

DEPARTMENT OF THE NAVY

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MESSAGE FROM THE SECRETARY OF THE NAVY





MESSAGE FROM THE ASSISTANT SECRETARY OF THE NAVY
(FINANCIAL MANAGEMENT & COMPTROLLER)



THE ASSISTANT SECRETARY OF THE NAVY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, D.C. 20350-1000

December 2003

I am pleased to present the Department of the Navy's Fiscal Year 2003 Annual Financial Report. This report reflects the Department's continuing commitment to fiscal accountability and proper stewardship of public resources.

Providing Congress and the public with relevant, reliable, and timely financial information, affirmed by favorable audit opinions, remains a priority of the Department of the Navy. A key step toward achieving this goal is the mid-range financial improvement plan. This comprehensive plan identifies interim financial improvements and links those improvements to the Department of Defense transition plan that is in support of the Business Enterprise Architecture. The objective of the Department of the Navy's mid-range plan is to ensure material financial statement line items are auditable so that ultimately a favorable audit opinion will be achieved on the Department of the Navy and Department of Defense-wide financial statements.

Financial information combined with nonfinancial information on program performance enables Congress and public to assess the efficiency and effectiveness of Department of the Navy operations. The Department of the Navy's balanced scorecard for risk management provides a means for this assessment. Developed in coordination with the Department of Defense, the scorecard integrates the objectives of the Fiscal Year 2002 President's Management Agenda with the risk framework delineated in the Fiscal Year 2001 Quadrennial Defense Review Report. The scorecard includes performance measures by which the Department of the Navy can track progress in achieving strategic goals related to the President's Management Agenda initiatives and the four areas of risk in the Quadrennial Defense Review Report — Force Management, Institutional, Operational, and Future Challenges.

The Department of the Navy will build upon its transformational efforts to achieve excellence in business and financial management. This commitment to excellence supports our naval forces, Department of Defense transformation goals, and ultimately, the security of our nation.

Dionel M. Aviles







DEPARTMENT OF THE NAVY

MANAGEMENT'S DISCUSSION AND ANALYSIS



The Department of the Navy (DON) was established on April 30, 1798. The official seal of the Department of the Navy is engraved on the Navy and Marine Memorial. The Navy and Marine Memorial is dedicated to the thousands of Americans who have perished in the sea and to those whose destiny still is linked with our naval and maritime services.

Management's Discussion and Analysis

Managing the Courses of Change: Transformation and Reform in the 21st Century

Introduction

The Navy tradition of continuous forward deployment characterizes the Department's transformation and management reform efforts in Fiscal Year (FY) 2003. A continuous focus on force and support structure transformation has led to significant progress in these two areas. Similarly, the Department's continuous focus on the President's Management Agenda initiatives has yielded noteworthy results. The progress made in transformation and reform while engaged in the Global War on Terrorism and various humanitarian, crisis-response and combat operations signifies the historic strength, endurance, and commitment of the Department of the Navy (DON).

Force Transformation

The Naval Transformation Roadmap is DON's guide for achieving transformational capabilities critical to executing the enduring roles of assurance and deterrence, command of the seas, power projection, and homeland security. Among the transformational capabilities being pursued are those that enhance power projection - namely, Sea Strike. In August 2003, DON deployed the first Expeditionary Strike Group (ESG-1), a Sea Strike achievement. ESG-1 facilitates broad application of Sea Strike capabilities by integrating the complementary striking power of Navy and Marine Corps forces. This integration of the Navy and Marine Corps into the joint force is the keystone of naval transformation.

Modernization of naval forces facilitates force transformation. As part of its modernization efforts, DON signed a block buy contract in August 2003 for construction of a 2003 Virginia class fast attack submarine.

The FY 2004 Department of Defense Appropriations Act included Language and funding to support a five-ship multi-year procurement in FY 2004-2008. Pending Congressional authorization, DON plans to transition the block buy contract to a multi-year procurement in FY 2004.



UNITED STATES NAVY

The Navy shall be organized, trained, and equipped primarily for prompt and sustained combat incident to operations at sea. It is responsible for the preparation of naval forces necessary for the effective prosecution of war except as otherwise assigned and, in accordance with integrated joint mobilization plans, for the peacetime components of the Navy to meet the needs of war.

(Section 5062, Title 10, U.S. Code)

FOUNDED 13 OCTOBER 1775



UNITED STATES MARINE CORPS

The Marine Corps shall be organized, trained, and equipped to provide fleet marine forces of combined arms, together with supporting air components, for service with the fleet in the seizure or defense of advanced naval bases and for the conduct of such land operations as may be essential to the prosecution of a naval campaign.

(Section 5063, Title 10, U.S. Code)

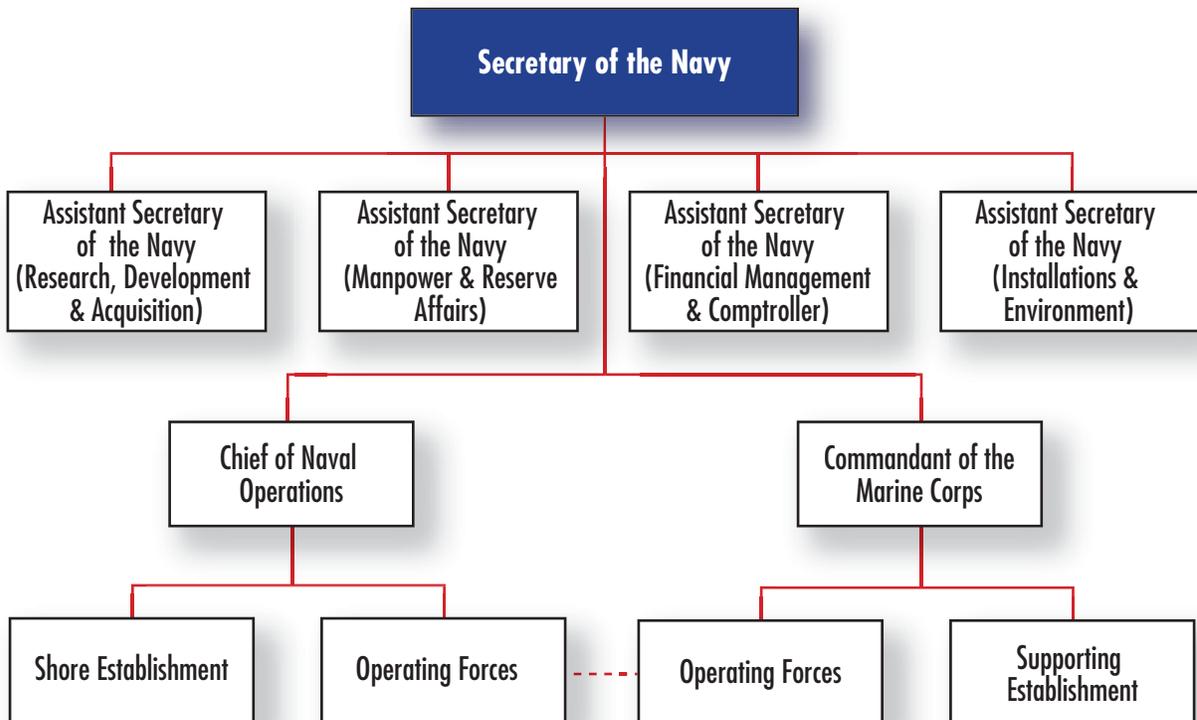
FOUNDED 10 NOVEMBER 1775





Support Structure Transformation

DON's continued focus on support structure transformation has led to several notable achievements in FY 2003. Specifically, DON increased public-private ventures to accelerate improvements to military family housing. DON's accelerated efforts support the Department of Defense (DoD) goal to eliminate inadequate family housing units by FY 2007. Also, the Navy Marine Corps Intranet (NMCI) was successfully installed for the Secretary of the Navy and his staff. This represents a key step in the NMCI program. In addition, DON in support of the DoD transition plan for business modernization and systems integration that is based on the DoD Business Enterprise Architecture developed a financial management improvement plan. The latter represents a key step toward achieving a favorable audit opinion on the FY 2007 DoD-wide financial statements.



Management Reform and Risk Management

DON, in coordination with DoD, developed a balanced scorecard for risk management that integrates the objectives of the FY 2002 President's Management Agenda with the risk framework delineated in the FY 2001 Quadrennial Defense Review Report. DON will track progress in achieving strategic goals related to the President's Management Agenda initiatives (see illustration) and the four areas of risk—Force Management, Institution, Operations, and Future Challenges—by means of performance measures. To the right is an example of the balanced scorecard (excluding scores).

DON developed the strategic goals and performance measures in the balanced scorecard in support of the President's Management Agenda government-wide initiative, Budget and Performance Integration. As part of this initiative and beginning with the FY 2004 budget submission, the Office of Management and Budget assessed and evaluated the effectiveness of selected DoD programs based on these goals and performance measures. Among the DON programs contributing to this selection were the Joint Strike Fighter F/A-18 E/F, Family Housing, and the Navy Marine Corps Intranet. The performance assessment yielded an overall rating of adequate or better in six out of seven DON program areas reviewed.

The following is a discussion of each strategic goal and related performance measure by risk category, as presented in the balanced scorecard extract. While the goals and performance measures primarily relate to Budget and Performance Integration, some also apply to the other President's Management Agenda initiatives. The applicability of each goal and related performance measure to the President's Management Agenda initiatives is also included in the discussion.

President's Management Agenda

Five Government-Wide Initiatives:

- Strategic Management of Human Capital
- Competitive Sourcing
- Improved Financial Performance
- Expanded Electronic Government
- Budget and Performance Integration

Program Initiatives Related to Department of Defense:

- Privatization of Military Housing
- A "Right-Sized" Overseas Presence
- Coordination of Veterans Affairs and Defense Programs and Systems

(A copy of the President's Management Agenda is available at the Office of Management and Budget's website)

RISK CATEGORY	STRATEGIC GOAL	PERFORMANCE MEASURE
Force Management	Ensure Sustainable Military Tempo	Ships Deployed
		Marine Expeditionary Units Deployed
		Active/Reserve Navy/Marine Corps End Strength
	Maintain Reasonable Force Costs	Civilian Manpower Levels
Institution	Streamline Decision Processes, Drive Financial Management and Acquisition Excellence	Number of Navy Marine Corps Intranet Seats
		Implement Enterprise Resource Planning
	Improve Readiness and Quality of Key Facilities	Number of Privatization Projects
Operations	Ensure Force Levels	Battle Force Ships
		Number of Marine Corps Land Forces
	Ensure Force Readiness	Navy/Marine Corps Personnel Readiness Ratings
		Active Steaming Days Per Quarter
Future Challenges	Define and Develop Transformational Capabilities	Implement Enhanced Naval Capabilities to Project Offense, Defense and Sovereignty Around the Globe
		Major Platform Research and Development





Risk Category: Force Management

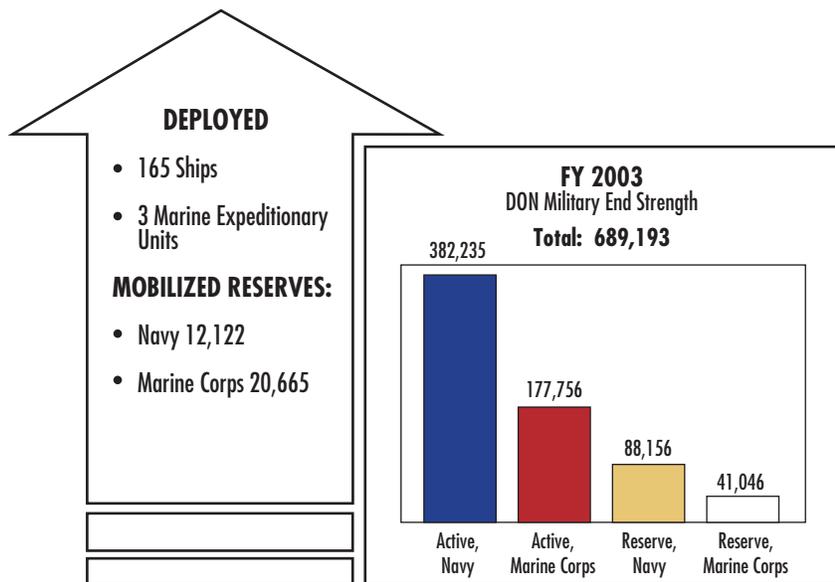
The ability to recruit, retain, train, and equip sufficient numbers of quality personnel and sustain the readiness of the force while accomplishing its many operational tasks.

~ FY 2001 Quadrennial Defense Review Report

Strategic Goal 1: Ensure Sustainable Military Tempo

DON must be able to provide and maintain ready forces necessary to support military operations at any tempo. In FY 2003, operating tempo remained high primarily due to the Global War on Terrorism. However, DON sustained a force structure necessary to meet deployment requirements of the Global War on Terrorism and other military operations. Components of the FY 2003 force structure included ships deployed, Marine Expeditionary Units deployed, and military end strength (Navy and Marine Corps, Active and Reserve). The following is an illustration of these components.

FY 2003 Military Tempo: Measures of Performance



Military Tempo and the President's Management Agenda.

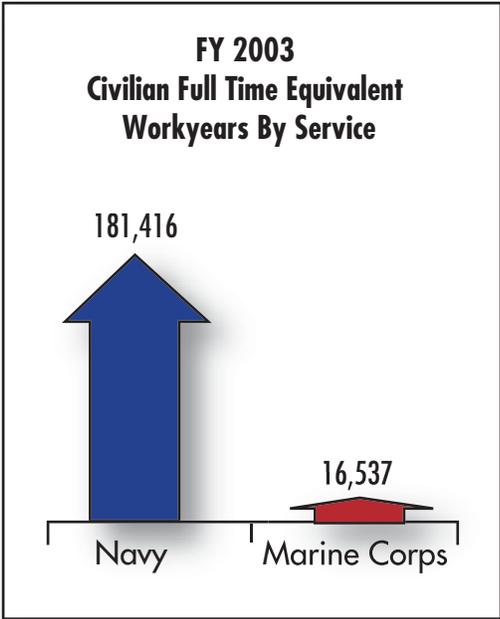
DON's goal to ensure sustainable military tempo supports Strategic Management of Human Capital, and Budget and Performance Integration. One of the expected near-term results of Strategic Management of Human Capital is a high-performing workforce. Sustainable military tempo relies in part on armed forces who are well-trained, competent, and ready to achieve mission objectives - all characteristics of a high-performing workforce. This is also consistent with the expected long-term results of Budget and Performance Integration: better control over resources and accountability.

Strategic Goal 2: Maintain Reasonable Force Costs

DON continues to work at becoming a more efficient organization. Reducing the number of civilian full time equivalent (FTE) workyears (how DON tracks civilian personnel) is one way DON strives to improve operational efficiency. Over the past 13 years, DON has reduced civilian FTE workyears by approximately 44 percent - total FY 1990 civilian FTE workyears were nearly 350,000 compared to 197,953 in FY 2003. Through civilian FTE workyear reductions, DON increases cost-saving opportunities for modernization and recapitalization requirements. (See Chart)

Force Costs and the President's Management Agenda.

DON's goal to maintain reasonable force costs supports Strategic Management of Human Capital, and Budget and Performance Integration. DON civilian FTE workyear reductions promote efficiency and greater effectiveness, which is a goal of Strategic Management of Human Capital, as well as better control over resources and accountability for results, an expected long-term result of Budget and Performance Integration.



Sailors aboard USS Constellation (CV 64) lower the colors for the last time during the ships decommissioning ceremony.





Risk Category: Institution

The ability to develop management practices and controls that use resources efficiently and promote the effective operation of the Defense establishment.

~FY 2001 Quadrennial Defense Review Report

Strategic Goal 1: Streamline Decision Processes, Drive Financial Management and Acquisition Excellence

This strategic goal distills the business transformation initiative underway in the Department of Defense. DON remains committed to business transformation as exemplified by its information technology initiative, the Navy Marine Corps Intranet (NMCI), and its financial management initiative, the Enterprise Resource Planning (ERP) system pilots.

NMCI. In FY 2003, DON continued its phased-in seat management approach for implementing NMCI. Of the 297,213 seats ordered, approximately 109,602 have been cut over. NMCI was installed for the Secretary of the Navy and his staff in August 2003.

ERP. Ongoing in FY 2003 are four DON ERP system pilots:

- SIGMA (Program Management under the DON General Fund and Navy Working Capital Fund);
- CABRILLO (Warfare Center Management under the Navy Working Capital Fund only);
- SMART (Aviation Supply and Maintenance under the DON General Fund and Navy Working Capital Fund); and
- NEMAIS (Regional Ship Maintenance under the DON General Fund and Navy Working Capital Fund).

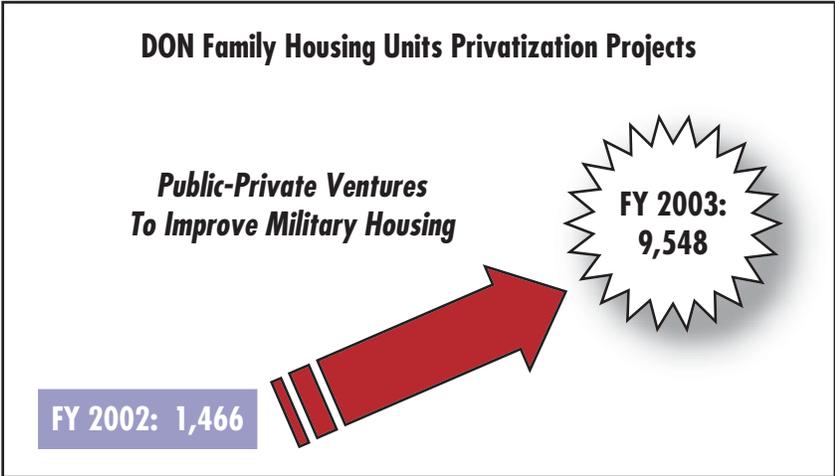


The pilots use commercial off-the-shelf software approved and certified by the Joint Financial Management Improvement Program. DON successfully reached the "go-live" point on all four pilots.

Business Transformation and the President's Management Agenda. DON's goal to streamline decision processes, and drive financial management and acquisition excellence supports Improved Financial Performance, and Budget and Performance Integration. NMCI and ERP extend access to real-time, decision-quality information to all levels of management. Improving the timeliness of information to support operating, budget, and policy decisions is consistent with the Improved Financial Performance, and Budget and Performance Integration initiatives.

Strategic Goal 2: Improve Readiness and Quality of Key Facilities

Among key facilities slated for improvement are housing units for DON military personnel and their families. DON has accelerated progress toward family housing improvements by engaging in public-private ventures (see below). These ventures provide private-sector capital and expertise to build and manage family housing units.



Key Facilities and the President's Management Agenda. DON's goal to improve readiness and quality of key facilities supports Privatization of Military Housing, and Budget and Performance Integration. Increased reliance on public-private partnerships is a goal of Privatization of Military Housing and improves performance of the Family Housing Program, consistent with Budget and Performance Integration.



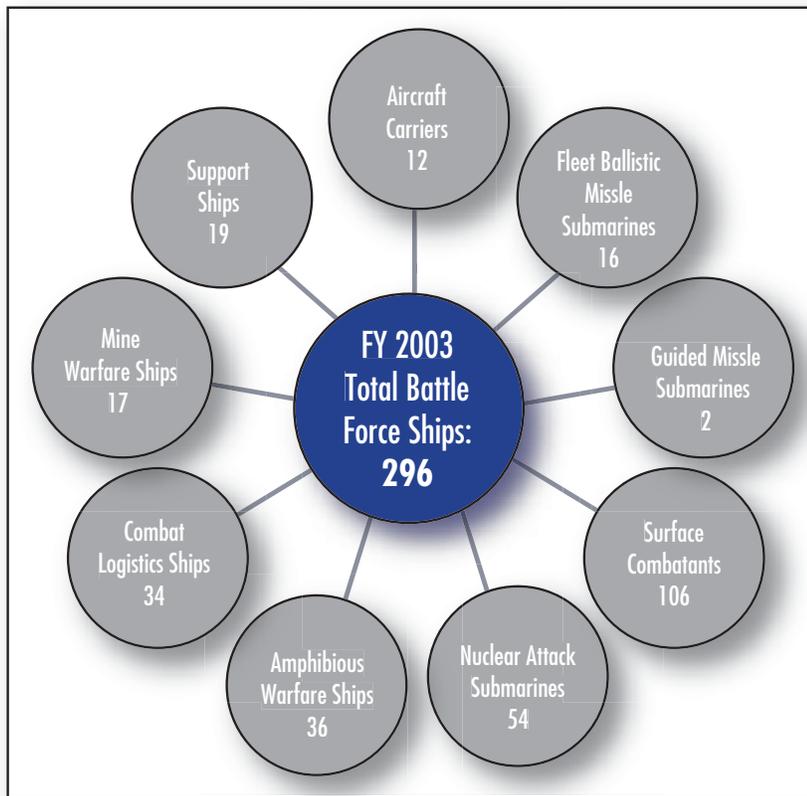
Risk Category: Operations

The ability to achieve military objectives in a near-term conflict or other contingency.

~FY 2001 Quadrennial Defense Review Report

Strategic Goal 1: Ensure Force Levels

Projecting power from the sea is critical to the security of the U.S. and its interests abroad. DON remains focused on the fleets' and Marine Corps' ability to fulfill deployment requirements for U.S. and related international defense missions. Battle force ships and Marine Corps land forces are components of DON's total force structure (see illustrations below).



Force Levels and the President's Management Agenda. DON's goal to ensure force levels supports Strategic Management of Human Capital, and Budget and Performance Integration. One of the expected near-term results of Strategic Management of Human Capital is a high-performing workforce. DON's total force structure relies in part on armed forces who are well-trained, competent, and ready to achieve mission objectives - all characteristics of a high-performing workforce. This is also consistent with the expected long-term results of Budget and Performance Integration: better control over resources and accountability for results.

FY 2003 Marine Corps Land Forces

- Marine Expeditionary Forces: 3
- Marine Expeditionary Brigades: 4
- Battalions: 71

Strategic Goal 2: Ensure Force Readiness

DON armed forces must be fully prepared to meet the demands of the Global War on Terrorism and other operational activities. Measures of force readiness include the number of Navy and Marine Corps personnel on deployment, and active steaming days per quarter (i.e., number of days ships are away from homeport). DON refers to the latter measure as active force operating tempo (OPTEMPO). DON has established 54 days and 28 days as OPTEMPO goals for deployed and non-deployed forces, respectively. Non-deployed OPTEMPO levels comprise training of fleet units; however, fleet units must be combat ready and rapidly deployable. In FY 2003, DON exceeded both OPTEMPO goals.

Force Readiness and the President's Management Agenda.

DON's goal to ensure force readiness supports Strategic Management of Human Capital, and Budget and Performance Integration. One of the expected near-term results of Strategic Management of Human Capital is a high-performing workforce. Force readiness relies in part on armed forces who are well-trained, competent, and ready to achieve mission objectives - all characteristics of a high-performing workforce. This is also consistent with the expected long-term results of Budget and Performance Integration: better control over resources and accountability for results.

**FY 2003
DON Force Readiness**

**Military Personnel Deployed:
38,655**

(as of September 4, 2003)

OPTEMPO Goals Exceeded:

- 67.3 Days Deployed





Risk Category: Future Challenges

The ability to invest in new capabilities and develop new operational concepts needed to dissuade or defeat mid- to long- term military challenges.

~FY 2001 Quadrennial Defense Review Report

Strategic Goal: Define and Develop Transformational Capabilities

DON remains focused on defining and developing transformational capabilities. Inherent to this goal is the integration of the Navy - Marine Corps Team into the joint force, part of the Naval Power 21 vision. To realize this integration, DON deployed the first Expeditionary Strike Group (ESG-1) in late August 2003. ESG-1 is a new combination of operational assets, leveraging the robust capabilities of the Peleliu Amphibious Ready Group and the 13th Marine Expeditionary Unit (Special Operations Capable). Together, the Amphibious Ready Group and Marine Expeditionary Unit become a more flexible, powerful unit, capable of projecting power from the sea over the land. This power projection is critical to countering emergent threats and strategies that seek to compromise the security of the U.S. and its interests worldwide.

"TOP 3" Platforms	Description	FY 2003 (in Millions)
Joint Strike Fighter (JSF)	JSF is a family of aircraft that meets the needs of the U.S. Navy, U.S. Marine Corps, U.S. Air Force, and allies. (Procurement of the U.S. Marine Corps and U.S. Navy JSF variants expected to begin in FYs 2006 and 2008, respectively.)	\$1,663
DD(X)	DD(X) is a family of advanced multi-mission warships capable of long-range firepower in support of forces ashore. (Construction of lead ship expected in FY 2005.)	\$ 570
C4I	Command, Control, Communication, Computers and Intelligence (C4I) programs enhance combat capability of U.S. Naval forces. Among the C4I concepts is Information Technology for the 21st Century (IT-21), which supports C4I system linkages afloat, ashore, and to the Internet. These linkages ensure that accurate and relevant information can be gathered swiftly and transmitted securely to forces and their commanders.	\$ 594

Research and Development (R&D) is a key component in developing transformational capabilities. DON continues funding for several R&D platform efforts in FY 2003. The top three platforms (in terms of FY 2003 funding under Research, Development, Test and Evaluation, Navy) are the Joint Strike Fighter, DD(X), and C4I (see chart).

Transformational Capabilities and the President's Management Agenda.

DON's goal to define and develop transformational capabilities supports Budget and Performance Integration. Continued investment of time and funds to transform the DON force structure promotes better control of resources and accountability for results, an expected long-term result of Budget and Performance Integration.

Management Integrity

As required by implementing guidance from the Office of Management and Budget and DoD, under the Federal Managers' Financial Integrity Act of 1982, DON must evaluate its system of internal accounting and administrative controls (i.e., management controls) on an annual basis. The objective of this evaluation is to determine whether reasonable assurance exists that:

- obligations and costs are in compliance with applicable laws;
- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
- revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of reliable accounting, financial, and statistical reports and to maintain accountability over the assets.

For FY 2003, DON issued a "qualified" Statement of Assurance, citing existing (no new) material weaknesses in its management controls. With the exception of these weaknesses, DON's system of internal accounting and administrative controls in effect during the 12-month period ending June 30, 2003, taken as a whole, provides reasonable assurance that it can execute its mission effectively and protect its critical assets. The basis for reasonable assurance includes an established control environment, continued emphasis on risk assessment, specific control activities, continuous communication and flow of information, and monitoring performed by both command management and the audit /investigative /inspection community. Additionally, recent military actions (e.g., Operation Iraqi Freedom) confirm the strength of DON's management controls, as it effectively executes its missions.





Reporting Results

For financial reporting purposes, DON is organized into two reporting entities: the DON General Fund and the Navy Working Capital Fund. Below is a discussion of each reporting entity.

General Fund

The DON General Fund (GF) supports overall Department operations. Direct appropriations from Congress replenish the GF. Included among the various GF appropriations are Operation and Maintenance; Military Personnel; Family Housing; Procurement; Military Construction; and Research, Development, Test, and Evaluation.

Fiscal Year 2003 Overview

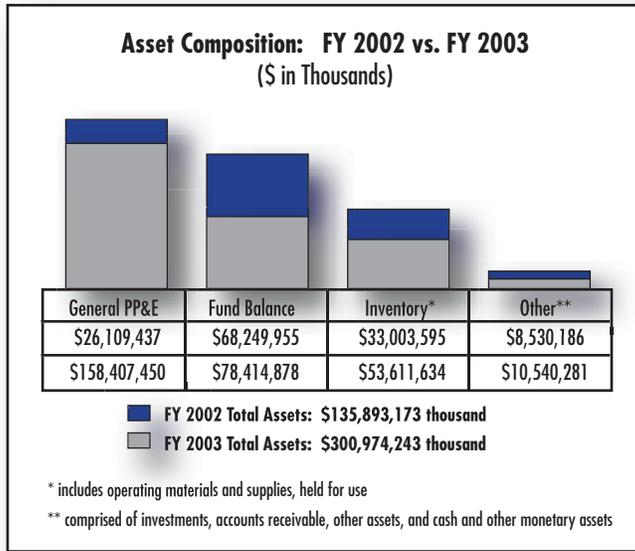
Asset Composition

FY 2003 marked a shift in GF asset composition with general property, plant, and equipment (PP&E) replacing Fund Balance with Treasury as the largest component of total GF assets (see chart). General PP&E accounted for 53 percent of total GF assets in FY 2003 while Fund Balance with Treasury accounted for 26 percent of total GF assets. This shift was the direct result of DON's implementation of the Federal Accounting Standards Advisory Board's (FASAB's) new accounting standard — Statement of Federal Financial Accounting Standard Number 23, "Eliminating the Category National Defense Property, Plant and Equipment" (issued in May 2003). Pursuant to this new accounting standard, DON reported military equipment as part of General PP&E in FY 2003. The net book value (i.e., acquisition value less accumulated depreciation) of military equipment was \$133 billion (see "Valuation of Military Equipment").

Implementation of the new accounting standard also affected operating materials and supplies (OM&S) in FY 2003. Previously expensed, tactical missiles and torpedoes were classified as OM&S, held for use. DON reported a value of \$23 billion for tactical missiles and torpedoes in FY 2003, contributing to an 83 percent increase in OM&S, held for use.

Valuation of Military Equipment. *Revisions to DoD's accounting processes and systems (under the Business Enterprise Architecture initiative) preclude DoD and DON from accumulating the information necessary to value and report military equipment in accordance with generally accepted accounting principles, as required by FASAB's Statement of Federal Financial Accounting Standards Number 23. In the interim, DoD and DON will base the value of military equipment for financial statement presentation purposes on data provided by the Bureau of Economic Analysis, Department of Commerce.*

(For more details, see Note 10 in General Fund Notes to the Principal Statements.)



Liability Composition

Liability composition remained relatively constant between FY 2002 and FY 2003 (see chart). Environmental liabilities comprised 57 percent of total DON liabilities in FYs 2002 and 2003, with the vast majority of environmental liabilities classified as noncurrent (i.e., not payable within the current year of operations). Of the noncurrent environmental liabilities, over 70 percent were attributable to nuclear powered aircraft carriers and nuclear powered submarines. The noncurrent liability for nuclear powered aircraft carriers increased by 14 percent in FY 2003 due to the addition of the Ronald Reagan aircraft carrier and an adjustment for inflation. The noncurrent liability for nuclear powered submarines remained unchanged in FY 2003. Additional changes to environmental liabilities in FY 2003 included an 11 percent decrease for accrued environmental restoration at active installations. This decrease was a result of adjusted predictions using more conservative estimates that approximate the expected rate of execution.

