

GAO

Report to the Chairman, Subcommittee on
Defense, Committee on Appropriations,
House of Representatives

April 1989

FINANCIAL MANAGEMENT

Operating Cash Requirement for Air Force Stock Fund Can Be Reduced



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**Accounting and Financial
Management Division**

B-234963

April 7, 1989

The Honorable John P. Murtha
Chairman, Subcommittee on Defense
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

In a December 1, 1988, letter, the former Subcommittee Chairman requested that we review certain Department of the Air Force stock fund pricing and refund practices. As part of this review, we were to determine whether the stock fund's current 11-day operating cash target could be reduced. Because these issues are of continuing interest to the Subcommittee, we are sending you the results of our work.

We found that the Air Force accounting system did not produce needed information for managing and determining the stock fund operating cash balance. However, based on budgetary information and estimates provided to us by the Air Force, we believe that the balance can be substantially reduced from the current 11-day cash target to approximately 3 days. Using a 3-day cash target could reduce the stock fund customers' budget authority by over \$215 million. Refunds to selected customers have been a major factor in reducing the operating cash balance to less than 11 days in recent years. Since 1984, the Congress has permitted the stock fund to refund over \$1 billion. We were unable to determine the ultimate disposition of the refunds because they were merged into other accounts.

Background

The Air Force stock fund provides for the financial management, inventory control, and distribution of consumable items of supply and low-cost equipment to support both peacetime and wartime operations. At the end of fiscal year 1988, the stock fund had a total inventory value of \$8.4 billion and annual sales of \$9.6 billion. The total assets held by the stock fund, consisting of inventory and cash, are referred to as the stock fund corpus.

The stock fund operates under a revolving fund concept, whereby it buys and holds inventory for sale to authorized customers, such as the Air Force's Operation and Maintenance appropriation. Sales of stock fund inventory generate cash that is used to replenish inventory levels.

To ensure that sufficient cash is available to pay incoming bills from suppliers, Department of Defense (DOD) Regulation 7420.13-R requires that the stock fund maintain a certain level of funds with the Department of the Treasury. With the concurrence of congressional committees, DOD has used 11 days of operating cash to accommodate fluctuations in revenue received from customers and payments made to vendors. Such a cash level is achieved by adding a surcharge to the acquisition cost of inventory items in setting prices charged customers. For the Air Force stock fund, disbursements for 1 day are worth about \$27 million, for an 11-day total of \$297 million.

While the stock fund obtains most of its funds by selling inventory items to its customers, it also receives appropriations from the Congress. These funds are intended to purchase war reserve material and inventory items to support weapon systems modernization and modification. By appropriating funds for these items, the congressional committees attempted to make certain stock fund purchases more visible in the budget. These appropriations increase the corpus of the stock fund and are available to cover stock fund cash needs.

The stock fund has only a single cash balance consisting of both the operating and appropriated cash amounts. Therefore, when calculating the fund balance that is available to cover stock fund cash needs, DOD officials can use the appropriated funds, to the extent they remain available, to cover temporary cash shortages in the operating portion of the stock fund. For a 36-month period from October 1985 through September 1988, the total stock fund monthly ending cash balance was not less than \$398 million or the equivalent of about 15 days' cash. The total stock fund cash balance is generally at its lowest level at the end of each fiscal year.

Congressional Committees Have Raised Concern Over the Amount of Cash Balances

On two occasions since 1982, congressional committees have expressed concern over the amount of cash balances in DOD stock funds. In December 1982, the House Appropriations Committee directed the Office of the Secretary of Defense (OSD) to reduce the operating cash requirement from 15 days to 11 days for the military services' stock funds. In 1985, the House Appropriations Committee proposed lowering the operating cash requirement from 11 days to 5 days and projected that this decrease would save the Air Force approximately \$180 million. The Appropriations Conference Committee, however, requested OSD to study the matter.

OSD opposed any change because, according to its analysis, the stock funds would have become insolvent 18 times during the 6-year period from 1977 to 1982 if they had been operating at the 5-day cash target. OSD did not use the appropriated cash balance, which was available at that time, in calculating whether the stock fund would have become insolvent.

Air Force Did Not Report Stock Fund Accounting System Deficiencies

The Air Force 1988 Federal Managers' Financial Integrity Act report stated that its stock fund accounting system substantially conformed to the Comptroller General's requirements. The Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512(b) and (c)) gives agency management the primary responsibility for maintaining adequate systems of internal control and accounting. The act requires agency heads to report annually to the President and the Congress on the status of these systems, and holds managers responsible for correcting identified deficiencies. In this regard, the Air Force reports annually to the Secretary of Defense, who prepares a consolidated report for the Department of Defense.

Section 4 of this act requires a separate annual report on whether an agency's accounting system conforms to the principles, standards, and related requirements prescribed by the Comptroller General. The Comptroller General's accounting principles and standards specify that an agency's accounting systems must be able to produce financial information needed by management that is accurate, useful, complete, timely, and consistent.

In addition, chapters 11 and 14 of the DOD Accounting Manual require that accounting systems produce reliable accounting results and reports that will be the basis for preparing and supporting agency budget requests. The DOD Accounting Manual further specifies that the primary objective of DOD accounting systems is to provide actual accounting data needed for budget formulation, fund control for enacted budgets, and accounting support for budget execution. Since the Air Force formulates its budget requests based on maintaining an 11-day operating cash balance with the stock fund, reliable accounting system data detailing the appropriated and operating cash balances are imperative.

Objectives, Scope, and Methodology

The objectives of our review were to determine (1) whether the Air Force stock fund can operate at less than the currently required 11-day operating cash balance, (2) how refunds made to stock fund customers

affected the 11-day cash balance, and (3) how stock fund customers used the refunds. To accomplish these objectives, we discussed with OSD and Air Force officials how stock fund (1) inventory prices and surcharges are determined, (2) appropriated and operating cash balances are calculated, and (3) cash was returned to customers. We examined Air Force stock fund budget submissions and related accounting records for fiscal years 1984 through 1989. We reviewed congressional reports and legislation as well as DOD and Air Force regulations concerning stock fund cash balances and refund policies. We also reviewed the Air Force's Federal Managers' Financial Integrity Act reports.

To respond to the Subcommittee's December 1988 request, we relied on our ongoing effort in this area. We performed our work at OSD, the Air Force Headquarters, the Air Force Logistics Command, and the Air Force Accounting and Finance Center. We completed our work in February 1989 and conducted it in accordance with generally accepted government auditing standards.

For our review, we used the fund balances included in Air Force budget documents. Air Force officials could only provide us with year-end data developed from budgetary documents because the accounting system does not produce information that distinguishes between appropriated and operating stock fund cash balances. We could not verify the accuracy of the budgetary data since we could not reconcile it to accounting system reports.

The Subcommittee asked us for certain information regarding the use of refunds. In this report, the term "refund" describes two kinds of payments: (1) payments made under various statutory transfer authorities and (2) payments made to adjust the original price charged stock fund users. Although different legal consequences may attach to the funds paid, depending on the basis used for payment, we have used the same term to cover both.

Accounting System Does Not Produce Needed Information on Stock Fund Balances

One difficulty we had in performing our analysis was obtaining accurate and reliable stock fund cash balance information from the accounting system. The Air Force accounting system does not produce information that distinguishes between appropriated and operating stock fund cash balances. Since the accounting system does not produce the needed detail on the cash balances, the Air Force depends on other data sources, such as budgetary documents, to obtain needed information. We could not verify the accuracy of this information since we could not reconcile it to reports produced from the accounting system.

The official monthly stock fund accounting reports submitted to Air Force headquarters and OSD do not separately identify the operating and appropriated cash balances. An Air Force budget official told us that, when the Congress began appropriating funds for war reserve material in fiscal year 1977, he advised the Air Force Accounting and Finance Center and the stock fund division managers of the need to provide accurate reports that separately account for operating and appropriated cash balances. The Air Force has made some improvements to its accounting system by adding additional accounts for appropriated funds. However, the accounting system data are still not used by Air Force officials to make decisions on setting stock fund prices.

Furthermore, since the accounting system information is considered incomplete and inadequate, OSD has adjusted stock fund financial data for budgetary purposes. For example, in fiscal year 1988, OSD noted that the separate cash positions in the two categories were annual estimates lacking detailed verification. Applying historical disbursement rates, OSD calculated that Air Force's appropriated cash balance was overstated by \$294 million. After adjusting the \$294 million "for uncertainty," OSD arrived at an overstatement of \$131 million. OSD then reclassified this amount as operating cash and directed that it be transferred to the Air Force's Operation and Maintenance appropriation. Since accounting system data on the stock fund cash balances were inadequate, we could not validate OSD's calculations.

We are currently reviewing another situation related to accounting practices that may have adversely affected the stock fund's cash position. Our preliminary observations indicate that the stock fund accounting system does not have adequate internal controls to ensure that all sales of aircraft fuel are entered into the system. As a result, monthly accounting reports used to collect funds from those sales are inaccurate and unreliable. This matter will be discussed in a future report.

Air Force managers need reliable information on appropriated and operating cash balances to set stock fund prices. Until the accounting system can produce this information, we believe the Air Force should identify this deficiency in its future Federal Managers' Financial Integrity Act reports.

Stock Fund Operated at Substantially Less Than an 11-Day Cash Balance

The Air Force budget reports show that in recent years the stock fund has functioned with less than an 11-day operating cash balance. Since 1986, the stock fund fiscal year-end operating balances have been equivalent to less than a 3-day supply of cash. Although the stock fund has been able to operate with this lower balance, the Air Force plans to rebuild its operating cash balance and achieve the 11-day target during fiscal year 1990. However, if the stock fund were to maintain an operating cash balance of 3 days, stock fund prices could be lowered with a corresponding reduction in DOD budget authority of over \$215 million.

Stock Fund Has Functioned at Less Than a 3-Day Supply of Operating Cash

Table 1 displays the fiscal year-end operating cash balances from 1984 through 1988 in dollars and equivalent days. Our analysis showed the total stock fund cash balance is generally at its lowest level at the end of each fiscal year.

Table 1: Stock Fund Year-End Operating Cash Balances for Fiscal Years 1984 Through 1988

Dollars in millions

Fiscal year	Year-end operating balance	Equivalent days ^a
1984	\$446	17
1985	564	21
1986	(42)	(2)
1987	63	2
1988	0	0

^aCalculated using the \$27 million per day disbursement rate.

In 1984 and 1985 the operating cash balances exceeded the 11-day operating cash target. Since 1986, however, the fiscal year-end operating cash balances have been less than 3 days. Significant amounts of appropriated cash were available in the stock fund during those years to cover any temporary operating cash shortages. Table 2 displays the fiscal year-end appropriated cash balances from 1984 through 1988 in dollars and equivalent days.

**Table 2: Stock Fund Year-End
Appropriated Cash Balances for Fiscal
Years 1984 Through 1988**

Dollars in millions		
Fiscal year	Year-end appropriated balance	Equivalent days ^a
1984	\$1,191	44
1985	1,152	43
1986	887	33
1987	621	23
1988	419	16

^aCalculated using the \$27 million per day disbursement rate.

These appropriated funds have significantly increased the stock fund cash balance and have been used by the Air Force to cover temporary shortages of operating cash. For example, the Air Force used appropriated funds to cover the \$42 million deficit at the end of fiscal year 1986.

As previously discussed, the 1985 OSD study on lowering the target cash balance to 5 days did not include appropriated funds in its calculations. During the period covered by OSD's 1985 analysis (fiscal years 1977 through 1982), the Congress had not begun appropriating large sums to the stock fund for weapon systems modernization and modification. From fiscal years 1977 through 1982, the Air Force stock fund received an average of \$38 million per year in appropriated funds for war reserve material. These funds would not have substantially affected the stock fund cash balance.

However, for fiscal years 1983 through 1989, the Congress appropriated an average of \$421 million a year, which provided substantial resources to the stock fund to cover temporary operating cash shortages. These appropriated funds are oftentimes not disbursed for 2 or more years after they are appropriated. Furthermore, the Air Force is currently budgeting to receive \$349 million (about 13 days' supply of cash) in additional stock fund appropriations for fiscal year 1990 and \$280 million (about 10 days' supply of cash) in fiscal year 1991. During fiscal years 1990 and 1991, the Air Force does not plan to make any refunds. By combining the appropriated cash balance with the 3-day operating cash balance discussed above, the Air Force should have sufficient funds to manage its cash needs in the immediate future.

Air Force Plans to Rebuild the Operating Cash Balance to 11 Days

The Air Force plans to rebuild its stock fund operating cash balance to 11 days in fiscal year 1990. However, if the Air Force continues its current practice of operating the stock fund at less than a 3-day cash target, stock fund prices could be reduced with a corresponding reduction in DOD budget authority of over \$215 million. Table 3 shows the range of possible budget reductions if the 11-day cash target is reduced.

Table 3: Budgetary Impact of Reducing the Stock Fund's 11-Day Operating Cash Target

Dollars in millions	
Number of days reduced	Corresponding customer price reductions ^a
8	\$216
6	162
4	108
2	54

^aCalculated using the \$27 million per day disbursement rate.

By reducing the cash target below 11 days, the surcharge added to the selling price of inventory items should be reduced, thus lowering the prices the stock fund charges its customers by a corresponding amount. This, in turn, could result in a reduction to DOD budget authority. Because stock fund customers should theoretically be able to purchase the same quantity of items at reduced prices, the customers' ability to perform their missions should not be adversely affected.

Refunds Total Over \$1 Billion in Last 5 Years

The reductions in stock fund operating cash below the 11-day target for the past 3 years can mostly be attributed to customer refunds. Since fiscal year 1984, the stock fund has refunded over \$1 billion to customers, with \$711 million of that amount refunded in the last 3 fiscal years. These refunds were made with various levels of congressional involvement and approval. The refunds were generally authorized to offset budget reductions in the customers' accounts, which allowed Air Force units to have more money to spend for general operating and maintenance purposes.

When we attempted to determine how these refunds were used by customers, we found that the refunds had been merged with customers' appropriations and, therefore, had lost their identity. As a result, neither we nor the Air Force could determine how the refunds were ultimately used other than for the general purposes of the appropriation which received the refund.

Table 4 displays the refunds made during the year as well as the fiscal year-end operating cash balances after refunds in dollars and equivalent days.

Table 4: Stock Fund Refunds and Year-End Operating Cash Balances for Fiscal Years 1984 Through 1988

Fiscal year	Refunds		Operating cash after refunds	
	Amount	Equivalent days ^a	Amount	Equivalent days ^a
	1984	\$128	5	\$446
1985	225	8	564	21
1986	310	11	(42)	(2)
1987	270	10	63	2
1988	131	5	0	0

^aCalculated using the \$27 million per day disbursement rate.

By continuing to make refunds to customers for fiscal years 1986 through 1988, the Air Force reduced the operating cash balance of the stock fund significantly below the 11-day operating cash target. According to a DOD budget document, concern was expressed that, since the 1988 refund would lower the operating cash balance well below the 11-day target, the Congress might permanently direct the stock funds to operate at less than the 11-day operating cash target.

The refunds were made only to selected customers and were not distributed proportionately. Table 5 shows the difference between the amounts customers could have received if the refund had been distributed proportionately, based on sales, and the amounts they actually received.

Table 5: Comparison of 1988 Refunds Stock Fund Customers Could Have Received to Refunds Actually Received

Customer	Proportionate share	Refund received	Difference
Air Force Operation and Maintenance	\$30	\$131	\$101
Air Force Industrial Fund	60	0	(60)
Foreign Military Sales	18	0	(18)
Department of the Navy	12	0	(12)
Air Force Guard and Reserve	6	0	(6)
Other customers	5	0	(5)

If the 1988 refund had been made in a proportionate manner, certain customers could have received millions of dollars in additional funds. For example, the Foreign Military Sales customers and the Department of the Navy did not receive any refunds. If the funds had been distributed proportionately, these customers could have received \$18 million and \$12 million, respectively. As a result of the stock fund's disproportionate refund practices, certain customers financed the refund made to the Air Force Operation and Maintenance appropriation.

Conclusions

The Air Force needs to improve its stock fund accounting system so that it produces reliable information on operating and appropriated cash balances. OSD and Air Force officials need this information for managing stock fund cash balances and for setting stock fund prices. Until corrective actions are taken, we believe the Air Force should identify this deficiency in its future Federal Managers' Financial Integrity Act reports.

The Air Force has operated the stock fund on less than an 11-day supply of operating cash by relying on funds appropriated by the Congress. Based on current estimates, we believe that the Air Force stock fund can continue to rely on the appropriated funds to compensate for any temporary operating cash shortages.

Refunds to selected customers have been the main reason why the stock fund operating cash balance has been reduced from a 21-day supply in 1985 to less than 1 day at the end of 1988. The refunds were merged with the customers' other appropriations and used for the general purposes of those funds. Information regarding the specific use of the refunds was not available.

Recommendations

We recommend that the Secretary of the Air Force take the following actions:

- Improve the stock fund accounting system so that it produces accurate and reliable reports on both the appropriated and operating cash balances. Until this system deficiency is corrected, include this deficiency, together with planned corrective actions, in the Air Force Federal Managers' Financial Integrity Act reports to the Secretary of Defense.
- Prepare future budget submissions to the Congress using an operating cash target of approximately 3 days as long as appropriated funds are available to cover temporary operating cash shortages.

As requested by your office, we did not obtain written comments on a draft of this report. We did, however, discuss its contents with pertinent DOD and Air Force officials and have incorporated their views where appropriate. DOD officials were concerned that the soundness of the stock fund financial condition would be reduced by lowering the 11-day cash target. We believe that DOD's practice of using appropriated funds to cover temporary operating cash shortages is sufficient evidence that the stock fund can function on a reduced operating cash balance.

Unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from the date of the report. At that time we will send copies to the Secretary of Defense, the Secretary of the Air Force, and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of Jeffrey C. Steinhoff, Director, Financial Management Systems Issues. Major contributors are listed in appendix I.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Frederick D. Wolf', written in a cursive style.

Frederick D. Wolf
Assistant Comptroller General

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