A MESSAGE FROM THE SECRETARY OF THE TREASURY

I am pleased to present the fiscal year 2003 *Financial Report of the United States Government*, which presents and discusses the Government's financial operations for the year. The report includes consolidated financial statements and important disclosures about the government's stewardship responsibilities. Since the first report pursuant to the Government Management Reform Act of 1994 was issued for fiscal year 1997, we have made great strides in improving the usefulness of this important report.

For fiscal 2003, the U.S. Government is reporting a net operating cost of $665 billion, an increase of $300 billion from the $365 billion net operating cost reported last year. The increase is primarily attributable to the increased cost of the global war on terrorism, increases in the government's post-retirement liabilities and a decline in tax revenues caused by the sluggish economy. The report reflects the adoption of a new accounting standard this year which requires the recording as an asset of military equipment and its related depreciation resulting in an increase to assets of $383 billion.

Twenty seven major departments and agencies received unqualified audit opinions on their FY 2003 financial statements and eight Departments issued their audited financial statements by mid-November, a significant increase from last year. When this accelerated reporting time frame is accomplished by all agencies, it will set the stage for the timely preparation of this report. I look forward to when we can issue the Financial Report in December so that it is available to support the budget deliberation process.

While much has been accomplished, much more remains to be done. Our efforts are well underway to eliminate the significant weaknesses cited by the auditors concerning the report's data and processes. It will require a concerted effort across government to resolve these matters and, working with OMB and through the President's Management Council and the Chief Financial Officer's Council, Treasury believes we will succeed.

The government's finances are important and complex, and our reporting will not be truly effective until it provides reliable information in a timely and useful form. Treasury is committed to meeting that challenge and to producing and reporting financial information that meets the highest standards expected by the American public.

John W. Snow

MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The quality and timeliness of financial reporting in the Federal Government has come a long way since the first Governmentwide report subject to audit issued in March 1998 for fiscal year 1997. At that time, only 8 of the 24 Chief Financial Officers Act (CFO Act) agencies received clean opinions on their 1997 financial statements. This year, 20 of the 24 agencies received clean opinions and 21 of the 32 entities, most significant to these statements, had audited financial statements issued by the end of the calendar year. This improvement in both quality and timeliness was concurrent with the application of new accounting principles and new accounting systems, and involved performing reconciliations that had never been attempted before. This has been a monumental effort requiring years of planning and preparation and the efforts of thousands. However, we still have much to accomplish before we meet our objective of timely, useful financial reporting.

The accompanying *2003 Financial Report of the United States Government* is required by 31 U.S.C. § 331(e)(1) to be submitted to Congress by March 31, and consists of Management's Discussion and Analysis (MD&A), Statements of Net Cost, Statements of Operations and Changes in Net Position, Reconciliations of Net Operating Cost and Unified Budget Deficit, Statements of Changes in Cash Balance from Unified Budget and Other Activities, Balance Sheets, Stewardship Information (Unaudited), Notes to the Financial Statements, and Supplemental Information (Unaudited). Each section is preceded by a description of its contents.

Executive Summary

Purpose

This *Financial Report of the United States Government* is prepared to give the President, Congress, and the American people information about the financial position of the Federal Government. This report provides, on an accrual basis of accounting, a broad, comprehensive view of the Federal Government's finances that is not available elsewhere. It states the Government's financial position and condition, its revenues and costs, assets and liabilities, and other obligations and commitments. It also discusses important financial issues and significant conditions that may affect future operations.

Operating Results

Revenues were down by $81.7 billion primarily due to lower tax collections and costs were up by $225.8 billion due to, among other things, fighting the global war on terrorism. This resulted in a net operating cost of $665.0 billion. This compares with the net operating cost of $364.9 billion for fiscal year 2002. This MD&A discusses results in a historical context and includes a chart (page 17) that shows the relationship of prior U.S. budget deficits as a percentage of the U.S. gross domestic product (GDP), which is the total value of goods and services produced in the United States.

Economic Results

After recovering in fiscal year 2002 from the economic downturn, the economy continued to accelerate in fiscal year 2003 and achieved strong growth. The rate of increase in real GDP picked up in each of the last three quarters of the fiscal year and productivity continued to record substantial gains. The labor market stabilized in fiscal year 2003 following job losses in the previous year and in the final quarter of the fiscal year, employment began to increase. Improvement in the economy was aided by new fiscal policies in 2003, but the lingering effect of the recession and loss in equity wealth, the war with Iraq, homeland security spending, and lower taxes enacted to stimulate growth contributed to a widening in the Federal budget deficit to $374.8 billion for the fiscal year.

Overall Perspective

The 2003 balance sheet shows assets of $1,394 billion and liabilities of $8,499 billion, for a balance or negative net position of $7,105 billion. The Government's responsibilities to make future payments for social insurance and certain other programs are not shown as liabilities according to Federal accounting standards; however, they are measured in other contexts. These programmatic commitments remain Federal responsibilities and as currently structured will have a significant claim on budgetary resources in the future.

As summarized below, and in a more detailed table on page 12 of this section, the net present value for all of the responsibilities (over a 75-year period) is $34,825 billion, including Medicare and Social Security payments, pensions and benefits for Federal employees and veterans, and other financial responsibilities. The reader needs to understand these responsibilities to get a full understanding of the Government's finances.

Overall Perspective (In billions of dollars)	2003 Balance Sheet	2003 Additional Responsibilities	2003 Combined Amounts	2002 Balance Sheet	2002 Additional Responsibilities	2002 Combined Amounts
ASSETS	$ 1,394	$ -	$ 1,394	$ 997	$ 616[1]	$ 1,613
LIABILITIES & NET RESPONSIBILITIES						
Social Insurance	--	(26,858)	(26,858)	--	(24,149)	(24,149)
Fed. empl. & veterans pensions/benefits	(3,880)	--	(3,880)	(3,589)	--	(3,589)
Federal debt held by the public	(3,945)	--	(3,945)	(3,573)	--	(3,573)
Other liabilities & responsibilities	(674)	(862)	(1,536)	(654)	(771)	(1,425)
Total Liabilities & Net Responsibilities	$ (8,499)	$ (27,720)	$ (36,219)	$ (7,817)	$ (24,920)	$ (32,736)
BALANCE (Total Assets minus Total Liabilities & Net Responsibilities)	($7,105)	($27,720)	($34,825)	($6,820)	($24,304)	($31,123)

[1] Source: Fiscal Year 2004 Analytical Perspectives, page 37, Defense Fixed Reproducible Capital, Nonfinancial Assets.

Note: Overall details may not add to total due to rounding.

The table does not reflect the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 that was enacted on December 8, 2003. The Department of Health and Human Services (HHS) actuaries estimated that this legislation would result in direct spending outlays totaling $534 billion over the 2004-2013 period. The 75-year period net present value estimate is not yet available.

Significant Reporting Items for Fiscal Year 2003

Department of Defense Property Addition

In fiscal year 2003, the Department of Defense's (DOD) reported general property, plant, and equipment, net increased by $323.7 billion or 264.2 percent over fiscal year 2002. The majority of this increase was due to the initial recording of the value of DOD's military equipment.

Beginning with the fiscal year 2003 financial statements, DOD was required to record on the balance sheet the value of its military equipment under the new Statement of Federal Financial Accounting Standard No. 23, *Eliminating the Category National Defense Property, Plant, and Equipment* (SFFAS No. 23) issued by the Federal Accounting Standards Advisory Board (FASAB) in May 2003. SFFAS No. 23 establishes generally accepted accounting principles for valuing and reporting military equipment in Federal financial statements. Previously, military equipment was reported as national defense property, plant, and equipment in the Stewardship Information section of this report. For a detailed discussion of this increase, see the Assets section of the Asset and Liability Summary of this report.

Creation of the Department of Homeland Security

On March 1, 2003, more than 20 entities and offices and some 180,000 employees were transferred into the Department of Homeland Security (DHS). The creation of the DHS in 2003 was the most significant transformation of the Federal Government since 1947 when the various branches of the U.S. Armed Forces were merged into a new Department of Defense.

In the aftermath of the September 11, 2001, terrorist attacks, the President and the Congress recognized the need to coordinate the efforts of many Federal agencies, offices, and programs which had responsibility for various aspects of protecting and securing our homeland. President Bush proposed the creation of DHS, and Congress passed legislation establishing this new department. See the U.S. Government Structure & Performance section of this report for further details and a chart showing the entities transferred into DHS.

Iraq Operations

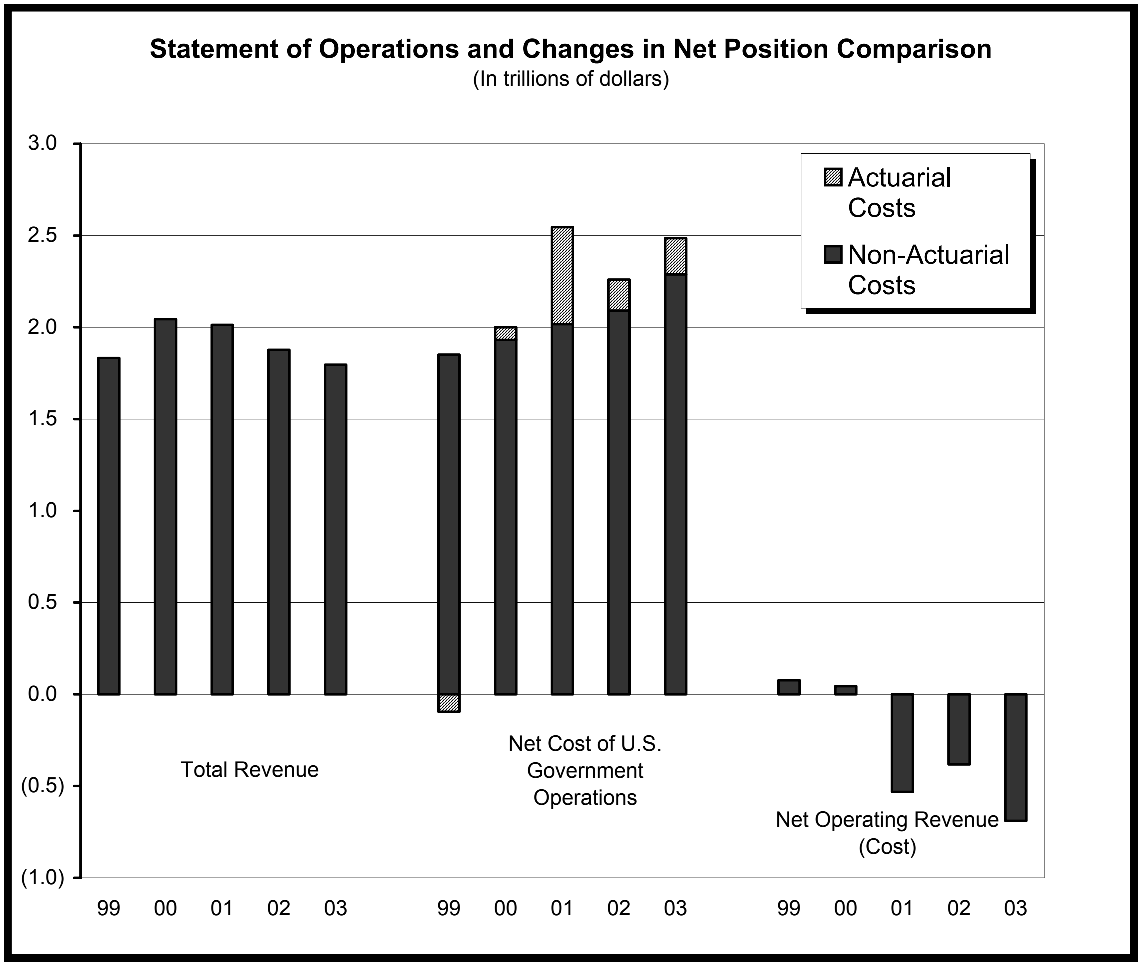
In March 2003, an international coalition led by the United States liberated Iraq and is overseeing a transformation. The vision for a sovereign, stable, prosperous, and democratic Iraq centered on four goals: establishing a secure environment, restoring essential services, promoting economic growth, and developing good governance through a legitimate constitutional government. To conduct military operations and address these goals in 2003, several sources of funding were used: appropriated and nonappropriated funds (seized and vested assets and the Development Fund for Iraq). U.S. agencies obligated $3.9 billion in appropriated funds for Iraq relief, renewal, and construction. Congress also appropriated funds to DOD for Operation Iraqi Freedom in the Emergency Wartime Supplemental Appropriations Act, 2003 (Public Law 108-11) the Consolidated Appropriations Resolution, 2003 (Public Law 108-7). DOD obligated $42.4 billion for incremental costs in support of Iraqi Freedom. For further discussion of the cost of Iraq operations and funding sources and uses, see Iraq Operations in the Financial Results section at the end of the Revenue and Cost Summary.

Debt Ceiling

On February 20, 2003, Treasury's outstanding debt reached the statutory limit of $6,400 billion. This requires Treasury to change its normal borrowing operations to stay within the limit. When this occurs, numerous statutory tools are used which allow the Government to manage without issuing new debt and to continue operations for short time periods. On May 27, 2003, President Bush signed legislation increasing the statutory debt limit to $7,384 billion (P.L. 108-24). For further discussion of the debt ceiling, see the Federal Budget and Federal Debt section of the MD&A.

Financial Results

Revenue and Cost Summary

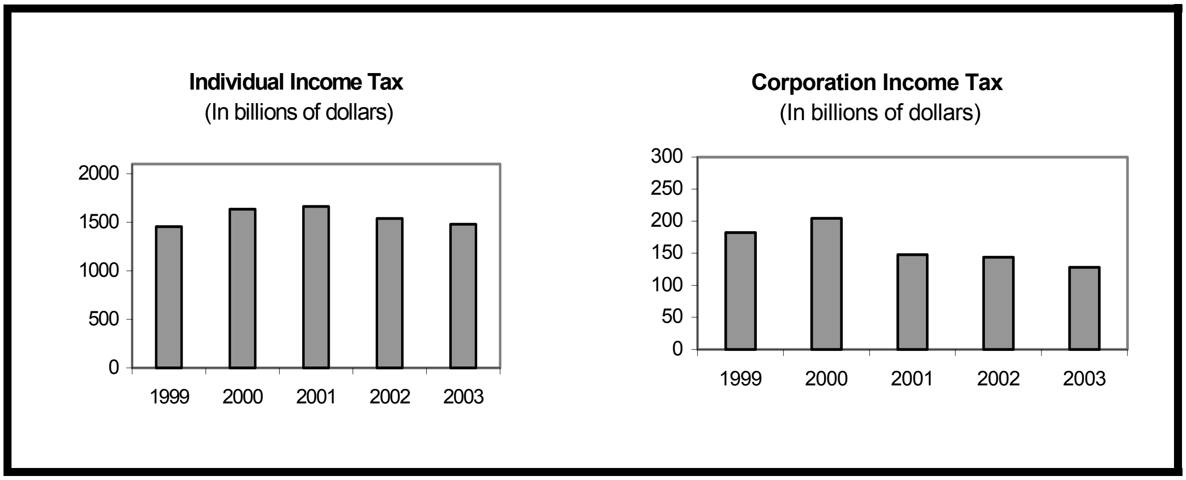


Accrual-Based Results

The financial statements (pages 58-62) present information about the financial position of the Federal Government, the net costs of its operations, and the financing sources used to fund its operations. The information in these statements gives a comprehensive view of the Government's finances. The information is reported generally on the accrual basis of accounting in which costs are recorded when a liability is incurred. This differs from the primarily cash basis used in calculating the budget results, in which outlays are recorded when bills are actually paid. See Note 1B (Basis of Accounting and Revenue Recognition) of this *Financial Report* for a discussion of how revenues are recorded.

The net operating cost as shown in these financial statements for fiscal year 2003 was $665.0 billion, compared to a budget deficit of $374.8 billion. The primary component of the difference between the budget and accrual reported results is the recognition of the year's actuarial expense for pension and health liabilities for civilian and military employees and veteran's compensation of $290.6 billion. This difference is similar to fiscal year 2002 which had a net operating cost of $364.9 billion and a budget deficit of $157.7 billion. For a detailed reconciliation between the two numbers, see the Reconciliations of Net Operating Cost and Unified Budget Deficit in the Financial Statements section.

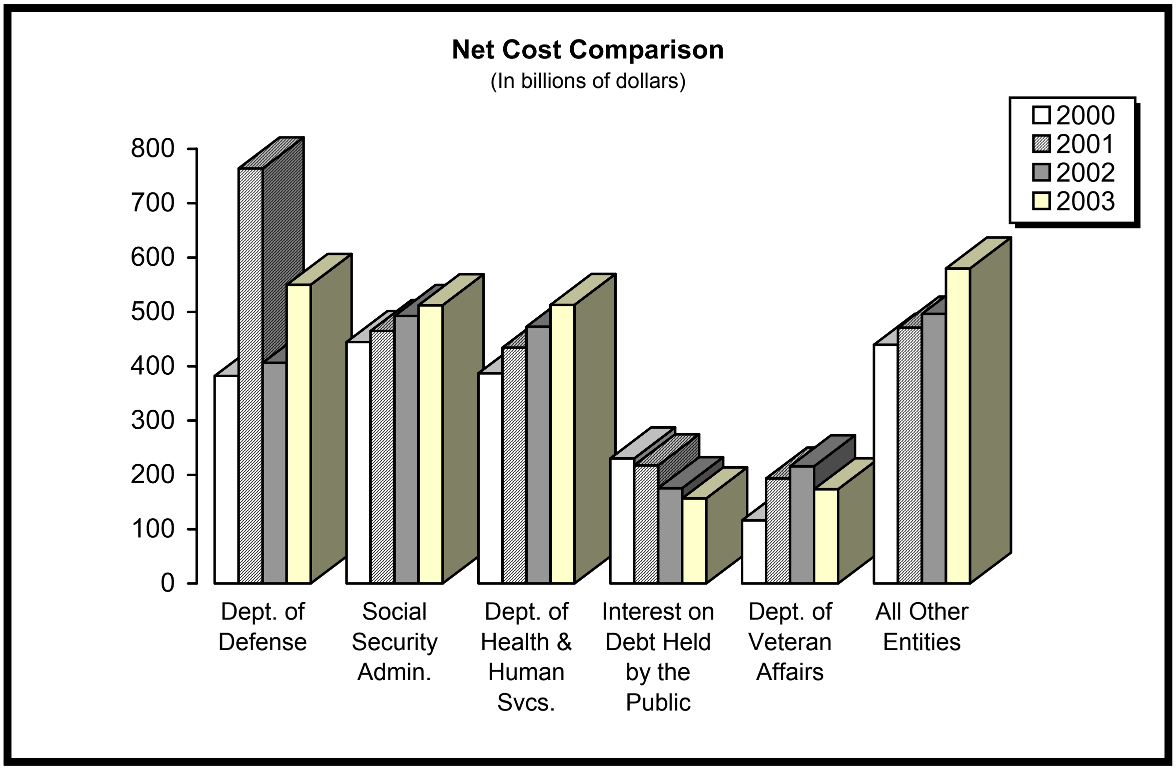
Because the Government traditionally has been viewed from a budget perspective, and because many of the terms used to describe financial events have different meanings when describing budget outcomes, a conscious effort has been made to refer to budget-based amounts by using the term “budget” in order to eliminate any possible confusion. Net operating revenue (cost) is the term used to represent accrual-based operating results and equates to revenue less net cost of Government operations.



The Government’s main source of revenue comes from its ability to demand payments from the public (e.g., taxes, duties, fines, and penalties). As shown in the chart above, the Government’s principal source of revenue is individual income tax. In 2003, this revenue category was $1,481.3 billion, representing 82.5 percent of total revenue. This compares to $1,538.6 billion in 2002, a decrease of $57.3 billion or 3.7 percent from 2002. Since fiscal year 2000, when they were 10.0 percent of total revenue, corporate income taxes have fallen until they are 7.1 percent of total revenue in fiscal year 2003.

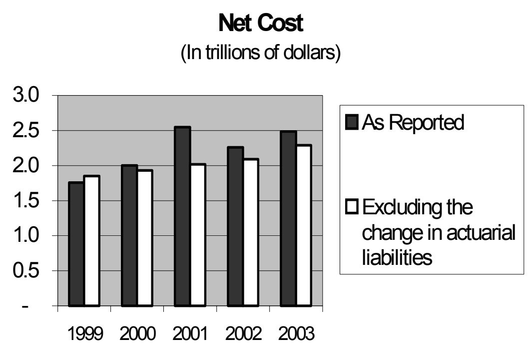
In 2003, total revenue was $1,796.0 billion. This amount compares to $1,877.7 billion in 2002, a decrease of $81.7 billion or a decline of 4.4 percent. Revenue has declined primarily due to a drop in individual income tax and tax withholdings and can be attributed to a variety of factors, including an economy recovering slowly from a recession, recently enacted tax cuts, and a decline in capital gains realizations.

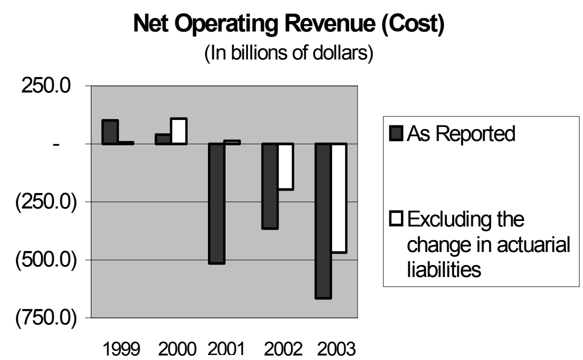
In addition to revenue from its ability to tax, the Government’s other source of revenue comes from providing goods and services to the public for a price. This type of revenue is called “earned” revenue because it results from the exchange of transactions. Examples of earned revenue include the postage and mailing fees paid to the U.S. Postal Service and Medicare Part B premiums collected by HHS (these premiums do not comprise the majority of Medicare Part B’s funding). This revenue is used to pay for or *offset* the costs of administering these programs or services and is included in the calculation of net cost on the Statements of Net Cost. In fiscal year 2003, the Government earned $164.8 billion from this type of revenue. This amount compares to $156.6 billion in fiscal year 2002, an increase of $8.2 billion or 5.2 percent.



The above chart compares significant elements of net cost by fiscal year. The largest charge was DOD's fiscal year 2003 cost increase of $143.4 billion, or 35.3 percent. This increase was primarily incurred due to fighting the global war on terrorism and an increase in DOD's military post retirement costs. DOD's military post retirement costs increased mainly due to an increase in its actuarial liabilities. DOD's cost in 2003 was also affected by the adoption of SFFAS No. 23 which required, for the first time, capitalizing military equipment and recording depreciation expense. The significant decrease in DOD cost from fiscal year 2001 to 2002 is the result of the initial non-recurring effect of the extension of $293.0 billion in medical benefits to retired personnel and another $91.3 billion in other actuarial assumption changes in 2001.

The social insurance costs at the Social Security Administration (SSA) and HHS continued their consistent upward trend during fiscal year 2003. From fiscal year 2002 to 2003, the net costs of SSA and HHS increased by 4.0 percent and 8.5 percent, respectively. The interest on debt held by the public continued to decrease during fiscal year 2003. Even while the debt principal increased again, the interest on the debt decreased by $18.6 billion, or 10.6 percent, due to the lower interest rates that continued to prevail in fiscal year 2003. The fiscal year 2003 $42.2 billion, or 19.6 percent, decrease in costs for the Department of Veterans Affairs (VA) shows the significant impact of changes in the actuarial calculation of the liability for future years' veterans' compensation and burial benefits on the Department's total cost (see further discussion in the Liabilities section of the MD&A).





The charts above show that over the past 5 fiscal years, significant costs associated with certain employee benefit liabilities have had a major impact on the Government's cost of operations. These incremental costs are the result of changes in interest rates and other actuarial assumptions. Also shown is that, absent these adjustments, all other costs are steadily trending upward and the net operating revenue (cost) has fluctuated from break-even in fiscal year 1999 to a net operating cost of $468.4 billion in fiscal year 2003. Actuarial liabilities include Federal employee and veteran benefits payable and are discussed in Note 11 of the Notes to the Financial Statements section.

Iraq Operations

Iraq Relief & Reconstruction

In March 2003, an international coalition led by the United States liberated Iraq and is overseeing a transformation. The vision for a sovereign, stable, prosperous, and democratic Iraq centered on four goals: establishing a secure environment, restoring essential services, promoting economic growth, and developing good governance through a legitimate constitutional government. Total funds of $9.5 billion were available in 2003 for Iraq relief and reconstruction efforts overseen by the Coalition Provisional Authority. This includes both appropriated and nonappropriated funds (seized and vested assets and the Development Fund for Iraq). Of this amount, approximately $7.6 billion was allocated or committed.

Appropriated Resources—In 2003, $4.5 billion in congressionally appropriated resources were used for Iraq relief, renewal, and reconstruction. Of this amount, about $3.9 billion was obligated in fiscal year 2003; this includes $1.1 billion in funds obligated by DOD for oil infrastructure and Coalition Provisional Authority administrative expenses.

Operation Iraqi Freedom

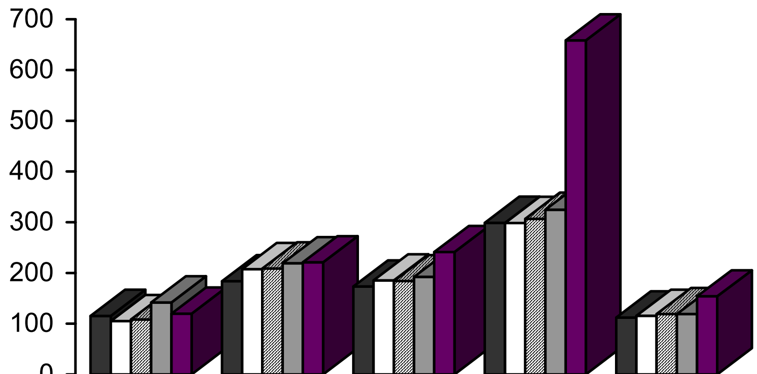
In the Emergency Wartime Supplemental Appropriations Act, 2003 (Public Law 108-11) the Consolidated Appropriations Resolution, 2003 (Public Law 108-7), Congress appropriated funds to DOD for Operation Iraqi Freedom. DOD obligated $42 billion for incremental costs in support of Operation Iraqi Freedom: $10 billion was spent for personnel pay and personnel support costs; and $6 billion was spent to transport personnel, equipment, and materials. The remaining $26 billion was spent for military operations, including the incremental costs for feeding and housing the troops, fuel for combat vehicles, logistics support, other military necessities, and Coalition Provisional Authority operating expenses.

Asset and Liability Summary

Assets

The assets of the U.S. Government are the tangible resources available to pay liabilities or to satisfy future service needs. The accompanying chart depicts a 5-year comparison of the major categories of reported assets as of September 30, for fiscal years 1999 through 2003.

Assets - Key Items Comparison
(In billions of dollars)



	Cash and Other Monetary	Loans Receivable, Net	Inventories and Related Property, Net	Property, Plant and Equipment,	All Other Assets
1999	115.2	183.7	173.3	298.8	112.0
2000	104.9	207.6	185.2	298.5	115.3
2001	108.0	208.9	183.8	306.7	118.7
2002	141.6	219.2	192.2	324.7	118.8
2003	119.6	221.1	241.2	658.2	153.8

Looking at the chart above, fiscal year 2003 property, plant, and equipment exceeded all other asset category increases. This increase mainly was due to a change in the way that DOD reports its military equipment.

In May 2003, the FASAB issued SFFAS No. 23 which became effective for accounting periods beginning after September 30, 2002. SFFAS No. 23 establishes generally accepted accounting principles (GAAP) for valuing and reporting military equipment in Federal financial statements. That is, it requires the capitalization and depreciation of the cost of military equipment, including the cost of modifications and upgrades. Previously, military equipment was expensed when acquired and reported as national defense property, plant, and equipment in the Stewardship Information section of this report.

In fiscal year 2003, the DOD equipment component increased by $324.6 billion. Most of this increase was due to the inclusion of $325.1 billion in military equipment on DOD's balance sheet. The $325.1 billion net book value is the result of an estimated total acquisition cost of military equipment of $1,123.5 billion with accumulated depreciation of $798.4 billion. This change also resulted in a change in accounting principle ($383.1 billion) reported on the Statements of Operations and Changes in Net Position and Note 17 of this report.

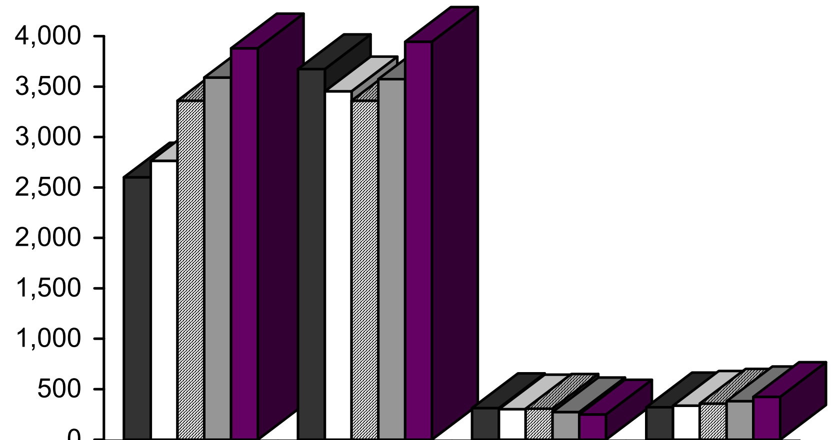
DOD has determined that it is not yet possible to accumulate the information necessary to value its military equipment for financial statement presentation using its own financial systems. Instead, DOD based the value of its military equipment on data provided by the Bureau of Economic Analysis, Department of Commerce. DOD is working to revise its accounting processes and systems to provide this information in the future. (See DOD's individual financial statements for further details).

Liabilities

This chart presents a 5-year comparison of the major components of liabilities reported on the balance sheets as of September 30, for fiscal years 1999 through 2003. At the end of fiscal year 2003, the U.S. Government reported liabilities of $8,498.6 billion, as compared to $7,816.7 billion for September 30, 2002, an 8.7 percent increase.

Liabilities - Key Items Comparison

(In billions of dollars)



	Federal Employee and Veteran Benefits Payable	Federal Debt Securities Held by the Public and Accrued	Environmental and Disposal Liabilities	All Other Liabilities
1999	2,600.7	3,674.2	313.2	321.1
2000	2,764.7	3,454.2	301.2	336.8
2001	3,360.8	3,359.3	306.8	358.0
2002	3,589.4	3,573.2	273.0	381.1
2003	3,880.0	3,944.9	249.9	423.8

In fiscal year 2003, Federal debt securities held by the public and accrued interest increased 10.4 percent so it is, once again, the largest liability on the balance sheet at $3,944.9 billon. This is a $371.7 billion increase over the balance at the end of fiscal year 2002. Both fiscal years' 2003 and 2002 increase in debt held by the public primarily is due to total Federal spending exceeding total Federal revenues.

The next largest liability, $3,880.0 billion, is Federal employee and veteran benefits payable (which was the largest for fiscal year 2002), which consists of pension, disability, and retiree health care costs for Federal civilian and military employees, as well as for veterans. This liability also increased in fiscal year 2003 by $290.6 billion or 8.1 percent. The largest component of this liability is for civilian and military pensions which, with a combined balance of $1,929.4 billion, increased 3.7 percent in fiscal year 2003. The next largest piece of this liability, $954.8 billion for veterans' compensation and burial benefits, increased $105.6 billion or 12.4 percent, due to a large increase in the average size and number of veteran compensation beneficiaries resulting from Agent Orange cases and an increase in the assumed average benefit payment. The civilian and military retiree health benefits component, $927.4 billion, has more than doubled since fiscal year 2000. The military retiree health component has increased threefold since fiscal year 2000, primarily due to a law passed in 2001 that extended new health benefits to military retirees effective in 2002. See Note 11 in the Notes to the Financial Statements section for a more detailed explanation of this liability.

Another liability is related to environmental cleanup costs associated with environmental damage and contamination. As of September 30, 2003, the recognized cost of cleaning up environmental damage and contamination across Government programs was estimated to be $249.9 billion, a decrease of $23.1 billion or 8.5 percent from September 30, 2002. The most significant component of this reduction relates to the Department of Energy (Energy). Energy has reduced its environmental liability by $26.3 billion or 12.5 percent in fiscal year 2003; this is the second year in a row that Energy's environmental liability decreased. The decrease in 2003 primarily was due to restructuring the cleanup program to focus on its core mission and accelerating cleanup.

Additional Responsibilities

Historically, the Government's financial situation has been evaluated primarily from a cash-based budgeting perspective that measures the flow of funds in and out of Government accounts. As a first step in examining our financial position, we are presenting a condensed perspective based on forward-looking accrual principles. This perspective is meant to complement the cash-based budget estimates of future spending and receipts.

In addition to accrual-based results, the overall perspective depicted below includes many responsibilities disclosed throughout this report but not captured by accrual-based operating results or liability balances. An attempt is made here to go beyond the balance sheet to also examine the impact of these other responsibilities.

Overall Perspective

The schedule below reveals a more complete picture of the Government's financial responsibilities—its liabilities and responsibilities on the balance sheet as well as its responsibilities that are tracked off the balance sheet.

Overall Perspective
(In billions of dollars)

	2003			2002		
	Balance Sheet	Additional Responsibilities	Combined Amounts	Balance Sheet	Additional Responsibilities	Combined Amounts
ASSETS						
Inventory, cash	$ 361	$ -	$ 361	$ 334	$ -	$ 334
Property, plant & equipment	658	-	658	325	[1] 616	941
Loans receivable	221	-	221	219	-	219
Other	154	-	154	119	-	119
Total Assets	$ 1,394	$ -	$ 1,394	$ 997	$ 616	$ 1,613
LIABILITIES & NET RESPONSIBILITIES						
Social Insurance						
Medicare (Parts A & B)	-	(15,006)	(15,006)	-	(12,896)	(12,896)
Social Security (OASDI)	-	(11,742)	(11,742)	-	(11,215)	(11,215)
Other (Railroad Retirement)	-	(110)	(110)	-	(38)	(38)
Subtotal, Social Insurance	-	(26,858)	(26,858)	-	(24,149)	(24,149)
Fed. empl. & veterans pensions/benefits	(3,880)	-	(3,880)	(3,589)	-	(3,589)
Federal debt held by the public	(3,945)	-	(3,945)	(3,573)	-	(3,573)
Other liabilities	(674)	-	(674)	(654)	-	(654)
Other responsibilities	-	(862)	(862)	-	(771)	(771)
Total Liabilities & Net Responsibilities	$ (8,499)	$ (27,720)	$ (36,219)	$ (7,817)	$ (24,920)	$ (32,736)
BALANCE (Total Assets minusTotal Liabilities & Net Responsibilities)	($7,105)	($27,720)	($34,825)	($6,820)	($24,304)	($31,124)

[1] Source: Fiscal Year 2004 Analytical Perspectives, page 37, Defense Fixed Reproducible Capital, Nonfinancial Assets.

Note: Overall details may not add to total due to rounding.

Social Insurance Calculations

The social insurance present value amounts are based on 75-year actuarial projections of scheduled benefits and legislated taxes for current participants.

The present value of these future responsibilities (at January 1, 2003), as presented in the pertinent agencies' financial statements, is $15,006 billion for Medicare and $11,742 billion for Social Security. These numbers are from the Statements of Social Insurance on page 64 of this *Financial Report*. The total of these future responsibilities, including Other and Railroad Retirement social insurance responsibilities of $862 billion and $110 billion, respectively, is $27,720 billion. These items are not recorded on the balance sheet because current accounting standards (GAAP) do not permit it. FASAB is reviewing this area and if it determines that it is proper to record these items, we will do so. A more detailed discussion of these projections and the future outlook for Social Security and Medicare is found in the Stewardship Information section.

As can be seen, the impact of these responsibilities is significant. Clearly, the social insurance component represents a major fiscal responsibility and serious future challenge for the Federal Government. Medicare and Social Security increased by $2,110 billion (or 16.4 percent) and $527 billion (or 4.7 percent), respectively, over fiscal year 2002. Moreover, the 2003 combined total of the future responsibilities (i.e., $27,720 billion) is more than three times the 2003 total accounting liabilities and responsibilities on the balance sheet (i.e., $7,105 billion).

Federal Budget and Federal Debt

At this time, the largest liability for the Federal Government is the Federal debt held by the public and accrued interest, which was $3,945 billion in 2003. This was an increase of $372 billion over the 2002 debt of $3,573 billion. There are two kinds of Federal debt: debt held by the public and the debt the Government owes to itself.

Debt Held by the Public

The first kind of Federal debt is debt held by (or owed to) the public. It includes all Treasury securities (bills, notes, bonds, and other securities) held by individuals, corporations, Federal Reserve banks, foreign governments and other entities outside the U.S. Government. This debt is included as a liability on the balance sheet.

Debt the Government Owes to Itself

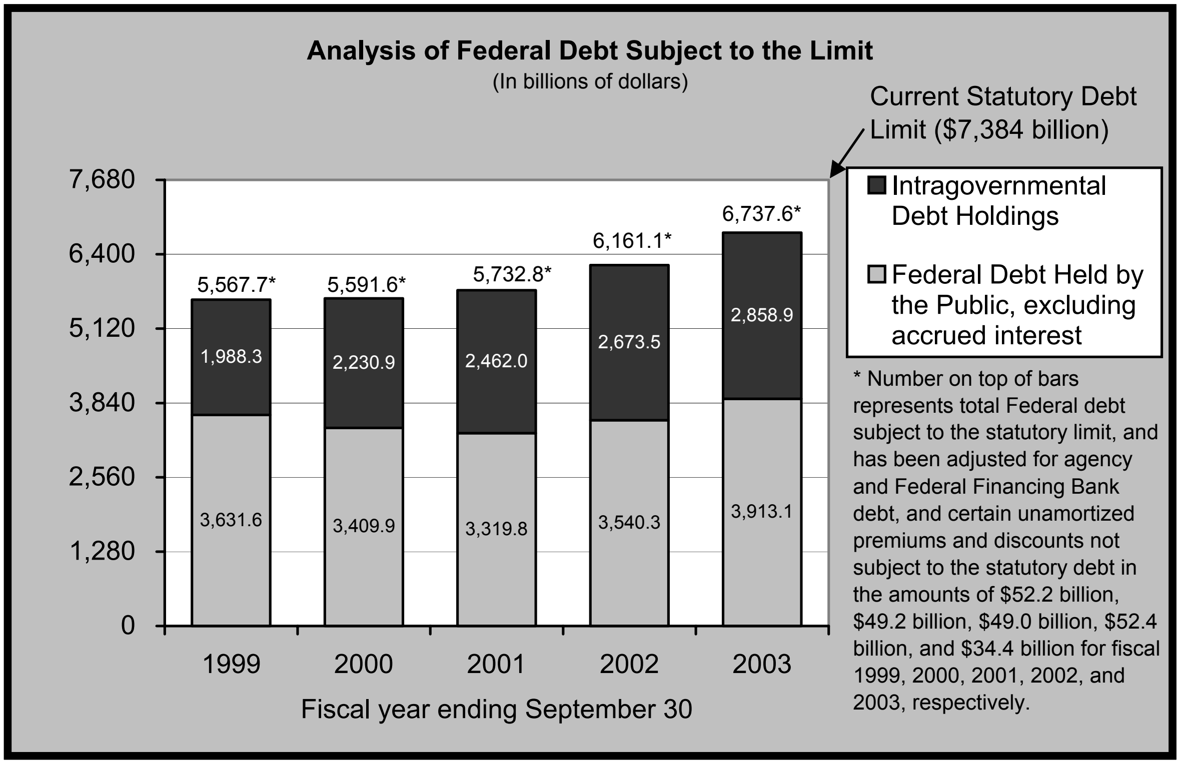
The second kind is debt the Government owes to itself (intra-governmental debt), primarily in the form of special nonmarketable securities held by various parts of the Government. The laws establishing Government trust funds generally require the excess receipts of the trust funds to be invested in these special securities. This debt is not included on the balance sheet since these payments are claims of one part of the Government against another and are eliminated for consolidation purposes.

Statutory Debt Ceiling (Limit)

Both kinds of debt are included in the total debt subject to the limit set by the Congress. The Congress has traditionally exercised control on the size of the Government's debt by establishing limits on the amount of Treasury securities that can be outstanding. This limit is known as the debt ceiling.

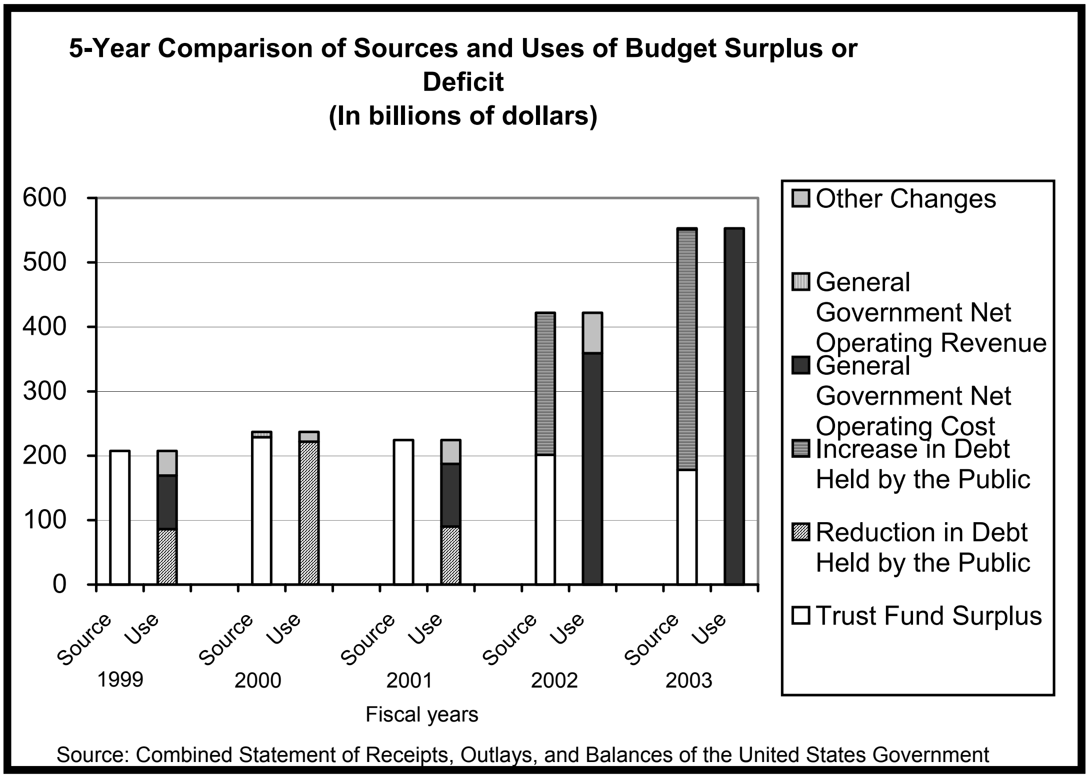
On February 20, 2003, Treasury's outstanding debt reached the statutory limit of $6,400 billion. When this occurs, various statutes authorize the Secretary of the Treasury to "suspend the issuance of additional amounts of obligations of the United States, if such issuances could not be made without causing the public debt of the United States to exceed the public limit, as determined by the Secretary of the Treasury." On May 27, 2003, President Bush signed legislation increasing the statutory debt limit to $7,384 billion (P.L. 108-24).

The following chart shows the amounts of debt held by the public and intra-governmental debt from 1999 through 2003.



Sources & Uses of Surpluses or Deficits

Federal Government operations are composed of two parts: 1) funds that are called trust funds in the Government, which receive their funding from dedicated collections (including collections from the Treasury and other Federal agencies), and 2) general Government, which is funded mainly from general revenues and borrowing. Many of the larger trust funds finance social insurance programs (such as Social Security and Medicare) and Federal military and civilian retirement programs. The following chart illustrates a 5-year comparison of the budget surpluses or deficits of these two parts of Government and how the budget surpluses were used and budget deficits funded.



Trust fund surpluses (the white area in the chart) are invested in Federal debt securities. The cash invested in Federal debt securities is mainly used for two purposes: to reduce the debt held by the public (the diagonally striped area) and to fund the general Government net operating cost (the dark gray area). Other changes (the light gray area) primarily consist of outlays under various loan programs. In fiscal years 2003 and 2002, it was necessary to increase the debt held by the public since the general Government net operating cost exceeded the trust fund surplus.

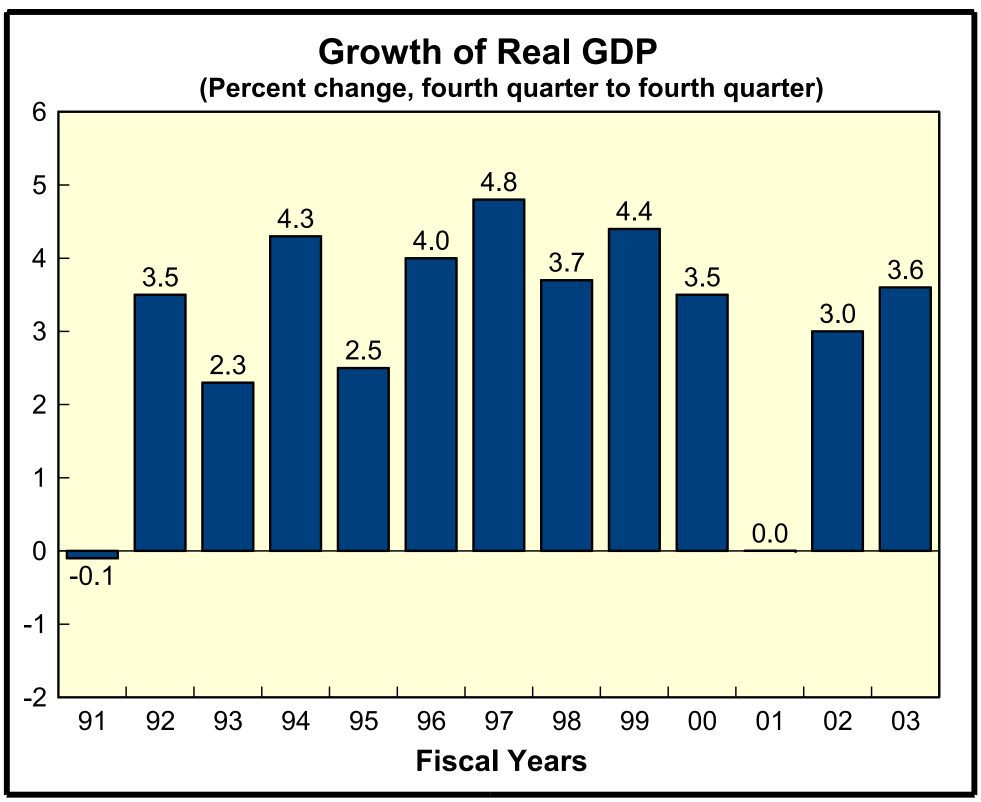
Previous budget surpluses, based primarily on a cash basis, are almost entirely due to the trust fund surpluses. General Government operations experienced budget deficits for fiscal years 1999, 2001, 2002, and 2003, and had a small surplus for fiscal year 2000.

Economic and Budgetary Results

After recovering in fiscal year 2002 from the economic downturn, the economy continued to accelerate in fiscal year 2003 and achieved strong growth. The rate of increase in real GDP picked up in each of the last three quarters of the fiscal year and productivity continued to record substantial gains. The labor market stabilized in fiscal year 2003 following job losses in the previous year; and in the final quarter of the fiscal year, employment began to increase. Improvement in the economy was aided by new fiscal policies in 2003, but the lingering effect of the recession and loss in equity wealth, the war with Iraq, homeland security spending, and lower taxes enacted to stimulate growth contributed to a widening in the Federal budget deficit to $374.8 billion for the fiscal year.

The Economy in Fiscal Year 2003

Real GDP increased 3.6 percent over the four quarters of fiscal year 2003, building on the solid growth recorded in the prior year after the economy underwent a recession in fiscal year 2001. Growth accelerated through fiscal year 2003, starting with a 1.3 percent annual rate of gain in the first fiscal quarter (the fourth quarter of calendar year 2002) and culminating in an 8.2 percent surge at an annual rate in the final quarter (the third quarter of 2003). That was the largest quarterly advance in 20 years and partly reflected the effects of the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), which was enacted in May. Rapid productivity growth, lower marginal tax rates on individual income, and advance child tax credit checks helped lift disposable personal income in the July-September quarter and fueled a 6.9 percent annual rate increase in real consumer spending. Business investment also surged in that quarter due to improved business profits and cashflow, helped by JGTRRA provisions that increased the bonus depreciation write-off on equipment and raised the expensing limit for small businesses. Real investment in equipment and software jumped at a 17.6 percent rate in the final quarter of fiscal year 2003, the largest increase since the first quarter of calendar year 1998. Rising profits and cashflow stemmed from low unit labor costs, which were held in check by exceptional productivity growth of 5.0 percent over the four quarters of the fiscal year.



Of special importance was a firming in labor market conditions in fiscal year 2003 following a loss of 1.3 million jobs in fiscal year 2002. Declines in payroll jobs diminished through fiscal year 2003 and totaled about 300,000 for the year as a whole, but losses bottomed out towards the end of the year and employment increased in the final 2 months. Those job gains extended into fiscal year 2004 along with a downward trend in the unemployment rate, which averaged 6.0 percent for all of fiscal year 2003.

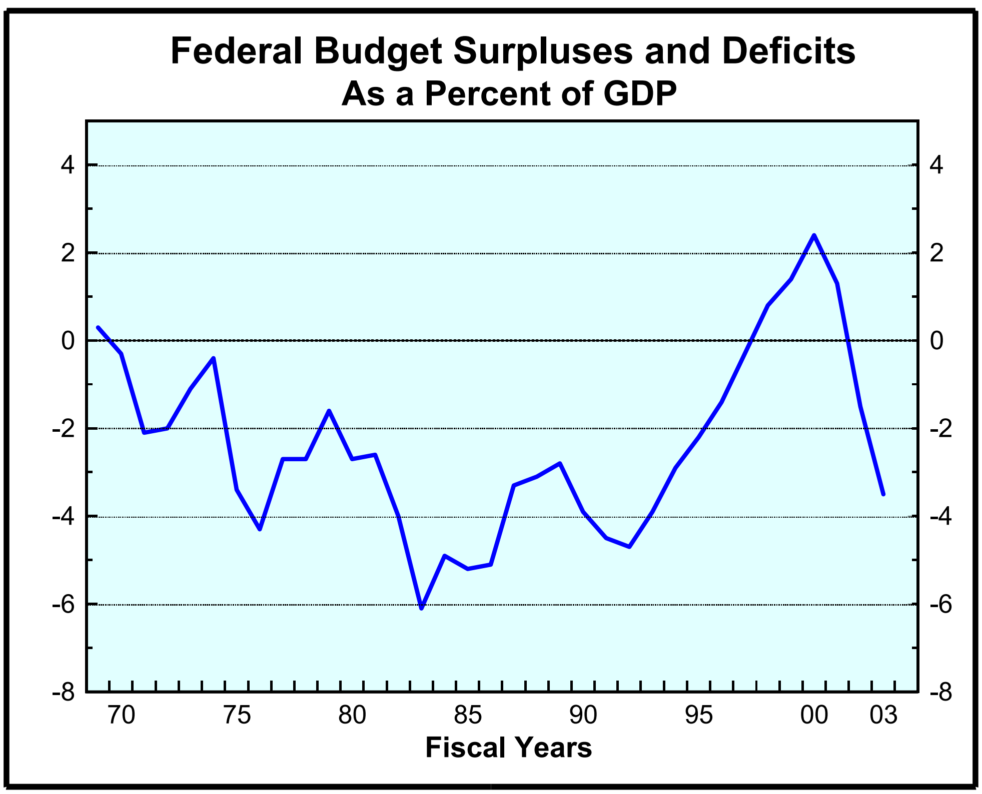
Although the overall consumer price index (CPI) rose 2.3 percent over the year, faster than over the previous fiscal year, the "core" CPI (which excludes food and energy prices) was up just 1.3 percent over the 12 months of fiscal year 2003, the smallest increase since the mid-1960s.

Budget Results

The unified Federal budget deficit was $374.8 billion in fiscal year 2003, up from $157.7 billion in fiscal year 2002 but $81 billion lower than had been projected in the Mid-Session Review. The deficit represented an estimated 3.5 percent of nominal GDP, the highest such share since fiscal year 1993 but well below the shares that were prevalent in the mid-1980s. The lagging economy in the early part of the year and declines in the stock market contributed to the deterioration in the unified budget balance, as did increased defense and homeland security spending and the economic growth plan.

Receipts decreased for the third straight year but the decline was just 3.8 percent, less than the 6.9 percent decrease in fiscal year 2002. In dollar terms, receipts fell by $71.1 billion to $1,782 billion. That represented a 16.5 percent share of GDP, down for the third year in a row after the share reached a record high of 20.8 percent in fiscal year 2000. Outlays rose $145.9 billion in the latest year, or 7.3 percent, and represented a 19.9 percent share of GDP. Departments with the largest rates of growth included Education, Defense, and Homeland Security.

Debt held by the public, excluding accrued interest, increased by $372.8 billion, or 10.5 percent, in fiscal year 2003. That represented a relatively modest 36.2 percent of GDP compared to the average 44.5 percent share that prevailed from the late 1980s through most of the 1990s.



U.S. Government Structure & Performance

Mission & Organization

The Constitution set out the Government's original mission:

> "…to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare and secure the blessings of liberty to ourselves and our posterity."

Today, the Federal Government's primary mission (managing the security of the nation, homeland, and economy) are still derived from this original mission. Other missions have developed as the Congress authorized the creation of other agencies to carry out various objectives established by law. Some of these objectives were to: promote health care, foster income security, boost agricultural productivity, provide benefits and services to veterans, facilitate commerce, support housing, support the transportation system, protect the environment, contribute to the security over energy resources, and assist the States in providing education.

U.S. Government's Organization

The fundamental organization of the U.S. Government was set out in the Constitution. Article I vested legislative powers in a Congress consisting of a Senate and a House of Representatives; Article II vested executive powers in a President and Vice President; and Article III vested judicial power in a Supreme Court and lower courts to be established by the Congress. An organization chart follows.

THE GOVERNMENT OF THE UNITED STATES

THE CONSTITUTION

LEGISLATIVE BRANCH

THE CONGRESS

SENATE HOUSE

Architect of the Capitol
United States Botanic Garden
General Accounting Office
Government Printing Office
Library of Congress
Congressional Budget Office

EXECUTIVE BRANCH

THE PRESIDENT
THE VICE PRESIDENT
EXECUTIVE OFFICE OF THE PRESIDENT

White House Office
Office of the Vice President
Council of Economic Advisers
Council on Environmental Quality
National Security Council
Office of Administration
Office of Management and Budget
Office of National Drug Control Policy
Office of Policy Development
Office of Science and Technology Policy
Office of the U.S. Trade Representative

JUDICIAL BRANCH

THE SUPREME COURT OF THE UNITED STATES

United States Courts of Appeals
United States District Courts
Territorial Courts
United States Court of International Trade
United States Court of Federal Claims
United States Court of Appeals for the Armed Forces
United States Tax Court
United States Court of Appeals for Veterans Claims
Administrative Office of the United States Courts
Federal Judicial Center
United States Sentencing Commission

DEPARTMENT OF AGRICULTURE
DEPARTMENT OF COMMERCE
DEPARTMENT OF DEFENSE
DEPARTMENT OF EDUCATION
DEPARTMENT OF ENERGY
DEPARTMENT OF HEALTH AND HUMAN SERVICES
DEPARTMENT OF HOMELAND SECURITY
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
DEPARTMENT OF THE INTERIOR
DEPARTMENT OF JUSTICE
DEPARTMENT OF LABOR
DEPARTMENT OF STATE
DEPARTMENT OF TRANSPORTATION
DEPARTMENT OF THE TREASURY
DEPARTMENT OF VETERANS AFFAIRS

INDEPENDENT ESTABLISHMENTS AND GOVERNMENT CORPORATIONS

African Development Foundation
Central Intelligence Agency
Commodity Futures Trading Commission
Consumer Product Safety Commission
Corporation for National and Community Service
Defense Nuclear Facilities Safety Board
Environmental Protection Agency
Equal Employment Opportunity Commission
Export-Import Bank of the U.S.
Farm Credit Administration
Federal Communications Commission
Federal Deposit Insurance Corporation
Federal Election Commission
Federal Housing Finance Board
Federal Labor Relations Authority
Federal Maritime Commission
Federal Mediation and Conciliation Service
Federal Mine Safety and Health Review Commission
Federal Reserve System
Federal Retirement Thrift Investment Board
Federal Trade Commission
General Services Administration
Inter-American Foundation
Merit Systems Protection Board
National Aeronautics and Space Administration
National Archives and Records Administration
National Capital Planning Commission
National Credit Union Administration
National Foundation on the Arts and the Humanities
National Labor Relations Board
National Mediation Board
National Railroad Passenger Corporation (Amtrak)
National Science Foundation
National Transportation Safety Board
Nuclear Regulatory Commission
Occupational Safety and Health Review Commission
Office of Government Ethics
Office of Personnel Management
Office of Special Counsel
Overseas Private Investment Corporation
Peace Corps
Pension Benefit Guaranty Corporation
Postal Rate Commission
Railroad Retirement Board
Securities and Exchange Commission
Selective Service System
Small Business Administration
Social Security Administration
Tennessee Valley Authority
Trade and Development Agency
U.S. Agency for International Development
U.S. Commission on Civil Rights
U.S. International Trade Commission
U.S. Postal Service

Original source: *U.S. Government Manual 2003/2004*

The United States is impressive in its position as one of the world powers. The following table illustrates several interesting facts about the United States, as compared with other countries.

Item of Interest	United States	Estimate as of	Country Rank	Comments
Land area only	9.2 million sq. km	2003	4	Russia, China, and Canada are larger
Population	290.3 million	2003 (July)	3	China (1.3B) and India (1.0B) are greater
Gross domestic product (GDP) (basis: purchasing power parity)[1]	$10.4 trillion	2002	1	China was second with $5.7 trillion
GDP per capita	$37,600	2002	2	Luxembourg was first with $44,000
Low infant mortality rate	6.75 deaths per 1,000 live births	2003	42	Countries with populations > 50 million with lower rate: Italy, 6.19; UK, 5.28; France, 4.37; Germany, 4.23; Japan, 3.30.
Electricity production	3.72 trillion kWh	2001	1	China was second with 1.42 trillion kWh
Military expenditures–percent of GDP	3.2 percent	2003 (Jan 1)	47	North Korea was first with 33.9 percent (FY02)

[1] Purchasing power parity indicates how many units of currency are needed in one country to buy the same amount of goods and services purchased with one unit of currency in another country.
Source: Central Intelligence Agency's *The World Factbook 2003*

Creation of the Department of Homeland Security

The creation of DHS in 2003 was the most significant transformation of the Federal Government since 1947 when the various branches of the U.S. Armed Forces were merged into a new Department of Defense. In the aftermath of the September 11, 2001, terrorist attacks, the President and the Congress recognized the need to coordinate the efforts of many Federal agencies, offices, and programs which had responsibility for various aspects of protecting and securing our homeland. President George W. Bush proposed the creation of DHS, and Congress passed the Act that established this new department.

More than 20 agencies and offices and some 180,000 employees were transferred into DHS on March 1, 2003. They are located, for the most part, within one of four major program directorates: Border and Transportation Security, Emergency Preparedness and Response, Science and Technology, and Information Analysis and Infrastructure Protection. A fifth directorate coordinates management of the DHS. The Secret Service and the Coast Guard, although located within DHS, remained intact and report directly to the Secretary of DHS. In addition, the Immigration and Naturalization Service's adjudications and benefits programs are now the Bureau of Citizenship and Immigration Services. The following chart shows how the incoming or *legacy* organizations or programs fit within the new department.

THE DEPARTMENT OF HOMELAND SECURITY

ORGANIZATIONS OR PROGRAMS TRANSFERRED INTO HOMELAND SECURITY

BORDER AND TRANSPORTATION SECURITY

- U.S. Customs Service (Treasury)
- Immigration and Naturalization Service (part) (Justice)
- Federal Protective Service (GSA)
- Transportation Security Administration (Transportation)
- Federal Law Enforcement Training Center (Treasury)
- Animal and Plant Health Inspection Service (part) (Agriculture)
- Office for Domestic Preparedness (Justice)

SCIENCE AND TECHNOLOGY

- Chemical and Biological Defense Programs (Defense)
- Environmental Measurements Laboratory (Energy)
- Plum Island Animal Disease Center (Agriculture)
- Environmental Measurements Laboratory (Energy)

DEPARTMENTAL OPERATIONS

- Includes the Offices of the Secretary and the Management Directorate

EMERGENCY PREPAREDNESS AND RESPONSE

- Federal Emergency Management Agency (FEMA)
- Strategic National Stockpile and the National Disaster Medical System (HHS)
- Office of Emergency Preparedness (HHS)

INFORMATION ANALYSIS AND INFRASTRUCTURE PROTECTION

- Critical Infrastructure Assurance Office (Commerce)
- Federal Computer Incident Response Center (GSA)
- National Communications System (Defense)
- National Infrastructure Protection Center (Justice, FBI)
- Energy Security and Assurance Program (Energy) (includes National Infrastructure Simulation and Analysis Center)

OTHER PROGRAM ORGANIZATIONS AND BUREAUS

- U.S. Coast Guard (Transportation)
- U.S. Secret Service (Treasury)
- Bureau of Citizenship and Immigration Services (part) (INS)
- Office of the Inspector General

Source: *Based on information provided by the Department of Homeland Security*

Significant Performance Accomplishments

Progress on Audited Financial Statements

As recently as 1996, not only were just six agencies able to issue financial statements with clean opinions, but most agencies took as least 5 months to issue them. Before implementing the Improved Financial Performance Initiative of the President's Management Agenda, 18 of 24 of the Government's major agencies received clean opinions on their audited financial reports, however, it still took 5 months to prepare most of them. Today, most major agencies are getting clean audit opinions and issuing them in a condensed period of time.

A clean audit opinion provides assurance that agencies are responsibly accounting for the people's money. If it takes them 5 months to issue audited financial statements, however, it is a good indication they do not have timely and accurate financial information available on a regular basis. That is why the Administration is working with all agencies to close their books more quickly. Eight agencies have accelerated the issuance of audited financial reports to 45 days after year end, which is the 2004 Governmentwide requirement. One particular agency of note is the U.S. Agency for International Development (USAID), which not only accelerated the reporting of its financial statements, but also received a clean opinion for the first time in its history. Additionally, agencies are now reporting quarterly financial information in addition to the end of the year data.

Through the first quarter of fiscal year 2004, four agencies–Education, Environmental Protection Agency (EPA), National Science Foundation (NSF), and SSA – have demonstrated their ability to use timely and accurate financial information to make decisions about program management. For example, Education uses up-to-the-minute financial data to track whether schools are receiving the appropriate amount of Federal funds. In addition, EPA's Leaking Underground Storage Tank program negotiates performance commitments with grantees and provides resources based on those commitments. If a grantee is not meeting its commitments, EPA may withhold some resources from the nonperformers and redirect those resources to grantees that are meeting their commitments.

The President's Management Agenda: Ensuring Government's Effectiveness

In August 2001, The President's Management Agenda (PMA) was launched with the broad goal of making the Government results-oriented and focused on achievement and accountability. Over the past 2 ½ years, Federal agencies have established aggressive implementation plans for the PMA and are meeting their goals. As a result, the Federal Government is better managed and achieving greater results. It is managing its finances and investments more professionally and efficiently. It is providing better service to the American people. The Government is getting the people it needs to accomplish its mission at the best value to the taxpayer. Most important, it is evaluating its performance; asking what works, what doesn't, and what to do about it.

Five areas of emphasis, or subcomponents, were identified for the agenda:

Strategic Management of Human Capital:

- Helps the Government maximize the value of its most important resource, its workforce. Agencies are now establishing and implementing practices to manage their personnel to achieve their missions.

Competitive Sourcing Initiative:

- Before this initiative was launched, too few agencies regularly assessed the efficiency and effectiveness of the commercial activities they performed. Today, by contrast, a steadily increasing number of agencies are looking to competition to strengthen both the return on taxpayer investment and overall customer satisfaction.

Improved Financial Performance Initiative:

- Helps the Government ensure the availability, accuracy, and timeliness of its financial information, helping it make better decisions about program management.

The Expanded Electronic Government Initiative:

- Focuses on two key areas – strengthening agencies' management of their information technology (IT) resources and using the Internet to simplify and enhance service delivery.

The Budget Performance/Integration Initiative:

- Helps agencies use meaningful information about how programs are performing to inform their budget and management decisions.

The PMA measures the Government's progress toward its goals through the use of the Executive Branch Management Scorecard. This Scorecard is used to assess agencies' overall status in achieving the expected levels of achievement, or standards for success, identified in the agenda. Their quarterly efforts in working toward those goals are also assessed.

Implementation of the PMA has brought focus and attention to how the Government is operated, and identified ways that it can be more effective. Agencies are improving—managing for and achieving better results.

	Explanation of Status Scores
Green	Agency meets all of the standards for success.
Yellow	Agency achieves some, but not all, of the criteria.
Red	Agency has any of a number of serious flaws.
	Explanation of Progress Scores
Green	Implementation is proceeding according to plans.
Yellow	Slippage in implementation schedule, quality of deliverables, or other issues requiring adjustments by agency in order to achieve initiative on a timely basis.
Red	Initiative in serious jeopardy. Unlikely to realize objectives without significant management intervention.

The Scorecard

Executive Branch Management Scorecard										
	Current Status as of September 30, 2003					Progress in Implementing the President's Management Agenda				
	Human Capital	Competi-tive Sourcing	Financial Perf.	E-Gov	Budget/ Perf. Integra-tion	Human Capital	Competi-tive Sourcing	Financial Perf.	E-Gov	Budget/ Perf. Integra-tion
AGRICULTURE	R	Y	R	Y	R	G	G	G	Y	G
COMMERCE	Y	Y	R	Y	Y	G	Y	G	G	G
DEFENSE	Y	Y	R	R	Y	G	Y	G	G	G
EDUCATION	Y	Y	R	Y	R	G	G	G	G	G
ENERGY	Y	Y	Y	Y	Y	G	G	G	G	G
EPA	R	R	G	Y	Y	G	G	G	G	G
HHS	R	Y	R	R	R	G	G	G	Y	Y
HOMELAND	R	R	R	R	R	G	G	G	Y	G
HUD	R	R	R	R	R	Y	Y	G	Y	G
INTERIOR	R	Y	R	R	R	G	G	Y	Y	Y
JUSTICE	R	Y	R	R	R	G	G	G	G	G
LABOR	Y	R	Y	Y	Y	G	Y	G	G	G
STATE	Y	R	R	R	R	G	Y	G	G	G
DOT	Y	Y	R	R	Y	G	G	G	G	G
TREASURY	R	R	R	R	R	Y	Y	Y	Y	Y
VA	R	R	R	Y	Y	G	R	G	G	G
USAID	R	R	R	R	R	G	R	G	G	G
CORPS OF ENGINEERS	Y	R	R	R	R	G	Y	Y	G	Y
GSA	R	Y	Y	R	R	G	G	G	G	Y
NASA	Y	R	R	R	Y	G	G	G	G	G
NSF	R	R	G	G	Y	Y	R	G	G	Y
OMB	R	R	R	R	R	G	Y	Y	G	R
OPM	Y	Y	Y	Y	R	G	G	G	G	G
SBA	Y	R	R	Y	Y	G	G	Y	Y	G
SMITHSONIAN	R	R	R	R	R	R	R	Y	Y	Y
SSA	Y	R	G	Y	Y	G	G	G	G	G
Legend: R = Red Y = Yellow G = Green										

Systems, Controls, and Legal Compliance

Systems

The Federal Government continues to face agency-specific and Governmentwide challenges in modernizing and standardizing its financial management systems. Much emphasis has been placed on streamlining systems and standard processes across the agencies and minimizing redundant investments in duplicative systems. The Administration's Expanded Electronic Government initiative (E-Gov) has focused on leveraging information technology to make the Federal Government more citizen-centered and results oriented.

For example, the *E-Payroll* initiative is working to consolidate 22 Federal payroll systems down to two payroll provider partnerships in order to simplify and standardize Federal payroll processes. The E-Payroll initiative completed a major milestone in August with the successful migration of Energy, the first agency to migrate to an E-Payroll provider. Several other agencies have also completed their migrations in this area.

The *Grants.gov* initiative will minimize the burden of finding and applying for grants and enable agencies to make awards more efficiently. This initiative recently completed the "Find Grant Opportunities" and the "Apply for Grants" features of the Grants.gov web site, which was officially launched in November.

The *Geospatial One-Stop* initiative introduced GeoData.gov, a portal featuring "one-stop" access to geospatial information and resources from diverse sources, quickly compiled and posted links to web sites, maps and information from numerous Government sources on the impact of Hurricane Isabel that shut down much of the East Coast of the United States as well as the September 25th earthquake in Japan and its potential impact on the United States. GeoData.gov responded twice in the month of September to major natural disasters.

The *Recruitment One-Stop* initiative unveiled the new look and feel of www.usajobs.opm.gov, showcasing new user-friendly features such as: enhanced job search engine and sorting capability, resume storage, a personal career management homepage, and improved accessibility for disabled users. The web site is the foremost destination for those seeking employment with the Federal Government, allowing job seekers to quickly and easily find and apply for Federal jobs in a centralized location.

Additionally, the *Expanding Electronic Government* initiative is making progress in several other areas, such as the *Financial Management Line of Business*. The *Financial Management Line of Business* initiative will standardize data structures and business processes for core accounting systems within a well-defined common architecture. This initiative will address opportunities for more effective IT spending in the areas of: Financial Management, Human Resources, Federal Health Architecture, and Case Management.

Further information on Expanded Electronic Government, the E-Gov Strategy, or other E-Gov topics of interest can be found at www.egov.gov, the official web site of the President's E-Government initiatives. The web site is an up-to-date, public source of information about the E-Gov Initiatives and their accomplishments.

Controls

The Federal Government has historically emphasized the need for good internal controls in its internal management review and external financial reporting requirements. Together, these requirements assist management in ensuring the integrity of Government financial management information.

Since its passage in 1982, the Federal Managers' Financial Integrity Act has required agencies to annually report on the adequacy of their management controls. To meet this reporting requirement, agencies undertake annual internal reviews of key controls over major programs to determine if they are functioning properly. Any control deficiencies identified are reported by the head of the agency to the President.

The Federal Financial Management Improvement Act of 1996 requires agency management and independent financial auditors to determine whether financial management systems meet systems requirements, comply with the U.S. Government Standard General Ledger, and adhere to accounting standards. Independent auditors report their determination as part of their annual financial audit report on agency financial statements, which is included in agencies' annual Performance and Accountability Reports.

Beginning in 2003, the Federal Information Security Management Act of 2002 requires reviews of agency information security programs to ensure they meet Federal requirements and that significant deficiencies are reported.

Both financial and information technology internal controls are also reviewed and reported on by independent auditors as part of the annual agency financial audit. Internal control deficiencies reported by agencies that materially affect the Governmentwide financial statements are described in the accompanying report prepared by the General Accounting Office (GAO).

Where controls are not functioning as planned, agencies are responsible for developing and implementing corrective action plans to address how financial management systems and internal controls will be improved.

Eliminating Erroneous Payments

The Administration has launched a major effort to eliminate erroneous payments—in other words, payments the Government makes in error. In most instances, such payments are overpayments. However, in all cases, taxpayers are shortchanged.

Selected Federal agencies have been required to report the extent of erroneous payments made in their major benefit programs. Information we have today tells us that for programs with nearly $1 trillion in annual payments, erroneous payments exceed $35 billion annually.

Congress endorsed the President's effort to eliminate erroneous payments by passing the Improper Payments Information Act of 2002 (P.L. 107-300). The Act requires an estimate of the extent of erroneous payments from all Federal programs and in effect expands the scope of review to all Government expenditures. In May 2003, the Administration provided guidance as to how Federal agencies must comply with the Act. Now, all major agencies are beginning to develop and implement plans to identify and eliminate erroneous payments in all programs and activities susceptible to significant erroneous payments. Ultimately, full implementation of the Act will lead to a review of every dollar that the Government spends.

Legal Compliance

Federal agencies are required to comply with a wide range of laws and regulations, including appropriations, employment, health and safety, and others. Responsibility for compliance primarily rests with agency management; compliance is addressed as part of agency financial statement audits. Agency auditors tested for compliance with selected laws and regulations related to financial reporting. As a result of their testing, auditors found no instances of material noncompliance that affected the Governmentwide financial statements. There were, however, instances that were material to an individual agency, and these were reported in the individual agencies' financial statement audit reports.

Basis of Accounting and Reporting Entity

Accounting Standards

The accompanying financial statements were prepared based on U.S. GAAP standards developed by FASAB, except as noted in GAO's auditor's report.

GAAP for the Federal Government is tailored to the U.S. Government's unique characteristics and special needs. For example, the Stewardship Information section of this report contains important information about diverse subjects such as land set aside for the use and enjoyment of present and future generations, heritage assets, and social insurance programs such as Social Security.

Accrual Basis

GAAP requires that these financial statements be prepared using the accrual basis of accounting, but permits the use of modified cash accounting for taxes and duties. Under the accrual basis, transactions are reported when the events creating the transactions occur, rather than when cash is received or paid (cash basis). Therefore, expenses are recorded when incurred, exchange revenue is recorded when earned, and taxes and duties (the majority of nonexchange revenue) are recorded on a modified cash basis of accounting (generally when received). In contrast, Federal budgetary reporting is generally on the cash and obligation basis in accordance with accepted budget concepts.

The most significant difference between cash and accrual bases involves the timing of recognition and measurement of revenues and costs. For example, GAAP requires recognition of liabilities for costs related to environmental cleanup when the events requiring such costs occur and, among other things, the Government has acknowledged responsibility for the event. By contrast, current budget concepts recognize such costs later, at the time payment is made for the cleanup. Additionally, GAAP requires the recognition of depreciation expenses on fixed assets, a liability for accrued leave, and the total actuarial liabilities for pensions, retired pay, and post-retirement health benefits. These differences are reflected in the Reconciliations of Net Operating Cost and Unified Budget Deficit that is found in the Financial Statements section of this *Financial Report*.

Coverage

These financial statements cover the executive and legislative branches, as well as parts of the judicial branch of the U.S. Government. A list of the significant entities included in these financial statements is in the Appendix. Information from the judicial branch is limited because these entities are not required by law to submit comprehensive financial statement information to the Treasury. The Federal Reserve System is excluded because of its private ownership and independence. The Federal Retirement Thrift Investment Board is excluded because it charges all of its administrative expenses to the Thrift Savings Fund. Therefore, it has no financial activity that would affect the Government's results. Moreover, Government-sponsored but privately-owned enterprises (e.g., the Federal Home Loan Banks, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation) are also excluded since the Federal Government does not control them and is not responsible for their finances.

Additional Information

Details about the information contained in these financial statements can be found in the financial statements of the individual agencies listed in the Appendix. In addition, related U.S. Government publications such as the *Budget of the United States Government*, the *Treasury Bulletin*, the *Monthly Treasury Statement of Receipts and Outlays of the United States Government*, the *Monthly Statement of the Public Debt of the United States*, the *Economic Report of the President*, and the Trustees' Reports for the Social Security and Medicare programs may be of interest.

History of the Report

Financial Reports of the United States Government

Benefiting from a private-sector produced report that featured financial statements for the U.S. Government's 1973 and 1974 fiscal years, Treasury has published financial statements for the Government in every fiscal year since 1975. The earliest reports were budget-based and unaudited, though Treasury hired private sector firms to conduct independent reviews of source data and collection procedures. The CFO Act of 1990 established the position of Chief Financial Officer in 24 agencies and FASAB to develop Federal accounting standards and concepts. The Government Management Reform Act of 1994 (GMRA) required audited financial statements from most Government departments and agencies beginning in fiscal year 1996. GMRA also required the U.S. Government to submit consolidated financial statements audited by GAO beginning with fiscal year 1997's *Financial Report of the United States Government*. In 1999, the American Institute of Certified Public Accountants recognized FASAB as the promulgator of GAAP for the Federal Government. FASAB continually reviews its reporting standards to enhance the usefulness of the Government's financial statements to all users.

Visit http://www.treas.gov/offices/economic-policy/speeches_testimony_refund.html for a more detailed history of the *Financial Report of the United States Government.*

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