortune 500 2006," Fortune Magazine, 17 April 2006 (accessed 23 January 2008) available from http://money.cnn.com/magazines/fortune/fortune500/full_list/*

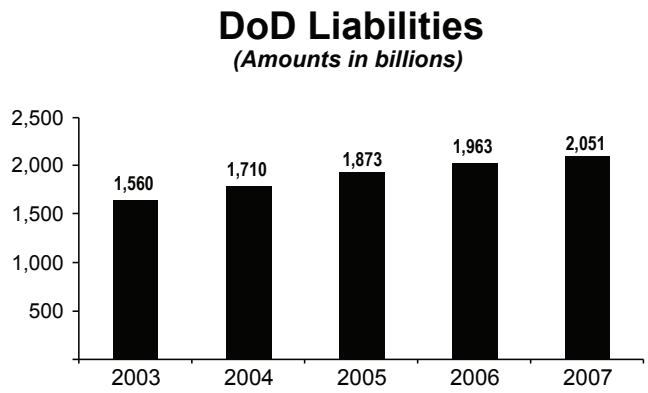
Liabilities

As in the private sector, the financial health of an organization depends heavily upon its long and short-term liabilities. In the case of the Department of Defense, liabilities total over $2 trillion and exceed assets by $544 billion. While this seems to present a very negative financial position (e.g., more is owed than owned), it is recognized that no good business can operate for long in this manner and accommodations have been made for this aspect of the financial position. In addition, the differences in financial management between the private sector and Federal government actually work to our benefit in this situation. Future revenue sources from outside the Department's normal appropriations will be provided to cover the majority of these liabilities. The presentation of the financial position has a fundamental challenge rooted in accounting standards requiring recognition of long-term actuarial liabilities (e.g. guarantee to retirees). Conversely, the same standards do not permit recognition of the revenue that will offset these liabilities until actually realized. As a result, the financial information appears skewed by these long-term liabilities due to their enormity, which puts the Department in a negative equity financial position.

Unusually high levels of liabilities that are not funded may lead to the following unwanted conditions and can generate undesirable levels of risk for a Federal agency. For example, high liabilities may:

- Indicate difficulty to support current programs with current resources,
- Force future program reductions,
- Require increased resources, or
- Limit capacity to finance additional capital assets.

For the Department, the largest component of the $2.1 trillion in liabilities consists of military retirement pensions and retiree health care benefits of $1.5 trillion (computed on an actuarial basis). From a financial solvency point of view, the key issue regards the funding sources for these liabilities and the risk(s) associated with realizing that funding.



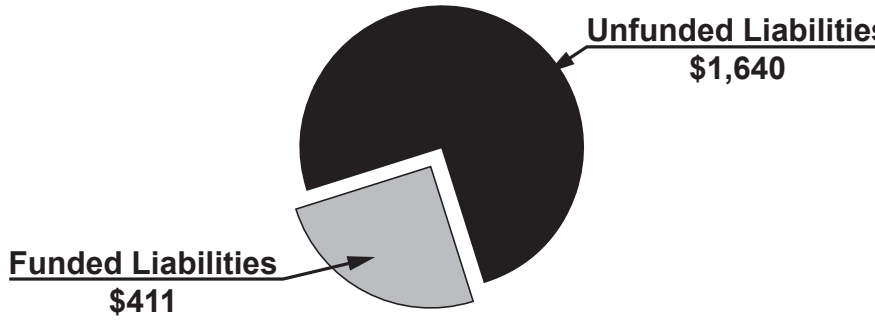
The $1.5 trillion in retiree pensions and health care may be broken into two categories as outlined in Public Law 98-94:

- Cost of paying retirement and health care benefits earned in the current year. The majority of these costs will be funded from DoD sources.
- Costs incurred prior to originating the current program (1984 and prior) will be funded from the U.S. Treasury. These liabilities are computed on an actuarial basis to include estimated costs for new benefits added to the program.

In addition to breaking down the liabilities into the two major components, the Department's total liabilities include a funded and unfunded component.

- The funded component represents that portion for which appropriations or offsetting receipts are currently available.
- The unfunded component represents that portion for which the Department must receive funds in the future in order to pay.

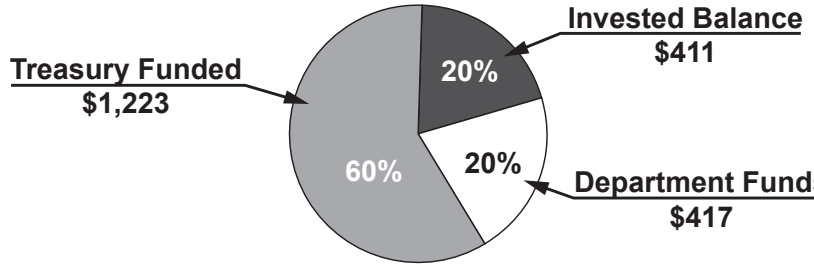
Unfunded vs. Funded Liabilities
(Amounts in billions)



The following chart shows a breakdown of funding sources for the Department's total liabilities.

- $411 billion is primarily covered by DoD investments for future health and retirement benefits.
- $1.2 trillion will come from the U.S. Treasury to cover health and retirement benefits at inception of the current health and retirement programs.
- $417 billion will come from future DoD appropriations and will be justified through the normal budgetary process primarily to cover health benefits for retirees not eligible for Medicare.

Funding Sources for Liabilities
(Amounts in billions)

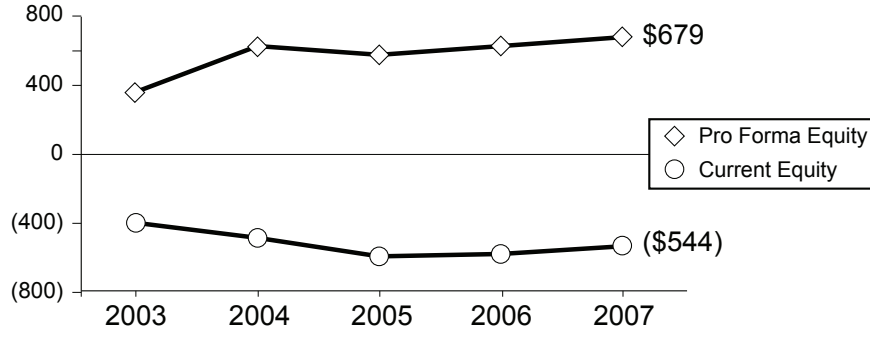


$2.1 Trillion in Total Liabilities

As an added complexity, significant debt of approximately $500 billion was carried into the program in 1984. This debt was planned to be paid over a 50-year period. However, despite annual payments, the debt increased each year because payments from the U.S. Treasury were less than the total cost of interest on the debt. The DoD Board of Actuaries, appointed by the President to set actuarial assumptions for the Military Retirment Fund, determined that a revised payment plan was necessary to pay the annual cost of interest and the total liability. Effective with fiscal year 2008, Treasury contributions will be increased and the debt amortized over a 42-year period. The debt is projected to be eliminated by 2025, assuming no significant changes occur in benefits, assumptions, and/or actuarial experience.

As a result of these long-term dynamics, when liabilities that will be funded from non-DoD sources are factored out, much of the long-term risk is mitigated and the Department is in a good financial position with regard to its long-term financial solvency. Using this approach, the Department would have a positive equity position of $679 billion or nearly $2 in assets for every $1 in liabilities as reflected in the following graph.

Pro Forma Equity
Excluding Treasury Funded Liabilities
(Amounts in billions)



Future Financial Implications

Private sector corporations thrive on their ability to forecast their degree of future financial success. Stockholder confidence rises and falls with the simplest of financial indicators, and the U.S. and global markets are affected. The impacts are far-reaching, and the Federal government is subject to similar effects coupled with the complexities of executing robust domestic and foreign policy.

Progress. The Department of Defense holds a positive view of its financial future. Comprehensive budgetary and proprietary financial processes that justify and defend the annual President's Budget request are in place and working. Significant progress is being made on automated systems through the leveraging of new technologies. These new technologies are delivering higher productivity, greater efficiencies, and strengthened internal controls across the Department.

Confidence. There is a distinction between the justification for the level of confidence regarding short and long-term financial health. Utilizing commonly accepted private sector financial indicator, the financial statements for the Department reflect short-term financial solvency. Conversely, the confidence in the long-term financial position is based upon a different premise as certain liabilities are factored out to draw a solvency conclusion. This is a different approach to align revenue and expenses in the light of the restrictions imposed by the congressional appropriations process. Long-term confidence is dependent upon factors outside the control of the Department, and the risk level is higher in this category. A review of the Department's liabilities reveals that approximately 91% are related to military retirement and health care benefits. They are such a large part of the financial liabilities that all discussions on the future financial condition of the Department begin and end with them in mind.

- Short-term Financial Position. The value of current assets exceeds that of current liabilities, and present a limited risk to the current financial health. The limited risk exists primarily because of the timing of congressional appropriations and war-time priorities. However, historical precedence has shown that the necessary support from the Congress and the Administration will be provided as needed to accomplish the Administrations' priorities.

- Long-term Financial Position. Long-term financial success is reliant upon funding outside of the Department's influence. The risk is greater due in part to several factors such as the inability to control the future costs of military retirements and health care and the receipt of funds sourced from outside the Department's appropriations. Without the continuing financial support of the Congress and the Administration, the Department will be unable to satisfy long-term commitments.

- Trends. Between the periods of 2003 - 2007, current assets grew 65% or $169 billion. Concurrently, long-term assets grew 22% during this same period due largely to the growth in investments to fund military retirement and health benefits. Future equities should continue trending in a positive direction now that the annual contributions from U.S. Treasury have been increased (assuming no changes in the actuarial estimates). Since 2005, the Department's negative equity declined 10 percent.

Conclusion

The Department continues its journey to improve upon its management of the resources entrusted by the public, and a comprehensive plans has been established to further strengthen financial systems and processes. Included in recent improvements in financial management are the following:

- Confirmed military equipment baseline values by using internal documents resulting in improved reliability.
- Reduced management-identified material weaknesses across the Department from 116 to 19 since 2001and on track to eliminate the remaining.
- Implemented actuarial assumptions for military retirement benefits that will improve the overall financial position.
- Avoided $247 million in interest penalties since 2001 by paying invoices timely despite a two-fold increase in the dollar amount of payments.
- Achieved 99% accuracy in Military and civilian pay eliminating employee worries to focus on mission at hand.
- Improved the reliability of financial data by one of the Department's reportable entities that has received draft qualified opinion. This will be a significant break-through for the Department.

In summary, the Department is using a systematic and structured methodology to improve the relevance of its financial management and financial decision-making processes. These financial improvements are the result of plans to position the Department for future audit-readiness. The work toward auditability has been challenging but great strides have been made over the past several years. As a result, the Department has received an unqualified opinion on 15% of its assets and 50% of its liabilities. The Department expects to increase its overall audit readiness to two-thirds of combined assets and liabilities by the end of FY 2009. The financial outlook continues to reflect positive trends and planned financial improvements will help strengthen future financial prospects as efficiencies are gained, new technologies brought on-line, and the culture within the Department embraces full compliance with governmental accounting standards. While Departmental resources are limited and there are vast requirements that go unfunded each year, core missions are being satisfied by prioritizing requirements and ensuring that the most critical are funded. For the long-term outlook, the Department has been assured of a continuing source of appropriated funds to cover a significant portion of long-term obligations, which will come from outside normal appropriations.

The Department has significant financial challenges in the years ahead as support for those who fulfill the core missions in defense of nation evolves. The Department takes seriously the responsibility to provide accurate, reliable and relevant accounting of the public resources and believe it is financially positioned for success. Overall, a comprehensive effort has been made to prepare for the threats and challenges of a new era. At the heart of this effort is the transformation of not just a military structure but also a myriad of business systems and processes that hampered the Department's ability to support fully and efficiently the warfighters who defend the Nation. Addressing these dual challenges is a major task of the Department. Progress continues and despite the many challenges faced over the past several years, the Department is well positioned to satisfy its requirements and fulfill its chosen mission. As a united team, the Department of Defense is prepared to embrace the challenges that lie ahead and stand ready to protect the security of the country.

Further information on the items below as well as a complete version of this document are located at http://www.defenselink.mil/comptroller/afr.

- Agency Financial Report
- Management Challenges
- Financial Statement Audit Information

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