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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

More Effective Internal Controls Needed To Prevent Fraud And Waste In Military Exchanges

Military exchanges purchase over \$3 billion in goods annually to meet the needs and improve the well-being of military service members. Like other large retail organizations, exchanges are susceptible to fraud, waste, and abuse. Numerous instances of unlawful practices have been detected.

Exchange management and oversight organizations have been slow to recognize the problem and improve controls to deter fraud and waste. Efforts to strengthen controls and combat fraud are being made, but better information, strict compliance with existing procedures, and tighter controls will bolster these efforts.

This report contains recommendations to help exchanges and oversight organizations take a more active and systematic approach to combating fraud and to improving the overall system for managing procurement.



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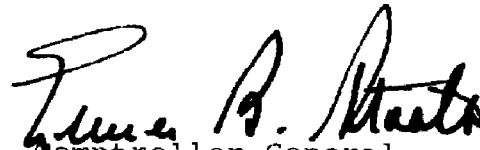
COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the efforts taken by the military exchange systems and by the services and the Department of Defense to prevent fraud and waste in exchange procurement. The report contains recommendations to the Secretary of Defense which could further improve controls, strengthen oversight, and provide a systematic approach to combat fraud and waste.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretaries of the services.


Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

MORE EFFECTIVE INTERNAL CONTROLS
NEEDED TO PREVENT FRAUD AND
WASTE IN MILITARY EXCHANGES

D I G E S T

The extent of fraud in military exchanges is unknown; however, the Department of Defense reported to the Congress that, during the first half of fiscal year 1980, exchanges accounted for 58 percent of all potential fraud cases referred for investigation in the Department. (See p. 1.)

On December 9, 1980, the House Armed Services Committee met with the Chiefs of Staff of the services and expressed grave concern about fraud in the military exchange systems. The Committee directed the military officials to develop a plan within 30 days for combating fraud in the exchanges to include consideration of the findings and recommendations in this report.

A Department of Justice task force formed in early 1977 to investigate fraud in the Army and Air Force Exchange Service had carried out investigations resulting in the conviction of six buyers, a deputy region chief, seven sales representatives, and a vendor for kickbacks and other unlawful activities by September 30, 1980. Numerous administrative actions had been taken against employees and other parties. In the Navy's exchange system, 13 cases of procurement fraud were detected during the 5-year period ended December 1979. (See pp. 6 and 26.)

Controlling fraud in organizations the size of military exchanges requires preventive management at all levels, including strong internal controls and an environment in which controls are understood and enforced. The exchanges have not achieved this but

are acting to strengthen their controls and to insure compliance with their policies and procedures. (See pp. 4 and 25.)

GAO found that exchange managers were slow to take corrective action because they lacked information on the extent and nature of fraud in their operations, did not enforce or monitor the enforcement of standards of conduct, and were not aware of the extensive noncompliance with policies and procedures. (See pp. 4 and 25.)

Since this study began, exchange officials have initiated numerous actions to combat fraud and waste in their operations, including

- establishing a program to assess vulnerability to fraud and waste;
- strengthening the internal audit function;
- establishing a fraud, waste, and abuse hotline; and
- instituting a registration system to increase visibility of sales representatives.

Although these actions are commendable, GAO believes that more should be done to strengthen controls.

A management information system on the extent and nature of fraud is needed. Standards of conduct should be strictly and uniformly enforced, and managers should be held accountable for compliance with policies and procedures. Further improvements should be made in the management of procurement to avoid waste. (See pp. 4 and 25.)

The Navy's exchange system did not have an effective internal audit function because it lacks the independence, time, and qualified

staff to perform audits with due professional care. Also, these reviews do not meet GAO standards for audits of governmental organizations. (See p. 32.)

The Board of Directors of the Army and Air Force Exchange Service, the Naval Supply Systems Command, and the Office of the Secretary of Defense have not been aggressive in exercising their oversight responsibilities. These organizations need to make sure that exchange managers take effective actions to combat fraud and waste in their operations. (See pp. 21, 37, and 41.)

Department of Defense policies governing procurement with nonappropriated funds, unlike its policies for appropriated funds, did not require the use of formal advertising procedures where practicable, nor did they provide separate GAO access to contractors' records to check compliance. (See p. 43.)

RECOMMENDATIONS

To strengthen internal controls and oversight, the Secretary of Defense should direct the exchanges to:

- Develop a management information system to provide data on the nature and extent of fraud in their operations.
- Develop a system of management controls to deter fraud and reduce the likelihood of waste. (See pp. 23 and 39.)

The Secretary should direct the Army and Air Force Exchange Service to improve its management of procurement by (1) establishing a results-oriented buying capability with detailed buy plans and buyer performance evaluations, (2) clarifying criteria and identifying opportunities for increasing competitive procurement, (3) enhancing

buyer performance by providing career paths and training programs, and (4) requiring periodic audits of contracts for pricing compliance. (See p. 23.)

The Secretary should direct the Navy to:

- Overhaul its exchange internal audit function by (1) assigning a person to head the unit whose independence has not been impaired, (2) staffing audits with more qualified auditors, and (3) providing sufficient time to make audits properly and in accordance with GAO standards.
- Comply with Defense policy to give the contracting officer or his representative access to contractor records and make audits for compliance with contract terms. (See p. 39.)

GAO also recommends that the Secretary of Defense (1) establish an Exchange Executive Board or similar organization with representation from his office to set goals, evaluate performance, and provide guidance to the exchange systems and (2) revise nonappropriated fund procurement policies to require use of formal advertising wherever practicable and provide for separate GAO access to contractor records for nonappropriated fund negotiated contracts. (See p. 45.)

AGENCY COMMENTS

The Army and Air Force Exchange Service and the Navy generally agreed with GAO's findings and recommendations. The actions they have initiated should strengthen their internal controls and improve the management of exchange procurements. (See pp. 23 and 39.)

The Office of the Secretary of Defense said it agreed with the findings and was studying GAO's proposals to determine what actions should be taken. (See p. 45.)

C o n t e n t s

		<u>Page</u>
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Management of procurement	1
	Principles of good management controls against fraud, waste, and abuse	2
	Objectives, scope, and methodology	3
2	AAFES ACTIONS TO COMBAT FRAUD AND STRENGTHEN BUYING CONTROLS NEED TO BE AND INCREASED	4
	Extent of fraud unknown	5
	Management attitudes affect employee misconduct	7
	Noncompliance with policies and procedures is widespread	10
	Initiatives to prevent and detect fraud and waste	12
	Opportunities for improving procure- ment management	16
	AAFES Board of Directors oversight lacking	21
	Conclusions	22
	Recommendations	23
	Agency comments	23
3	MORE AGGRESSIVE ACTIONS ARE NEEDED TO COMBAT FRAUD AND WASTE IN NAVY EXCHANGES	25
	Reporting system inadequate	26
	Enforcement of standards-of-conduct violations not monitored	27
	Noncompliance with policies and proce- dures is extensive	30
	Followup on fraud cases needed	31
	Overhaul of internal audit needed to make it effective	32
	Initiatives to prevent fraud and waste	35
	Naval exchange oversight needs strength- ening	37
	Conclusions	38
	Recommendations	39
	Agency comments	39

CHAPTER		<u>Page</u>
4	OSD SHOULD STRENGTHEN OVERSIGHT AND POLI- CIES GOVERNING EXCHANGE OPERATIONS	41
	OSD lacks an effective monitoring and feedback system	41
	Procurement policies should be strengthened	43
	Loose personnel screening practices do not provide adequate hiring safeguards	44
	Conclusions	44
	Recommendations	45
	Agency comments	45

APPENDIX

I	Letter dated November 3, 1980, from the Deputy Commander, Army and Air Force Ex- change Service	46
II	Letter dated December 2, 1980, from the Principal Assistant Secretary (Manpower and Reserve Affairs), Department of the Navy	52

ABBREVIATIONS

AAFES	Army and Air Force Exchange Service
DOD	Department of Defense
GAO	General Accounting Office
NAVRESSO	Navy Resale and Services Support Office
OSD	Office of the Secretary of Defense

CHAPTER 1

INTRODUCTION

Military exchanges are the largest and one of the most vital components of the Department of Defense's morale, welfare, and recreation 1/ program. The exchanges, which are nonappropriated fund activities, are intended to improve service members' overall satisfaction with military life and attract dedicated men and women to military careers by (1) providing authorized customers with goods and services at the lowest practicable prices and (2) generating profits to partially fund other morale and recreation programs. In accomplishing this mission, the exchanges have reported that their selling prices are, on the average, 20 percent less than commercial sector prices. Also in 1979 the exchanges contributed \$129.5 million to the service members' welfare and recreation activities.

Recent disclosures indicate that fraud, waste, and abuse may be eroding these goals. For example, Defense reported to the Congress that exchanges accounted for 58 percent of the 391 potential fraud cases in Defense referred for investigation during the first half of fiscal year 1980. Exchange procurement appears to be highly susceptible to fraud involving kickbacks and gratuities, which, according to Defense investigators, is one of the most simple crimes to commit, yet one of the most difficult to prevent and detect. This report discusses the efforts the exchange systems have taken to prevent and detect fraud and identifies additional opportunities for improving controls over exchange procurement.

MANAGEMENT OF PROCUREMENT

The Assistant Secretary of Defense (Manpower, Reserve Affairs and Logistics) is responsible for overall policymaking and management oversight of the military exchanges. This oversight is primarily concerned with assuring that Defense policies are correctly interpreted so the exchanges can operate effectively and efficiently.

1/Other activities include clubs, libraries, golf, bowling, gymnasiums, hobby shops, and other recreation activities.

The Army and Air Force Exchange Service (AAFES) and the Navy Resale and Services Support Office (NAVRESSO), the two largest exchange systems, are among the top retail establishments in the United States. The Commanding Officer, AAFES, has command and control of 227 exchange outlets worldwide. Procurement is accomplished at four levels of management: headquarters, exchange regions, area exchanges, and overseas offices. The major purchase of resale merchandise is centralized at the headquarters level. During 1979, AAFES purchases for resale totaled \$2.4 billion, of which 60 percent, or \$1.4 billion, were made by headquarters contracting officers (buyers). The Commanding Officer reports to the Board of Directors of AAFES which is responsible for directing and monitoring exchange operations.

NAVRESSO is under the control of the Naval Supply Systems Command. NAVRESSO provides technical guidance and administrative support to 148 independent exchanges which come under management control of base commanding officers. NAVRESSO also provides technical guidance to the small exchange program of the Military Sealift Command and directly manages Navy commissary stores and ships' stores afloat. The Commander, NAVRESSO, sets the policies and the procedures for the Navy to purchase resale merchandise. Procurement is made at NAVRESSO headquarters, area support complexes, and installations. However, the major purchase of resale merchandise is decentralized at the installation level. Buyers at this level usually select their merchandise from bulletins negotiated at NAVRESSO. These bulletins set forth items and prices available to the exchanges. During 1979 resale merchandise purchases totaled \$909 million, of which 84 percent, or \$760 million, were made by buyers at the installation level. The remaining purchases represent NAVRESSO regional and centralized procurement on behalf of the exchanges.

PRINCIPLES OF GOOD MANAGEMENT CONTROLS AGAINST FRAUD, WASTE, AND ABUSE

As in any business the size of AAFES and NAVRESSO, controls are necessary to prevent individuals from (1) stocking excessive or unsalable merchandise, resulting in unnecessary inventory cost and eventual markdown or writeoff, (2) paying more for goods than they should, and (3) accepting lower quality products. Much has been written on what can be done to control fraud in business. The universal answer is that preventive management at all levels at all times is the best deterrent to dishonesty and includes (1) a strong system of

internal controls to promote economical and efficient operations and to safeguard assets against fraud, waste, and abuse and (2) the establishment of an environment in which controls are understood, encouraged, and consistently enforced.

OBJECTIVES, SCOPE, AND METHODOLOGY

This review was directed at evaluating exchange programs to deter fraud and waste by examining the

- aggressiveness of oversight by exchange management at all levels,
- adequacy of internal controls,
- adequacy of audits and other reviews in combating fraud, waste, and abuse, and
- alternative procurement methods that might be used to deter fraud and waste.

We directed our review primarily at how the exchanges buy goods for resale. Our field work was conducted from September 1979 to September 1980 at the Office of the Secretary of Defense (OSD); Air Force Office of Special Investigations; Naval Supply Systems Command and Naval Investigative Service headquarters, Washington, D.C.; at AAFES headquarters, Dallas, Texas; at AAFES Alamo Exchange Region in San Antonio, Texas; and at NAVRESSO headquarters, Brooklyn, New York. We also visited private retail establishments, national retail associations, and several AAFES and NAVRESSO vendors.

At the military installations listed above, we reviewed instructions and directives relating to procurement and personnel management, minutes of meetings, and correspondence; analyzed audit, inspection, and investigative reports; examined contract records; and held discussions with knowledgeable officials. At retail establishments and associations visited, we held discussions with officials on how they manage procurement. At AAFES and NAVRESSO vendors, we reviewed the vendors' records to test compliance with contract price provisions.

CHAPTER 2

AAFES ACTIONS TO COMBAT FRAUD AND STRENGTHEN

BUYING CONTROLS NEED TO BE INCREASED

AAFES management is acting to strengthen internal controls to deter fraud and waste in its procurement. But this has not always been the case, and more could be done. Before 1975, AAFES managers had been slow to recognize the seriousness of the problem because they lacked information on the extent and nature of known fraud in their operations, had a permissive attitude toward violations of their standards of conduct, and were not aware of widespread noncompliance with policies and procedures. AAFES has now

- established an office to assess the vulnerability of its policies and procedures to fraud and to detect internal control weaknesses;
- strengthened its internal audit function;
- begun comprehensive auditing of its contractors for pricing compliance;
- established a fraud, waste, and abuse hotline;
- established a registration system for vendors and representatives to increase their visibility in the procurement system and to aid investigators;
- reemphasized the responsibility of its Safety and Security Division to be the focal point for detecting and investigating potential fraud, waste, and abuse in its operations; and
- directed that a study be made to assess the adequacy of its programs to deter and detect fraud, waste, and abuse.

These actions are commendable, but more needs to be done to improve buying and personnel management controls. A management information system should be installed to identify the nature and extent of fraud in AAFES operations. AAFES standards of conduct need to be strictly and uniformly enforced, and managers need to be held accountable for failing to comply with AAFES policies and procedures. Improvements should also be made in AAFES management of the procurement function.

AAFES Board of Directors could have been more active in providing the leadership and direction necessary to combat fraud and waste in AAFES procurement. Actions the Board took to determine the potential for fraud within AAFES were not effective. Further, the Board did not adequately insure that its policies were carried out and did not enforce its standards of conduct.

EXTENT OF FRAUD UNKNOWN

AAFES has no system for informing management of the extent of bribes, kickbacks, and gratuities identified in its retail buying activities. Although AAFES has obtained the basic information, it has not compiled and analyzed this information in a format usable by management. For example, the Safety and Security Division, as office of primary responsibility for combating fraud, issues a number of statistical reports. These reports primarily concern employee theft, robbery, and shoplifting. Data concerning bribes and gratuities are included in the category "all others." This category, however, also includes data on the number of narcotics and vandalism incidents, and assaults, as well as cash variances over \$50. The inability to separate fraud from other improprieties makes it impossible to quantify the extent of known fraud within the organization and in what areas it is occurring.

For almost 20 years, fraud has been a problem in AAFES procurement. In 1966 the Commander of the European Exchange System voiced concern over kickback schemes and requested the Air Force Office of Special Investigations to investigate a number of AAFES merchandising specialists (buyers). According to Air Force records, subsequent investigations, involving Air Force investigators; the Federal Bureau of Investigation, Department of Justice; Internal Revenue Service, Department of the Treasury; and the German Tax Investigations Office, resulted in the conviction of 10 AAFES buyers

and vendors' sales representatives 1/ in both U.S. and German courts. These investigations and subsequent convictions concerned kickback schemes perpetrated since 1962.

In 1975, AAFES provided information to the Federal Bureau of Investigation, which caused an investigation into alleged bid rigging on construction contracts. During this investigation, it was revealed that AAFES headquarters' buyers were receiving kickbacks and gratuities from vendor representatives. A Department of Justice task force was therefore formed in Dallas in 1977 to conduct further investigations into these matters. In 1978 a second task force was established in San Antonio, Texas, after investigative efforts of the Dallas task force uncovered evidence of kickbacks at the Alamo Exchange Region. As of September 30, 1980, the combined task force efforts had resulted in the conviction of six buyers, an AAFES deputy region chief, seven sales representatives, one vendor, and numerous administrative actions against employees and other persons involved. Six other cases are at various stages of investigation and prosecution. According to an Assistant U.S. Attorney in Dallas, investigations will continue so long as fraud is uncovered at AAFES.

Our analysis of Air Force investigations made between January 1, 1975, and December 31, 1979, indicates that a significant number of employees and large amounts of money were involved. For example, of 372 individuals who had retail procurement authority during this period, 66 were investigated for standards-of-conduct violations involving allegations of procurement-related irregularities. Allegations were substantiated in 23 cases, and 4 others are still being investigated. The substantiated allegations involved receipt of kickbacks and gratuities by headquarters and regional buyers, a deputy region chief, and an exchange region chief. The gratuities and kickbacks were given by vendor representatives and vendors and included clothing, furniture,

1/AAFES has, for many years, conducted a substantial amount of business through vendors' representatives, who act as the intermediary between the buyer and the manufacturer. The representative is often an independent firm which is providing its services to one or more manufacturers on a commission basis. Services usually range from calling on AAFES buyers for the purpose of presenting a manufacturer's merchandise to performing in-store service, such as reordering and inventorying stock.

gift certificates, and large amounts of cash. For example, several AAFES employees were convicted of receiving cash payments ranging from \$500 to \$26,000. These amounts are substantially less than what investigations and indictments have disclosed, which have been estimated by investigators in some individual cases to be as much as \$150,000.

An effective management information system could provide AAFES with the data necessary to determine trends, assess vulnerability, establish the level of resources needed to deter fraud, map antifraud strategies, and evaluate the scope and effectiveness of audits and investigations.

A management information system is basically an intelligence system which can serve as a major analytical tool to combat fraud. The crime of fraud is often not a neat set of easily described acts but, rather, a complex, subtle, and dynamic process. An information system shows a pattern of this process to anticipate the how, when, and where of fraud and provides the basis for attacking the problem.

A management information system should include data on

- past fraud schemes perpetrated, methods of perpetration, and means by which detected;
- experiences and findings of other agency offices and law enforcement agencies; and
- management weaknesses previously identified by investigators, auditors, or others, which increase vulnerability to fraud.

This body of knowledge should be systematically organized and analyzed to permit reconstructing past events and facilitating the identification of trends, patterns, or unusual occurrences indicating possible fraud.

MANAGEMENT ATTITUDES AFFECT EMPLOYEE MISCONDUCT

AAFES believed that establishing any additional controls in buying would represent nothing more than overmanaging, would be uneconomical, and would not detect kickbacks and gratuities because the past instances of fraud were perpetrated outside the system of internal control and involved collusion. Instead, it has set high standards of conduct for their employees, punished some violators, and published violators' names so employees could see that standards are

enforced. However, the failure of AAFES management to insure strict and uniform enforcement has contributed to a perceived permissive attitude toward violations of those standards among AAFES employees.

AAFES standards of conduct prohibit personnel from soliciting or accepting any gift, gratuity, favor, entertainment, loan, or any other thing of monetary value, either directly or indirectly from any person, firm, corporation, or other entity which does business with AAFES. In addition, regulations require employees to report any instance in which things of value are offered or when a conflict occurs. These standards have remained substantially unchanged since 1971. Violating these standards is cause for disciplinary actions, which include oral and written reprimands, suspension of pay, downgrading, separation from employment, and expulsion from AAFES' executive management program.

Historically, each AAFES commander has issued a memo annually reiterating these standards to employees and required employees to acknowledge every 6 months that they understand them. Also, when a vendor was reported to be offering gratuities, a letter was sent explaining the AAFES standards. These reiterations appear to have achieved less than the desired results. Our review has shown recurring instances in which management either inconsistently applied the standards or failed to deal directly with problems when they occurred.

Our review of the 82 investigations conducted between January 1, 1975, and December 31, 1979, disclosed that 10 individuals with procurement authority violated the standards of conduct by not reporting receipts of gifts. Investigations of 11 cases involving 10 employees, 3 of whom were supervisors, were conducted in 1976 (3 cases), 1978 (3 cases), and 1979 (5 cases). Although Air Force investigators determined that each allegation was founded, disciplinary actions were taken against only three individuals in the 1979 cases. None of the three disciplined employees were supervisors. One official involved in advising AAFES management of the disciplinary actions which should be taken said a reason for the absence of disciplinary action was a lax attitude toward applying the standards of conduct regarding the reporting of gifts.

Another illustration of the leniency demonstrated in enforcing the standards of conduct occurred after AAFES management specifically prohibited employees from making direct purchases of merchandise from vendors for personal use. The

specific guidelines were implemented in December 1975 and reiterated again in a June 1976 letter from the commander. AAFES records showed, however, that as late as October 1977 employees continued to make purchases in violation of the standards. In three cases involving purchases of a \$1,600 diamond ring, shoes, and \$1,900 in furniture--the three employees involved received oral counselings--a nondisciplinary action. The official who bought the furniture, a deputy region chief, pled guilty about 4 years later to accepting kickbacks at the exchange region. The individual who purchased the ring has been indicted on similar charges.

In another case, in September 1978, AAFES internal auditors reported that a buyer purchased merchandise from firms which employed his sons and from firms which had previously employed him. The buyer reported this apparent conflict of interest when it was accidentally discovered by his supervisor 1 year after his assignment to the buying position. The supervisor never took action to determine if there was a conflict of interest, nor did he report it to higher authorities until after it was discovered by internal auditors about 2 years later.

Although Internal Audit developed information on the above case, which showed significant increases in purchases from the firms in question, a detailed investigation was not made. Less than 2 weeks after disclosure by Internal Audit, management determined, without investigation, that no procurement irregularities had occurred and transferred the buyer to a nonbuying position at another region. AAFES officials we contacted explained that an investigation was not made because none was requested by AAFES management.

We interviewed two former AAFES buyers convicted of accepting bribes and kickbacks and two former vendor representatives who pled guilty to bribery charges. The comments made by these individuals further illustrate the existence of a permissive attitude. One convicted buyer said he accepted kickbacks and gratuities because "it came with the desk." He explained, that when he transferred into his regional position, he was approached by a sales representative who wished to continue a kickback arrangement established with the buyer's predecessor. The former buyer we interviewed noted that it was a common practice to accept gifts and gratuities. One convicted vendor representative commented that competition from other vendor representatives who were also paying kickbacks to buyers forced him to give kickbacks. He cited how his annual commission on sales increased from \$9,000 to over \$160,000 after he began giving kickbacks.

These circumstances and management inconsistencies regarding code-of-conduct enforcement do not go unnoticed by employees. The comment of one convicted buyer that she did not think anything would really happen to her because everyone was doing it and nothing was ever done to others speaks dramatically to the responsibility management must bear for allowing circumstances to exist that could convey an impression of permissiveness.

NONCOMPLIANCE WITH POLICIES
AND PROCEDURES IS WIDESPREAD

AAFES management assured Defense in January 1980 and the Board of Directors, on a number of occasions, that the buying function was effectively performed, that procedures were sound, and that buying controls were adequate and effective. Three external reviews of the procurement management system have been made in the last 10 years. Each of the reviews found the system basically sound, and the recommendations to further strengthen controls were incorporated into AAFES policies and procedures. Additionally, in 1978, the Commander, AAFES, appointed an ad hoc committee to conduct a comprehensive review of internal control procedures pertaining to merchandise procurement. We believe that these reviews do not adequately support the assurances given Defense and the Board of Directors. Only one of the studies, which was directed by the Chairman of the Board, was an indepth review, and it showed that management application of buying policies and procedures did not insure complete system discipline. The other studies addressed only policy and procedures and did not determine whether AAFES practices were in compliance with them.

After our review began, AAFES initiated a broad study of its procurement function, and in March 1980 Internal Audit reported to the Board that its survey showed that AAFES procurement regulations were sound but were not always strictly adhered to.

Our limited review confirmed the Internal Audit's findings that procedures were not adhered to and showed noncompliance in the areas of documentation of procurement decisions and maintenance of vendor ordering and payment files.

Lack of documentation

AAFES relies on an approval process for succeedingly higher levels of purchase amounts and documentation as an additional control that no one person can unduly influence

the buying process. However, current studies showed that documentation was lacking and approvals were not always obtained. We believe that, without adequate documentation, the supervisory approval process is not an effective control.

AAFES' internal audit of procurement which was ongoing when we completed our work found that a common problem running through the entire AAFES buying process was a lack of documentation and compliance in several key areas, such as

- justifying the addition of items to the AAFES inventory,
- documenting negotiations,
- justifying price increases, and
- supervising approvals.

In two 1979 reports, Internal Audit also informed management that contracting officers were exceeding their procurement authority without proper approvals.

Our review of one exchange region's records on 13 contracts and 7 contract files at AAFES headquarters showed noncompliance in the following areas:

<u>Type</u>	<u>Number of instances</u>
Purchases exceeding buyer's authority without approval	3
Justification lacking for item or source selection	9
Documentation missing on vendor negotiation	4
Necessary approvals absent	4
Justification lacking for price increases	7

Vendor master file controls are largely ignored

Controls over adding and making changes to the vendor master file were not complied with. The vendor master file is the control list of vendors authorized to do business

with AAFES. Information from the file is used in preparing mechanized purchase orders. Since February 1980, the file has also been the single source of authorized payment addresses for the AAFES accounts payable system. To strengthen controls over the procurement process, a 1978 study on buying recommended that buyers be prevented from adding vendors to the file or making changes to the file without supervisory approval. A January 1979 change to AAFES' procedures implemented this recommendation.

We examined all 185 vendor master file actions initiated from January 1 to March 31, 1980, and found that 51 vendor additions to the file had been initiated by unauthorized individuals, and 175 of the 185 actions had not received supervisory approval. Officials responsible for file maintenance and control said they had never required supervisory approvals and were unaware of regulations requiring approvals.

Further, headquarters buyers are specifically prohibited from making telephonic requests for additions to the file. Despite this prohibition, we identified 11 instances during our 3-month sample period (January through March 1980) where the unit processed telephonic requests from buyers. Unit officials said they were aware of the prohibition against accepting these requests but did so if a buyer stated the request was an emergency. One official stated that he felt he had a responsibility to be as responsive as possible to the buyers and that the unit's actions were consistent with this responsibility.

INITIATIVES TO PREVENT AND DETECT FRAUD AND WASTE

Since the Department of Justice task force began its investigation for fraud in exchange procurement, AAFES officials have taken a number of actions to combat fraud and waste. Following disclosures by the task force of fraud in AAFES procurements, the Commander, AAFES, established an ad hoc committee on procurement in July 1978 to review the adequacy of internal controls. The group found that adequate checks and balances existed but recommended additional actions to strengthen procurement controls. All of the recommendations were implemented.

In January 1980, AAFES established a Fraud and Inspection Office in its audit division. This office's primary mission is to determine those areas (including the procurement function) where AAFES is most susceptible to fraud and

waste. It will also train the entire audit staff on risk assessments as well as make audits in the areas determined to have a high degree of vulnerability.

From September 1979 to July 1980, AAFES made significant improvements in its internal audit function, including improving its interface with the Board of Directors. As a result of a recent Army Audit Agency report, AAFES has staffed the director of internal audit position with a qualified auditor and provided more detailed information to the Board of Directors on significant audit findings. After our study began, Internal Audit initiated a worldwide review of the procurement function to evaluate the adequacy of internal controls and to determine the extent of, and reason for, noncompliance with policies and procedures.

Fraud hotline installed and visibility of vendors have been improved

AAFES established a toll-free hotline in March 1980 to encourage and facilitate the reporting of fraud, waste, and abuse within AAFES. As of August 21, 1980, 617 calls were received, of which 136 related to alleged fraud, waste, or abuse. Of these 136 calls, 3 related to purchasing irregularities concerning bribes and kickbacks and were referred for investigation.

Changes have also been made in the procedure employees are to follow in reporting gratuities and kickbacks. Now the employees are to report receipt of items to the AAFES Safety and Security Division. Formerly employees reported such matters to an immediate supervisor.

AAFES, in July 1980, instituted a registration program for vendors and their representatives because investigators complained that a major problem in the merchandising operation was that AAFES had no way to routinely identify the representatives with whom they do business. Since representatives are not a party to contracts between vendors and AAFES, representative firms have operated under a blanket of obscurity which, in view of past and present investigative findings, worked against the exchange. The registration system will provide more visibility to the representatives and, according to AAFES, will provide an audit trail to trace transactions among buyers, vendors, and their representatives.

Fraud prevention programs
have been reemphasized

In August 1979, AAFES designated its Safety and Security Division as the office in charge of the AAFES program to eliminate fraud, waste, and abuse in AAFES operations. In July 1980, AAFES again reemphasized that this division is responsible for overseeing the total loss prevention program, including procurement fraud which should be instituted by every level of AAFES management.

This division's ability to carry out its responsibilities, however, could be improved. None of the AAFES Safety and Security specialists have received training in retail buying. We believe the accomplishment of their mission (loss prevention) would be enhanced with an understanding of the merchandise system and relationships between AAFES and the vendors.

In June 1980, the Commander, AAFES, designated the AAFES Plans and Management Division to oversee AAFES programs to detect and deter fraud, waste, and abuse. Objectives set forth in the designation are to insure that management controls are meaningful and effective, to provide the ability to detect fraud, and to provide a means of keeping top management informed about problems. As part of this effort, a study is being made to determine if the AAFES capability to detect and deter fraud, waste, and abuse can be improved.

Pricing compliance audits begun

We do not believe that AAFES' efforts in pricing compliance audits were adequate prior to our review. Annually, contracts for purchases of approximately \$2 billion are subject to a price protection clause that guarantees that vendor prices and discounts will be as favorable or better than those offered to any other customer. Because of our findings, AAFES is instituting a program to periodically audit its vendors.

In the past several years, AAFES suspected six vendors of violating the price protection clause. AAFES negotiated settlements of \$200,000 and \$35,000 in two cases, is negotiating for rebates from three other companies, and, in the sixth case, it determined the suspicion was unfounded.

Due to the relative significance of the proven pricing violations, AAFES plans to examine the records of five other

selected companies. Although this is a positive initiative, it is a one-time action and does not establish criteria to be used in any future selections of companies to be reviewed. AAFES is also negotiating with the Defense Contract Audit Agency to conduct future pricing reviews of selected vendors.

Additional emphasis placed
on competitive buying

Effective competition is probably the best method for assuring fair and reasonable prices. AAFES has taken initiatives to increase the amount of goods it buys competitively. However, refinements are needed to clarify and emphasize instructions governing the use of this process.

As early as 1976, internal reviews showed that the criteria for identifying products for multiple-source competitive negotiation were vague and that the process had not always been used even though circumstances suggested it could have been. In February 1979 Internal Audit reported that about \$500,000 worth of record albums could have been purchased in this manner. Our findings confirmed these observations. We noted that in one case a merchandise selection committee's vote resulted in a tie between two vendors' products. The instructions state that when this occurs both vendors should be requested to submit offers. Instead, the buyer, with his supervisor's approval, negotiated with only one of the vendors.

The Merchandising Division Director, in December 1979, asked headquarters merchandising groups to identify additional products which were suitable for competitive negotiation. During the previous year, 14 categories of goods amounting to approximately \$52 million, or 3.7 percent of headquarters' purchases, were obtained by this method, including such items as vitamins, Christmas trees, flashlight batteries, and blank recording tapes. Institutional foods, which are used in AAFES snack bars and fast-food facilities, accounted for about \$21 million of the total.

Since December 1979, merchandising branches have identified 29 product categories with annual purchases of \$25 million for competitive negotiation. Contained in the new list are such items as auto batteries, fire extinguishers, electric blankets, military clothing, mattress pads, and shoe trees.

During our review, management established a directive to reiterate competitive negotiation and to expand the scope

of its use. The directive sets forth the general circumstances under which the procedure will be utilized, and it required headquarters groups to report monthly on the amount of contracts awarded. However, it did not contain specific criteria to identify products for competitive negotiation. In addition, attention has only been directed to procurements at the headquarters level. AAFES was unable to quantify or list the products which were brought through competitive negotiation at other organizational levels because an information system did not exist that could provide this data. AAFES officials acknowledged that such a system would be useful for oversight and said they would explore development of such a system.

OPPORTUNITIES FOR IMPROVING PROCUREMENT MANAGEMENT

AAFES could improve the management of its procurement by establishing buyer accountability, reassessing and clarifying the merchandise selection committee function, and providing career paths and more training for its buyers.

Merchandise plans and goal setting could increase buyer accountability

AAFES management has not required buyers to perform the detailed planning common to larger retailers and necessary for accountability and efficiency. Planning efforts are inconsistent, lack documentation, and have been hindered because information systems do not generate enough data. The AAFES merchandise planning system is not based on policy direction or goals established by top management. Instead, the detail and extent of planning is left to the discretion of individual buyers and supervisors. A standard format for plans has not been developed, and the AAFES procedures only require plans for seasonal merchandise.

We obtained information from a national retailing association representing 35,000 retailers, from two major retailers, and from literature on retail buying which showed that, to achieve effectiveness and accountability, detailed accurate merchandise buying plans are a must. Most large retailers devise standard formats for buy plans, some actually print forms for their buyers' use. In compiling and documenting the plans, the following information is used:

- Past market experience for each category of merchandise.

- Complete previous year sales and markdown data broken down by size, style, color, and vendor.
- Market strategies and customer information to determine major price groupings.
- Sales projections for the coming year and/or season which reflect both goals and store level input, usually expressed in units and dollars.

Retail industry officials told us that buy plans should be compared to actual results and be monitored continually using input from store managers and online sales information.

AAFES procedures for seasonal merchandise buy plans require the buyer, after reviewing the market, to justify the sources and items selected and the total dollars to be allocated to each vendor. The procedures, however, are not specific regarding what is required in preparing and documenting the plan. We interviewed five AAFES buyers and reviewed files to determine how they developed plans for seasonal merchandise. One buyer did not prepare plans even though procedures required them for the type of merchandise being procured. The remaining four buyers had plans which included the required source, item, and cost information. However, two plans did not have documentation to support item and source selection, and, in another case, the rationale behind item selections was limited. In the last case, the buyer had subjectively ranked vendors and products with some justification for doing so. But the information was not as detailed as that observed at the private retailer we visited.

The four buyers incorporated some data from store requirements and warehouse issues into their planning; however, units sold and the markdowns taken were not used because present merchandising systems do not generate such information. None of the plans indicated how well previous plans were met and none contained information on whether the merchandise would sell well.

AAFES is developing an information system which, when implemented, should be capable of providing the data necessary for better planning. Use of this data would give buyers additional planning capability comparable with that observed at major retailers. Also, more detailed planning will enable AAFES to be more effective in such cost-saving areas as contracting for definite quantities, which was recommended in 1971 by a joint Army, Air Force, and AAFES

review team but has not been achieved for the majority of merchandise procurement.

Buy plans can also be used as goals against which buyer performance can be evaluated, thus increasing accountability. In 1975 and 1977 reports, the AAFES Internal Audit recommended that the merchandising division establish definitive standards to evaluate buyer performance. Internal Audit stressed the importance of such evaluation standards to call management's attention to adverse buying trends. Although merchandise division officials concurred in Internal Audit's recommendation, definitive buyer evaluation standards have not been developed.

Several factors have hindered AAFES in evaluating buyer performance, including the lack of detailed merchandise plans and retail sales feedback. National retailing officials told us that detailed buy plans were an absolute necessity for providing buyer direction and for setting a performance expectation against which the buyer's action can be measured. Retail sales data becomes significant in determining whether a buyer is meeting the plan. Although AAFES is now developing a system which should provide the capability to capture data at the retail store level, such data alone without detailed buy plans would not provide the basic criteria to evaluate the impact of buyer decisions.

Merchandise selection committee function needs clarification and reassessment

Merchandise selection committee procedures are unclear on the method of vote counting to be used resulting in (1) inconsistent application, (2) being ignored on occasions, and (3) being subject to manipulation. Finally, selection committees are a costly mechanism whose need should be reassessed if AAFES adds strict accountability into its buying process.

A merchandise selection committee is a major tool for selecting items, and, according to AAFES, committees provide an additional check and balance on the buyer to deter collusion between a buyer and vendor or their representative. Committees are composed of the buyer and up to 11 other people. The committees choose, from competing products, the items that AAFES should stock for the next year or longer.

Inadequate procedures on committee voting have caused buyers to employ varying techniques for voting on selections and counting ballots. Further, a buyer desiring to

manipulate a committee selection could do so simply by changing the method of counting. We found five different methods of recording and tallying selection committee votes in the five committees we reviewed. When there are tie votes, the buyer is supposed to negotiate further with the selected vendors to obtain the best price. However, in one case we examined, there was a tie, but instead of negotiating with two vendors, an attempt was made to break the tie by having the committee members vote a second time. This second vote resulted in another deadlock, so the buyer's supervisor, who was not a member of the committee, cast a ballot to end the stalemate and provide a basis for sole-source purchase.

From January through September 1980, AAFES headquarters convened 40 selection committees. Costs for such committees are not routinely maintained; however, for 3 committees involving 9 to 12 members and lasting from 2 to 9 days, costs ranged from \$5,000 to \$25,000.

Career development paths should
be established for AAFES buyers

A trained and experienced buying staff could improve the effectiveness and efficiency of the buying function. A career path, which stipulates appropriate training and experience necessary for each merchandising specialist level, has not been established even though this is a necessary requirement for any organization. At the time they were hired, AAFES buyers generally did not have training and experience in retail procurement.

Both our review and AAFES's current survey of procurement revealed that AAFES retail personnel policies and practices differ from those in the private sector. For example, AAFES has had a longstanding view that retail store or inventory management experience is desirable when considering an individual for a buying position. In the private sector, however, individuals who hold positions similar to AAFES buyers are hired, trained, and developed as buyers throughout their career with the company. Private sector officials we talked with considered retail store management and retail buying as separate, distinct, and incompatible career paths.

At AAFES headquarters and at the regions, there are gaps in the career ladder which have necessitated transfers out of the retail buying areas to progress in the merchandising field. This situation is shown by the following table of authorized merchandising assistant and/or specialist positions and actual staffing in grades 9 through 12.

	<u>Merchandising grades</u>			
	<u>9</u>	<u>10</u>	<u>11</u>	<u>12</u>
Headquarters:				
Authorized	12	0	0	43
Actual	8	0	0	46
Regions:				
Authorized	21	1	10	25
Actual	20	1	6	25
Totals:				
Authorized	33	1	10	68
Actual	28	1	6	71

As shown above, unaltered progression from a grade 9 merchandising assistant to a grade 12 merchandising specialist at AAFES headquarters is impossible, and the chance of such progression in the regions is extremely limited. Consequently, personnel are subject to losing product knowledge and technical buying skills they may have acquired.

A merchandising training curriculum should be established

AAFES has not implemented a formal program to train individuals for buying positions, which was recommended almost 10 years ago. In June 1971 a joint Army, Air Force, and AAFES review team concluded an indepth evaluation of AAFES purchasing policies, procedures, and management practices. In its report to the Chairman, Board of Directors, the review team noted that AAFES lacked a career training program for buying personnel. The review team recommended that AAFES design and implement such training programs which provide for completion of (1) courses on a recurring and progressively advanced basis and (2) prescribed courses as a basis for assignment and advancement. No action was taken until August 1979, when AAFES began to develop a plan to establish training agreements which would allow AAFES to promote merchandising assistants with high potential within the merchandising career field through accelerated training. As of August 1980, the plan to develop this training program is still in the formative stages.

Retail industry officials have emphasized to us that, to establish an effective buying process, formal training in

purchasing policies, procedures, and management practices was absolutely necessary. The AAFES Internal Audit study found that most private retailers had programs lasting from 3 to 5 years prior to the time the individual became a buyer.

AAFES BOARD OF DIRECTORS OVERSIGHT LACKING

The Board, in our opinion, needs to become more aggressive in exercising its oversight responsibilities for directing and monitoring AAFES operations. Although the Board has been apprised of individual cases of fraud in procurement as they were identified, its members, until recently, never directed AAFES to determine the extent of the problem in AAFES operations. Furthermore, the Board has relied on management's assurances that internal controls were sound without seeking external or internal review of whether procurement policies were carried out and its standards of conduct were enforced.

The Board is responsible for approving AAFES policies and for insuring that these policies are carried out effectively.

From June 1976 to June 1980, Board minutes and memoranda showed that the Board was apprised on 11 occasions of individual fraud investigations, of suspected misconduct occurring at AAFES, and of AAFES fraud programs. For example, in June 1979, the Board Chairman was provided information on the activities of the Department of Justice task force which showed 19 AAFES employees and 10 firms or their employees were either known or suspected to be involved in misconduct and actual fraud involving gratuities and kickbacks. Board members were also briefed on the AAFES program to prevent losses and detect fraud which primarily discussed AAFES' physical security and employee theft detection efforts. Even though the Board was apprised of these investigations, they reacted passively and failed to direct AAFES management to take actions to combat the problem.

In March 1980 the Board was briefed on the AAFES internal audit of procurement which showed that AAFES procurement regulations were not being followed in all instances. At that meeting the Board cautioned AAFES management about the noncompliance with procurement procedures; however, it never directed AAFES management to take any actions to hold managers accountable for not following procurement policies and procedures.

At the Board's September 1980 meeting, we briefed the Directors on our findings and suggested that they direct AAFES to take actions to overcome the problems we identified. At the meeting, the Board directed the Commander, AAFES, to act on the following:

- Arranging for the Army Audit Agency to review administrative controls in AAFES.
- Providing the Board with a report on white-collar crime to include any trends that are evident.
- Instituting a system of controls which stresses prevention of white-collar crime.
- Reviewing current controls for adequacy and instituting new controls, if needed.
- Assuring compliance with policies and procedures and exacting uniform and equitable disciplinary action for noncompliance.

CONCLUSIONS

The number of cases of fraud in AAFES procurement identified by the Department of Justice task force indicates that a serious problem exists. We believe AAFES management has been slow to recognize the existence of fraud but is now acting to combat it. AAFES initiatives are commendable; however, a systematic strategy will be needed to overcome the problem. This strategy will require as much knowledge as possible about how, where, and why fraud can occur in AAFES operations. In developing a system of management controls to deter fraud and reduce the likelihood of waste, AAFES will need to (1) monitor actions taken to enforce its standards of conduct and to hold managers accountable for compliance with policies and procedures, (2) analyze past instances of fraud to determine system weaknesses, (3) provide for periodic audits to make sure that controls are effective, and (4) assess exchange operations to determine vulnerability to fraud and waste.

The Board needs to be more aggressive in exercising its oversight role. The Board has a duty to insure that the interests of Army and Air Force military personnel are protected from fraud and waste and that its policies are effectively implemented. Although informed of instances of fraud and lack of compliance with policies and procedures, the Board failed to direct AAFES management to take corrective

actions. We believe that actions directed by the Board in September 1980 should strengthen AAFES internal controls if the Board remains vigilant and makes sure its policies are properly implemented.

RECOMMENDATIONS

We recommend that, to strengthen AAFES internal controls and to deter fraud, waste, and abuse in its procurement operations, the Secretary of Defense direct AAFES to:

- Develop a management information system to provide data on the nature and extent of fraud, waste, and abuse in its programs.
- Develop a system of management controls to deter fraud and reduce the likelihood of waste.
- Improve its management of procurement by (1) establishing a results-oriented buying capability with detailed buy plans and buyer performance evaluations, (2) clarifying criteria and identifying opportunities for increasing competitive procurement, (3) enhancing buyer performance by providing procurement career paths and training programs, and (4) requiring periodic audits of contracts for pricing compliance.

AGENCY COMMENTS

AAFES officials generally agreed with our findings and recommendations. AAFES has initiated a number of actions which, we believe, will strengthen its controls and enhance procurement operations. (See app. I for a discussion of these actions.)

AAFES said that, in August 1980, it began developing a management information system which will gather data from all appropriate sources for analyses and decisionmaking. AAFES stated that it planned to use the information for trend analysis AAFES-wide and to keep the Board informed on all aspects of fraud, waste, and abuse.

AAFES commented that it was actively reemphasizing every aspect of management controls and requested the Army Audit Agency to review its administrative controls over procurement. Also an indepth study of the adequacy and enforcement of AAFES standards of conduct is underway which will include the establishment of tables of punishment for effective and equitable treatment.

AAFES said it was developing and implementing a merchandise management master plan which will include a comprehensive plan for each commodity. AAFES stated that, after the plan is implemented, it will reassess its use of selection committees. AAFES agreed with the desirability of expanding competitive procurement and established criteria for identifying products to be purchased under this method.

AAFES said it recognized the need for an improved career path with appropriate training and experience and is undertaking a review of its headquarters staffing structure.

AAFES said it was working with the other exchange systems to develop policies and procedures for audits of contract pricing compliance.

CHAPTER 3

MORE AGGRESSIVE ACTIONS ARE NEEDED TO COMBAT

FRAUD AND WASTE IN NAVY EXCHANGES

Navy exchanges, like other retail operations, are susceptible to fraud and waste and must have strong internal controls to minimize it. NAVRESSO lacks an adequate management information system to identify instances of bribes, kickbacks, gratuities, and conflict-of-interest violations in Navy exchange operations. We found that local enforcement of violations of NAVRESSO's standards of conduct was not monitored in a systematic way, noncompliance with policies and procedures was extensive, and NAVRESSO and the exchanges could have been more timely in correcting some reported deficiencies. If this situation is not corrected, the internal controls will not be effective and the potential for fraud will increase. Finally NAVRESSO's internal audit of exchange operations must be improved to provide a more professional evaluation of its internal controls.

Since our review began, NAVRESSO has increased its emphasis on resolving some longstanding problems and has initiated actions to combat fraud and waste. Specifically, NAVRESSO has

- established a system to restrict the rehiring of persons who have been fired as a result of a wrongdoing or who resigned while under investigation;
- established a requirement that all fraud cases will be brought to the attention of the Commander, NAVRESSO;
- increased emphasis on systemwide buying;
- established a registration system for vendors and representatives; and
- requested higher command approval to permit the Commander, NAVRESSO, to submit supplemental performance ratings on naval exchange officers.

But NAVRESSO needs to do more. The management information system needs to be improved to identify the nature and extent of known fraud and to help assess exchange vulnerability to it. All fraud cases should be analysed to determine

the potential for fraud at other exchanges. NAVRESSO should make sure that appropriate actions are taken against employees and vendors involved in fraud. The internal audit function needs an overhaul to improve its independent and objective evaluation of exchange operations. Its standards of conduct must be uniformly enforced, and managers must be held accountable for following policies and procedures.

The Naval Supply Systems Command review groups have made numerous recommendations to improve procurement and personnel management controls at NAVRESSO and the Navy exchanges. However, the Commander, Naval Supply Systems Command, has not made sure that appropriate actions are taken on all findings and recommendations which he considered valid.

REPORTING SYSTEM INADEQUATE

NAVRESSO does not have an adequate system to inform management of bribes, kickbacks, gratuities, and conflicts of interest in exchange operations. NAVRESSO's office of security receives a number of reports on incidents occurring at the exchanges. However, the data is not compiled in a format usable by management. For example, exchange incident reports primarily concern shoplifting, burglary, and robbery, while information on bribes and gratuities and conflicts of interest are included in an "other" category. The other category also includes data on bomb threats, sabotage, riots and any other unlawful acts occurring at the exchanges. Thus NAVRESSO is unable to quantify the extent of known or reported incidents of bribes, kickbacks, and conflict-of-interest violations or where it is occurring.

There have been 45 investigations of procurement-related fraud during the 5-year period ended December 31, 1979. Forty-two individuals were investigated for standards-of-conduct violations involving alleged procurement irregularities and conflicts of interest. Six individuals in procurement positions were also investigated for standards-of-conduct violations involving alleged theft and larceny of exchange assets, and there were four investigations for attempted bribery of exchange employees. Furthermore, there were four investigations of alleged procurement irregularities and attempted bribery occurring in the Navy's ships' stores afloat.

Most of the fraud investigations were terminated by the Naval Investigative Service because (1) the allegations were determined to be invalid, (2) further investigation was

considered to be nonproductive (the facts did not justify further investigative efforts), or (3) the culpable parties could not be identified. In 16 completed investigations, however, culpable parties were identified, 13 involved alleged gratuities or attempted bribery by vendors and representatives, and 3 related to larceny cases. Ten investigations into bribery, procurement irregularities, and conflicts of interest were still open at the time of our review, and, according to Investigative Service officials, they were also opening several other investigations of matters referred from the Department of Justice task force.

Although these statistics do not depict a widespread problem of fraud, NAVRESSO lacks an information system which could provide auditors and investigators alike with the data necessary to determine trends, assess vulnerability, and enhance investigative and preventive efforts. The problem may be more serious because there has not been adequate followup on investigative reports to determine whether the potential for fraud existed at other Navy exchanges which purchased goods from the same vendors. (See p. 31 for further discussion of this matter.)

ENFORCEMENT OF STANDARDS-OF- CONDUCT VIOLATIONS NOT MONITORED

NAVRESSO has not systematically monitored fraud investigations to determine whether Navy officials in charge of the independent Naval exchanges are taking action to discipline employees involved in improprieties or fraud and taking appropriate actions against vendors or their representatives involved. Such actions are important administrative controls because they not only provide critical data for meaningful analysis but also convey to employees and vendors alike that management will respond aggressively to violations of the standards of conduct. Administrative actions against vendors are also important to protect the Government's interests in the case where other agencies may be doing business with the same vendors and to deter others from offering gratuities or bribes.

Administrative actions against vendors are prescribed in Defense Acquisition Regulations and include debarment and suspension which basically prohibits a vendor from doing business with the Navy and/or other executive branch agencies. Generally, the maximum period of debarment is 3 years and suspension is 18 months. Some of the causes set forth in the regulations for debarment and suspension actions include (1) conviction or suspicion based on adequate evidence

of fraud in obtaining, or attempting to obtain, a contract or the commission of an offense indicating a lack of business integrity, (2) clear and convincing evidence of a violation of contract provisions, including violation of the gratuities contract clause, and (3) for other cause of such serious and compelling nature which brings into question the vendor's responsibility as a Government contractor.

We attempted to obtain information on the disciplinary actions taken against employees who were found to have violated Navy's standards of conduct and the administrative actions taken against the vendors. We were unable to determine what actions were taken because of a lack of data. Therefore, we asked NAVRESSO, on June 18, 1980, to provide us with information on actions taken by them or exchange officials against employees and/or vendors on 11 investigative cases where violations occurred according to records at the Naval Investigative Service. On September 29, 1980, NAVRESSO responded to our questions; but after taking more than 3 months to gather the data, their response was incomplete in some cases, and in others their responses showed that actions were not always taken. The following table lists the cases and the disciplinary and debarment and/or suspension actions taken.

<u>Case</u>	<u>Type</u>	<u>Number of employees involved</u>	<u>Action</u>	<u>Number of vendors</u>	<u>Action</u>
1	Kickbacks	1	Suspended—later resigned.	1	None—firm went out of business after pleading guilty to fraud.
2	Attempted bribery reported by employee	(a)	(a)	1	Debarred
3	Conflict of interest	2	One employee received a non-disciplinary verbal reprimand. Other employee received none.	1	None
4	Larceny	1	NAVRESSO could not provide data.	(a)	(a)
5	Gifts	1	15-day suspension	1	None
6 and 7	Conflict of interest and gifts	2	NAVRESSO could not provide data.	1	NAVRESSO could not provide data.
8	Gratuities	3	None	2	None
9	Gratuities and larceny	5	One employee suspended and later resigned. Action on others pending grand jury proceedings.	1	Pending outcome of grand jury proceedings.
10	Falsifying procurement documents	3	NAVRESSO could not provide data.	1	NAVRESSO could not provide data.
11	Attempted bribery reported by employees	(a)	(a)	1	None

a/Not applicable.

NONCOMPLIANCE WITH POLICIES
AND PROCEDURES IS EXTENSIVE

Although there are prescribed purchasing and merchandise controls, our review of NAVRESSO field inspection and audit reports revealed numerous violations and noncompliance with controls at the exchanges and at NAVRESSO. If management allows widespread noncompliance to continue, over time the effectiveness of its internal controls will deteriorate and a permissive environment will exist, contributing to fraud and waste in the system.

Two Navy investigations of alleged fraud made in 1978 illustrate the failure to comply with internal controls spanning the entire purchasing process. The violations included lack of competition, buying locally at higher prices than negotiated by NAVRESSO, failing to determine quantity requirements, adding items to the inventory without justification, ordering and receiving merchandise without required documentation, paying for merchandise that exceeded order quantity, failing to obtain approvals on purchasing and merchandise forms, failing to prepare merchandise control forms, and lack of separation of duties (the person buying was also receiving the merchandise). Investigative reports showed that as a result of these violations, excessive merchandise was bought which, in some instances, had to be marked down. In addition, the exchanges paid higher prices than necessary for the merchandise purchased, some of which was of poor quality.

Even though the noncompliance contributed to the alleged wrongdoings, management had not corrected the problem. Subsequent audits at the two exchanges continued to show noncompliance in the areas of lack of competition, improper preparation of merchandise control forms, and failure to follow prescribed receiving procedures and payment controls.

As part of its responsibility for overseeing exchange operations, NAVRESSO merchandising and procurement staff make advisory visits to the exchanges to review individual department operations, train exchange staff, and provide technical and administrative assistance in correcting and resolving management problems. During 1979 NAVRESSO made 112 such visits to 50 exchanges and 5 support complexes. NAVRESSO also makes about 80 internal audits of exchange operations annually. We reviewed all NAVRESSO advisory visits for 1979 and 12 audit reports prepared in 1980. Many of these reports indicated that noncompliance with established

policies, procedures, and plans was a common and continuing problem throughout the exchange system. Exchange management agreed with these findings.

The 12 audit reports showed noncompliance findings such as lack of competition, failing to obtain approvals, excessive purchases, not maintaining adequate stock controls, and failing to plan procurements. In eight reports, findings were repeated from previous audits or advisory visits. For example, at one exchange the audit report showed that failing to follow stock controls and to plan for procurements was causing out-of-stock conditions for high-demand items and excess inventories of slow-moving items. The audit report stated that numerous advisory visits had reported on these problems but they continued to exist. At another exchange internal audits from 1974 to 1980 showed continued noncompliance resulting in inadequate stock control, excessive inventories, lack of competition, lack of separation of duties, and buying locally at prices higher than negotiated by NAVRESSO.

Noncompliance was also evident at NAVRESSO headquarters. Prior inspections and contract management reviews made by the Naval Supply Systems Command reported numerous instances in which buying practices did not follow policies and procedures. For example, in March 1979 a Naval Supply Systems Command review at NAVRESSO pointed out instances in which buyers failed to follow regulations and instructions and concluded that major efforts must now be made to insure compliance at all operating levels.

Also the lack of documentation and supervisory review continues to be a problem. NAVRESSO utilizes merchandise councils to review and approve additions and changes to its contracts. These councils are required to document the basis for their decisions regarding new items or vendors, significant price changes, and deleted vendors. We reviewed one council's proceedings on 152 actions covering new items, new vendors, price changes, and deletions from July to December 1979. There was no documentation to show what decisions were reached on 35 of the 152 actions, and justification for council decisions were not documented in 59 instances.

FOLLOWUP ON FRAUD CASES NEEDED

NAVRESSO had no systematic program to followup on fraud investigations to determine whether the potential for fraud existed at other exchanges. Our review of two 1978 investigations previously discussed and other records at

NAVRESSO indicated a potential for fraud at other Navy exchanges. At the time of our review, the vendors involved in these two investigations were doing business with 15 other exchanges. The following illustrates what we believe are indications of possible fraud, which should have been looked into:

--At one exchange, the department serviced by a vendor involved in one case had excessive inventories and was not properly accounting for stock on hand. The vendor's products contributed to part of the excesses, and there was evidence that poor quality merchandise was sold to the exchange.

--At two exchanges, the department serviced by the vendor in the other case had excessive inventories. Also, the exchanges were buying the vendor's products at higher prices than similar products available on NAVRESSO contracts.

NAVRESSO officials said they would followup on these cases.

OVERHAUL OF INTERNAL AUDIT
NEEDED TO MAKE IT EFFECTIVE

Internal audits of exchange operations do not provide an adequate professional evaluation of internal controls because they lack the independence, time, and qualified staff needed to perform effective audits. The head of internal audit and the audit team leaders are military officers whose independence has been impaired because they previously served in management capacities in the exchange system. Besides qualified auditors, the audit teams include specialists who also serve in an advisory capacity to the exchanges being audited. In addition, NAVRESSO has not been auditing its contractors for compliance with contract provisions.

The public accounting firm hired by NAVRESSO to conduct annual financial audits reported, on three occasions, deficiencies in the internal audit function. In 1977, 1979, and 1980, the public accountants sent management letters to the Commanders of NAVRESSO and the Naval Supply Systems Command criticizing internal audits for insufficient documentation supporting audit reports, lack of supervisory review, and use of merchandising specialists who are unqualified to perform financial audits.

Audits lack independence

The internal audit function is headed by, and audits are staffed with, individuals who have been involved in the management and operations of the exchanges being audited. This creates an inherent conflict of interest which could compromise the independence needed to make internal audits effective. The Navy's practice has been to assign military officers to head the unit and to lead the audit teams who previously were exchange officers. Also, the audit teams are composed of qualified auditors augmented by specialists from NAVRESSO's merchandising divisions who are responsible for advising and assisting exchanges in their day-to-day operations.

A NAVRESSO division director recognized the independence problem in a February 1980 memorandum sent to NAVRESSO's top management. The director said:

"This arrangement creates a situation during the rest of the year whereby these specialists provide advice and assistance to the same persons they inspect. Over periods of time, professional or personal friendships are developed making an unbiased audit difficult."

Insufficient time allowed to conduct proper audit

The quality of audits of exchanges could be significantly improved if sufficient time were allowed for them. NAVRESSO's Internal Audit examines each Naval exchange every 2 years. The audit team is generally allowed 5 to 10 days for the review, regardless of exchange size. Sales in 1979 varied from about \$500,000 at small exchanges to \$45 million at a large exchange.

We examined workpapers and reports and held discussions with the auditors relating to audits of six exchanges made during the period January 1976 and December 1979. We noted the following problems which appear related to the lack of time:

--Team members signed off that audit steps were performed when they had been done. Auditors told us that they had to do so because insufficient time was provided to do all of the audit work. (This occurred at five exchanges.)

- Team members seldom identified underlying causes; thus, recommendations were not directed toward resolving problems such as excessive inventories. (This occurred at all exchanges.)
- Findings in audit reports were not supported by workpapers. (This occurred at five exchanges.)
- Team members only tested records for recent months because time did not permit finding older records. (This occurred at all exchanges.)

Audits not conducted professionally and in accordance with standards

We have set standards for audits of governmental organizations identifying the elements of a quality audit. NAVRESSO's audits were not made with due professional care in accordance with those standards.

Our standards provided that (1) audits be made by competent persons, (2) findings and conclusions be based on evaluation of all pertinent facts and supported by documentation, and (3) underlying causes should be identified to determine appropriate corrective action.

As described in the preceding sections, these standards were not being met. The lack of sufficient time for the audits and the heavy dependence on persons other than auditors are the major reasons for failing to comply with our standards.

Contracts not audited

Although NAVRESSO spends almost \$1 billion for goods and services, these contracts are not audited for compliance with contract terms. We found that NAVRESSO did not comply with Defense policy by failing to include a provision in its contracts giving the contracting officer or his representative access to records. NAVRESSO officials explained that this omission was due to their misinterpretation of a prior change in Defense policy.

We made a limited test of six contracts and found instances of overcharges on two of them. We brought these to the attention of NAVRESSO officials, and they obtained a \$2,300 refund on one contract and are negotiating with the other vendor for a refund.

INITIATIVES TO PREVENT FRAUD AND WASTE

During our review we identified NAVRESSO efforts to (1) make concerted efforts to increase systemwide buying in order to obtain lower prices, (2) develop needed procurement training programs, and (3) improve screening of personnel assigned to positions of trust. Also, NAVRESSO initiated actions to register vendors, provide supplemental ratings of exchange officers, and increase oversight of matters relating to cases of fraud.

Systemwide procurement emphasized

In their 1973, 1975, 1976, and 1979 reports, Naval Supply Systems Command inspectors recommended more use of systemwide procurement.

The 1979 report estimated that savings of about 20 percent were achievable using this method. Also, at meetings in 1976 and 1979, NAVRESSO's advisors from the private sector stressed the advantages of systemwide buying, including acting as a deterrent to fraud which is potentially more prevalent in decentralized buying operations. While concurring in these recommendations, NAVRESSO said that staffing limitations hindered its ability to meet its goal of 300 systemwide procurements.

During 1979, NAVRESSO had 68 systemwide contracts for resale merchandise valued at about \$26 million. It also had 23 such contracts for supplies and equipment which totaled \$5 million. Total procurements for 1979 was about \$909 million.

During our review NAVRESSO increased its efforts in this area. In January 1980 an office was created in the contracting division to help meet its goal of 300 contracts by the end of 1980. Additional staff were assigned in April 1980. In addition, NAVRESSO officials identified 264 contracts with annual procurements totaling at least \$29 million for possible systemwide procurement. Because of their success thus far, NAVRESSO officials increased their goal to 1,100 systemwide contracts by the end of 1982.

Training to be given

NAVRESSO has been slow to provide needed training to its procurement staff. In six reports between 1970 and 1979, Navy inspectors recommended that formal training in procurement be given to NAVRESSO and field staff; but NAVRESSO took no action until we began our review.

NAVRESSO has developed a training course which will cover all aspects of the procurement cycle. The course is being given to all personnel involved in purchasing starting in the fall of 1980.

Personnel screening improved

In 1976 and 1979 reports, Navy inspectors pointed out the need for NAVRESSO to develop an effective system to screen personnel before assigning them to positions of trust. In August 1980, NAVRESSO implemented a mechanized system to provide data on employees who have received unsatisfactory performance ratings or disciplinary actions, have been terminated for cause, or resigned while under investigation. For promotions or rehires, the selecting official will use this data to determine suitability and submit a recommendation to a review board and to the Commander, NAVRESSO, for approval.

Other actions being taken

NAVRESSO instituted a vendor registration system at Navy exchanges in January 1980 and at its headquarters in June 1980 similar to the one adopted by AAFES. This system was adopted as a result of our previous report 1/ which showed that NAVRESSO had no method for detecting potential violations of conflicts of interest. The system will also be used as a reference source to resolve problems with representatives and vendors.

In March 1980, NAVRESSO issued instructions to all exchange employees reminding them of the requirement to apprise the Commanding Officer, NAVRESSO, of all investigations into alleged malfeasance or improprieties. Exchanges were instructed to provide timely information on all major events occurring during the investigation, including the final disposition of the case. In October 1980, the Navy issued instructions for exchanges to follow in taking actions against persons involved in wrongful acts. These instructions emphasized the need for the exchange officer to take prompt and appropriate action against wrongdoers and provided guidelines to insure consistency in disciplinary actions.

1/"Employee Standards of Conduct: Improvements Needed in the Army and Air Force Exchange Service and the Navy Resale System Office" (FPCD-79-15, Apr. 24, 1979).

NAVRESSO issued guidelines in September 1980 to assist Navy exchanges in developing comprehensive programs for the prevention of fraud, waste, and abuse. Exchanges were directed to establish fraud, waste, and abuse prevention committees, whose purpose is to review operations and to reduce unauthorized deviations from approved policies and procedures. As part of this prevention effort, the guidelines also require exchange officers to take disciplinary action against individuals who violate established procedures.

Navy officials also recommended a change to Navy policies to permit the Commander, NAVRESSO, to give supplemental performance ratings on naval exchange officers who are now being rated by base commanding officers. In a July 1980 letter to higher command, the Commander, Naval Supply Systems Command, supported this change. He stated that:

"* * * This change in policy is considered to be warranted because of the congressional, GAO and DOD interest in the Fraud, Waste and Abuse Program and in the interest generated by the news media as to fraud and corruption in the operation of Navy Exchanges. As the Program Manager, the Commander, Navy Resale and Services Support Office, would be in a better position to ensure that Navy Exchange officers maintain system integrity over internal controls, standards of conduct, recordkeeping accountability and overall responsibility for the efficient operation of their exchanges * * *."

NAVAL EXCHANGE OVERSIGHT NEEDS STRENGTHENING

The Commander, Naval Supply Systems Command, needs to more aggressively carry out his responsibilities for directing and controlling NAVRESSO operations. In May 1976 the Commander recognized the seriousness of the problem when he stated to the Navy Resale System Advisory Committee 1/:

1/The Navy Resale System Advisory Committee was established in 1946 by the Secretary of the Navy. The Committee is composed of experts from the private sector in merchandising, finance, and business administration. This Committee reviews various policies and operations of the Navy's resale system and makes recommendations for improvements in these areas.

"I've noticed an increasing number of investigations being conducted by the Naval Investigative Service of allegations against individuals for improper conduct, for steering business in certain directions, for taking entertainment that is clearly out of line according to our standards * * *."

At this meeting, he indicated that, on the basis of a study of these and other problems, he concluded there was no alternative, except to tighten controls and strictly enforce them. Yet our findings demonstrate that all of the problems have not been effectively resolved.

As discussed in the above sections, Naval inspectors have reported similar findings both prior to and subsequent to that meeting. Yet, even though exchange officials agreed with the findings and recommendations, corrective actions were not taken prior to our study. Furthermore, on three occasions since then, the public accounting firm has reported inadequacies in the internal audit function, but no actions were taken to correct them.

CONCLUSIONS

The potential for fraud exists in the Navy's exchange system because of some weaknesses in internal controls and noncompliance with policies and procedures. The Commander, NAVRESSO, needs to strengthen controls by improving his internal audit organization and making sure that managers are held accountable for compliance with policies and procedures.

Since our review began, NAVRESSO has taken some steps to improve controls, but more needs to be done. More knowledge will be needed on the nature, extent, and trends of fraud, waste, and abuse to overcome the problem. Also strict enforcement of standards of conduct will be necessary to maintain system integrity.

We also believe that Naval Supply Systems Command oversight of the exchange system needs improvement. The Commander has a duty to insure the integrity of the Navy's exchange system to protect the interests of naval personnel from fraud and waste. Although informed of instances of alleged improprieties and continued problems in procurement, internal audit, and personnel management, the Commander has not made sure that effective actions to correct the problems were implemented.

RECOMMENDATIONS

We recommend that, to strengthen internal controls and to deter fraud and waste, the Secretary of Defense direct NAVRESSO to:

- ^--Develop a management information system to provide data on the nature and extent of fraud and waste in exchange systems.
- Develop a system of management controls to deter fraud and reduce the likelihood of waste.
- Overhaul the internal audit function by (1) assigning a person to head the unit whose independence has not been impaired, (2) staffing audits with more qualified auditors, and (3) providing sufficient time to make audits properly and in accordance with our audit standards.
- Comply with Defense policy to give the contracting officer or his representative access to contractor records and make audits for compliance with contract terms.

In addition, we recommend that the Secretary of Defense direct the Naval Supply Systems Command to exercise more active leadership to insure NAVRESSO is taking prompt and effective actions to overcome problems identified in its operations.

AGENCY COMMENTS

The Navy generally agreed with our findings and recommendations and initiated a number of actions which, we believe, will strengthen its controls to deter fraud and waste. The Navy said it was establishing fraud, waste, and abuse subcommittees at four levels of exchange management and that it had initiated a program to receive, review, and analyze causative factors on all cases reported to the Naval Investigative Service.

The Navy commented that actions were being taken to create a management information system on personnel who have a history of unsatisfactory work performance or who have been disciplined for abuse or mismanagement to preclude their transferring or rehiring.

The Navy said it was taking steps to improve the internal audit function. Additional time would be provided where justified, and a study was underway to determine the practicality of functional audits, including the type of personnel to be utilized.

The Navy stated that NAVRESSO would revise its contract provisions to include the prescribed access-to-records clause and make arrangements to conduct audits of contracts for compliance with contract terms.

The Navy stated also that the Commander, Naval Supply Systems Command, would intensify current ongoing initiatives to exercise more oversight. The initiatives were in the following areas (1) Navy Resale Advisory Committee, (2) inventory losses, (3) contracting management reviews, (4) policy guidance, (5) command inspections, and (6) financial oversight. (The Navy's comments are included as app. II.)

CHAPTER 4

OSD SHOULD STRENGTHEN OVERSIGHT

AND POLICIES GOVERNING EXCHANGE OPERATIONS

OSD needs to take a more active role in overseeing exchange operations and to establish a mechanism to obtain the information necessary to more effectively fulfill its oversight responsibility. In addition, OSD's nonappropriated fund acquisition policy is not consistent with its policies governing appropriated fund procurements by not requiring (1) the use of formal advertising where practicable and (2) a provision in negotiated contracts allowing us separate authority to examine contractors' records. At our suggestion, OSD has amended its personnel screening policy to insure uniform application by the services and to prevent the hiring of individuals with unsuitable backgrounds.

OSD LACKS AN EFFECTIVE MONITORING AND FEEDBACK SYSTEM

OSD does not have a system to be apprised of what is happening in the exchanges. It does not receive exchange internal audit reports, special studies, or investigative reports on exchange operations unless it requests them. Because of staffing limitations, its personal knowledge of operations is restricted. Consequently, OSD was generally unaware of the seriousness of exchange problems and the lack of action to correct them.

Within the Office of the Assistant Secretary of Defense (Manpower, Reserve Affairs and Logistics), only one official is responsible for monitoring exchange activities. Although exchanges constitute a major segment of his Assistant Secretary's responsibility, he is also responsible for other activities, such as alcohol package stores, clubs, libraries, and sports programs. He said that his responsibility is primarily limited to issuing broad policy statements. He does not become involved in the management and operation of exchanges, and a significant amount of his time is devoted to answering congressional inquiries.

OSD, in response to a December 1979 newspaper article alleging fraud in exchanges, requested the exchange systems to provide a list of actions taken to deter and/or detect fraud. In addition, OSD requested the systems to provide a list of prospective actions being considered for future implementation and recommended changes to Defense policy.

AAFES replied in January 1980 that its current system of internal control is adequate to deter fraud and other illegal activities. AAFES reported that it was instituting a registration system for vendors. NAVRESSO stated it considers its management controls to be sound, and it did not recommend changes in Defense policy.

In addition, because of reports of problems with fraud and large inventory losses in the exchange systems, OSD, in February 1980, requested the Defense Audit Service to make a special study. The Audit Service was asked to (1) review the adequacy of the services' audit support and the adequacy of internal exchange audit functions in precluding or detecting fraud or mismanagement, (2) analyze negative performance indicators (e.g., inventory loss rates, invoice payment errors, and bad check incidence), and (3) review procurement practices as they relate to increasing the percentage of contracts and dollar value of exchange merchandise procured competitively. The study was underway when we completed our work.

In March 1980, OSD concluded that staff support and oversight currently provided to the exchange systems by the military departments needed to be expanded. It directed the Assistant Secretaries of the Army, Navy, and Air Force (Manpower, Reserve Affairs and Logistics) to establish a formal inter-service working group to develop, exchange, and review the policies and procedures related to fraud prevention and detection. It directed the services' nonappropriated fund instrumentalities, acquisition offices, and investigative agencies to share information and for departments to take action as is warranted by its own investigation.

In a related area, we noted that OSD strengthened its oversight of the military commissary program by establishing a Defense Commissary Executive Board in October 1980. The Board is a policymaking group empowered to set goals, evaluate performance, and provide guidance to the services in the operation of their respective commissary systems. The Board will be composed of the following voting members:

- Deputy Assistant Secretary of Defense (Military Personnel Policy) (Chairman).
- Deputy Assistant Secretary of Defense (Supply, Maintenance and Transportation).
- Commander, U.S. Army Troop Support Agency.

--Commanding Officer, Navy Resale and Services Support Office.

--Commander, Air Force Commissary Service.

--Director, Facilities and Services Division, Headquarters, U.S. Marine Corps.

PROCUREMENT POLICIES SHOULD BE STRENGTHENED

Unlike policies governing contracting with appropriated funds, OSD does not require the services to use formal advertising procedures nor provide for separate GAO access to contractor's records when contracting with nonappropriated funds. During our review we brought these matters to OSD's attention, and it is studying whether these policies should be changed.

The Armed Services Procurement Act requires formal advertising for procurements with appropriated funds unless exceptions are justified. However, Defense Instruction 4105.67 establishes as policy that acquisition with nonappropriated funds will be done primarily through competitive negotiation. It permits formal advertising provided the services determine that the method is more advantageous. However, none of the contracts awarded by AAFES or NAVRESSO during the past few years used the formal advertising method. Exchange policies state that procurement will be through negotiation on the basis of full and free competition, as distinguished from formal advertising. We recognize that, because of brand preferences, formal advertising may not be appropriate for most purchases of resale merchandise; however, AAFES spends about \$90 million on construction in addition to concession contracting and purchases of supplies where such procedures can be used.

After we pointed out the inconsistency in these policies in February 1980, OSD asked the Defense Morale, Welfare, and Recreation Coordinating Committee to study whether the policy should be changed. Its study has not been completed.

The same Defense instruction directs the services to include a clause in their negotiated contracts valued in excess of \$2,500 which gives the contracting officer or his representative access to the contractor's records to assure compliance with contract terms. The instruction does not call for a separate provision giving us independent access to the contractor's records, which is the case in appropriated fund purchases. Because we believe that such access is necessary to fulfill our oversight responsibilities, we suggested, in

June 1980, that OSD revise the instruction to give us the necessary authority. OSD was considering making this change when we completed our work.

LOOSE PERSONNEL SCREENING PRACTICES DO
NOT PROVIDE ADEQUATE HIRING SAFEGUARDS

OSD did not assure itself that the exchanges had properly implemented its hiring and placement policy. Department of Defense Instruction 1401.1M, Personnel Policy Manual, establishes the general policy that proper recruitment, selection, and placement procedures are vital factors in the development of a viable and effective work force. The policy delegated to the exchanges considerable latitude in developing and administering their own personnel practices and provides general guidelines to the exchanges in developing recruitment and employment procedures. The policy also suggested the exchange services use, as a guide, the suitability provisions governing the hiring of Federal civil service employees, which provide that the conduct to be considered should include delinquency or misconduct in prior employment and criminal or dishonest conduct. Defense policy also provided that recruitment and employment procedures should at a minimum include a submission of a complete and accurate application form, reference checks, and any security and/or other preemployment investigations the exchanges deem necessary.

To properly apply suitability criteria, an adequate background investigation must be conducted. At AAFES, we found that suitability criteria existed, but background investigations were conducted only for individuals having access to classified information. At NAVRESSO, we learned that background checks have been made since 1970; however, according to NAVRESSO officials, they had no written criteria to determine suitability.

At our suggestion, OSD amended its policy to require (1) a favorable background investigation for applicants to positions of trust and (2) applicants' suitability be determined by using the policy governing Federal civil service employees and those not meeting the criteria could only be hired with the approval of the local commander.

CONCLUSIONS

We believe that, because of OSD's limited involvement in exchange operations and its lack of a feedback system to monitor the programs, OSD has not effectively fulfilled its

oversight responsibilities. In our opinion, OSD could strengthen its oversight by establishing an exchange executive board similar to the Commissary Executive Board it recently formed. Such a board would be consistent with OSD's philosophy of having limited involvement in day-to-day operations yet would provide OSD with first-hand knowledge of what is happening in the exchange systems.

We also believe that OSD should strengthen its nonappropriated fund procurement policies by making them consistent with policies covering appropriated fund procurement.

RECOMMENDATIONS

We recommend that, to strengthen OSD oversight and procurement policies, the Secretary of Defense

- / --establish an exchange executive board or similar organization with OSD representation to set goals, evaluate performance, and provide guidance to the exchange systems;
- require the use of formal advertising procedures for procurements with nonappropriated funds wherever practicable; and
- provide for our separate access to contractor records for nonappropriated fund negotiated contracts.

AGENCY COMMENTS

OSD officials said they agreed with our findings and were studying our proposals to determine what actions should be taken.



DEPARTMENTS OF THE ARMY AND THE AIR FORCE
 HEADQUARTERS ARMY AND AIR FORCE EXCHANGE SERVICE
 DALLAS, TEXAS 75222



8 NOV 1997

SUBJECT: Initial GAO Draft Report on Military Exchange Management
 Controls Over Procurement Practices and Personnel
 (GAO Code 963120)

Mr. Thomas Eickmeyer
 General Accounting Office
 441 G Street NW, Room 4023
 Washington, DC 20548

1. We have reviewed your Chapter 2 of the subject report, and first want to express our appreciation for the opportunity to react to it before it is put into final form. Quite obviously, it is to our mutual interest that the final report be as factual as possible and give each subsequent reader a proper perspective and view into AAFES problems and actions being taken to correct them.
2. You have succinctly discussed a very complex concern to all of us--management controls over procurement practices and personnel. Concern in this area will always be paramount in our minds, and your work has assisted us considerably in dealing with our responsibilities. You will find our responses (Inclosure 1) to your recommendations to be very positive; they will clearly indicate we want to do everything possible to deter irregular conduct in AAFES procurement.
3. I have every confidence that your final product will appropriately bring to everyone an understanding about the problems AAFES has had, the actions taken in the past, and the initiatives now under way. And most important, it will demonstrate that AAFES is very positively approaching its responsibilities. If we can be of further help, as you bring your audit to a close, please let us know.

NORRIS W. OVERTON
 Brigadier General, USAF
 Deputy Commander

1 Inclosure
 As stated

RESPONSES TO GAO RECOMMENDATIONS, CHAPTER TWO,
INFORMAL DRAFT REPORT ON MILITARY EXCHANGE MANAGEMENT CONTROLS
OVER PROCUREMENT PRACTICES AND PERSONNEL (CODE 963120)

Procurement practices and the potential for fraud, waste, and abuse is a very serious concern to AAFES at all levels of management. Careful attention is being given every policy and procedural detail; every control is being reexamined to ensure management systems are adequate; and every management level in AAFES is emphasizing compliance with established controls. AAFES sincerely appreciates the assistance of GAO in these concerns. Recommended actions are being aggressively implemented, as directed by the Board of Directors.

"Develop a management information system to provide data on the nature and extent of fraud, waste, and abuse in its programs."

The Commander, AAFES, on 1 August 1980, approved initiation of an AAFES master plan program to deal with detection of fraud and the prevention of waste and abuse. This program is a permanent, ongoing oversight activity that will coordinate and monitor all AAFES activities for the detection of fraud, waste, and abuse and provide the Commander and top management with information on the extent and nature of fraud, waste, and abuse within AAFES. Information gathered from all appropriate sources will be analyzed and compiled in a management information format which will support making meaningful decisions within AAFES.

The system will have the capability to store and recall information in varying formats to provide history, trends, and weaknesses and will enable management to evaluate the overall situation, map strategies, and establish preventive measures. It will involve expanding a current data base, which presently captures specific incident data, to further define and analyze related incidents. Input will be expanded to include relative information from other agency reports. In this regard, a close liaison has recently been developed between AAFES, NAVRESSO, and MCES security and audit elements which will ensure interchange of information relating not only to fraud detection, but also specific case data. Additionally, the AAFES Safety and Security and the Audit and Inspection Divisions are in the early stages of a joint project to develop a separate data base which will receive input from all of the various surveillance systems employed by AAFES (audits, loss-prevention surveys, accounting technician reports, management assistance team visit reports, etc.). This information will be used for trend analysis from an AAFES-wide viewpoint down to exchange/branch level.

The Commander, AAFES, using the management information system, will keep the Board of Directors fully informed on all aspects of fraud, waste, and abuse in AAFES.

"Develop a system of management controls to deter fraud and reduce the likelihood of waste. The system should include strict enforcement of standards of conduct, holding managers accountable for compliance with policies and procedures, and periodic audits to make sure that the controls are effective."

Inclosure 1

It is generally recognized that past instances of fraud in AAFES were perpetrated outside the system of internal control and involved collusion. However, in response to a recognition that strict management control must be maintained, the Board of Directors has specifically directed that AAFES review its current internal management controls to determine if further controls could be instituted or management action taken that might strengthen the system. The Board further specified that AAFES should determine if managers are complying with current procedures and are being held accountable. When disciplinary action is appropriate, the Board specified that equal justice for all must be assured. Additionally, the U.S. Army Audit Agency has been requested by the Board to include, in their future audits of AAFES, a review of AAFES administrative controls within the procurement and contracting processes.

In response to this direction by the Board of Directors, AAFES is actively reemphasizing every aspect of required management controls and strengthening those which are weak. The Commander, AAFES has directed an in-depth study into the adequacy and enforcement of AAFES standards of conduct, including establishment of tables of punishment for effective and equitable treatment. From this study, AAFES will implement changes which will ensure consistent, but firm attention to all instances of standards violation.

Through the AAFES master plan for fraud, waste, and abuse, management attitudes, at all levels, are being emphasized. This will be a positive program with a communication network that will transmit management thoughts and policies on daily operations to all levels of the work force, as well as provide top management information on problems, discrepancies, and the actions taken to solve them. The program will give AAFES personnel an overall feeling of belonging to a team devoted to promoting economy and efficiency in daily business operations. The program will promote leadership by example and create a daily operating atmosphere that will inspire efficiency.

Established procedures which inhibit the possibility of fraud will be strictly enforced, and uniformly and consistently applied. Compliance with established procedures will be emphasized constantly, at all levels, and reviewed regularly by management assistance teams, security, and audit. Intensified effort is under way in the area of purchasing, procurement authority, and procurement limitations. Controls have been strengthened in the area of Vendor Master File changes, now requiring the signature of a branch chief or his assistant on all requests for change; telephonic changes are not accepted. To assist review personnel, several training opportunities have been identified, and security and audit personnel will attend. The fraud segment of the Air Force Office of Special Investigations Senior Investigation Course is already being used, and assistance from the Federal Bureau of Investigation has been requested for training of security and audit personnel in procurement fraud detection.

AAFES internal auditors are very actively reviewing during FY 1980 all aspects of procurement management controls. Continuous audits in various segments of the procurement function are planned. For FY 1981, procurement of new construction, vehicles, equipment, and motion picture films will be conducted; in subsequent years, functional audits of the procurement of merchandise and services for retail, food, vending, services, and expense supplies departments are planned. In each audit, there will be a specific evaluation of the adequacy of controls established for the procurement function, and a determination of the extent of compliance with the

controls. Since a very strict independence is maintained by AAFES auditors from operational managers, the Commander, AAFES and the Board of Directors will have a continuing independent and objective review of procurement activities and related controls.

"Improve management of procurement by (1) establishing a results-oriented buying capability with detailed buy plans and buyer performance evaluations, (2) clarifying criteria and identifying opportunities for increasing competitive procurement, (3) enhancing buyer performance by providing procurement career paths and training programs, and (4) requiring periodic audits of contracts for pricing compliance."

The AAFES Merchandise Management Master Plan Program, when fully implemented, will strengthen controls to deter fraud, waste, and abuse in the buying function. It requires using tools and procedures to measure the performance and effectiveness of the procurement function and procurement personnel. Its objective is to develop performance measurement techniques for tracking the selling performance of items and product lines which will supply decision-making information and objective evaluation of merchandise and personnel performances. AAFES will further refine its marketing plan to ensure that there will be a comprehensive plan for each commodity which will represent an orderly and disciplined approach to marketing situations, ensuring that all aspects of the situation will be considered in a systematic manner prior to reaching a decision and instituting a program. As this program gains momentum, the merchandise selection committee procedure will be reassessed as a technique in determining assortments. The marketing plan specifies that it will:

- a. Examine major facts in a marketing situation for a product line or commodity.
- b. Express the market opportunity or customer requirements being addressed.
- c. Establish investment requirements, earnings objective, and sales potential.
- d. Document product objectives, return on investment calculations, markdown guidance, and inventory performance standards.
- e. Coordinate the interrelationships between items and commodities.
- f. Propose the AAFES strategy to accomplish the departmental objective.
- g. Recommend specific selling and promotional clearance tactics to support the strategies.
- h. Require formal and professional training for commodity branch chiefs and supervisory merchandising specialists in the essential elements and development of marketing plans.

AAFES fully concurs in the desirability of expanding use of multiple-source competitive procurement and has established criteria for identification of products for competitive negotiation. During 1980, 14 additional categories were competed, amounting to over \$21 million. An additional 20 categories have been identified to be

competitively negotiated by 1981. Directives will outline specific criteria to be used in identifying products for competitive negotiations.

AAFES recognizes the need for an improved career path which stipulates appropriate training and experience necessary for each merchandising specialist level and is undertaking a review of staffing structure at the headquarters level. The prior practice of including inventory control and retail operations in the merchandising career path best served AAFES needs under the previous separation of functional responsibilities between the headquarters and regional levels, and the essential requirement for mobility of the AAFES UA workforce. Under AAFES merchandise management and sales management master plan programs, emphasis at regional level is shifting from procurement to selling. Thus, most procurement will be centralized at headquarters level making a reassessment of career progression grade levels appropriate. A draft training plan has been developed which incorporates training courses available from outside agencies. This plan will be refined and modified appropriately and made consistent with the staffing structure, including training positions that result from the manpower and position classification review.

Audits regarding contract pricing compliance were discussed at a meeting of the Procurement Subcommittee, Armed Forces Exchange Coordinating Committee on 16-17 September 1980. AAFES, NAVRESSO, and MCES agreed and developed initial policy and procedures for a coordinated audit program for audits to be conducted at all exchange services. Action has been initiated for the initial audit and subsequent audits are planned as the program is developed and further refined.

To implement and test this audit procedure, AAFES is now reviewing a contractor's records, using its own internal audit staff, and has requested access of another contractor for review by the Defense Contract Audit Agency. Results will be evaluated and a final determination made as to how such audits should be conducted. Criteria for future reviews will then be established and documented.

"The AAFES Board of Directors take a more active role in combating fraud and waste by directing AAFES management to take the necessary actions to strengthen internal controls and by making sure that its policies are complied with."

The AAFES Board of Directors has been, and always will be, very concerned with combating fraud and waste at every AAFES management level. To accomplish its basic policy and guidance responsibilities, the Board has delegated to the Commander, AAFES, daily operational management and relies on the Commander to inform it of concerns and action taken in all management areas, but especially in fraud, waste, and abuse. The Commander, AAFES has, and will continue to so inform the Board, to include specific briefings by AAFES fraud, waste, and abuse program monitors and internal auditors. Together, the Board of Directors and top AAFES management take a very active role in directing all AAFES activities.

During the September 1980 quarterly meeting of the Board of Directors, very specific direction was given the Commander, AAFES, concerning ensuring that management controls are proper and complied with, and perpetration of fraud uniformly dealt with. The Board, through its Finance Committee, is briefed quarterly by the AAFES Director of Audit and Inspection on all reports of audit and any related fraud activities. Significant audit report items are provided all members of the Board of

Directors. Whenever appropriate, the Board of Directors will aggressively request other studies of AAFES management systems and involve itself enough to ensure that its directions are complied with. Problems, deficiencies, or weaknesses that are identified in ongoing reviews of internal controls will be briefed to the Board of Directors, making the Board of Directors an active participant in monitoring the action taken to correct failures to comply with policies and standards of conduct.

Members of the Board of Directors are fully aware of the serious responsibility they have in directing AAFES and will continue to do everything in their power to ensure that the mission of AAFES is accomplished in a professional, effective, and efficient way. The suggestions of the GAO have strengthened their resolve.

GAO note:

This recommendation was deleted from the final report because the Board took our recommended actions at its September 1980 meeting. (See p. 22.)



DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON D C 20350

2 25 1980

Mr. T. A. Eickmeyer
Group Director, Federal Personnel
and Compensation Division
U. S. General Accounting Office
Washington, DC 20548

Dear Mr. Eickmeyer:

This is in response to your informal request to review and provide comments on Chapter # 3 of the draft GAO Report, "More Effective Internal Controls Needed to Prevent Fraud and Waste in the Military Exchanges" (OSD Case #5566).

The Report recommends that more aggressive actions must be initiated to develop a management information system and controls to identify instances of fraud and waste, enforcement of compliance with policies and procedures to deter fraud and waste, including more intense audits of operations and contract compliance.

Navy exchange sales for 1979 were \$1.2 billion and, for the first six months of 1980, increased 13% over the comparable period in 1979. Navy exchange retail inventory shortages over the last ten years were less than 1% of sales which is about one half of the amount of inventory losses experienced in the commercial sector. When comparing the 1979 operating results of the Navy Exchange Program to other military exchange services, the Navy Exchange Program which employs approximately 29,000, provided a greater return on net assets (25.7%), larger dollar dividend per active duty (\$71.00) and lesser profit retention (25.4%). A net profit of \$50.1 million (4.1% of total sales) was achieved in 1979. The Navy Exchange Program return on working capital is about three times higher than in the commercial sector while maintaining an inventory turnover of 4.5 vice 3.3 in the commercial sector. Finally, Navy exchange retail selling prices average 20% below the average commercial price for similar items. Annually, a major CPA firm (Peat, Marwick, Mitchell & Co.) conducts an in-depth audit of the Navy Exchange Program. The recent audit conducted by the aforementioned firm in April 1980, which included a review of internal controls, concluded that their study/evaluation did not disclose any conditions which suggested any significant material weaknesses.

Specific comments on the GAO recommendations are provided as enclosure (1).

Sincerely,

A handwritten signature in black ink, appearing to read "JME", with a stylized flourish at the end.

J. M. EGORBA
Principal Assistant
(Manpower & Reserve Affairs)

Encl:
(1) Navy Comments

Navy Comments on GAO Report Entitled "More Effective Internal
Controls Needed to Prevent Fraud and Waste in Military Exchanges"
(OSD Case #5566)

I. Recommendations and comments:

A. Recommendations on pages 43n & 43o: [39]

(1) The Secretary of Defense (SECDEF) direct Navy Resale and Services Support Office (NAVRESSO) to develop a management information system to provide data on the nature and extent of fraud and extent of fraud and waste in exchange systems; and

(2) SECDEF direct NAVRESSO to develop a system of management controls to deter fraud and waste. The system should include strict and uniform enforcement of standards of conduct and holding exchange officers and managers accountable for compliance with policies and procedures.

Navy Comment: Concur. The following actions have been taken to identify, catalog, analyze and to create a management information system related to fraud, waste and abuse and have been initiated prior to or during the GAO review:

o Establishment of Fraud, Waste and Abuse subcommittees at four levels:

- A Fraud, Waste and Abuse Subcommittee of the Armed Forces Exchange Coordinating Committee (AFECC).

- A subcommittee of the combined Navy Morale, Welfare and Recreation (MWR) Coordinating Committee.

- An internal NAVRESSO Fraud, Waste and Abuse Committee composed of senior members of NAVRESSO's staff.

- Exchange and commissary subcommittees for local coordination.

o Initial issuance of OPNAVINST 5527.1 dated 4 March 1980 which directs that independently commanded Navy exchanges inform NAVRESSO of the current status of field investigations which could impact on the system.

o Initiation of a program to receive, review and analyze causative factors on all cases reported to the Naval Investigative Service.

o Establishment at NAVRESSO of a mechanized data system which maintains personnel records of field and headquarters employees with a history of unsatisfactory work performance who have been disciplined for abuse or mismanagement of government property. This system precludes the transferring or rehiring of employees who have been identified as unsatisfactory performers or found guilty of malfeasance.

o Forwarding management information concerning Navy exchanges, including information on inventory shrinkage, to Navy Exchange Officers monthly through the Navy Exchange Management Performance System Program (MPS-DP7). Also, NAVRESSO is currently developing/designing a program which will provide a quarterly "profile" of each exchange by sales group with ten key indicators to compare performance to be forwarded quarterly to Navy Exchange Officers along with the MPS-DP7.

o To ensure reasonable consistency within the field, OPNAVINST 5527.2 dated 24 October 1980 was promulgated establishing policy regarding aggressive investigation and command disciplinary action for persons committing offenses against the Navy exchange system.

o In September 1980, NAVRESSO published NAVRESSOINST 4385.2 (Subj: Local Fraud, Waste and Abuse Exchange Program). Its purpose is to set forth guidelines to assist Navy exchanges in developing comprehensive local programs for the prevention of fraud, waste and abuse and to reemphasize the need for compliance with existing directives pertaining to this subject.

o In November 1980, a questionnaire on the causative factors of fraud, waste and abuse in exchanges was distributed at the 1980 Navy Exchange Officers Conference. The purpose of the questionnaire is to assist NAVSUP/NAVRESSO in formulating future guidance.

o The Navy Exchange Security and Loss Prevention Guide (PUB #63) was published in September 1975 and has been revised/expanded in August 1976 and March 1980 with another major revision to be promulgated in December 1980. This Guide was prepared by NAVRESSO for the purpose of providing the Navy Exchange Officer and his security staff with a working knowledge of basic security procedures found to be useful in implementing an effective loss prevention program. This Guide provides the vehicle for NAVRESSO to issue information bulletins monthly to all Navy exchanges identifying issues having fraud, waste and abuse implications and provide "lessons learned."

[39]

B. Recommendation on page 43o: SECDEF direct NAVRESSO to overhaul the internal audit function by assigning a qualified auditor to head the unit, staffing audits with only qualified auditors, and providing sufficient time to conduct properly and in accordance with GAO audit standards.

Comment: Concur. NAVRESSO is taking steps to improve the internal audit function by complying with the recent Naval Audit Service (NAVAUDSVC) recommendations. As a result of a recent NAVAUDSVC review of the overall NAVRESSO audit program, it has been concluded that additional audit time will be provided whenever the nature of specific audit/review requirements so justify. In addition, a study by NAVRESSO is underway to determine the practicality of functional audits (specific operational areas such as retail, services, accounting, etc). These

audits would be performed at a number of exchanges within a short time span to determine the effectiveness of specified functions. The areas of the aforementioned study to be looked at are:

- Types of personnel to be utilized on audits.
- Expansion of on-site audit time to fully develop problems encountered.
- Strengthening of field supervision and greater emphasis on documentation of audit findings and workpaper preparation.
- Analysis of common and repeat findings to determine whether policies and procedures require revision.
- Feasibility of establishing audit branches at each FSO.
- Restructuring the findings format of the report to reflect condition, cause and effect in the forward section of the report where applicable.

[39]

C. Recommendation on page 43o: SECDEF direct NAVRESSO to comply with Defense policy to permit the contracting officer or his representative access to records and conduct audits for compliance with contract items.

Comment: Concur. NAVRESSO will take action to revise its contract general provisions to include the DOD clause providing for contracting officer access to contractor's records and books. Arrangements have been made with the Defense Contract Audit Agency to conduct audits in appropriate contracts to assure compliance with contract terms.

D. Recommendation on page 43o: SECDEF direct NAVSUP to exercise more active leadership to assure NAVRESSO is taking prompt and effective actions to overcome problems identified in its operation.

Comment: Concur. The Commander, Naval Supply Systems Command (NAVSUP) will intensify the current ongoing initiatives in this regard within constrained resources which can be made available for this important purpose. Past and current NAVSUP "leadership" initiatives include:

o The Navy Resale Advisory Committee: Established in 1946 and chaired by the COMNAVSUP, provides a significant oversight role of the operation of the Navy Exchange Program. This committee is composed of distinguished leaders in the field of retailing, finance, management-consulting and business education. Committee members are appointed by the Secretary of the Navy. Meetings are held twice yearly with the Assistant Secretary of the Navy for Manpower, Reserve Affairs and Logistics representing the Secretary. A comprehensive agenda for each meeting is prepared which includes an update on operations, fraud, waste and abuse progress reports, new proposals regarding system objectives, business strategy, policies and organization. The Advisory Committee members, through their counsel and guidance, make a major contribution to the vitality of the Navy Resale System and provide a very high quality of present day professional operational oversight.

o NAVSUP formed a Study Group to analyze NAVRESSO Inventory Losses: In May 1976, this Study Group was tasked to develop a plan to reverse the inventory loss trend and determine the cause for high loss levels and recommend actions to:

- a. Reverse the increasing loss trend.
- b. Improve present physical and accounting safeguards to prevent and detect losses.
- c. Identify key management indicators that will assess future loss levels; these indicators will also provide for remedial actions to be initiated prior to exceeding a defined, acceptable level for losses.

All facets of retail operations and the management thereof were examined. The Study included a detailed analysis at selected individual exchanges and commissary stores. Improved loss prevention and timely loss detection measures were emphasized; existing safeguards such as physical security, accounting controls, material custody in the warehouse and sales area, personnel practices, inventory procedures, etc. were also evaluated.

o Contracting Management Reviews: Prior to 1976, contract management reviews (CMR) conducted by NAVSUP were done in conjunction with the normal Command Inspection Program of NAVRESSO. Subsequently, however, the decision was made by NAVSUP to conduct a separate review of the contracting procedures utilized by NAVRESSO. There have been three to date. Every three years, the NAVSUP Headquarters CMR Staff performs a CMR of NAVRESSO Headquarters with a follow-up review every eighteen months. The most recent NAVSUP CMR of NAVRESSO concluded that "NAVRESSO is performing its contracting operations in a satisfactory manner. Management and the employees . . . have taken aggressive action to implement all recommendations contained in the IG (NAVSUP Command Inspection) and CMR reports of March 1979."

o NAVSUP Policy Guidance:

- On October 30, 1980, NAVSUP forwarded to NAVRESSO a policy statement to increase the emphasis NAVSUP places on loss prevention control. NAVSUP asked that it be widely promulgated to all exchange officers and officers in charge.

- In November 1980, NAVSUP directed that a questionnaire on fraud, waste and abuse in exchanges be distributed at the 1980 Navy Exchange Officers Conference. The purpose of the questionnaire is to help NAVSUP/NAVRESSO in formulating future guidance.

- A Fraud, Waste and Abuse Committee was established by COMNAVSUP. This committee monitors all matters relating to Fraud, Waste and Abuse under the purview of NAVSUP, including the Navy Exchange Program.

- COMNAVSUP consistently and aggressively provides direct (personal) direction and guidance to the COMNAVRESSO on matters pertaining to the worldwide operation of the Navy Exchange Program.

o NAVSUP Command Inspections: Command inspections of NAVRESSO Headquarters are conducted every three years in accordance with the Naval Command Inspection Program. A follow-up inspection is performed eighteen months after the Command inspection. Command inspections review all aspects of the NAVRESSO mission, determine performance of the mission, note discrepancies and recommend corrective actions. Follow-up inspections review status of Command inspection recommendations. The aforementioned inspections require quarterly status reports be submitted on all recommendations until action is complete. Also, NAVSUP monitors the inspection efforts of NAVRESSO in its auditing of Navy exchanges.

o NAVSUP Financial Oversight: Since 1976, the Comptroller of the Navy Supply Systems Command annually reviews the NAVRESSO operating budget, the Long Range Operating Plan, the Five Year Capital Investment Plan and various operating targets such as sales projections, expense and profit ratios, etc. The COMNAVSUP's approval of NAVRESSO's financial plans is based upon analytic review of these plans and includes such items as a facilities payback analysis for the capital construction budget, etc. Thereafter, a quarterly review of financial operating statements is the basis for continuing guidance by the COMNAVSUP to the COMNAVRESSO.

GAO note: Numbers in brackets refer to pages in this report.

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