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STATEMENT OF

ROBERT F. KELLER, DEPUTY COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE

SPECIAL SUBCOMMITTEE ON NONAPPROPRIATED FUNDS IN DOD

COMMITTEE ON ARMED SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON
[GAO]
GENERAL ACCOUNTING OFFICE REVIEW OF THE

MANAGEMENT OF NONAPPROPRIATED FUNDS

[DOD]
IN THE DEPARTMENT OF DEFENSE

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Nonappropriated Federal funds Grants
Funds management
Accounting systems
Procurement practices
Recreation
Internal audits
~~External audits~~
Investments
Loans

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Mr. Chairman and Members of the Subcommittee:

We are glad to be here today to discuss our reports to the House Committee on Appropriations on the management of nonappropriated fund activities in the Department of Defense. These reports were made in response to a request from the Chairman of the Committee for the General Accounting Office to make a review and evaluation of the operation and management of nonappropriated fund activities in the Department of Defense.

We issued a report on our evaluation of the management of exchange and motion picture services on March 25, 1971, and another on the management of clubs and other recreational activities on May 7, 1971. These were based on twelve reviews made in 1970 at a number of installations throughout the world.

These reports incorporated a number of suggestions designed to improve management and controls in the following areas:

- A. Accounting for Appropriated Fund Support
- B. Allocation of Exchange Profits of Welfare and Recreation Activities
- C. Financing Clubs and Messes
- D. Procurement Practices
- E. Internal and External Audits
- F. Controls Over Assets
- G. Investments, Loans and Grants

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At the outset it should be recognized that nonappropriated fund activities of the DOD occupy a unique position. They render a service vital to the morale of military personnel and their dependents, from first term men to retirees. They are non-profit activities with a captive clientele, partially subsidized by appropriated funds, but free of the laws and regulations which

apply to appropriated fund activities. ~~At the same time~~ they receive many of the benefits of Government agencies in their dealings with commercial enterprises. They are very substantial operations with sales in FY 70 of about \$4 billion made through several hundred activities. These conditions make it all the more important that these activities be operated with skill and professionalism--and in accordance with the best business practices.

SEE
TAB D

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A. ACCOUNTING FOR APPROPRIATED FUND SUPPORT

The exchanges are established to sell consumer goods and services at DOD installations and to provide funds out of their profits to supplement other morale, welfare and recreational activities within DOD. In fulfilling their two-fold purposes, the exchanges received significant appropriated fund support. In FY 70 the exchanges received appropriated fund support of at least \$140 million while providing nonappropriated funds of \$130 million to morale, welfare and recreation programs.

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The Army and Air Force Motion Picture Service was established to furnish the Army and the Air Force with entertainment motion pictures and to produce funds out of its profits to supplement other morale, welfare and recreational activities. The major appropriated fund support provided to the service consists of the use of theater facilities and the transportation of film between stateside and overseas locations. Adequate data are not available for an estimate of these costs. At the time of our review only three theaters had been built

with appropriated funds over the past four fiscal years and most theaters were much older structures. The Army and Air Force Motion Picture Service ~~had~~ suspended dividend payments for a 5-year period beginning in 1970 to provide nonappropriated funds to construct and renovate theaters.

The Navy Motion Picture Service is operated under a \$5 million grant from the Central Recreation Fund maintained by the Bureau of Naval Personnel by assessments against Navy exchanges and other nonappropriated fund activities.

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 film shows aboard ships and at Navy and Marine Corps overseas installations are given without charge. The stateside Navy film expenses are covered by an average charge of 25 cents for each attendee.

Although the Navy utilizes a few landbased theaters built with appropriated funds, the total amount of appropriated fund support for the Navy Motion Picture Service, in our opinion, is negligible.

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We were able to obtain estimates of support provided to clubs and other recreation activities. These activities, which generated combined annual revenues of \$47.1 million, reported a combined net profit of \$11.4 million. Not included in their operating costs was appropriated fund support of some \$15.3 million. Without this support--or if required to reimburse the government for appropriated fund support--many of these activities would have operated at a loss, and many would not have been able to exist.

We believe that ^{the} these amounts of appropriated fund support are understated by many millions of dollars because the Department of Defense does not maintain accounting systems that identify the amount of support provided to nonappropriated fund activities, and because the costs required to be reimbursed were significantly understated. For example, rates for utilities furnished by the Government were inadequate to recover all of its costs; transportation from one overseas area to another--and general services such as management planning, auditing and engineering--were not billed or identified as appropriate fund support.

SEE
TAB A

These problems emphasize the need for new procedures to identify the full amount of appropriated fund support to these activities. Further, the military departments should evaluate management effectiveness, usage, benefits provided, and the need for this appropriated fund support.

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B. ALLOCATION OF EXCHANGE PROFITS TO WELFARE AND RECREATION ACTIVITIES

In FY 70 the Army and Air Force exchange, after providing \$26 million for depreciation, reported earnings of \$120 million and paid dividends of \$85 million to central welfare funds. The Navy exchange provided \$6 million for depreciation, reported earnings of \$57 million and paid dividends of \$39 million. The Marine Corps exchange provided \$1.8 million for additions to capital, reported earnings of about \$11.1 million and paid dividends of \$6.1 million to recreation funds.

The dividends paid by the Army and Air Force and Navy exchanges represented about 70 percent of earnings and those

SEE
TAB B

paid by the Marine Corps exchange about 55 percent. The remainder of earnings were retained for future improvements.

ALLOCATION OF DIVIDENDS

Each military department uses a different system for allocating dividends received from the exchanges to welfare and recreational activities.

The Board of Directors of the Army and Air Force Exchange and Motion Picture Service annually declares a dividend which is paid quarterly to the Army and Air Force central welfare funds on the basis of the respective department's personnel strengths.

The Army's Nonappropriated Fund Division receives the Army's share of the dividends into the Central Welfare Fund, establishes quarterly rates for redistribution to major commands, central post funds, and unit funds on the basis of personnel strength and distributes the funds twice monthly as requested by the major commands. The quarterly rates per man vary from \$1.45 for smaller commands to \$1 for larger commands. Unit funds received \$.50 a man.

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The Air Force operates in a similar manner except that distributions are made to major commands which further distribute funds as needed by installations, but at rates not less than \$1.50 a man a quarter and to isolated units at not less than \$2.25 a man a quarter. At the time of our review the Air Force headquarters distribution rate was \$6 a man per quarter but during 1971 this rate was raised to \$7.

On the other hand in the Navy and Marine Corps each installation receives a share of the profits earned by the local exchange to carry on welfare and recreation activities. Thus, installations with larger exchanges have more funds available whereas smaller installations may not generate sufficient revenue to support an adequate program. The central funds obtain revenue from the exchanges through assessments . This revenue is used by the central funds to finance grants and loans in an attempt to equalize installation programs.

The Army and Air Force methods for distribution of exchange profits appear more closely related to welfare and recreation needs than the Navy and Marine Corps method. We suggest that the Navy and Marine Corps consider commingling the profits of the individual exchanges, distributing profits not needed for exchange operations to central recreation funds, and allowing the funds to be redistributed to welfare and recreation activities at all levels according to their needs.

C. FINANCING CLUBS AND MESSES

DUES

Dues are not normally charged by Navy clubs and messes, chiefly because of the transitory nature of many club patrons. The majority of clubs we reviewed in the Army and Air Force relied on a dues system to provide necessary operating income. Some clubs reported a profit without the use of dues, some did not show a profit until dues were included, and others showed a loss even after dues were included.

Dues may often be the most expedient and practical method for a club to maintain financial stability. For example, the Navy's Subic Bay Commissioned Officers' Open Mess was having trouble repaying an expansion loan from the Central Recreation Fund and had not fully funded existing liabilities. Commissioned officers' messes in the Navy are permitted dues on an exception basis and we suggested such a system be imposed at Subic Bay on a short-term basis as a means to solving its problems. The commanding officer informed us after our review that certain controls had been subsequently established and if they were not successful a dues system would be established.

FINANCIAL REPORTING AND CONTROL

Although the frequency of financial reporting by clubs and other recreational activities appears to be adequate, many reports contained inaccurate data. Headquarters officials made little use of financial statements and tended to leave the management review of them to the lower commands.

SEE
TAB F

The inaccurate reporting of results of operations, the failure of some commands to take necessary corrective action, and a lack of follow-up to insure that corrective action was taken resulted in ineffective use of financial statements.

The Army, partially in recognition of the lack of command attention to the management of nonappropriated funds, has established a Directorate of Nonappropriated Funds, Clubs and Open Messes, within Army headquarters, headed by a Brigadier General who reports to the Deputy Chief of Staff for Personnel.

Initially all clubs and messes will be under the command of numbered armies and other commands except for the Sixth Army area. Clubs and messes in this area will report to a separate command which, in turn, will report to the Director. After six months of operation the best method will be selected to manage all clubs and messes.

*When is the
State Army
Area
S.F. [unclear]*

The Army's experience should be examined by the other services to determine whether similar action is needed to improve the management of nonappropriated fund activities.

D. PROCUREMENT PRACTICES

Purchasing of supplies, services and equipment is a significant function of nonappropriated fund activities. We encountered many instances of inadequate control over purchasing practices.

Although DOD's nonappropriated fund activities are instrumentalities of the Federal Government, they are not subject to the Armed Services Procurement Regulations. Purchasing policies for nonappropriated fund activities are outlined in regulation of the military departments which require "fair and equal consideration of offers from suppliers." We found that these requirements had not been given sufficient attention.

EXCHANGES

On June 30, 1970, the Army and Air Force exchange service had about 1,700 active price agreements which were negotiated with selected vendors without competition. Included were such items as spark plugs, automobile antifreeze and paper cups where brand is not a significant factor. Stateside Area Support Centers

for the exchange determined the requirements of the individual exchanges under their jurisdictions and issued purchase orders against these price agreements. In certain circumstances purchase orders were also issued by the headquarters against these agreements.

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 original price agreement terms.

How about the Navy.

We understand that the procurement methods of the Army and Air Force exchange which were practiced during our review are still continuing.

CLUBS AND RECREATIONAL ACTIVITIES

Some of the clubs and recreational activities we reviewed did not formally advertise for vendor proposals and, of those that advertised, some did not provide sufficient time and information for vendors to adequately respond. At the Headquarters, 6th Army, for example, a contract for insurance for substantially all 6th Army nonappropriated fund activities was awarded after a period of only 17 days was allowed

for the 10 solicited agents to submit proposals. Under the circumstances only the agent who had previously provided the insurance had the necessary information to make an adequate proposal.

Most activities solicited small groups of vendors and contended that these groups provided what the activities wanted at low prices, although other activities in the same geographical area were obtaining similar items from other suppliers at lower prices. This practice did not ensure that the activities concerned would receive the lowest prices.

We were also concerned because most of the clubs and other recreational activities we visited, failed to properly use purchase orders. Frequently, purchase orders for goods and services, either were not obtained or were prepared and approved after receipt.

In each of the military departments, limitations have been established on the size of the purchases that may be made without (1) the approval of the installation commander or (2) the assistance of a purchasing and contracting officer. Some activities have disregarded these limitations.

We recommended that the military departments consider establishing consolidated purchasing offices where many clubs and other recreational activities operated in a small geographical area. Our report cited the San Antonio, Texas area (12 clubs at five installations--four Air Force and one Army) as an opportunity for a joint, interservice procurement office.

The Army, Navy, and Air Force have concurred with the concept of centralized area procurement. They have initiated changes in the field that should result in the establishment of central agencies where feasible within their respective services.

We have also been advised that the Army and the Air Force are each testing open mess procurement guidance which was developed to establish specifications, encourage competitive bidding, provide an audit trail and generally improve procurement practices.

We have not received any indications, however, that DOD is moving toward the establishment of joint, interservice area procurement offices for nonappropriated fund activities.

E. INTERNAL AND EXTERNAL AUDITS

The three military exchange systems and the Army and Air Force Motion Picture Service are audited annually by independent certified public accountants. Inspection teams representing various military headquarters' offices regularly perform audits of selected exchange and theater operations. We found that of the other welfare and recreational activities, only the Army Central Welfare Fund had been audited by certified public accountants.

Despite this audit coverage, we found that improvements in the auditing work were necessary to improve internal controls over the nonappropriated funds.

EXTERNAL AUDITS OF EXCHANGES

A change in the type of work performed by certified public accountants for the exchanges would be beneficial. Although certified statements were prepared annually, insufficient emphasis was placed on inquiries into management policies and internal controls.

We suggested that, inasmuch as auditing is an important part of internal control over operations and resources, reports by certified public accountants could be of far greater usefulness if more emphasis were placed on improving policies, procedures and practices of internal control.

The Army and Air Force Exchange Service ~~has~~ awarded a new contract, effective June 8, 1971, to a CPA firm for the annual examination of the exchange system. The contract provides for tests and reviews as considered necessary in evaluating and testing internal accounting controls, procedures, methods, and checks that are in use, including the internal audit program.

INTERNAL AUDITING

Each of the exchange systems have internal auditing staffs. In addition, the Navy exchange is audited by the Naval Audit Service, the Navy internal audit organization. We were of the opinion that the Marine Corps exchange internal audit group was authorized insufficient staff, having only 10 auditors to conduct reviews of the central fund and 27 exchanges around the world. The scope of review was severely limited and exchange officials and base commanders, at times, have refused to follow the auditors' recommendations on the basis that insufficient work was performed.

Other welfare and recreation activities are audited internally in a variety of ways. Headquarters funds--except for the Army Central Welfare Fund--are audited by the central audit services. Installation level funds are audited on an exception basis in the Army and Navy, while the Air Force Auditor General performs such audits periodically. The Marine Corps has established a separate internal audit staff which audits nonappropriated fund activities other than exchanges.

Generally we found that the three departmental internal audit staffs were spending a minimal amount of time on nonappropriated funds--from 0.7 to 6.5 percent of total effort during the last few years. The audits

SEE
TAB E

of civilian restaurants of the Army and Air Force vary between the services-the Army audits are made annually whereas the Air Force audits are made on an average of 27.8 months.

Although the Army and Air Force have recently completed special audits of clubs and messes, little attention was being given to most welfare and recreation activities because the bulk of departmental resources lie in the appropriated fund areas. Most Air Force installation level activities we visited had not been audited in two years.

INTERNAL REVIEW

Air Force fiscal control offices at most installations daily monitor nonappropriated fund activities and they conduct periodic reviews of internal controls and operations. Army activities are periodically reviewed by internal review staffs. Navy activities on the other hand are audited quarterly by boards appointed by the installation commander. These boards were composed of officers who more often than not had no background in auditing and whose duties in this regard were additional rather than primary.

In conclusion we found that whether they were audited by internal auditors, reviewers, or boards, little time was spent on nonappropriated funds. The audits performed by internal review staffs, central audit agencies and certified public accountants have not provided the evaluations needed by the activity managers.

We suggested that a separate office be established directly under the Secretary of each military department for the purpose of auditing clubs, messes, and other welfare and recreation activities at installation, major command, and headquarters levels. These offices should be

adequately staffed with competent auditors who meet professional standards. Further, we believe that these separate offices should be supported with nonappropriated funds contributed by the central funds. Thus, individual activities would be relieved of the financial burden of localized effort; and central audit agencies, supported by appropriated funds, can concentrate on auditing appropriated fund activities.

In recognition of the auditing problem Secretary Laird issued a memorandum on October 17, 1969, directing that action be taken to upgrade audit coverage given to nonappropriated funds and requiring that a portion of the activities be audited by independent public accountants. After considering comments of the military services, the Secretary issued DOD Instruction Number 7600.6 on November 3, 1970. Simply stated this instruction requires that 25 percent of clubs and messes and certain other activities with over \$100,000 in nonappropriated funds be audited by independent accountants and the balance by internal auditors on a selected basis.

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We have recently learned that the Army has responded to the need for more and better audits by transferring the responsibility for auditing nonappropriated funds to the Army Audit Agency. To fulfill this responsibility the agency has received some 169 personnel spaces--financed by appropriated funds--primarily from internal review staffs.

F. CONTROLS OVER ASSETS

Each of the military departments has prescribed procedures in regulations and manuals which are generally adequate for control over the assets of nonappropriated fund activities. Our review indicated that the prescribed procedures were essentially adhered to by headquarters activities, but were consistently violated by installation activities.

CASH

The weakest area of internal control found among installations non-appropriated fund activities was cash. Some prescribed cash procedures should be improved while others that were adequate were simply not being followed. Cash shortages ranging up to several thousand dollars could not be explained. Responsibilities for custody and recording of assets were not adequately divided; cash registers and receipts were not always used; concessionaire income was not controlled; cash was not deposited on time; and inadequate procedures were used to measure expected cash receipts from bar operations. At two Army clubs in Germany, for example, the noon cashiers were not ringing up sales on the cash registers upon receipt but instead were waiting until business slowed and then were ringing up all receipts at one time. SEE TAB G

The most flagrant violations of cash procedures encountered during our review dealt with slot machines. Since our report was issued, the Army and the Air Force have taken steps to prohibit the use of slot machines on their installations. The Navy and the Marine Corps continue to permit the use of slot machines at their overseas installations.

As background to these divergent decisions by the military services, I would like to emphasize that at the time of our review, the Navy and Marine Corps had issued detailed departmental guidelines on the acquisition, operation and disposal of slot machines but the Army and Air Force had delegated this responsibility to overseas commands. We found that slot machine controls were more effective in Navy and Marine Corps installations. Further, the Navy and Marine Corps rely on slot machine income--without members dues--to underwrite overseas clubs.

Both our own observations and the reports of the Army and Air Force exchange internal auditors revealed unsatisfactory cash controls in various stateside and Far East installation exchanges. Typical violations of prescribed procedures were:

- Receipts for petty cash or working funds were not obtained.
- Petty cash was reimbursed prior to approval of vouchers.
- 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.

In our review of the Army and Air Force Motion Picture Service in Europe, we noted that the service reports have 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.

At Ramstein Air Base, Germany, the golf club's annual income was about \$177,000. Typifying the lack of control over club resources which we encountered, and in violation of Ramstein and Air Force prescribed procedures, the same employee received cash, prepared receipts, posted accounts receivable, and performed numerous other golf club tasks incompatible with the separation of duties required to provide good internal control over cash.

INVENTORY

Poor control over the inventory of merchandise and supplies was evidenced at many installations by unexplained shortages, ineffective systems for recording issues, unrestricted access to warehouses by activity employees, poorly conducted periodic counts, and exposure of inventory to the weather.

At the time of our review the inventory shortages at the exchanges had been increasing. The Army and Air Force exchange experienced an inventory shortage of \$17.8 million (1.15% of sales) in 1968 as compared to \$25.6 million (1.47% of sales) in 1970. The smaller Navy exchange experienced a similar trend.

SEE
TAB C

Since our review, the Army and Air Force exchange has established special security forces at major installations and introduced other protective measures designed to reduce inventory losses. In fiscal year 1971, it reported a loss rate of 1% of sales as compared to the rate of 1.47% for fiscal year 1970.

DOD has generally been in agreement with our comments on the lack of control over cash and other resources at clubs and other recreational activities. The Air Force is dealing with this problem primarily by improving the selection, assigning and training of personnel for Special Services activities. The Army has issued a new regulation which prescribes detailed procedures for maintaining an adequate system of control over cash and other resources. The Navy has emphasized greater command-level awareness of the requirements of nonappropriated fund activities and has supplemented its reviews and inspections.

FACILITIES

The exchanges determine the location and type of their facilities and services to be established. These facilities and services vary significantly from installation to installation and do not always achieve an equitable distribution among active duty personnel, or between active duty and retired personnel.

We believe that particular attention should be directed to meeting the needs of active duty servicemen on a more equitable basis.

Our study of clubs and other recreational activities also revealed instances of questionable construction projects which were undertaken when nonappropriated funds became readily available.

*Check
Appendix*

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G. INVESTMENTS, LOANS, AND GRANTS

At the time our representatives visited the various military headquarters, and the headquarters of the exchange and motion picture services, they found that the combined exchanges and the Army and Air Force Motion Picture Service had invested about \$100 million in cash not required in current operations. Another \$90 million was invested by the central mess and welfare funds. The great majority of these funds were in U.S. Government securities, a small portion of funds were in certificates of deposit, and the Navy investments also were in bank notes and bankers' acceptance notes. The Marine Corps Mess Fund had over \$3 1/2 million in ordinary savings accounts.

The investments ostensibly were for later distribution or for earning interest to be used for grants and loans. Most impressive was the Army and Air Force Exchange investment of \$49.5 million in U.S. Government securities on which it had earned about \$2.9 million in interest during fiscal year 1970. The exchange had found that it took just about 7 days for exchange checks to clear the bank and had established a fund float which it had invested. The fund float accounted for \$44.7 million of the exchange's investments.

GRANTS AND LOANS

Grants and loans to clubs, messes, and other revenue-producing activities are obtained primarily by assessments on these activities. Funds for grants and loans to recreation type activities are withheld from exchange dividends.

We found that although the financial condition of the receiving activity may be considered, approving activities did not have clear policies on conditions governing approval of a grant rather than a loan. Consequently, large sums of money were distributed to clubs and other activities without a demonstrated need.

For example, the officers' open mess at Ramstein Air Base had an outstanding interest-free loan from a major command central fund in the amount of \$37,000 at the same time it had \$25,000 on deposit, earning interest, with the same fund. The mess managers had approved the deposit of an additional \$25,000. Thus it was earning interest from the loan fund on money it had obtained interest-free from the fund.

Air Force officials contended that

- the mess did not need the funds,
- the interest could be considered a grant to the mess,
- grants of funds were authorized, and
- the amount of the loan also could have been a grant.

Assessments on clubs and messes were based on gross sales of food or liquor or on slot machine income. The Army Central Mess Fund had significantly increased its income by increasing the cost of decals for all activities selling liquor.

Because these assessments against operations often were based on gross revenues, some activities have had difficulties, even to the extent of suffering losses, in paying these assessments.

The military departments should review the bases for these assessments and give consideration to assessing net profits rather than gross sales or income, or to converting to some other basis which would not create a financial hardship for the paying activity.

CONCLUSION

Subsequent to the issuance of our reports, which were made available to the Department of Defense with consent of the Committee, we learned that the Deputy Secretary of Defense on August 5, 1971, authorized the establishment of a Nonappropriated Fund Management Study Group to determine what controls are necessary over nonappropriated fund activities and to develop policy guidelines for implementing such controls.

Major considerations of this group will include:

- the authorization of appropriated fund support,
- utilization of nonappropriated funds,
- responsibilities and relationships for nonappropriated funds within and between OSD and DOD components,
- nonappropriated fund financial management policies,
- consolidation of separate nonappropriated funds,
- evaluation of the military departments' club and special service organizations, and
- the feasibility of greater coordination of procurement operations.

I understand this study is now underway and is expected to be completed this fall.

This completes my formal presentation.