

GAO

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

May 1990

# FINANCIAL MANAGEMENT

## Analysis of Operating Cash Balance of Navy Stock Fund



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Accounting and Financial  
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May 2, 1990

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

Dear Mr. Chairman:

In an April 11, 1989, letter, you requested that we review and prepare separate reports on certain Army, Navy, and Defense Logistics Agency stock fund pricing and refund practices. You made this request following our April 1989 report<sup>1</sup> to you on the Air Force stock fund, which discusses the budgetary impact of reducing the operating cash balance of that stock fund. In responding to your most recent request, we reviewed the operating cash balances of the Army, the Navy, and the Defense Logistics Agency and briefed your staff on the status of our work. This, the second in our series of reports on stock fund cash balances, presents baseline information on (1) whether the Navy stock fund can operate with less than an 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.

## Results in Brief

We found that the Navy stock fund has functioned with substantially more than an 11-day operating cash balance. From 1985 through 1989, the stock fund average month-end operating balance has been the equivalent of about a 39-day supply of cash, or about \$600 million more than required if it had maintained 11 days of cash.

While the Navy stock fund has substantially exceeded the 11-day operating cash target, we believe, similar to our earlier position regarding the Air Force, that the Navy stock fund can operate with less than an 11-day operating cash balance. The Department of Defense, considering the normal fluctuations in income received from customers and payments made to suppliers, established the 11-day requirement to ensure that a sufficient amount of cash was available to pay bills from suppliers. However, our analysis of the Navy's operating cash balances from fiscal year 1985 through fiscal year 1989 showed that the average

<sup>1</sup>Financial Management: Operating Cash Requirement for Air Force Stock Fund Can Be Reduced (GAO/AFMD-89-60, April 7, 1989).

While the stock fund obtains most of its funds by selling inventory items to its customers, it also receives appropriations from the Congress. The congressional committees indicated that these funds are intended to purchase war reserve material and inventory items to support weapon system modernization and modification. By designating funds for these items, the congressional committees attempted to gain a degree of budget visibility for certain stock fund purchases. These appropriations increase the corpus of the stock fund and are available to cover stock fund cash needs. For fiscal year 1990, the Navy stock fund received \$40.5 million in appropriated funds.

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, Defense 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.

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## Objectives, Scope, and Methodology

Based on our April 1989 report on the Air Force stock fund, which discusses the budgetary impact of reducing the operating cash balance of the stock fund, you requested that we review certain Army, Navy, and Defense Logistics Agency stock fund pricing and refund practices. In responding to your request, we reviewed the operating cash balances of these stock funds and briefed your staff on the status of our work. The objectives of our review were to determine (1) whether the Navy stock fund can operate with less than an 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 the Office of the Secretary of Defense and Navy officials how stock fund (1) inventory prices and surcharges are determined, (2) operating cash balances are calculated, and (3) cash was returned to customers. We examined Navy stock fund budget documents and related accounting records. We reviewed congressional reports and legislation as well as Department of Defense and Navy regulations concerning stock fund cash balances and refund policies. We also reviewed the Navy's Federal Managers' Financial Integrity Act reports.

We performed our work at the Office of the Secretary of Defense, Office of the Comptroller of the Navy, the Naval Supply Systems Command, and the Navy Accounting and Finance Center. We conducted our work

**Table 1: Information on the Stock Fund Operating Cash Balances for Fiscal Years 1985 Through 1989**

Dollars in millions

Fiscal year	Fiscal year-end balance	Average month-end balance	Range of month-end balances	
			High	Low
1985	\$1,084	\$938	\$1,084	\$760
1986	742	996	1,358	699
1987	693	957	1,495	439
1988	574	725	1,077	262
1989	635	572	702	474

Table 1 shows that for the 5-year period, the fiscal year-end and average month-end cash balances were always greater than \$500 million and that the lowest balance was \$262 million in 1988. To relate this information to an 11-day requirement, table 2 provides the same data as shown in table 1, but converts the dollar information to equivalent days. To determine the equivalent days of cash for each fiscal year, we used the Department of Defense formula of total stock fund operating expenditures divided by 360 days. The one day disbursement rate for fiscal years 1985 through 1989 was \$19.4 million, \$21.3 million, \$21.8 million, \$22.6 million, and \$23.3 million, respectively.

**Table 2: Information on the Stock Fund Operating Cash Balances for Fiscal Years 1985 Through 1989 Converted to Equivalent Days**

Fiscal year	Fiscal year-end balance	Average month-end balance	Range of month-end balances	
			High	Low
1985	56	48	56	39
1986	35	47	64	33
1987	32	44	69	20
1988	25	32	48	12
1989	27	25	30	20

Table 2 shows that the fiscal year-end and average month-end Navy stock fund operating cash balances have been substantially higher than 11 days. Except for a brief period in 1988, the stock fund operating cash balance did not go below 20 days. The reason the operating cash balance fell to 12 days at one point in 1988 was because the Navy refunded \$828 million to customers, or an equivalent of a 37-day supply of cash, during May and June of that year. The impact of refunds is discussed later in this report.

Our analysis also showed that for the 5-year period, the operating cash balance varied by more than a 5-day supply of cash in 21 months. The cash balance rose by more than 5 days 18 times and fell by more than 5 days 3 times. According to Navy officials, on the three occasions that the cash balance decreased, the Navy did not properly process collection or expenditure data that resulted in the operating cash balance for the month being lower than it should have been.

For example, between August and September 1986, the operating cash balance decreased by \$191 million or the equivalent of a 9-day supply of cash. According to Navy officials, the cash balance decreased because the Navy did not promptly process \$135 million or 6 days of collections during September. If this collection data had been processed during September when it should have, the operating cash balance would have decreased by about \$56 million, or 3 days.

## Refunds Total Over \$3.4 Billion in Last 5 Years

The Navy has made substantial amounts of refunds from the stock fund to its customers—over \$3.4 billion since fiscal year 1985. These refunds have helped the Navy reduce the excessive amounts of operating cash in the stock fund. Table 3 shows the refunds made during the year as well as the fiscal year-end operating cash balances after refunds, in dollars and equivalent days.

**Table 3: Stock Fund Refunds and Year-end Operating Cash Balances for Fiscal Years 1985 Through 1989**

Fiscal year	Refunds		Operating cash after refunds	
	Amount	Equivalent days	Amount	Equivalent days
1985	\$194	10	\$1,084	56
1986	890	42	742	35
1987	1,383	63	693	32
1988	916	41	574	25
1989	25	1	635	27
<b>Total</b>	<b>\$3,407<sup>a</sup></b>			

<sup>a</sup>Total does not add due to rounding.

Of the \$3.4 billion amount, the Navy made \$2.1 billion in refunds with various levels of congressional involvement and approval. These refunds were generally intended to offset budget reductions in the customers' accounts, which allowed Navy 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

**Table 4: Amount of Refunds Received by Stock Fund Customers From Fiscal Years 1985 Through 1989**

Dollars in millions					
Customer	1985	1986	1987	1988	1989
Navy, Operation and Maintenance <sup>a</sup>	\$194	\$830	\$1,011	\$879	\$0
Navy Reserve, Operation and Maintenance	0	59	67	0	0
Army, Operation and Maintenance	0	0	67	0	0
Air Force, Operation and Maintenance	0	0	45	0	0
Marine Corps, Operation and Maintenance	0	1	0	15	0
Navy Industrial Fund	0	0	8	0	0
Navy Aircraft Procurement	0	0	186	0	0
Coast Guard	0	0	0	22	25
<b>Total<sup>b</sup></b>	<b>\$194</b>	<b>\$890</b>	<b>\$1,383</b>	<b>\$916</b>	<b>\$25</b>

<sup>a</sup>The amounts received by Navy Operation and Maintenance customers to purchase aviation depot-level repairables follow: \$558 million in 1986, \$487 million in 1987, and \$66 million in 1988.

<sup>b</sup>Totals may not add due to rounding.

Over the last 5 years, \$2.9 billion, or 86 percent, of Navy stock fund refunds have been received by the Navy, Operation and Maintenance appropriation. The Navy, Operation and Maintenance appropriation amounts include funds received by customers to purchase aviation depot-level repairable inventories.

## Conclusion

Since 1985, the Navy stock fund operating cash balance has been substantially more than an 11-day cash requirement and can be reduced. During 1989, the House and Senate Appropriations Committees recommended that Defense change its policy and lower the stock fund operating cash requirement from 11 days to 5 days. Our analysis shows that a 5-day cash supply is adequate and, as a result, we are not making any recommendations at this time.

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 Defense and Navy officials and have incorporated their views where appropriate.

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



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# Major Contributors to This Report

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Please contact me at 275-9507 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix I.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Jeffrey C. Steinhoff". The signature is written in a cursive style with a large, stylized initial "J".

Jeffrey C. Steinhoff  
Director, Financial Management  
Systems and Audit Oversight

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found that the refunds had been merged with customers' appropriations and, therefore, had lost their identity. Navy officials told us that there is no requirement to (1) separately account for these refunds and (2) determine how these refunds are used. As a result, neither we nor the Navy could determine how the refunds totaling \$2.1 billion were ultimately used other than for the general purposes of the appropriation which received the refund.

Navy officials told us that the remaining \$1.3 billion in refunds was used by customers to purchase aircraft inventory, which is commonly referred to as aviation depot-level repairables. In 1985, the Navy began financing the aviation depot-level repairable inventories through the stock fund. At that time, the Navy stock fund received aviation inventories valued at about \$12 billion without paying for them because the Navy had already purchased these items with appropriated funds.<sup>2</sup> Further, customers now had to use their operation and maintenance funds to pay for aviation inventories that, prior to 1985, had been paid for with other appropriations. To ensure that customers had sufficient operation and maintenance funds to fulfill their missions, the Navy decided to refund \$1.3 billion to them from 1986 through 1988.

The \$3.4 billion in refunds were made to the following customers. While we were not able to determine how all the refunds were used, table 4 shows the amount of refunds made from the Navy stock fund from fiscal years 1985 through 1989.

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<sup>2</sup>We are currently performing, at your request, a comprehensive review of Navy appropriations, financial management, internal controls, and budget execution changes from when its stock fund began to finance depot-level repairables. As stated above, the Navy stock fund received \$12 billion in inventory without paying for it. You also requested that we review similar factors in the Army and Air Force, should these services begin financing depot-level repairables through their stock funds. We will be reporting on these issues at a later date.

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According to Defense budget documents, the Navy planned to reduce its operating cash balance to 11 days at the end of fiscal year 1989. However, as tables 1 and 2 show, the Navy did not do this, ending fiscal year 1989 with a 27-day supply of cash or \$379 million more than planned. When we questioned Navy officials about why the year-end cash balance was so high, they told us that the budget is an estimate and that the Navy had overestimated the amount of expenditures to be incurred in fiscal year 1989. As a result, the fiscal year-end 1989 operating cash balance was larger than planned.

In our April 1989 report, we stated that the Air Force stock fund operating cash balance could be substantially reduced. 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 Defense budget authority.

Acting on our recommendations, in November 1989 the House and Senate Appropriations Committees recommended lowering the stock fund operating cash requirement from 11 days to 5 days, which resulted in the Congress reducing the fiscal year 1990 Defense budget by \$707.2 million. Further, 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.

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**Decreases in Stock Fund  
Month-end Cash Balances  
Usually Less Than 5 Days**

The viability of the recently adopted 5-day operating cash target was borne out in the Navy stock fund. Our analysis of the operating cash balances from fiscal years 1985 through 1989 showed that the average month-end change was 4.4 days.

Since the cash balance is designed to cover normal fluctuations in stock fund income and payments, changes in the month-end cash balances are a key measure in analyzing the needed level of the stock fund cash balance. In analyzing the month-end changes in the operating cash balances, we adjusted the operating cash balances for refunds. As agreed with the Office of the Secretary of Defense and Navy officials, refunds need to be added back to the operating cash balance because they are not part of the normal stock fund process of income received from customers and payments made to vendors.

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from June 1989 through March 1990 in accordance with generally accepted government auditing standards.

For our review, Navy officials provided us with month-end data on the appropriated and operating cash balances, which were developed from a statistical estimate of the total cash balance. We did not verify the accuracy of the statistical estimate. In performing our work, we analyzed the month-end Navy stock fund cash balances. When large fluctuations in the cash balances occurred from one month to the next month, we obtained Navy officials' explanations for the fluctuations.

The Subcommittee also asked us to provide it 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.

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## Stock Fund Operated at Substantially More Than an 11-Day Operating Cash Balance

The Navy stock fund has functioned with substantially more than an 11-day operating cash balance. Navy information shows that the Navy lowered its average month-end stock fund operating cash balance from 48 days to 25 days between fiscal years 1985 and 1989. However, a 25-day operating cash balance is still substantially greater than needed, and even an 11-day balance is excessive. Our analysis of the operating cash balances from fiscal years 1985 through 1989 showed that the average month-end change was only 4.4 days. In essence, the cash balances changed, on average, less than 5 days from one month to the next, which was less than the 5-day cash target recommended by the House and Senate Appropriations Committees.

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## 5-Year Analysis of the Stock Fund Operating Cash Balance

Table 1 displays the fiscal year-end balances, the average month-end balances, and the range of the cash balances from 1985 through 1989.

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change in the cash balances from one month to the next month was only 4.4 days.

While the Navy stock fund has maintained a large operating cash balance for the past 5 years, the stock fund has also refunded \$3.4 billion to selected customers. These refunds have helped the Navy reduce the excessive amounts of operating cash in the stock fund. We were unable, just as the Navy was unable, to determine the ultimate disposition of \$2.1 billion in refunds because they were merged into other accounts. For the remaining \$1.3 billion, Navy officials told us these funds were used to purchase inventories for the repair of aircraft.

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## Background

The Department of the Navy stock fund is to provide for the financial management, inventory control, and distribution of consumable supply items to support both the Navy and Marine Corps peacetime and war-time operations. In addition, the Navy stock fund sells inventory items to other agencies, such as the Army, Air Force, and Coast Guard. While stock fund items are normally consumable items, the Navy stock fund also includes more expensive items that can be repaired. These expensive items are known as depot-level repairables. At the end of fiscal year 1989, the stock fund had a total reported inventory value of \$31.3 billion and annual sales of \$8.8 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 activities funded by the Navy'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 Regulation 7420.13-R requires that the stock fund maintain a certain level of funds with Treasury. Until November 1989 when the House and Senate Appropriations Committees recommended reducing this balance to 5 days, Defense had 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 when setting prices charged customers. For the Navy stock fund, disbursements for 1 day are currently worth about \$23.3 million, for an 11-day total of \$256.3 million.

