Part 1:
Management Discussion and Analysis

Mission, Organization, and Resources

Mission

The mission of the United States Armed Forces is to protect and advance the security and national interests of the United States, to deter aggressors and, if deterrence fails, to defeat any adversary.

Photos courtesy of Military Department webmasters

Organization

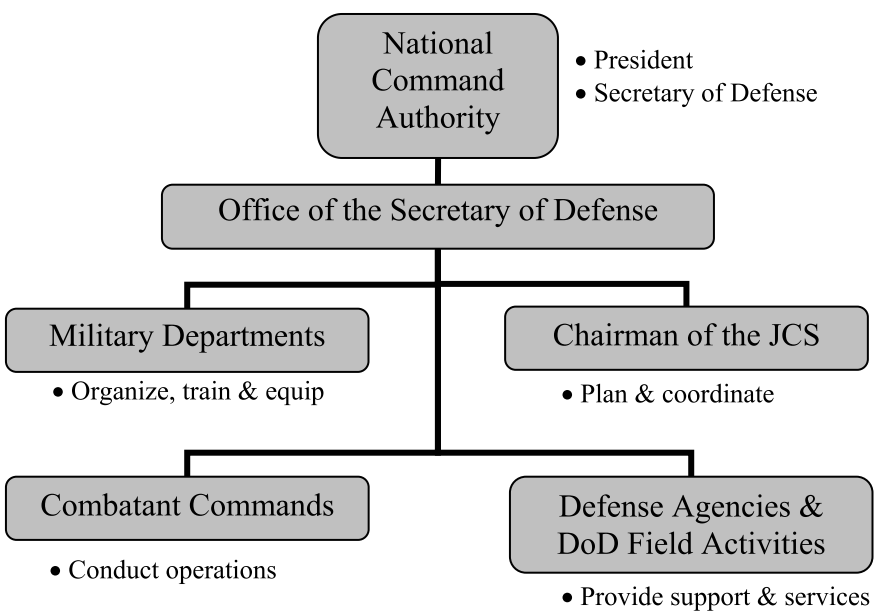
The Department of Defense (DoD) is a Cabinet-level organization that receives orders directly from the President of the United States. The Secretary of Defense is appointed by the President and is responsible for the formulation and execution of defense policy.

The Office of the Secretary of Defense carries out the Secretary's policies by tasking the Military Departments, the Chairman of the Joint Chiefs of Staff (JCS), the Combatant Commands, and the Defense Agencies and DoD Field Activities.

Military Departments. The Military Departments consist of the Army, Navy—of which the Marine Corps is a component—and the Air Force. The U.S. Coast Guard is also special component of the Navy in wartime, but is otherwise a bureau of the Department of Homeland Security.

These Departments recruit, train, and equip military forces. When the President and Secretary of Defense determine that military action is required, these trained and ready forces are assigned to a combatant command that is responsible for conducting the military operations.

The Military Departments are composed of Active Duty, Guard, and Reserve Forces. The National Guard and Reserve Components represent approximately half of America's total uniformed force. These forces provide additional support during military operations. They also perform critical humanitarian, peacekeeping, law enforcement, and disaster assistance missions for the Department of Defense, all of which are important to protecting the national security of the United States.



Chairman of the Joint Chiefs of Staff. The Chairman of the Joint Chiefs of Staff plans and coordinates troop deployments and DoD operations that are conducted by the Combatant Commands.

Combatant Commands. The nine Combatant Commands have responsibility for conducting DoD missions in specific geographical areas of the world. The Army, Navy and Marines, and Air Force supply forces to these commands.

Five of these commands have specific mission objectives for their geographic area of responsibility:

- U.S. European Command (EUCOM)
- U.S. Central Command (CENTCOM)
- U.S. Pacific Command (PACOM)
- U.S. Southern Command (SOUTHCOM)
- U.S. Northern Command (NORTHCOM)

For example, CENTCOM was primarily responsible for conducting Operation Iraqi Freedom.

The other four commands have worldwide mission objectives for their area of responsibility:

- U.S. Strategic Command
- U.S. Special Operations Command
- U.S. Transportation Command
- U.S. Joint Forces Command

For example, the U.S. Transportation Command is responsible for moving military equipment, supplies and personnel around the world for peacekeeping and military missions.

Defense Agencies and DoD Field Activities. Defense Agencies and DoD Field Activities provide support services that are commonly used throughout the Department. For instance, the Defense Finance and Accounting Service provides accounting services, contractor and vendor payments, and payroll services, and the Defense Logistics Agency provides logistics support and supplies to all DoD activities.

Combatant Commands with Geographic Responsibilities

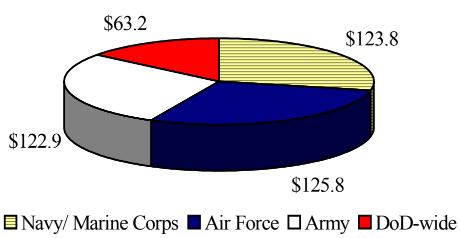
Resources

People. To provide the citizens of the United States with the highest level of national security, the Department of Defense employs 1.4 million men and women in Active Duty, another 1.2 million in the Reserve and Guard Components, and approximately 680 thousand civilians. Together, these men and women work daily to protect American interests in numerous countries.

Physical Assets. The Department maintains a robust infrastructure, operating more than 600,000 individual buildings and structures located at more than 6,000 different locations, and using more than 30 million acres. To protect the security of the United States, the Department uses about 250,000 vehicles, more than 15,000 aircraft, more than 1,000 oceangoing vessels, and some 550 public utility systems.

Budget. The Department's budget for fiscal year 2003 was $435.7 billion.

Fiscal Year 2003 DoD Budget
($ in Billions)



Total = $435.7 billion

Performance Highlights

Key Performance results are summarized in this section; detailed performance information provided in Part 2 and Part 5 of this report.

Strategic Plan

The attacks of September 11, 2001 ushered the United States into a new and dangerous period. Enemies will seek to strike the United States and its forces in novel and surprising ways. As a result, the United States must fight and win the present war against terrorism while preparing for future wars that will be notably different from those of the past century and even from the current conflict.

Some believe that, with the United States in the midst of a difficult and dangerous war on terrorism, now is not the time to transform our Armed Forces. The opposite is true. Now is precisely the time to make changes. The attacks of September 11, 2001 lent urgency to this endeavor.

Transforming the United States Armed Forces is necessary because the challenges presented by this new century are vastly different from those of the last century or even the last 10 years. During the Cold War, America faced a relatively stable and predictable threat. The challenges of the 21st century are much less predictable. Future attacks could grow vastly more deadly than those on September 11, 2001. Surprise and uncertainty thus define the challenge the Department of Defense faces in this new century—to defend the nation against the unknown, the unseen, and the unexpected.

Transforming the United States Armed Forces is the underlying theme in the Department's Quadrennial Defense Review report from 2001, which serves as our strategic plan. The Department is required by law to reevaluate defense missions and priorities every 4 years, immediately following the presidential election. These major assessments cover all facets of the Department's operations and result in the issuance of the Quadrennial Defense Review report (http://www.defenselink.mil/pubs/qdr2001.pdf).

Strategic Goals

The Quadrennial Defense Review, which serves as the Department's strategic plan, has four strategic defense policy goals.

Strategic Goals

1. Assuring allies and friends
2. Dissuading future military competition
3. Deterring threats and coercion against U.S. interests
4. If deterrence fails, decisively defeating any adversary

Assuring Allies and Friends. The presence of American forces overseas is one of the most profound symbols of the U.S. commitment to allies and friends. Through its willingness to use force in its own defense and that of others and to advance common goals, the United States demonstrates its resolve and the credibility of the U.S. military. The Department helps allies and friends create favorable balances of military power in critical areas of the world to deter aggression or coercion. The Department's strategic direction is inevitably linked with that of U.S. allies and friends.

Dissuading Future Military Competition. United States strategy and actions influence the nature of future military threats, guide threats in certain directions, and complicate military planning for potential adversaries. The U.S. also exerts influence by conducting research, development, test, and demonstration programs, and maintaining or enhancing advantages in key areas of military capability. Well targeted strategy and policy can therefore dissuade other countries from initiating future military competitions.

Deterring Threats and Coercion Against U.S. Interests. The Department provides forces and capabilities to the President that give him a wide range of military options to discourage aggression and coercion. The Department is enhancing future military capability by using global intelligence and information. The Department also requires forces that can strike with precision at fixed and mobile targets and that can be rapidly deployed and easily sustained to decisively defeat any adversary.

If Deterrence Fails, Decisively Defeating Any Adversary. U.S. forces must maintain the capability at the direction of the President to decisively defeat any adversaries of the United States and its allies and friends. Such a decisive defeat could include changing the regime of an adversary state or occupation of foreign territory until U.S. strategic objectives are met.

Annual Performance Goals and Results

The Department cannot achieve the goals of the defense strategy without a disciplined approach to managing risk. The previous emphasis on near-term operational risk minimized critically needed investments in people, in modernizing equipment, and in maintaining the defense infrastructure. The defense strategy attempts to balance various risks by establishing a framework composed of four risk categories.

1. **Force management risk** – This risk stems from issues affecting the ability to recruit, retain, train, and equip sufficient numbers of quality personnel and sustain the readiness of the force while accomplishing our many operational tasks.

2. **Operational risk** – This risk results from factors shaping the ability to achieve military objectives in a near-term conflict or other contingency.

3. **Future challenges risk** – This risk derives from issues affecting the ability to invest in new capabilities and develop new operational concepts needed to dissuade or defeat mid- to long-term military challenges.

4. **Institutional risk** – This risk stems from the management practices and controls that affect the efficiency with which resources are used and that shape the effectiveness of the Defense establishment.

This risk management framework guides the Secretary and his senior military and civilian advisors in making strategic trades in how we set management priorities and allocate resources.

The following paragraphs summarize the annual performance goals established to reduce risk in these four areas and summarize the Department's fiscal year 2003 results.

Reducing Force Management Risk

Force management risks steadily mounted during the past decade. The Department under-invested in its people, both in terms of compensation and quality of life factors such as housing. At the same time, the increase in deployments led to excessive operational tempo for units and excessive personnel tempo for service members. Together, these trends took a toll on military families, reduced morale, and contributed to the reduced ability to retain military personnel with key skills and leadership abilities. This negative cycle illustrates the kind of force management risk that the Department must monitor and control.

Just as the Department invests resources to maintain the operational readiness of its forces, it will now also consciously invest dollars to mitigate force management risks. These actions are indispensable in terms of sustaining the nation's commitment to an all-volunteer force, and to keeping faith with the men and women who serve in the uniform.

The Department met several of its fiscal year 2003 performance goals related to the force management risk area. These include maintaining military manning levels, meeting military recruiting goals, and meeting military retention goals. The Department continues to work toward improving the quality of military health care and other force management related goals because obtaining these goals is critical for ensuring effective civilian recruitment, training, and retention.

Reducing Operational Risk

During the past decade, near-term operational risks have been the dominant concern of the Department, crowding out attention given to other sources of risk. This was the result of the primacy in the Department's thinking of the two major theater war construct for sizing and planning United States forces. Under this construct, operational risk was measured almost exclusively in terms of the ability of the Armed Forces to wage two major theater wars simultaneously in Northeast Asia and Southwest Asia.

In 2001, the Department adopted a new approach to managing operational risk, moving away from the two major theater war construct and adopting a new construct that more realistically captures the demands facing the Armed Forces.

In 2003, the Department met several of its performance goals related to the operational risk area. The Department developed a building-block approach to aligning and packaging forces consistent with that new construct. In addition, the Department examined how to reshape the "global footprint" of forces stationed permanently or on rotation overseas, as well as their associated base infrastructure. It also established a formal feedback loop to ongoing operations by creating an integrated, Department-wide protocol for collecting and assessing lessons learned from recent or current operations, so as to quickly adjust how the United States allocates, equips, employs, and sustains capabilities in the field.

Reducing Future Challenges Risk

In light of the dynamic changes in the security environment, a premium has been placed on the need to manage future challenges risk. While many elements of the existing force will continue to contribute to the United States Armed Forces capabilities, defense managers acknowledge the need to develop new, leading-edge capabilities.

The Department met several fiscal year 2003 goals pertaining to the future challenges risk area. The Department completed a Joint Experimentation Campaign Plan to explore concepts developed both inside and outside of the Department—any new idea that could improve how we command and control joint forces across the battle space in cities, jungles, mountains, or forests. In March, the Department completed its evaluation of the lessons learned from Millenium Challenge 2000, the first joint exercise conducted by U.S. Joint Forces Command. In June, the Chairman of the Joint Chiefs of Staff published joint experiment performance goals for fiscal years 2004 and 2005. The Department also developed a prototype and defined standard operating procedures for the Standing Joint Force Headquarters.

In addition, an independent peer review panel rated 96% of the Department's Defense Technology Objectives—technologies such as radar, jet engines, nuclear weapons, night vision and smart weapons—as progressing satisfactorily for fiscal year 2003.

Reducing Institutional Risk

As the Department transforms its military capabilities to meet changing threats, it must do more to ensure that its people can focus their immense talents to defend America, and that they have the resources, information, and freedom to perform.

Mitigating institutional risk necessitates changing the way the Department conducts its daily business. It is a matter of urgency, because left alone, the current organizational arrangements, processes, and systems will continue to drain scarce resources from training, infrastructure, operations, and housing. In addition, if left unattended, institutional risks over time will increase risks in other areas like force management, operational, and risks related to future challenges.

The Department met several fiscal year 2003 goals related to the institutional risk area. For example, the Department reduced the percentage of its budget spent on infrastructure and reduced the number of inadequate military family housing units. The Department did not meet its performance goals for reducing major defense acquisition program cycle times, decreasing the recapitalization rate for funding DoD facilities and buildings, and reducing customer wait time in the supplies and materials ordering process.

Financial Highlights

Key Financial information is summarized in this section with detailed financial information provided in Part 3 of this report.

Financial Overview

The Department is continuing to improve its business management practices. To remain as the world's premier military power, it can do no less. The Department is currently teaming with IBM to transform our business processes and systems through the Department's Business Management Modernization Program (http://www.dod.mil/comptroller/bmmp/pages/index.html). This transformation effort is designed to better support the Department's combat forces and help achieve the Department's strategic goals.

Through this program, the Department developed the initial version of a new business enterprise architecture in April 2003—on schedule and under budget. The architecture helps describe how the Department's business processes and systems will integrate to ensure that accurate and timely financial information is readily available for decision makers. The architecture provides a foundation for breaking down inefficient stovepipe processes and systems and effecting streamlined, integrated business processes and systems.

The Department also developed a transition plan to help describe the transformation from the current business management structure to the future business enterprise architecture. The Department also initiated a corporate governance process to help implement the architecture.

During the next phase of business transformation, the Department will focus on business process reengineering by using the architecture as the starting point for changing business processes. Concurrent with maintaining and extending the architecture, the Department will implement the transition plan and ensure cross-functional management of business systems and processes.

When the architecture is fully implemented, the Department will more effectively and efficiently manage and account for resources. Architecture implementation will also help enable the Department to obtain a favorable audit opinion on its financial statements.

A summary of the Department's business enterprise architecture implementation plan follows, identifying key actions, the status, milestones, and costs.

Defense Business Modernization Program Summary

Action	Status	Milestone	Cost (thousands)
Business Enterprise Architecture	Version 1.0 delivered on schedule.	April 30, 2003	$65,793
Business Enterprise Architecture Transition Plan	Version 1.0 delivered on schedule.	April 30, 2003	$9,559
Business Process Reengineering	Developing initial information exchanges, data process models, and business rules.	April 30, 2004 – Business Enterprise Architecture and Transition Plan version 2.0	$63,269

Overhauling the Department's business and financial management processes and systems represents a major management challenge that goes far beyond financial accounting. The Secretary and his senior leaders are committed to changing the Department's business culture, thus improving the Department's combat support infrastructure.

Nearly 50 percent of the Department's liabilities received favorable audit results

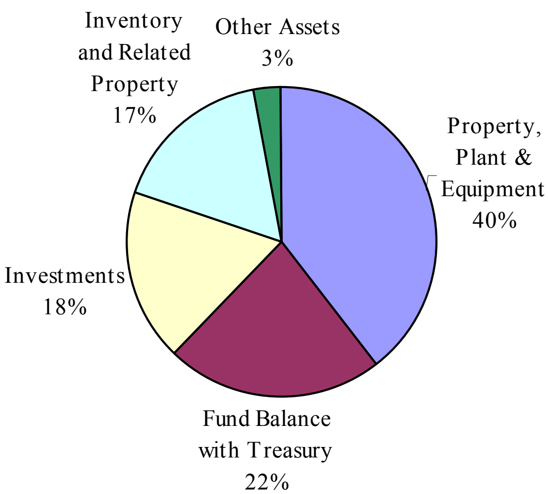
The Department has already made progress in transforming its business and financial processes and systems. A number of the Department's subordinate agencies including the Military Retirement Trust Fund, the Defense Commissary Agency, the Defense Contract Audit Agency, and the Defense Finance and Accounting Service received favorable audit opinions on their financial statements this year. Nearly 50 percent of the Department's liabilities received favorable audit results.

The Department created detailed financial improvement plans this year to obtain a favorable audit opinion on the fiscal year 2007 DoD-wide financial statements. These improvement plans will be used to provide disciplined leadership, identify corrective actions, implement solutions, and plan for audits commensurate with management's representations. Achieving this goal is critical because a favorable opinion provides independent assurance to the public and other external users that the Department's financial information is reliable and accurate.

The Department's Financial Indicators Program is aligned with the President's Management Agenda (discussed later) and the risk management framework established in the Department's strategic plan. The Financial Indicators Program provides the framework for establishing executive-level performance goals and tracking results; designates key performance outcomes, measures, and indicators; and assigns responsibility for cascading performance metrics to the individual component levels within the Department.

Financial Statement Analysis

Types of Assets



Assets. The Consolidated Balance Sheet shows that DoD assets as of September 30, 2003, were $1,129.9 billion, a net increase of $448.0 billion (66%) from fiscal year 2002.

A new federal accounting standard requiring military equipment (tanks, planes, ships, etc.) and missiles to be included on the balance sheet caused Property, Plant, and Equipment to increase $323.7 billion, and Inventory and Related Property to increase $48.0 billion.

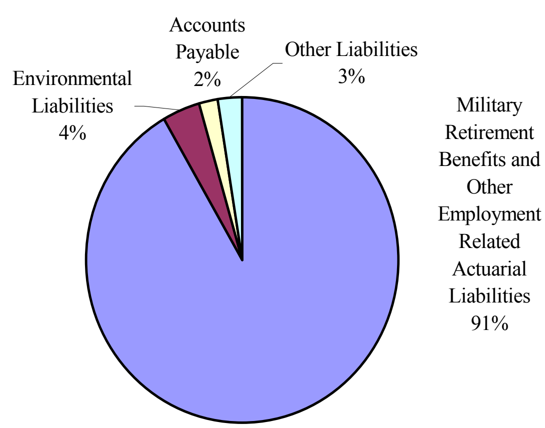
Increased funding to fight the Global War on Terrorism and to conduct Operation Iraqi Freedom and Enduring Freedom in Afghanistan caused the Fund Balance with Treasury to increase $46.2 billion. In addition, a small portion ($387 million) of the Fund Balance with Treasury increase is due to cash seized both inside and outside of Iraq during Operation Iraqi Freedom. The total cash seized as of September 30, 2003 was $2.5 billion and $2.1 billion was spent to support the Iraqi people and Iraq reconstruction effort.

Investments increased $24.8 billion primarily due to the receipt of funds for the Department's newly established Medicare Eligible Retiree Health Care Fund for retired military members and their dependents.

Assets

Asset Type	Fiscal Year 2003	Fiscal Year 2002	Change
	Billions		
Property, Plant, and Equipment	$446.3	$122.6	$323.7
Inventory and Related Property	$194.2	$146.2	$48.0
Fund Balance with Treasury	$252.0	$205.8	$46.2
Investments	$205.6	$180.8	$24.8
Other Assets	$31.8	$26.5	$5.3
Total	**$1,129.9**	**$681.9**	**$448.0**

Types of Liabilities



Liabilities. The Consolidated Balance Sheet shows that DoD liabilities as of September 30, 2003, were $1,558.6 billion, an increase of $107.3 billion (7%) from fiscal year 2002.

Military Retirement Benefits and Other Employment Related Actuarial Liabilities increased $100.8 billion due to expected changes in liabilities related to interest and accrual costs, and the net effect of other actuarial gains and losses such as: changes in actuarial assumptions including medical trend and salary increase, revised methodology for the projection of reservists, and a new military pay table.

Accounts Payable increased $3.7 billion which is primarily attributable to increased spending due to fighting the Global War on Terrorism, such as conducting Operation Iraqi Freedom and Operation Enduring Freedom.

Environmental Liabilities increased $2.1 billion primarily due to the Department of the Army's ongoing efforts to improve their estimating for closed ranges requiring environmental restoration.

Liabilities

Liability Type	Fiscal Year 2003	Fiscal Year 2002	Change
	Billions		
Military Retirement Benefits and other Employment Related Actuarial Liabilities	$1,429.6	$1,328.8	$100.8
Accounts Payable	$28.0	$24.3	$3.7
Environmental Liabilities	$61.5	$59.4	$2.1
Other Liabilities	$39.5	$38.8	$0.7
Total	**$1,558.6**	**$1,451.3**	**$107.3**

Costs. The Consolidated Statement of Net Cost shows that the total cost of operations for the Department of Defense for fiscal year 2003 was $512.3 billion, an increase of $132.1 billion (35%) from fiscal year 2002. The increased costs were primarily incurred due to fighting the Global War on Terrorism. As indicated by the table below, increases occurred in several major military programs to support this effort. Most notably, costs to pay military personnel increased by $22.2 billion and costs to operate, maintain, supply and transport forces increased by $35.7 billion. In addition, the Department's military retirement costs increased $34.3 billion due to increased actuarial liabilities. The Consolidating Statement of Net Cost provides a more detailed breakout of the Department's costs.

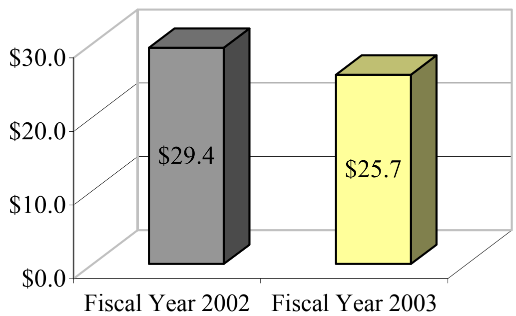
Costs

Program Type	Fiscal Year 2003	Fiscal Year 2002	Change
	Billions		
Military Personnel	$108.9	$86.7	$22.2
Operation & Maintenance	$176.2	$140.5	$35.7
Procurement	$60.0	$57.8	$2.2
Research, Development, Test & Evaluation	$51.1	$42.6	$8.5
Military Retirement	$48.8	$14.5	$34.3
Other Program	$67.3	$38.1	$29.2
Total	**$512.3**	**$380.2**	**$132.1**

Revenues. The Consolidated Statement of Net Cost shows that the total revenues received by the Department for fiscal year 2003 were $25.7 billion. This is a $3.7 billion (13%) decrease in revenues received in fiscal year 2002.

The decrease in revenues occurred primarily due to the amount of interest earned by the Military Retirement Fund. Interest on investments for this fund decreased from $12.4 billion to $10.0 billion due to falling interest rates on investments held in 2003.

Revenues
($ in billions)

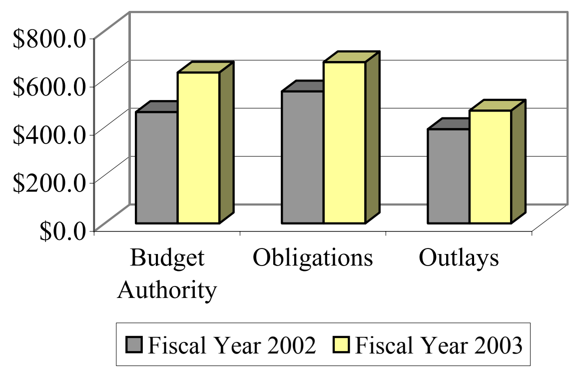


Budget Authority. This is the authority provided by law to incur financial obligations that will result in outlays. Specific forms of budget authority include appropriations, borrowing authority, contract authority, and spending authority from offsetting collections. The Combined Statement of Budgetary Resources shows that the amount of budget authority the Department had for fiscal year 2003 was $626.4 billion. This is a $163.8 billion (35%) increase from fiscal year 2002. Increased funding to fight the Global War on Terrorism caused this increase and the corresponding increases to both obligations and outlays, which are discussed next.

Obligations. An obligation is a binding agreement that will result in outlays, immediately or in the future. Budgetary resources must be available before obligations can be incurred legally. The Combined Statement of Budgetary Resources shows that obligations made during fiscal year 2003 were $669.8 billion, an increase of $121.4 billion (22%) from fiscal year 2002.

Outlays. An outlay is a payment to liquidate an obligation (other than the repayment of debt principal). Outlays generally are equal to cash disbursements, but also are recorded for cash-equivalent transactions, such as the subsidy cost of direct loans and loan guarantees, and interest accrued on public issues of public debt. Outlays are the measure of Government spending. The Combined Statement of Budgetary Resources shows that outlays made during fiscal year 2003 were $468.6 billion, an increase of $77.0 billion (20%) from fiscal year 2002.

Statement of Budgetary Resources
($ in billions)



Compliance with Legal and Regulatory Requirements

Each year the Department works aggressively to comply with laws made by Congress to ensure that the federal government provides the best possible service to the American people. Among these laws are the:

- Chief Financial Officers Act of 1990
- Federal Managers' Financial Integrity Act of 1982
- Federal Financial Management Improvement Act of 1996
- Inspector General Act Amendments of 1988
- Improper Payments Information Act of 2002
- Homeland Security Act of 2002

Chief Financial Officers Act

The Chief Financial Officers Act requires federal agencies to prepare auditable annual financial statements. Each year, the Department prepares annual financial statements.

As discussed earlier, several of the Department's subordinate agencies have received a favorable audit opinion on their financial statements. However, to date, the DoD-wide statements have received a disclaimer of opinion from the auditors, which means the statements are unauditable.

The Department created detailed financial improvement plans to obtain a favorable audit opinion on its fiscal year 2007 financial statements. These plans identify specific corrective actions, costs, and key milestones for improving the information reported in the Department's financial statements.

During the fiscal year 2002 DoD-wide financial statement audit, the auditors highlighted 13 financial statement weaknesses. The Department informed its financial statement auditors that two of these weaknesses relating to military retirement health care liabilities and problem disbursements were corrected in fiscal year 2003. A table summarizing the Department's remaining 11 financial statement weaknesses follows:

Financial Statement Weakness	Description	Status
Financial Management Systems	DoD-wide systemic deficiencies in financial management systems and business processes result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.	The Department developed the initial version of a new business enterprise architecture. The architecture helps describe how the Department's business processes and systems will integrate to ensure that accurate and timely financial information is readily available for decision makers. The Department expects to implement the financial management portion of the business architecture and correct this weakness by 4th quarter, fiscal year 2006.
Intragovernmental Eliminations	The inability to reconcile most intragovernmental transactions results in adjustments that cannot be verified.	The Department is actively working with other federal agencies to help resolve this issue. Many of the problems will be corrected with the implementation of the government-wide intragovernmental transactions web-based portal and the Department's business enterprise architecture over the next few years. The Department expects to resolve this weakness by 4th quarter, fiscal year 2006.
Accounting Entries	The Department continues to enter material amounts of unsupported accounting entries.	The Department has implemented a training program to minimize unsupported accounting entries. Total elimination of these entries is contingent upon full implementation of the Department's business enterprise architecture. The Department expects to correct this weakness 4th quarter, fiscal year 2006.

Financial Statement Weakness	Description	Status
Fund Balance with Treasury	A significant amount of disbursements are not accurately reported. Uncleared differences exist between cash transactions reported by the DoD and Treasury Department's records.	The Department strengthened internal controls for disbursements through reconciliation training and metric tracking to more accurately record disbursements. The Department also obtained legislation to clear old unreconcilable suspense accounts and check issue differences. The Department has a multi-phase program underway to enhance system functionality for improving expenditure reconciliation and reporting. The Department expects to clear this weakness by 4th quarter, fiscal year 2005.
Environmental Liabilities	Guidance and audit trails are insufficient. The inventory of ranges and operational activities (landfills, open burning pits, etc.) is incomplete.	The Department issued guidance in October 2002 and will issue additional guidance for on-going operations within the next few months. An inventory of ranges is 95 percent complete and the operational ranges inventory will be completed by August 2004. The Department expects to correct this weakness by 4th quarter, fiscal year 2004.
General Property, Plant and Equipment (PP&E)	The cost and depreciation of PP&E is not reliably reported due to (a) a new accounting requirement that went into effect in fiscal year 2003 that classifies military equipment as General PP&E, (b) a lack of supporting documentation for PP&E with long useful lives, and (c) most legacy property and logistics systems are not integrated with acquisition and financial systems and were not designed to capture the acquisition cost, cost of modifications and upgrades or to calculate depreciation.	The Department implemented guidance and training to improve property accountability and provide better financial reporting. We developed an estimation model in coordination with the Bureau of Economic Analysis to record a value for the Department's military equipment in fiscal year 2003. We expect complete and reliable PP&E reporting by 4th quarter, fiscal year 2005.

Financial Statement Weakness	Description	Status
Government Furnished Material and Contractor Acquired Material	The cost of DoD property and material in the possession of contractors is not reliably reported due to a lack of an integrated reporting methodology with industry.	The Department is working on policy and processes to help correct this weakness. Implementation of new policy and the Department's business enterprise architecture will eliminate this problem. The Department expects to correct this weakness by 4th quarter, fiscal year 2005.
Inventory	The existing inventory valuation method does not produce an auditable approximation of historical cost because the associated gains and losses cannot be accurately tracked to specific items or purchases.	We will publish and implement policy that changes the Department's inventory valuation method to moving-average-cost in fiscal year 2004. This new policy will allow the Department to adequately capture necessary costs, gains, and losses. This policy and the implementation of the Department's business enterprise architecture will correct this weakness by 4th quarter, fiscal year 2005.
Operating Materials and Supplies	The Department's systems were designed to expense materials when purchased rather than when consumed.	The implementation of the Department's business enterprise architecture will correct this weakness by 4th quarter, fiscal year 2005.
Statement of Net Cost	The Statement of Net Cost is not presented by specific programs that align with major goals and outputs described in the Department's strategic and performance plans required by the Government Performance and Results Act. Revenues and expenses are reported by appropriation categories because financial processes and systems do not collect costs in line with performance measures.	The implementation of the Department's business enterprise architecture will correct this weakness by 4th quarter, fiscal year 2006.

Financial Statement Weakness	Description	Status
Statement of Financing	The DoD cannot reconcile budgetary obligations to net cost without making unsupported adjustments.	The implementation of the Department's business enterprise architecture will correct this weakness by 4th quarter, fiscal year 2006.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act requires federal agencies to assess the effectiveness of management, administrative and accounting controls, and financial management systems. Using self-assessments as the basis, this Act requires agency heads to provide an annual statement of assurance on the effectiveness of the management controls and to include material weaknesses found in management controls that warrant reporting to a higher level. The Department's fiscal year 2003 Annual Statement of Assurance is provided in the Deputy Secretary's Message at the front of this report.

Maintaining integrity and accountability in programs and operations:

(1) is critical for good government,
(2) demonstrates responsible stewardship over assets and resources,
(3) promotes high-quality, responsible leadership,
(4) enhances the sound delivery of services to customers, and
(5) maximizes desired program outcomes.

The Department regularly monitors and aggressively works to improve the management control effectiveness of its operations, programs and financial systems.

The Department uses periodic self-assessments as the basis for the annual statement of assurance and reports management control weaknesses relating to Sections 2 and 4 of this Act. Section 2 requires "internal accounting and administrative controls that reasonably ensure costs comply with applicable laws, assets are safeguarded, and revenue and expenses are recorded and accounted for properly." Section 4 requires that "accounting systems conform to principles, standards or related requirements prescribed by the Comptroller General."

The Department strongly encourages forthright reporting of material weaknesses in management controls on all operations important to mission accomplishment of defending our nation from adversaries, foreign or domestic. As old weaknesses are corrected, the same number or more may be found and reported. Therefore, the outstanding number of uncorrected weaknesses may not change significantly from one fiscal year to another. The Department monitors corrective activities and does not allow milestone slippage without justification by senior leaders.

The Department classifies management control weaknesses into 3 categories:

1. Section 2 Material Weaknesses: Weaknesses in management controls that warrant reporting to a higher level and usually affect a single DoD Component.

2. Section 2 Systemic Weaknesses: Material Weaknesses that affect management controls across organizational and program lines and usually affect multiple DoD Components.

3. Section 4 System Nonconformance Weaknesses: Systems nonconformance with the principles, standards or related requirements prescribed by the Comptroller General.

Last fiscal year, the Department had 70 uncorrected material weaknesses. In fiscal year 2003, the Department reported 10 new weaknesses, corrected 25 weaknesses, and consolidated the reporting of 15 additional weaknesses, leaving 40 uncorrected weaknesses at the end of fiscal year 2003. Of the 10 new weaknesses, 2 are systemic and 8 are material weaknesses.

The Department identified nine areas that affect numerous DoD Components as systemic weaknesses. The Department identified the remaining 31 weaknesses as material weaknesses affecting the individual component as indicated on the table below.

In fiscal years 2002 and 2003, the Department reported one Section 4 System Nonconformance Weakness which encompasses the entire DoD financial system noncompliance with control requirements. The Department also considers DoD financial system's noncompliance as a systemic weakness affecting multiple DoD Components. In addition, the auditors have identified DoD financial systems as a material weakness under the requirements of the Chief Financial Officers Act in both fiscal years 2002 and 2003.

The following table lists the systemic weaknesses (9), material weaknesses (31), and system nonconformance weakness (1). The material weaknesses are further divided into those adversely affecting the Department's financial operations, and those that adversely affect operations critical to the core mission of national defense or other critical DoD function. The systemic weakness correction dates reflect the Department's fiscal year 2003 position.

Section 2 Systemic Weaknesses
1. DoD Financial Management Systems and Processes: DoD financial and business management systems and processes are not fully integrated and do not provide information that is reliable, timely and accurate. The estimated correction date is 4th Qtr, fiscal year (FY) 2006.
2. Management of Information Technology and Assurance: DoD needs to better manage information technology and needs assurance that information technology is adequately protected. The estimated correction date is 3rd Qtr, FY 2007.

Section 2 Systemic Weaknesses (Continued)

3. Environmental Liabilities: The DoD has not developed the policies, procedures, and methodologies needed to ensure that cleanup costs for all of its ongoing and inactive or closed operations are identified, consistently estimated, and appropriately reported. Site inventories and cost methodologies to identify budget requirements and financial liabilities continue to need improvement. The estimated correction date is 1st Qtr, FY 2006.

4. Personnel Security Investigations Program: DoD hiring is adversely affected because personnel security investigations are backlogged. The estimated correction date is 4th Qtr, FY 2004.

5. Real Property Infrastructure: The Department has not adequately managed the real property infrastructure to halt the deterioration or obsolescence of facilities on military installations. The estimated correction date is 1st Qtr, FY 2006.

6. Contracting for Services: Acquisition oversight is not always adequate when contracting for DoD services and can result in failure to obtain the best value on individual procurements. The estimated correction date is 2nd Qtr, FY 2005.

7. Government Card Program Management: Instances of misuse, abuse, and fraud in respect to purchase and travel card use have been attributed to inadequate DoD emphasis on proper use of the cards, poorly enforced controls, and lax oversight. The estimated correction date is 4th Qtr, FY 2004.

8. Valuation of Plant, Property and Equipment on Financial Reports: The valuation of general plant, property, and equipment is not always correctly reported. FY 2003 is the first year DoD reported this as a systemic weakness. The estimated correction date is 4th Qtr, FY 2006.

9. Valuation of Inventory on Financial Reports: The valuation of inventory is not always correctly reported. FY 2003 is the first year DoD reported this as a systemic weakness. The estimated correction date is 2nd Qtr, FY 2006.

Section 2 Financial Material Weaknesses

Material Weaknesses	FY First Reported	Targeted Correction Date	
		As of FY 2002 (Qtr / FY)	**As of FY 2003** (Qtr / FY)
1. Adequate documentation does not always exist to support adjustments used to reconcile general ledger data to budgetary data. (Defense Finance and Accounting Service)	2003	N/A	1st / 2005

Section 2 Financial Material Weaknesses (Continued)			
Material Weaknesses	**FY First Reported**	**Targeted Correction Date**	
		As of FY 2002 (Qtr / FY)	**As of FY 2003** (Qtr / FY)
2. Policy for recording, reporting, collecting and reconciling accounts receivable from public and government sources is not always followed. (Defense Finance and Accounting Service)	2003	N/A	4th / 2004
3. DoD components do not properly monitor the estimation of accrued liabilities, when goods and services are provided. (Defense Finance and Accounting Service)	2003	N/A	2nd / 2004
4. Suspense account balances with the Treasury trial balances are not fully resolved and reconciled. (Defense Finance and Accounting Service)	1997	4th / 2003	4th / 2004
5. Appropriation balances in the accounting records do not always balance with the Treasury's balances and transaction level reconciliations are not always performed. (Defense Finance and Accounting Service)	1999	4th / 2003	4th / 2006
6. The actual loss of government funds could not always be fully identified because of improper disbursement transaction processing and inadequate documentation. (Defense Finance and Accounting Service)	2002	4th / 2003	1st / 2004
7. Due to inadequate supporting documents, freight supply payments are not properly pre-certified before they are made. (Defense Finance and Accounting Service)	1999	4th / 2003	4th / 2004
8. Telecommunication invoices are not always certified and obligations are not pre-validated prior to payment. (Defense Finance and Accounting Service)	2001	4th / 2003	1st / 2004
9. Payments less than $2,500 are not always certified and post payment audits are not always performed on electronic vendor payments to verify that the supporting documentation is correct. (Defense Finance and Accounting Service)	2002	4th / 2003	4th / 2004

Section 2 Financial Material Weaknesses (Continued)			
Material Weaknesses	**FY First Reported**	**Targeted Correction Date**	
		As of FY 2002 (Qtr / FY)	**As of FY 2003** (Qtr / FY)
10. Accounts receivable and accounts payable need to be actively managed and reduced to acceptable levels. (Defense Logistics Agency)	2002	4^{th} / 2003	4^{th} / 2004
11. Adequate management controls were not in place to detect or prevent disbursements in excess of obligations. (Office of the Under Secretary of Defense for Comptroller)	1994	4^{th} / 2003	2^{nd} / 2004
12. The military pay system has made invalid payments resulting in members separating from service in debt. (Defense Finance and Accounting Service)	2003	N/A	4^{th} / 2004

Section 2 Non-Financial Material Weaknesses			
Material Weaknesses	**FY First Reported**	**Targeted Correction Date**	
		As of FY 2002 (Qtr / FY)	**As of FY 2003** (Qtr / FY)
13. DoD's capital investment process for information technology does not confirm that the best investments are selected, that they deliver expected benefits, or that the final product or service delivers what DoD expects. (Defense Information Systems Agency)	2002	4^{th} / 2004	4^{th} / 2004
14. Procedures are not always adequate to ensure that the prices paid for contracts are reasonable. (Defense Logistics Agency)	2001	3^{rd} / 2003	4^{th} / 2004
15. Payments for fuel charges incurred as part of the DoD Fleet Card have been delinquent. (Defense Logistics Agency)	2002	4^{th} / 2003	4^{th} / 2004
16. Controls for assessing which employees can receive mass transit benefits are not always adequate. (Defense Logistics Agency)	2003	N/A	4^{th} / 2004

Section 2 Non-Financial Material Weaknesses (Continued)			
Material Weaknesses	**FY First Reported**	**Targeted Correction Date**	
		As of FY 2002 (Qtr / FY)	**As of FY 2003** (Qtr / FY)
17. Lack of oversight and guidance for cooperative programs with other countries has placed DoD's funds at risk of being allocated unnecessarily. (Defense Threat Reduction Agency)	2002	4^{th} / 2003	4^{th} / 2004
18. Better controls are needed to properly account for proceeds from submarine dismantlement scrap revenues. (Defense Threat Reduction Agency)	2001	4^{th} / 2003	4^{th} / 2004
19. Not all DoD components have completed essential continuity of operations plans. (Defense Threat Reduction Agency)	2002	4^{th} / 2003	1^{st} / 2004
20. Existing controls did not ensure that incidents of sexual assault among the cadet population were prevented or reported. (Air Force)	2003	N/A	4^{th} / 2005
21. Responsible DoD officials failed to secure host nation telecommunications agreements necessary to maximize the combat effectiveness of warfighters. (Air Force)	1999	4^{th} / 2004	4^{th} / 2004
22. Controls over management of spare parts were not always adequate to meet the warfighter mission. (Air Force)	1999	4^{th} / 2005	4^{th} / 2005
23. Better controls over efforts to provide safe areas surrounding air installations are needed to minimize public exposure from the hazards of aircraft operations. (Air Force)	2000	4^{th} / 2004	4^{th} / 2005
24. DoD has not established guidance or effective controls for processing line of duty and incapacitation pay, which adversely affects reservists who attempt to receive benefits after their duty obligation is met. (Army)	2002	4^{th} / 2004	4^{th} / 2005

Section 2 Non-Financial Material Weaknesses (Continued)			
Material Weaknesses	FY First Reported	Targeted Correction Date	
		As of FY 2002 (Qtr / FY)	As of FY 2003 (Qtr / FY)
25. Current processes for managing workload, linking workload to dollars required, or predicting future manpower requirements have not been established. (Army)	1997	4th / 2005	4th / 2005
26. Processes for reporting the readiness for going to war are not always accurate and consistent. (Navy)	2002	4th / 2003	3rd / 2004
27. Some procedures for projecting training requirements have not been adequate, causing inefficient use of training resources and lost operational work years. (Navy)	1999	4th / 2005	4th / 2006
28. Better management of Active and Reserve recruiting functions is needed to maintain a ready force. (Navy)	2001	4th / 2003	4th / 2004
29. Controls were not adequate to ensure that the program manager of the Joint Chemical Agent Detector—an Acquisition Category III program—reported cost breaches to the acquisition program baseline. (Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics)	2003	N/A	1st / 2004
30. DoD risks improperly storing Privacy Act information on systems. (DoD Counterintelligence Field Activity)	2003	N/A	4th / 2004
31. Automated management tools are needed to ensure accountability of Reserve Component personnel from home station to duty station and back home. (Army)	1988	4th / 2003	4th / 2004

Section 4 System Nonconformance Weakness		
Material Weakness	**FY First Reported**	**Targeted Correction Date** (Qtr / FY)
1. DoD Financial Management Systems: "Convoluted" business processes that include superfluous process steps—driven by overlapping accounting, operational, and organizational structures; and further complicated by aged and disparate systems—have caused an inability to consistently provide reliable financial and managerial data for effective decision-making.	1998	4th / 2006

Federal Financial Management Improvement Act

The Federal Financial Management Improvement Act requires federal agencies to conform to the United States Government Standard General Ledger, comply with all applicable federal accounting standards, establish financial management systems that meet government-wide standards and requirements, and support full disclosure of federal financial data, including the costs of federal programs and activities.

The Department does not fully comply with these requirements. However, as part of the Business Management Modernization Program, the Department teamed with IBM to develop an initial version of the business enterprise architecture in April 2003 to help transform our business processes and systems. The architecture helps describe how the Department's business processes and systems will integrate to ensure accurate and timely financial information is readily available for decision makers. When the architecture is fully implemented, the Department expects to meet all the requirements of this Act.

Inspector General Act Amendments

The Inspector General Act Amendments require explanation for all audit reports with recommendations open for more than 1 year. As of September 30, 2003, the Department had 218 audit reports open for more than 1 year. The total amount of monetary benefits that the Department can realize by implementing recommendations from these reports is $821 million. The Department closed out and implemented recommendations from 131 audit reports in fiscal year 2003 with claimed monetary benefits of $777 million.

Improper Payments Information Act

The Improper Payments Information Act requires federal agencies to report payments that should not have been made or that were made in an amount different than that required by law, regulation or contract. The

Office of Management and Budget Circular A-11, "Preparation, Submission and Execution of the Budget," includes provisions implementing this Act.

In accordance with these provisions, the Department is reviewing all programs and activities and identifying those which are susceptible to significant improper payments. The Department will then estimate the amount of improper payments and establish goals to reduce the amount of these payments. Programs that meet the threshold criteria established in this guidance will be reported in next year's report. Those not meeting the criteria will be tracked internally to ensure that all cost-effective measures are being taken to minimize the amount of improper payments.

For fiscal year 2003, the Office of Management and Budget Circular A-11 requires the Department of Defense to report improper payments for only two programs: Military Health Benefits and Military Retirement.

Military Health Benefits. The military health benefits program has numerous prepayment and postpayment controls built into the claims processing system to minimize improper payments.

One control is the claims edit system, which rebundles services that should be billed under a single comprehensive procedure code, but are broken out by medical service providers to increase reimbursement. This is a fraudulent practice condemned by national professional medical organizations.

An example of this practice is with a hysterectomy which bills out at a single comprehensive code that might pay $3,500. An unbundled claim would list multiple services to include exploratory surgery, tying of tubes, lysis of adhesions, and other procedures that would result in a payment of more than $10,000.

A cost avoidance of $74 million was realized in fiscal year 2002 and a cost avoidance of $143 million is projected for fiscal year 2003 as a result of military health benefits program rebundling edits.

The Department projected $53.484 million of improper payments (underpayments and overpayments) for the military health benefits program—purchased care program—in fiscal year 2003. This represents an error rate of approximately 1.36% of the $3.9 billion in military health benefits program payments made during fiscal year 2003.

Military Retirement. The Department conducts various types of prepayment and postpayment reviews for military retirement payments. One example is that all payments more than $9,000 made to retirees and more than $5,500 made to annuitants are reviewed. Another example is a monthly review of the retired pay file for similar social security numbers to minimize duplicate payments.

The Department projected $33.087 million of improper payments (underpayments and overpayments) for the Military Retirement Program in fiscal year 2003. This represents an error rate of 0.1% of the $32.7 billion in military retirement payments made during fiscal year 2003.

Homeland Security Act

This Act established the Department of Homeland Security and requires certain functions being performed by other federal agencies to be transferred to the Department of Homeland Security. In accordance with the provisions of this Act, the Department of Defense transferred two programs and their corresponding budgetary resources to the Department of Homeland Security in fiscal year 2003.

The Department of Defense transferred $1.022 billion in budgetary resources to the Department of Homeland Security. The breakout for these transfers follows:

- $416.5 million from DoD Bioterrorism Initiatives funds
- $400.0 million from the Iraqi Freedom Fund
- $75.6 million from the Defense Emergency Response Fund
- $130.7 million for the National Communication System

These budgetary resources will be used to pay for salary, benefits, contract, travel, supplies, and other program costs at the Department of Homeland Security.

President's Management Agenda


White House photo by Eric Draper

The Department continues progress towards accomplishing President George W. Bush's Management Agenda. The goal of this Agenda is to improve performance in five key federal management areas:

1. **Strategic Human Capital Management** is the transformation of how we employ, deploy, develop and evaluate the workforce. It places the right people in the right jobs to most effectively perform the work of the organization. Progress is achieved by meeting various objectives, such as aligning human capital strategies with mission goals and developing a results-oriented performance culture that rewards those who achieve desired results and correct performance deficiencies.

2. **Competitive Sourcing** is a process used to determine if a government function should be contracted out. Its objective is to improve the efficiency and effectiveness of activities the government performs so that taxpayers get more value for their tax dollar. Progress is measured by aspects, such as how well agencies implement competitive sourcing plans and the amount of cost savings realized.

3. **Improving Financial Performance** involves improving the quality and timeliness of financial information so that it can be used to reduce waste, fraud, and abuse and manage federal programs more effectively. Progress is achieved by meeting various objectives such as maintaining financial systems that meet federal requirements and obtaining favorable audit opinions on financial statements.

4. **Expanding Electronic Government** is designed to make better use of information technology investments to eliminate wasteful federal spending, reduce government's paperwork burden on citizens and businesses, and improve government response time to citizens. Progress is made by implementing government-wide or citizen-focused information technology systems, and developing business cases to support funding for all major system purchases.

5. **Budget and Performance Integration** seeks to link budget decisions to program performance. It gives dollars to programs that work and invokes reform, constraint, or cancellation of programs that do not work. Progress is attained by improving performance plans and results measurement, generation of regular reports that track spending to actual performance and outcome goals.

The Department's progress and current status ratings against the President's management goals in these five key federal management areas are depicted in the chart below. The scorecard employs a simple grading system: green for success, yellow for mixed results, and red for unsatisfactory.

The Department aggressively works each of these five key federal management areas and is making progress in each area. The Department improved its Current Status for Human Capital, Competitive Sourcing, and Budget and Performance Integration from red in fiscal year 2002 to yellow for fiscal year 2003.

The improvement for Human Capital was primarily the result of the Department executing its strategic plan by developing a de-layered, mission focused, and cost-effective organizational structure.

The improvement in the Competitive Sourcing initiative occurred because the Department achieved its goal of competing at least 15% (67,800) of its commercial functions (452,000) with the private sector.

The improvement for Budget and Performance Integration occurred due to the Department's implementation of the Office of Management and Budget's Program Assessment Rating Tool for more than 20% of DoD's programs in the fiscal year 2004 budget. This Tool assigns performance scores to these programs and will eventually be used as a basis for management's funding decisions.

President's Management Agenda Initiative	Current Status	Progress
Strategic Human Capital Management	Yellow	Green
Competitive Sourcing	Yellow	Yellow
Improving Financial Performance	Red	Green
Expanding Electronic Government	Red	Green
Budget and Performance Integration	Yellow	Green