



REPORT TO THE
COMMITTEE ON APPROPRIATIONS
HOUSE OF REPRESENTATIVES

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Evaluation Of The
Management Of Exchange And
Motion Picture Services B-148581

Department of Defense

B-148581

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

MARCH 25, 1971

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B- 148581

Dear Mr. Chairman:

In your letter of January 26, 1970, you asked us to make a comprehensive review and evaluation of the operation and management of nonappropriated fund activities in the Department of Defense. The results of our review and evaluation of the management of the exchange and motion picture services of the Army, Air Force, Navy, and Marine Corps are set forth in this report.

Although observations included in the report were discussed with exchange and other responsible officials, we did not request written comments from the Department of Defense. Because the report contains suggestions for actions which should be taken by the Department of Defense to improve its management of the exchange and motion picture services, you may wish to review these matters with Department of Defense officials.

We plan no further distribution of this report unless copies are specifically requested, and then we shall make distribution only after your agreement has been obtained.

Sincerely yours,

A handwritten signature in cursive script that reads "James B. Stacks".

Comptroller General
of the United States

The Honorable George H. Mahon
Chairman, Committee on Appropriations
House of Representatives

D I G E S T

WHY THE REVIEW WAS MADE

On January 26, 1970, the Chairman, Committee on Appropriations, House of Representatives, requested that the General Accounting Office (GAO) make a comprehensive review and evaluation of the operation and management of nonappropriated fund activities in the Department of Defense (DOD). This is GAO's report on its review and evaluation of the management of the exchange and motion picture services of the Army, Air Force, Navy, and Marine Corps.

Individual reports have been submitted previously by GAO to the Committee covering the results of GAO's inquiries into various club, morale, and recreational activities at selected locations in the United States, Europe, and the Far East.

FINDINGS AND CONCLUSIONS

Appropriated fund support exceeds profits distributed for morale purposes.

--The military exchanges are established to sell consumer goods and services at DOD installations and to provide revenue to supplement appropriated funds for the support of welfare and recreation programs. In fulfilling these two purposes, the exchanges received appropriated fund support of at least \$140 million and provided dividends of about \$130 million to the military departments for welfare and recreation programs during fiscal year 1970.
(See p. 8.)

--Data maintained by DOD are inadequate for identifying the full amount of appropriated fund support of exchanges and theaters. GAO believes that such identification is necessary for DOD and the Congress to consider the reasonableness of such support.
(See pp. 9 and 10.)

The exchanges lack many of the profit-oriented controls exerted in a commercial environment and many of the normal systemic controls exerted in the Government environment. (See p. 12.)

The exchanges determine the location and type of their facilities and services. The resulting location and nature of exchange and recreation

resources do not achieve an equitable distribution among active duty military personnel and between active duty and retired military personnel. (See p. 13.)

Large loans and investment funds are handled at exchange and theater headquarters.

- About \$100 million in cash that is not needed for current operations is invested by the exchange systems and by the Army and Air Force Motion Picture Service. (See p. 15.)
- The Army and Air Force Exchange Service has established a \$65 million line of credit with commercial banks, which has been utilized many times in the last 3 years but which is currently inactive. (See p. 15.)

Exchanges give inadequate recognition to competition in procurement.

- Many opportunities to utilize competition in contracting have been ignored by the Army and Air Force Exchange Service and by the Marine Corps Exchange Service. Price agreements are negotiated without competition and are used as the bases for certain future procurements by the central exchanges and by area exchange procurement offices. (See p. 18.) Contracts are negotiated, rather than opened for competition, even for such standard items as spark plugs, automobile antifreeze, paper cups, and other products. (See p. 19.)
- None of the exchange systems maintain appropriate surveillance over contractors or require documentation of contractors' certifications in price agreements that prices do not exceed those offered to other customers. (See p. 18.)
- The Marine Corps Exchange Service does not permit all qualified suppliers an equal opportunity to meet with exchange department managers and to write up orders. (See p. 19.)

Cash and other resources are inadequately controlled.

- Control over cash at individual exchanges and theaters is not adequate. Cash audits are not performed as scheduled, and concessionaires at exchanges are rarely required to document their reports of sales and of cash collected. (See p. 20.)
- Inventory shortages have been increasing annually in the Army and Air Force Exchange Service. (See p. 21.)

Improved auditing procedures are needed.

- Scope of work agreements between certified public accountants and exchange and theater management need revision because, although certified statements are prepared annually, the exchanges and

theaters do not receive the benefits that might be obtained from inquiries into management policies and practices and into the operation of internal controls. (See p. 23.)

- The internal auditing organization of the Army and Air Force Exchange Service does not, in GAO's opinion, sufficiently emphasize evaluating management techniques. (See p. 24.)

RECOMMENDATIONS OR SUGGESTIONS

GAO believes that improvement in the management of the exchanges and theaters would result from:

- Developing cost data by the military departments showing the value of appropriated fund support provided by the departments to the exchanges and theaters. (See p. 10.)
- Meeting the needs of the servicemen for exchange facilities with a more equitable distribution among active duty personnel and between active duty and retired personnel. (See p. 14.)
- Obtaining maximum competition in exchange procurements and, where negotiation is necessary, exercising surveillance over contractors' pricing. (See p. 19.)
- Giving special attention to existing requirements for controls over cash and inventories in the exchanges and theaters. (See p. 22.)
- Developing agreements with certified public accountants for a scope of work emphasizing improved management controls. (See p. 25.)
- Assigning, developing, and supervising internal audit staffs so that they meet the standards of professional auditing in the purpose, techniques, and scope of work. (See p. 25.)
- Coordinating work of certified public accountants and internal audit staffs to ensure sufficiently detailed evaluations of management practices without unnecessary duplication of effort. (See p. 25.)

MATTERS FOR CONSIDERATION BY THE COMMITTEE

Since DOD has not had an opportunity to prepare formal comments on the suggestions presented in this report, the Chairman may wish to review these matters with DOD officials.

The problems in identifying appropriated fund support discussed in this report give additional emphasis to the need for new procedures. As suggested in our earlier reports under this assignment, the Committee may

wish to consider directing the military departments to establish a system for identifying the costs of all types of appropriated fund support given to nonappropriated fund activities.

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ABBREVIATIONS

GAO	General Accounting Office
DOD	Department of Defense

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GAO believes that improvement in the management of the exchanges and theaters would result from:

- Developing cost data by the military departments showing the value of appropriated fund support provided by the departments to the exchanges and theaters. (See p. 10.)
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MATTERS FOR CONSIDERATION BY THE COMMITTEE

Since DOD has not had an opportunity to prepare formal comments on the suggestions presented in this report, the Chairman may wish to review these matters with DOD officials.

The problems in identifying appropriated fund support discussed in this report give additional emphasis to the need for new procedures. As suggested in our earlier reports under this assignment, the Committee may

wish to consider directing the military departments to establish a system for identifying the costs of all types of appropriated fund support given to nonappropriated fund activities.

CHAPTER 1

HOW THE MILITARY EXCHANGES AND THEATERS OPERATE

For many years the military services permitted sutlers and traders to provide for servicemen's needs, other than those supplied through congressional appropriations. To prevent certain abuses of these operations, the services in 1889 established post canteens and later replaced them with post exchanges. The stated purposes of these early canteens and exchanges were to sell ordinary articles to the servicemen and to afford them a means of entertainment.

Some earnings from the sales of the sutlers, traders, canteens, and exchanges were used by individual commanders for the welfare of military personnel. Similarly, today's exchanges and theaters generate revenue which, under procedures established by each of the military services, provide morale and recreational resources supplementing those derived from appropriated funds for military personnel.

Currently, the following three large-scale exchange organizations operate within DOD, and each performs worldwide financing, purchasing, storage, distribution, and retail functions as a Government instrumentality.

- The Army and Air Force Exchange Service
- The Navy Resale System Office
- The Marine Corps Exchange Service

The Army and Air Force Exchange Service is by far the largest of the three organizations. During fiscal year 1970, that exchange service reported sales of \$2 billion and net earnings of \$120 million.

The Secretary of Defense has vested in the Secretaries of the Army and Air Force, jointly and coequally, all functions, powers and duties relating to the exchange service. The chief of the exchange service, acting on behalf of a 14-member board of directors consisting primarily of military personnel, administers the operations of the exchange service from its headquarters in Dallas, Texas. Currently, the exchange service is comprised of 130 exchanges under 12 area support centers in the continental United States,

an offshore exchange system, the Pacific Exchange System, the European Exchange System, and the Alaskan Exchange System.

The Navy Resale System Office is the central office for Navy exchanges, commissary stores, ship's stores afloat, and exchanges of the Military Sea Transportation Service. The responsibilities of the system office involve a complex mixture of appropriated and nonappropriated fund support. While each of the activities receives a degree of appropriated fund support, the major appropriated fund activities are the commissary stores and ship's stores afloat.

The major nonappropriated fund activity under the system office is the Navy exchange which, for the year ended February 23, 1970, reported sales of \$754 million and net earnings of \$57 million. Among other activities, the Navy exchange is responsible for the operation of enlisted men's clubs.

The Secretary of the Navy administers the Navy exchange through a chain of command extending from the Chief of Naval Operations, the Chief of Naval Material, and the Naval Supply Systems Command to the Navy Resale System Office in New York City. A group of educators and businessmen form an advisory committee to the Commanding Officer of the Navy Resale System Office. Currently, the Navy exchange system is composed of 169 main and supporting exchanges under the headquarters and West Coast Branch.

The Exchange Service Division of the Marine Corps Quartermaster General is responsible for the general supervision of the Marine Corps Exchange Service but exercises no command authority over the exchanges. The Commandant of the Marine Corps exercises command authority over the exchanges directly through each installation commander to the base exchange officer. For the year ended January 25, 1970, the exchanges reported consolidated sales of \$159 million and net earnings of \$11 million. The Corps operates a total of 27 exchanges.

THEATERS

The Army and Air Force Motion Picture Service is a revenue-producing, self-supporting, nonappropriated fund

activity which was established in 1920 to furnish recreation to Army, and later Air Force, personnel through the medium of entertainment motion pictures. For fiscal year 1969 the motion picture service reported revenue of \$29 million and net earnings of \$6 million. The motion picture service is under the surveillance of the same board of directors as the Army and Air Force Exchange Service.

The Navy Motion Picture Service is operated under an annual \$5 million grant from the Central Recreation Fund maintained by the Bureau of Naval Personnel by assessments against Navy exchanges and other Navy nonappropriated fund activities. The film shows on board ships and at Navy overseas installations are given without charge. The stateside Navy film expenses are covered by an average charge of 25 cents for each attendee.

CHAPTER 2

APPROPRIATED FUND SUPPORT

The exchanges in DOD received appropriated fund support of at least \$140 million and provided dividends of about \$130 million to the military departments for welfare and recreation programs during fiscal year 1970. The appropriated fund support is discussed below, and the dividends are discussed in chapter 3.

DOD does not maintain accounting systems that identify the amount of appropriated fund support furnished to the exchanges. As a result, a proper accounting for operations and resources is not made, in our opinion, in the nonappropriated fund statements of the exchanges because revenue is shown to be generated without an adequate portrayal of the resources applied. In addition, the statements of military commands' use of appropriated funds do not give sufficient disclosure of the use of appropriated fund resources.

Exchange officials furnished us with the following estimates of fiscal year 1970 appropriated fund support provided to the exchanges for which they were not billed. Other appropriated fund support had been provided to the exchanges for which they had reimbursed the appropriations.

	<u>Total</u>	<u>Army and Air Force</u>	<u>Navy</u>	<u>Marine Corps</u>
	—————(000,000 omitted)—————			
Overseas				
transportation	\$ 83	\$ 76	\$ 7	\$-
Military pay	25	14	8	3
Facilities rental	10	5	5	-
Utilities	9	7	2	-
Maintenance and other				
services	9	7	2	-
Construction	<u>4</u>	<u>2</u>	<u>2</u>	<u>-</u>
	<u>\$140</u>	<u>\$111</u>	<u>\$26</u>	<u>\$3</u>

We believe that the information shown above understates by many million dollars the amount of appropriated fund support furnished to the exchanges in fiscal year 1970, because the management systems used by the services were inadequate for identifying the complete amount of the types of costs shown in that:

- Rates billed to the exchanges for utilities and for many other Government-provided stateside and overseas services were not sufficient to recover the Government's cost to furnish these services.
- Most of the costs of transportation of merchandise from one overseas area to another were not billed or identified as appropriated fund support to the exchanges, although the exchanges are permitted free transportation only from stateside ports.
- A broad range of other types of services, such as management planning, inspecting, auditing, and engineering, were not billed or identified as appropriated fund support for the exchanges. The Navy exchange reimburses the Government for some, but not all, the Navy engineering services it receives; other exchanges make no reimbursement for the Government-performed engineering services they receive.

The Congress has permitted the regulations of DOD components to have the force of law in the area of nonappropriated fund activities operated within DOD. DOD components have established through various regulations that the exchanges may receive almost any type of appropriated fund support necessary to provide exchange opportunities to the servicemen.

THEATERS

The Army and Air Force Motion Picture Service receives its major appropriated fund support from the use of theater facilities and from transportation of films between stateside and overseas locations. Adequate data are not available for an estimate of these costs. Over the past 4 fiscal years, only three theaters have been built with appropriated funds. Although existing worldwide theaters are being used, present

DOD policy is for theater construction and renovation to be financed with nonappropriated funds. The Army and Air Force Motion Picture Service has suspended dividend payments for a 5-year period beginning in 1970 to provide funds to fulfill this policy.

The Navy Motion Picture Service operates in a manner somewhat different than the Army and Air Force Motion Picture Service. Although the Navy utilizes a few land-based theaters built with appropriated funds, most of the Navy films are rotated among ships in a planned program for motion pictures to be shown at sea as often as possible. The total amount of appropriated fund support for the Navy Motion Picture Service is, in our opinion, negligible.

CONCLUSION

On the basis of presently available cost data, we conclude that annual appropriated fund support, as a minimum, regularly exceeds the annual dividends paid by the exchanges and theaters for the servicemen's welfare. Operating and cost data showing the value of appropriated fund support provided to the exchanges and theaters are not maintained by the military departments or by the exchange and theater services. We suggest that these data be developed by DOD, because we believe that such data are necessary for DOD and the Congress to determine the reasonableness of the appropriated fund support provided and to consider the possible desirability of the exchange and theater services making full reimbursement to the military departments for such support.

MATTERS FOR CONSIDERATION BY THE COMMITTEE

The problems in identifying appropriated fund support discussed in this report give additional emphasis to the need for new procedures. As suggested in our earlier reports under this assignment, the Committee may wish to consider directing the military departments to establish a system for identifying the costs of all types of appropriated fund support given to nonappropriated fund activities.

CHAPTER 3

ALLOCATION AND REPORTING OF REVENUE

The Army and Air Force exchange and the Navy exchange use significantly different procedures to allocate and report their revenues. Each of these two major exchange services generates sufficient funds to maintain complex organizational headquarters and subheadquarters, manage multimillion-dollar cash investment accounts, support impressive programs for construction and renovation of stores and warehouses, and provide dividends for servicemen's recreational facilities. The Marine Corps exchange operation is significantly smaller and more decentralized than the operations of the other services.

ARMY AND AIR FORCE

In fiscal year 1970 the Army and Air Force exchange, after providing \$26 million for depreciation, reported earnings of \$120 million and paid dividends of \$85 million. On the basis of military strength, the Army Central Welfare Fund received \$53.5 million of the dividends and the Air Force Central Welfare Fund received \$31.5 million.

The dividends paid to the central welfare funds represented about 70 percent of the exchange earnings. The remaining 30 percent was retained for future improvements. During the 7-year fiscal period 1959-65, the exchange distributed about 94 percent of earnings, as dividends but during the next 5 years it reduced the dividend rate to an average 68 percent. Exchange officials said that they reduced the rate because:

- In late 1965 the exchange acquired the Navy Vietnam exchange system and started a growth period requiring a considerable amount of capital expenditures.
- In the absence of appropriated fund support for construction of new facilities and improvements, the exchange had initiated an accelerated capital improvements program.
- Inflation had increased requirements for capital.

More fundamentally, however, exchange officials have advised us that they do not expect to return to the higher dividend rate, because they believe that it is not good business to distribute nearly 95 percent of earnings as dividends.

NAVY

In fiscal year 1970 the Navy exchange, after providing about \$6 million for depreciation, reported earnings of \$57 million and paid dividends of \$39 million, as follows:

	Amount (000,000 omitted)
Field installations	\$30
Bureau of Naval Personnel	<u>9</u>
	<u>\$39</u>

The Navy exchange earnings distribution was similar to that of the Army and Air Force exchange. Dividends represented about 70 percent of earnings and the remaining 30 percent was retained for future improvements and for entertainment in the enlisted men's clubs.

During the 5-year fiscal period 1965-69, the Navy exchange distributed about 71 percent of earnings.

CONTROLS

The Army and Air Force exchange and the Navy exchange have unique responsibilities in the generation of revenue and the allocation of resources. These exchanges lack many of the profit-oriented controls exerted in a commercial environment and many of the normal systemic controls exerted in the Government environment. Although the exchanges are centrally directed within their own organizations, they are quasi-independent of the military departments.

The exchanges, in addition to receiving the appropriated fund support discussed in chapter 2, have been granted a virtual monopoly to a broad base of ready consumers, and

in dealings with commercial enterprises they receive benefits as part of the Federal Government. In 1942 the Supreme Court held, in the case of Standard Oil v. Johnson, that the exchange services are instrumentalities of the Federal Government and thus are entitled to sovereign privileges and immunities.

Yet the exchanges are not required to be bound by the budgetary, supply, procurement, personnel, and other management systems that are established for other organizations in DOD. The exchanges receive advice, and often many of the services available, from these systems, without the usual limitations imposed by these systems.

The exchanges determine the location and type of their facilities and services to be established; as a result, these facilities and services vary significantly from installation to installation. It is possible that many servicemen spend 2- or 3-year tours of duty without having ready access to the better exchange facilities. Under the Navy system, such a situation is worsened, because each installation receives exchange dividends to apply to recreational purposes on the basis of its local exchange profit. In contrast, the Army and Air Force exchange profits are distributed by the respective departments to suborganizations on the basis of military strength.

The number of retired military personnel available in an area to use exchange facilities strongly influences the establishment of the more desirable types of facilities, because the exchanges establish facilities on the basis of expected sales.

MARINE CORPS

In fiscal year 1970 the decentralized Marine Corps exchange operations, after providing about \$1.8 million for additions to capital, reported earnings of about \$11.1 million and paid dividends of \$6.1 million directly to recreation funds at installations.

The Marine Corps exchange dividends represented about 54 percent of earnings, and 46 percent was retained for future improvements.

THEATERS

The Army and Air Force Motion Picture Service has suspended dividends for the next 5 years, as noted on page 10, and will apply the money to the theater construction program.

CONCLUSION

The location and nature of exchange resources do not always achieve an equitable distribution among active duty Army, Navy and Air Force personnel or between active duty and retired personnel. Although we recognize that many logistical and other management problems must be faced, we believe that priority attention should be directed to meeting the needs of the active duty servicemen on a more equitable basis.

CHAPTER 4

INVESTMENTS AND LOANS AT

EXCHANGE AND THEATER HEADQUARTERS

About \$100 million in cash that was not directed to current operations was invested by the exchanges and the Army and Air Force Motion Picture Service. As of early 1970 the Army and Air Force exchange had invested about \$49.5 million of this amount, the Navy exchange had invested about \$34.2 million, the Marine Corps exchange had invested about \$4.5 million and the Army and Air Force Motion Picture Service had invested about \$11.2 million.

During fiscal year 1970 the Army and Air Force exchange earned about \$2.9 million in interest from these investments which consisted of U.S. government securities.

The Army and Air Force exchange has established accounts with four banks which advise the exchange by telephone each morning of its currently recorded cash balance. After the exchange considers outstanding checks, anticipated receipts, and other items, investments of excess cash are negotiated with the four banks and with other banks. If required, funds are transferred between banks by wire. All investments are made by telephone and are confirmed in writing, normally by the executive director and the comptroller of the exchange.

The exchange has determined that there is an average time lag of 7 days between the date the check is written and the date the check clears the bank. This time lag establishes a fund float which is invested by the exchange. On the January 26, 1970, balance sheet date, cash investments not used in operations amounted to \$49.5 million, \$44.7 million of which was the fund float.

The exchange has established a \$65 million line of credit with the banks, which serves, in general, as a buffer against overdrafts. The line of credit was used regularly from May 1966 to January 1970 to buy the Navy Vietnam exchange system, to establish an inventory in Southeast Asia, and to fill the merchandise pipeline. The maximum amount

payable against this line of credit was \$57 million on December 1, 1967. The line of credit currently is not being used.

Included in this financial structure was a series of loans from the Army and Air Force Motion Picture Service. Since 1966 the exchange has borrowed about \$34 million from the motion picture service with the largest balance payable being \$7 million. Since May 1966 the exchange has paid accumulated interest of \$4.7 million on all of its loans, of which \$892,000 was paid to the motion picture service.

Although the Board of Directors of the Army and Air Force Exchange Service has sufficient authority to authorize the exchange to borrow money, these loans, in our opinion, have not been and must not be on the credit of the United States.

PURCHASE OF NAVY VIETNAM EXCHANGE

Since the majority of the U.S. personnel increases in Vietnam were in the Army and the Air Force, DOD designated that the Army and Air Force exchange provide all exchange services in that country. In December 1965 the Army and Air Force exchange paid \$18.6 million to the U.S. Navy Ship's Stores Office, a nonappropriated fund activity, for the Navy's Vietnam exchange merchandise and equipment.

Also, the Army and Air Force exchange paid \$18 million to the Navy Commissary, an appropriated fund activity, for its exchange-type merchandise located on Saigon wharves, in warehouses, and in the Navy pipeline. Under the Navy system all exchange merchandise is purchased and stored by the commissary until sold to the exchange.

OTHER INVESTMENTS

At February 23, 1970, the Navy exchange's investments, other than for self-insurance and certain reserves, amounted to \$34.2 million in bank notes, Federal intermediate credit bank debentures, and bankers' acceptance notes. Investment transactions, which are made at frequent intervals, are executed by the bank as directed by an official of the Controller's Division of the Navy-Resale System Office.

At January 25, 1970, the Marine Corps Exchange Fund investments amounted to about \$4.5 million in U.S. securities and in savings accounts.

At March 31, 1970, the Army and Air Force Motion Picture Service investments amounted to \$11.2 million in U.S. securities and in bank certificates.

CHAPTER 5

PROCUREMENT PRACTICES

During a limited review of procurement practices of the exchanges, we encountered many instances where the Army and Air Force exchange and the Marine Corps exchange had ignored opportunities to utilize competition in contracting for merchandise. In addition, we believe that neither the Army and Air Force, nor the Navy, nor the Marine Corps exchanges maintained appropriate surveillance over contractors' pricing and related contract terms.

On June 30, 1970, the Army and Air Force exchange had about 1,700 active price agreements which were negotiated with selected vendors by the exchange without competition. Stateside Area Support Centers for the exchange determine the requirements of the individual exchanges under their jurisdictions and issue purchase orders against the price agreements listed in Price Agreement Bulletins. In certain circumstances purchase orders are also issued by the headquarters against these price agreements.

Vendors were required to certify in the price agreements that the prices and terms offered to the exchange were as favorable as those offered to other customers. Exchange officials advised us, however, that they had never requested access to the vendors' customer files or seen documentation to support the certification. The exchange attempted to determine the reasonableness of the certification by comparing the certified prices with those offered to other Government agencies and with those shown on manufacturers' price lists.

When we visited the Army and Air Force exchange's Alamo Area Support Center in Texas, we learned that more advantageous prices could be obtained than those in the price agreements. The procurement staff at the center negotiated with the vendors and obtained better terms than those in the price agreements. The discounts ranged up to 6 percent of the prices.

Elsewhere we observed contracts for delivery at the price agreement terms. Although we would like to see the

maximum application of renegotiation of price agreements with vendors, we believe that purely competitive procurement would better serve the Government's interest, especially for items such as spark plugs, automobile antifreeze, paper cups, and other products now purchased by negotiation, although brand is not a significant factor.

MARINE CORPS

In its decentralized operations the Marine Corps exchange has not provided procedures adequate for permitting all qualified suppliers equal sales opportunities. At Camp Lejeune, North Carolina, a select group of suppliers had the privilege of visiting exchange sales locations, talking to department managers, and writing up orders for approval by the purchasing department. The remainder of the suppliers were required to present their goods to the purchasing department for consideration and, if purchases were to be made, the department prepared purchase orders for the desired goods.

Also, the purchasing department had awarded a major contract for renting television sets to military personnel without obtaining competitive bids.

CONCLUSION

Although we have performed a limited review of purchasing procedures, it is evident that the exchange systems do not provide for sufficient competition in contracting or for adequate surveillance over contractors' negotiated pricing. We suggest that maximum competition in procurement be obtained and that, where negotiation is necessary, surveillance over contractors' pricing be exercised.

CHAPTER 6

CONTROLS OVER CASH AND INVENTORIES

In many instances the controls exercised over cash and inventories by individual exchanges and theaters were ineffective.

From our observations and from the reports of the Army and Air Force exchange internal auditors, unsatisfactory cash controls have existed in various stateside and Far East exchanges. Typical violations of prescribed procedures were:

- Cash shortages at individual exchanges exceeded \$3,000.
- Receipts for petty cash or working funds were not obtained.
- Petty cash was reimbursed prior to approval of vouchers.
- Cash receipts were not deposited promptly.
- Expenditures of petty cash exceeded authorized amounts.
- Unannounced cash counts were not performed as prescribed.
- Contrary to the provisions of concessionaire contracts, operations of concessionaires were not audited periodically to verify commissions received by the exchanges.

The controls over cash in the Navy exchange had been clearly improved as a result of a November 1968 report issued by a certified public accounting firm on a special study of cash systems in the Navy exchange. The report contained numerous recommendations applicable to the individual exchanges and to the Navy exchange headquarters. The

exchange had initiated corrective action on all the recommendations, except those dealing with weak controls over cash received by mail and over dishonored checks.

The Marine Corps exchange exercised controls over cash that, in general, were satisfactory, except for vending machine receipts. We noted that the only machines which had coin counters were those serving coffee and soft drinks in cups. Inasmuch as the remainder of the machines lacked counters, we believe that the exchange should arrange for its employees to be present whenever contractors' staffs collect money from these machines.

In our review of the Army and Air Force Motion Picture Service in Europe, we noted that the service reports had overstated cash and understated expenses. Part of the problem was the delay in forwarding data from the individual theaters and part was the improper reporting of cash by certain theaters brought on by discrepancies in ticket controls.

INVENTORY

Each of the exchange services provides for complete annual inventories of its stock and for investigations of significant shortages. The largest shortages, as well as an unfavorable trend of increasing shortages, have been experienced by the Army and Air Force exchange, as shown below.

Exchange Inventory Shortage

<u>Fiscal year</u>	<u>Navy</u>		<u>Army and Air Force</u>	
	<u>Amount (millions)</u>	<u>Percent of sales</u>	<u>Amount (millions)</u>	<u>Percent of sales</u>
1968	\$4.2	0.67	\$17.8	1.15
1969	\$5.6	0.80	\$22.3	1.38
1970	\$5.3	0.70	\$25.6	1.47

Although the Marine Corps exchange has experienced significantly smaller shortages than those shown above, it does not have storage and distribution facilities comparable to those of the other exchange services and often uses the other services' facilities.

We reviewed shortage investigation reports of the Army and Air Force exchange and found that they generally were inconclusive and showed no evidence of gross negligence, fraud, dishonesty, or willful misconduct on the part of employees. Exchange officials are placing new emphasis on warehouse controls and on shortage investigations by a newly established special staff from the exchange headquarters.

CONCLUSION

The deficiencies in controls over cash and inventories described in this chapter represent violations of the exchange and theater manuals and regulations of the military departments. Thus we suggest that special attention be given by the three exchange systems and by the Army and Air Force Motion Picture Service to ensure that existing requirements are met. The steps initiated by the Army and Air Force exchange to reduce inventory shortages appear necessary and appropriate.

CHAPTER 7

INTERNAL AND EXTERNAL AUDITS

The three military exchange systems are audited regularly by internal auditors and are audited annually by firms of independent certified public accountants. In addition, inspection teams representing various military headquarters' offices regularly perform audits of selected exchange operations.

The Army and Air Force Motion Picture Service is audited annually by a firm of independent certified public accountants and by a joint Army and Air Force Inspector General Team.

Despite this audit coverage we believe that improvements in the auditing work are necessary to improve the internal controls over the exchanges and theaters.

A change in the type of work performed by certified public accountants for the exchanges would, in our opinion, be beneficial. Although certified statements are prepared annually, the exchange and theater systems place insufficient emphasis on inquiries into management policies and controls. The brief letters commenting on internal controls provided by the certified public accountants, together with certified statements, generally include only limited references to the improvements possible in the complex procedures that implement management policies.

On the other hand a special study into a limited area by one of these firms can prove very worthwhile. For example, the Navy exchange engaged a firm of certified public accountants to perform a special study of the exchange's cash receipts and sales recording systems as discussed on page 20. The report from the firm resulted in the numerous improvements in the Navy exchange procedures which were evident during our review.

The exchange and theater services should emphasize not only annual certifications but also special studies of controls when they are needed. The time for establishing the

priority of work, in our opinion, is before and during the initial agreement discussions with the certified public accountants.

INTERNAL AUDITING

The Navy exchange is audited by the Naval Audit Service, which is the central internal auditing organization for the Navy. In contrast, the Army and Air Force exchange and the Marine Corps exchange have established internal audit staffs within their own organizations. Although we noted no basic reason for favoring the use of a central audit staff or a separate exchange internal audit staff, we noted several significant weaknesses in the policies for the use of separate internal audit staff.

- Internal audit work in the Army and Air Force exchange has been limited to reviews of operations without evaluating policies and other management actions. The audit working papers have been prepared cursorily on an exception basis and have not clearly established the scope of work performed.

- The Marine Corps exchange established its own internal audit staff in January 1968 but authorized insufficient staff. The audit responsibilities for the exchanges are divided among three area audit offices under the control of the chief auditor at Marine Corps headquarters. There are only 10 auditors authorized to staff these offices and to conduct semiannual audits of the central exchange fund and the 27 exchanges. As a result the scope of work, in our opinion, is too severely reduced to provide the minimum coverage needed. The accuracy of individual exchange financial statements often has not been verified, and exchange officials and base commanders at times have refused to follow the recommendations of the auditors on grounds, basically, that the recommendations were not adequately supported.

CONCLUSION

Auditing is an important part of the internal control over exchange and theater operations and resources. We

suggest that the reports by certified public accountants on audits of exchanges and theaters could be of far greater usefulness if better agreements were developed with the accounting firms on the scope of work to be performed. Far greater emphasis should be placed on improving the policies, procedures, and practices of internal control.

We suggest that internal audit staffs be assigned, developed, and supervised in such a manner that the staffs meet the standards of professional auditing in the purpose, techniques, and reporting of their work. The work of the internal audit staffs should be coordinated with that of the public accountants to ensure sufficiently detailed evaluations of management practices without unnecessary duplication of effort.

CHAPTER 8

SCOPE OF REVIEW

Our review was conducted at the headquarters of the Army, Navy, Air Force, Marine Corps, Army and Air Force Exchange Service, Marine Corps Exchange Service, and Army and Air Force Motion Picture Service and at the Navy Resale System Office. We reviewed exchange management, storage, distribution, and retailing operations at the following sites.

ARMY AND AIR FORCE EXCHANGE SERVICE

Headquarters, Pacific Exchange System, Hawaii
Headquarters, European Exchange Service, Munich, Germany
Alamo Area Support Center, Texas
Clark Air Base, Philippines
Fort Lewis, Washington
Lackland Air Force Base, Texas
Ramstein Air Base, Germany
Retail Outlet, Frankfurt, Germany

NAVY EXCHANGE SYSTEM

Newport Naval Station, Rhode Island
Rota Naval Station, Spain
Subic Bay Naval Station, Philippines

MARINE CORPS EXCHANGE SERVICE

Camp Lejeune, North Carolina

ARMY AND AIR FORCE MOTION PICTURE SERVICE

Headquarters, Europe, Mainz-Kastel, Germany
Selected theaters

Our review was directed primarily toward the evaluation of systems of internal control and audit and the identification of management policies and practices for controlling appropriated and nonappropriated fund expenditures on behalf of the exchanges. We also traced the distribution of exchange revenues and profits.

All these matters and related management considerations were discussed with exchange officials at various echelons and with administrative military officials.

APPENDIX

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Congress of the United States
House of Representatives
Committee on Appropriations
Washington, D.C. 20515

January 26, 1970

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Honorable Elmer B. Staats
Comptroller General of the United States
General Accounting Office
Washington, D. C. 20548

Dear Mr. Staats:

The Committee is concerned with the management and operation of non-appropriated fund activities operated by the Department of Defense. In reporting the Department of Defense and Military Construction Appropriation Bills for 1970, the Committee voiced its concern with the policies and practices of the military services for the reporting and use of non-appropriated funds. The Committee is also interested in the support furnished non-appropriated fund activities from appropriated funds and in whether these activities are being properly managed to insure that there is no waste or other inappropriate use of such funds.

Accordingly, the Committee requests that the General Accounting Office make a comprehensive review and evaluation of the operation and management of non-appropriated fund activities. The review should include an investigation of the services' operating practices, procedures and management controls.

The Committee would appreciate a complete report as soon as possible. However, in view of the various types of non-appropriated activities and the extensive operations of the larger ones, individual reports may be submitted as the work

on each type of activity selected is completed.

The review should include, but not necessarily be limited to:

1. The extent to which various types of non-appropriated fund activities rely on support from appropriated funds, including such areas as personnel, facilities, transportation, and supply. The information obtained should be used as the basis for further detailed studies into selected areas to determine whether such support is necessary and should be more closely delineated in budget requests.
2. The procedures, guidelines, and controls established by each of the military services and the Department of Defense to insure that the collection of funds from various non-appropriated fund activities and the reallocation of these funds are in the best interest of the military personnel involved.
3. The adequacy of procurement practices and policies for the acquisition of facilities, materials, goods, and services.
4. The custody and control of all assets including facilities.
5. The control of the sale, donation, award, or other distribution of materials, goods, services, assistance, or other property acquired with non-appropriated funds.
6. The reporting of financial results of operations of non-appropriated fund activities to various levels of command in each of the military departments.

Sincerely,


Chairman