

GAO

Testimony



143774

For Release
on Delivery
Expected at
2 p.m.
Tuesday,
April 30, 1991

**Defense's Planned Implementation
of the \$77 Billion Defense
Business Operations Fund**

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Before the
Subcommittee on Readiness
Committee on Armed Services
House of Representatives



Mr. Chairman and Members of the Subcommittee:

As you are aware, the Department of Defense has various initiatives underway that are aimed at streamlining its operations and improving its efficiency. One of these efforts is the proposed establishment of the Defense Business Operations Fund. The Fund's proposed \$77 billion operation and 390,000 military and civilian personnel would dwarf most private sector businesses and civilian federal agencies. We are pleased to be here today to discuss GAO's views on Defense's planned implementation of the Fund in fiscal year 1992.

FUND'S IMPLEMENTATION IS PREMATURE

We support Defense's initiative to adopt a more businesslike approach to the management and operation of its support functions. This approach would focus the attention of management, at all levels, on the cost of carrying out Defense operations. At the present time, neither Defense nor the Congress is aware of the total support costs of operating components, such as Air Force fighter squadrons or Navy aircraft carriers. In the past, management focused on the elements of cost rather than on the total cost of operations. This initiative could increase the incentives and tools to manage existing resources with greater efficiency by identifying the total cost of operations and highlighting the cost implications

of decisions made by managers. In today's environment of decreasing budgets and an increasing federal deficit, it is vital that Defense spend the funds appropriated by the Congress in a more efficient and effective manner.

Although we support Defense's efforts to determine the full cost of support operations, we do not believe that Defense is in a position to implement the Fund at this time. Defense does not have the policies, procedures, and systems in place to implement and operate the Fund in a "businesslike" manner. At the present time, very little specific documentation is available on the policies and procedures for governing the Fund or on the methods for maintaining congressional oversight and control over the Fund. In fact, much of the information we are discussing today was only provided orally by Defense officials. Defense needs to describe to the Congress, the Fund managers, and the Fund customers precisely how the Fund would operate and how it would be controlled. Given the Fund's size and complexity, having this information would be absolutely essential before implementation.

Further, the existing component systems are not yet capable of providing accurate and reliable cost information. Only the existing industrial funds have the semblance of a cost accounting system. However, our past work and Defense's own Federal Managers' Financial Integrity Act reports have identified serious internal control weaknesses with many of these systems.

Without accurate cost information, the Fund's billings to its customers will not be credible. An inaccurate billing system could result in the Fund not receiving sufficient cash from its customers to cover the full cost incurred in producing goods and services.

BACKGROUND

In February 1991, the Deputy Secretary of Defense recommended that the Defense Business Operations Fund be established. The Fund would initially include the nine existing revolving funds operated by Defense and the military services, as well as four other activities, which are currently funded by appropriations. Defense estimates that the Fund would provide \$77 billion in services during fiscal year 1992. The proposed Fund would, if supported by adequate financial systems, enable Defense to accumulate the cost of services provided to the Fund's customers, including all support costs. By identifying these support costs, Defense would be better able to control and reduce them as the size of the military forces decline. In addition, the proposed Fund would enable Defense to determine the total cost of operating individual components, such as a military base or a fighter squadron.

Two other Defense initiatives which directly affect the Defense Business Operations Fund are the Corporate Information

Management (CIM) project and the Defense Finance and Accounting Service (DFAS). The CIM project, adopted in October 1989, represents Defense's long-term strategy to improve finance and accounting operations. An overall objective of the CIM effort is to provide standardization, improve the quality and consistency of data in Defense's various information systems, and reduce the number of redundant systems. Defense officials estimate that designing, developing, and implementing these systems could take several years. The CIM project is also considering selecting the best of the existing military service systems to serve as interim systems until it decides how best to implement CIM standard systems. In its April 23, 1991, testimony before this Subcommittee, GAO discussed concerns with Defense's management of the CIM project.¹

In January 1991, Defense officials made a major change in departmental accounting and finance responsibilities. The overall responsibility for these functions was shifted from each military service to a new Defense organization--the Defense Finance and Accounting Service. DFAS is intended to provide uniform accounting policy guidance, establish requirements for financial systems, provide finance and accounting services, and prepare financial statements. DFAS has already consolidated 22 major financial offices and organizations--16 of which were

¹Challenges Facing Defense's Corporate Information Management Initiatives (GAO/T-IMTEC-91-10, April 23, 1991).

operated by the military services and 6 of which were operated by Defense--into a single organization that will eventually incorporate 1,300 field activities.

These three initiatives are interrelated. The successful operation of the Defense Business Operations Fund will require effective and coordinated financial systems (CIM) and accurate financial reporting (DFAS). DFAS and the Fund are under the direction of the Comptroller of the Department of Defense, who is Defense's Chief Financial Officer (CFO). However, the CIM project is under the direction of the Assistant Secretary of Defense for Command, Control, Communications, and Intelligence. The CIM project will need to be closely coordinated with the Comptroller's office, because the Comptroller has the responsibility for ensuring that financial management systems comply with applicable requirements.

Defense informed us that it intends to rely on CIM, DFAS, and the Fund to help satisfy the requirements of the Chief Financial Officers Act of 1990. Defense's success in meeting the act's requirements to (1) develop reliable cost accounting systems and reports and (2) develop and report on performance measurements is closely linked to the Fund's successful implementation. Further, since the Fund will be a revolving fund, it will be required under the act to prepare financial statements annually and have them audited.

HOW REVOLVING FUNDS OPERATE

Revolving funds are modeled after businesslike operations; unlike those operations, however, they operate on a break-even basis by recovering the costs incurred in providing goods and services from customers. The revolving fund and its customers maintain a contractual (buyer-seller) type of relationship. The proposed Fund's customers would be Defense activities which receive appropriations, such as Operation and Maintenance funds.

There are basically two types of revolving funds: industrial funds and stock funds. Industrial and stock funds receive appropriations from the Congress which increase their cash balances. For fiscal year 1991, Defense industrial and stock funds received about \$2 billion in appropriated funds.

Industrial Funds

Industrial funds are designed to provide an effective means of financing, budgeting, accounting for, and controlling the costs of providing services, such as overhauling a ship or repairing an inventory item, such as a fuel pump. Defense activities typically financed under industrial funds include shipyards, aircraft repair facilities, and research and development activities. As of September 30, 1990, Defense had 80

industrial fund activities. For fiscal year 1991, Defense officials estimate these activities will sell services valued at about \$25 billion to their customers.

To facilitate the financial operations of industrial funds, the Congress has appropriated limited amounts of working capital. Most industrial fund budgetary resources (authority to incur obligations) are generated through customer orders. Under the reimbursable process, customers use their appropriations to finance orders placed with industrial fund activities. When an industrial fund activity accepts an order, its own budgetary resources are increased and the customers' appropriations are obligated by the amount of the order. The industrial fund then uses these budgetary resources to finance the obligations it incurs to fill customer orders.

Stock Funds

Defense stock funds provide for the financial management, inventory control, and distribution of supply items to support both peacetime and wartime operations. For fiscal year 1991, Defense officials estimate that the Department's stock funds will have inventory valued at \$66 billion and annual sales of \$39 billion. A stock fund buys and holds inventory for sale to authorized customers, such as activities funded with the Operation and Maintenance appropriations. Sales of stock fund

inventory generate cash that is used to replenish inventory levels.

To ensure that sufficient cash is available to pay bills from suppliers, Defense regulations require that stock funds maintain a certain level of funds with the Department of the Treasury. The cash level is to be maintained by adding a surcharge to the stock funds' acquisition cost for inventory items to cover related costs, such as transportation, when setting prices charged to customers.

PROPOSED OPERATION AND POTENTIAL

BENEFITS OF THE FUND

Defense's long-range goal is to move the financing of virtually all the support establishment into the Fund. Some activities that would not be in the Fund are (1) combat-type units, (2) procurement of major weapon systems such as ships, planes, and tanks, and (3) military construction not related to the operation of the Fund.

At one time, Defense officials estimated that financing support operations could add as much as \$100 billion to the Fund,

in addition to the \$77 billion² that would be incorporated in fiscal year 1992. At the present time, however, Defense is uncertain of the Fund's dollar volume if all support operations were included. After initial capitalization, the Fund would be sustained by charging its customers the full cost of goods and services provided.

From a financial perspective--for rate-setting and budgeting--the Fund will be administered by Defense's Comptroller. However, the operational management and control of existing revolving funds, such as shipyards or aviation depots, would remain with the military services. In essence, very little would change in the day-to-day operating responsibilities of existing industrial and stock funds.

The most immediate change is that the proposed Fund will have one cash balance, whereas now the existing nine revolving funds have separate cash balances. In the long-term, if properly implemented, the Fund would provide the total cost, including the

²According to the Fund's fiscal year 1992 budget justification book, the difference between the \$77 billion of goods and services provided by the Fund in fiscal year 1992 and the industrial and stock fund estimated sales of \$64 billion in fiscal year 1991 can be primarily attributed to (1) the plan to finance Army and Air Force repairable inventory items in the stock fund, (2) the plan to finance Fund-related capital investment projects in the Fund, and (3) the double counting of the Commissary operations in fiscal year 1992. Defense treated Commissaries in this manner to provide information for comparison purposes.

support cost, which managers should use in making decisions.

In fiscal year 1992, Defense plans for the Fund to include not only the nine existing industrial and stock fund operations valued at \$76 billion annually, but also four other support activities--DFAS, the Industrial Plant Equipment Services, the Defense Reutilization and Marketing Service, and the Defense Technical Information Service--whose services are valued at \$1 billion annually. The Fund would also include capital budgeting for equipment and construction used in its operations.

Defense has classified the goods and services provided by the existing industrial and stock funds and the four other support activities into the following 12 business areas: (1) supply operations, (2) depot maintenance, (3) base support, (4) transportation, (5) research and development, (6) reutilization and marketing, (7) industrial plant equipment services, (8) printing and publications, (9) technical information services, (10) financial operations, (11) information services, and (12) commissary services. These 12 business areas would consist of hundreds of activities, such as shipyards and aviation depots. For fiscal year 1993, Defense officials are considering expanding the Fund to include 2 more business areas--contract audit and contract management. Attachment I provides summary financial information for these 14 business areas. For a business area to be included in the Fund, Defense has specified the following

three criteria must be met: (1) outputs of the business must be identified, (2) a cost accounting system that relates cost to outputs must be in place, and (3) the customers of the business must be identified.

In those business areas where a cost system does not currently exist, such as supply operations, Defense officials have been using data recorded in existing financial management systems in an effort to arrive at an estimated cost. Defense officials informed us that determining the cost for the various business areas has been difficult because the military services' organizational structures, financial systems, and terminology are not uniform. Officials acknowledged that to the extent the existing systems produce unreliable data, the information used to determine the cost would be unreliable. In October 1990, Defense officials estimated that cost data for these business areas would be accumulated for fiscal year 1991. However, as of March 1991, the costs related only to supply operations has been developed. For the industrial funds, Defense officials intend to rely on existing systems to capture and record the costs of doing business.

Defense officials believe that they would derive several benefits from implementing the Fund. For example, the total cost of operations for a business area would be disclosed in the operating and capital budgets. Having cost information

available would help organizations more effectively manage their resources. For example, Defense officials would have information on the total costs to operate and maintain a base; such information could be considered in making base closure decisions. Defense officials also believe that the Fund would foster an environment that encourages managers to reduce costs. Headquarters and field managers would have oversight of the cost of doing business, and Defense officials could establish goals, such as the cost per output, for the individual services to meet.

FUND WOULD CHANGE FINANCING METHOD

I would like to briefly describe the changes envisioned in Defense budget accounts from implementation of the Fund. Defense's budget request is broken into several broad areas, with numerous budget accounts under each. The main existing areas which would be affected by the Fund's implementation are

- Procurement;
- Operation and Maintenance (O&M);
- Military Construction (MILCON);
- Military Personnel (MILPERS);
- Research, Development, Test, and Evaluation (RDT&E);
- Industrial Funds; and
- Stock Funds.

As described earlier, Defense officials propose incorporating the five existing industrial funds and the four existing stock funds into the Fund. In the President's fiscal year 1992 budget request, the Fund takes the place of the industrial and stock fund accounts. With the establishment of the Fund, most appropriations for Defense's stock and industrial fund operations would continue to be made to customers' accounts.

The President's fiscal year 1992 budget also proposes that the Defense Technical Information Service, the Defense Finance and Accounting Service, the Defense Reutilization and Marketing Service, and the Industrial Plant Equipment Services--all of which currently receive direct appropriations in O&M and RDT&E accounts--be included in the Fund. For example, the President's fiscal year 1992 budget for the Fund shows about \$45 million for technical information services that would have been appropriated to the RDT&E accounts in prior budgets. Instead, in the President's fiscal year 1992 budget, appropriations would be made to customers' accounts.

The Fund's implementation would also shift appropriations from two general areas--MILCON and Procurement--primarily to O&M. Currently, funds to construct facilities costing \$1 million or more are appropriated to the MILCON accounts, and funds to procure equipment, such as cranes and generators, are appropriated to the procurement accounts. Implementation of the

Fund, as proposed in the President's fiscal year 1992 budget, would shift that portion of these appropriations related to the Fund to the customers accounts.

In addition, in order to obtain upfront financing of Fund-related capital investments for fiscal year 1992, customer prices would be increased to cover the full amount of budget authority which--in prior budgets--would have been included in the MILCON and procurement budget requests. Defense officials stated that this amounted to about \$400 million for construction and about \$700 million for equipment. These amounts are included in the President's fiscal year 1992 budget as increases in customer appropriations accounts, primarily O&M.

After fiscal year 1992, Defense plans to change the capital investment budgeting basis for Fund-related businesses. Instead of requesting budget authority to cover the total costs of authorized capital investments, as MILCON and Procurement budget requests have done in the past, Defense would request budget authority needed to cover annual depreciation on equipment and construction put in place after September 30, 1991. Defense officials expect this depreciation amount to cover cash outlay needs for capital investments in any given year. Appropriations for depreciation would be made to customers' accounts, as depreciation would be one component of the prices charged to customers.

Further, the President's fiscal year 1992 budget proposal includes Fund-related personnel costs in the prices charged to Fund customers. The Fund would reimburse the MILPERS accounts for these costs. The MILPERS appropriation accounts in the President's fiscal year 1992 budget show increased reimbursables and a corresponding decrease in direct appropriations. In addition, customer accounts--mainly O&M--would receive increased appropriations. This is already being done for the industrial and stock funds in fiscal year 1991, so doing this for the four other activities to be included in the Fund would have a limited impact.

CONGRESSIONAL OVERSIGHT AND FUND CONTROL

The proposed Fund will have an impact on congressional oversight and control primarily in two areas for fiscal year 1992. The first involves MILCON. According to Defense officials, construction for the Fund's businesses would still be authorized in the MILCON authorization acts. The MILCON appropriations acts would approve a dollar amount for construction, but this approval would not represent budget authority. In fiscal year 1992, Defense appropriations acts would then appropriate the "approved" dollar amount to the customers' appropriations accounts, primarily O&M. In subsequent years, the Fund's MILCON amount would be funded by the

depreciation expense method described earlier. Therefore, the appropriations to fund that amount would come through customers' accounts rather than through the MILCON appropriation, as in prior years.

Defense officials stated that they would be legally required to execute construction projects authorized in the MILCON authorization acts and "approved" in the MILCON appropriations acts. However, if sufficient funding was not provided to cover "approved" construction projects in customer appropriations accounts, it is unclear how the "approved" construction projects would be executed. If the MILCON appropriations act does not "approve" the full amount requested for military construction projects in the Fund, the Defense Appropriations Subcommittees could make a corresponding downward adjustment to the customers' appropriation accounts.

The second impact on congressional oversight and control is very important to understand. Defense officials would have increased flexibility to shift budget authority, including cash, between the Fund's business areas. Currently, Defense policy requires that all transfers of budget authority, including cash, between the existing industrial and stock funds be approved by the Armed Services and Appropriations Committees. With the Fund, Defense's current policies would allow reprogramming of budget authority, including cash, under the more liberal rules

applicable to reprogramming within a single appropriation. For example, cash could be shifted from Navy Stock Fund supply operation activities to similar Army Stock Fund activities without consulting congressional committees. There may be advantages to the increased flexibility this would provide to Defense managers if the process was well controlled. With the proper reporting on the results of the Fund's 12 business areas, the Congress should continue to receive the information it needs to maintain oversight of the Fund. Conversely, without good reporting and control, the increased flexibility could lead to abuses.

EXISTING REVOLVING FUND SYSTEMS

HAVE SERIOUS WEAKNESSES

We believe the business concepts which would be embodied in the proposed Fund are desirable. However, Defense does not now have the financial management systems in place to operate the Fund as an effective and efficient business-type entity. For example, Defense's own Federal Managers' Financial Integrity Act reports have pointed out that the financial systems that would support the Fund lack adequate internal controls and the ability to report accurately on the results of operations.

If the Fund's financial systems do not reliably accumulate the costs incurred in producing goods and services and accurately bill the customers for those costs, the financial position of the Fund could be adversely affected. Discussed below are weaknesses within the existing industrial and stock fund accounting systems that we believe must be corrected before these operations should be placed into the proposed Fund.

Weaknesses in Industrial Fund

Accounting Systems

The Air Force's Depot Maintenance Services (DMS) Industrial Fund did not have adequate controls over material cost during fiscal year 1989.³ At that time, controls over the \$411 million of material cost incurred by DMS did not (1) ensure that material was charged to the correct job or (2) limit material issues to actual job requirements. As a result, DMS could have issued materials in excess of those needed for its repair functions and material costs for specific jobs may not have been correctly reported. For accurate cost accounting, control, and billing, DMS needs to know how much material each type of job should require and how much was actually used.

³Commander, Air Force Logistics Command, Wright-Patterson Air Force Base (GAO/AFMD-91-33ML, February 26, 1991).

The Air Force's fiscal year 1988 Federal Managers' Financial Integrity Act report disclosed the failure to limit material quantities to actual job requirements as a control weakness. In its fiscal year 1989 report, the Air Force reported that this material weakness had been corrected. However, our work indicated that controls were still not sufficient to limit direct material issuances to established standard and maximum requirements. Standard quantities are the amounts of materials or parts expected to be required based on engineering estimates and the history of material usage for similar jobs. Maximum quantities are the amounts which would be required if all such material or parts on the unit being repaired had to be replaced.

At the three Air Logistics Centers (ALC), we found that most material issues exceeded requirements. During fiscal year 1989, 61 percent of the material issuances at the Oklahoma City ALC exceeded standard requirements and 32 percent of the issuances exceeded maximum requirements. At the Ogden ALC, we found that during July and August 1989, 83 percent and 37 percent of the material issuances exceeded standard and maximum requirements, respectively. At the San Antonio ALC, we found that 61 percent of the material issuances exceeded standard requirements and 15 percent exceeded maximum requirements for a 6-week period in 1989.

In addition, since 1985, the Department of the Navy has reported in its Federal Managers' Financial Integrity Act reports that Navy's industrial fund accounting system is not in compliance with GAO's accounting principles, standards, and related requirements. Navy reported in its fiscal year 1990 report that the system had material deficiencies in the following areas: (1) general ledger control and reporting, (2) accounts receivable, (3) systems controls, (4) audit trails, (5) cash procedures, (6) system documentation, (7) system interfaces, (8) timeliness or usefulness of reports and budgetary accounting, and (9) property accounting, including accounting for government furnished material. For example, Navy reported that the industrial fund accounting system did not have adequate internal controls over resources to prevent cost overruns on work done for customers.

At the request of this Subcommittee, we are currently reviewing the accuracy and reliability of Defense's industrial fund accounting systems. Based on our preliminary observations, we have determined that some industrial fund activities may have incurred costs in excess of the amount of funds provided by their customers. This practice could affect the solvency of the industrial funds involved because they may not be reimbursed for the cost of work that has already been done. This practice is contrary to regulation, which provides that if cost overruns are anticipated, the industrial fund activities and customers should

renegotiate the terms of the work requested. If negotiations fail, the industrial fund activity should stop work.

Our preliminary observations also indicate that some industrial fund activities have incurred costs which cannot be matched to the proper job order. As a result, the cost of work performed on specific job orders may be understated because all applicable costs may not have been accurately allocated. Therefore, some customers may not have been properly billed for the work performed by the industrial fund activities.

Weaknesses in Stock Fund

Accounting Systems

Serious weaknesses also exist in the stock fund accounting systems. We have reported that the Air Force stock fund failed to collect about \$238 million for aircraft fuel that the Air Force contends was provided to customers from fiscal years 1981 through 1989 because data were not entered or accurately processed in the Aviation Fuel Management Accounting System (B-236940, October 17, 1989). This situation occurred throughout the 1980s because the billings were not reconciled to sales reported by the stock fund accounting system.

Further, we recently reported⁴ that inadequate Air Force stock fund management practices had increased the prices being charged to customers. Surcharge rates, which are added to material costs to cover operating expenses, increased from about 13 percent in fiscal year 1987 to over 20 percent in fiscal year 1989, partially due to unbilled sales. For example, we estimated that billing problems at one location had led to almost \$9 million in losses to the Fund during fiscal year 1989.

Furthermore, since fiscal year 1985, Navy has reported that its stock fund accounting system has material weaknesses. Many of the weaknesses are similar to those mentioned above regarding Navy's industrial fund accounting system. For example, the information produced by the stock fund accounting system required extensive manual manipulation and did not provide sufficient details to facilitate decision-making.

KEY ELEMENTS FOR SUCCESSFUL
IMPLEMENTATION OF THE FUND

The Fund's success hinges on its ability to provide managers the total cost, including support cost, that should be considered in making decisions. Therefore, while momentum for change in this direction should not be stifled, the size and complexity of

⁴Financial Audit: Financial Reporting and Internal Controls at the Air Logistics Centers (GAO/AFMD-91-34, April 5, 1991.)

the operations that would be involved mandates that any changes be well thought out and communicated and take place under circumstances conducive to achieving their ultimate goals.

We believe that Defense should not implement the Defense Business Operations Fund in fiscal year 1992. Prior to the implementation of the Fund, Defense needs to

- develop comprehensive and detailed policies and procedures to govern the Fund's operation,
- develop accurate and reliable cost accounting systems to capture and report cost data for each business area,
- ensure that systems are in place that accurately bill customers the full cost incurred in providing goods and services,
- ensure that systems are in place to accurately account for and record intrafund transactions,
- develop performance measurements to be used by managers to evaluate the resources entrusted to them,
- capture Fund-related capital investment cost, and

-- prepare financial statements that can be audited and are useful to the Congress in providing the information needed for oversight and control of the Fund and customers' appropriations to buy from the Fund.

I would like to discuss each one of these requirements.

Develop Policies and Procedures
on the Operation of the Fund

Defense is requesting that the Congress approve the establishment of a \$77 billion operation which, when compared to the sales reported by Fortune magazine's top 500 industrial corporations, would be equivalent to the fourth largest corporation in the United States--exceeded only by General Motors, Exxon, and Ford. However, at the present time little documentation is available on the policies and procedures for the Fund, even though Defense would like to implement it in October 1991--5 months from now. Defense has not clearly explained how the Fund would operate, its controls, the rationale for including each business area, the responsibilities for financial decision-making, and its financial management reporting requirements.

Many details about the Fund are still unknown, such as how the Congress would maintain its oversight and control over the \$77 billion business enterprise. Defense needs to describe to

the Congress, the Fund managers, and the Fund customers, exactly and in considerable detail, how it would operate. If these parties do not understand what the Fund is and how it should operate, the Fund will not be a success.

Development of an Accurate and
Reliable Cost Accounting System

The development of systems that produce credible cost information is essential for successful operation of the Fund. Users of these cost data, such as customers of the Fund, must be assured that the cost information is accurate because it will be used as the basis to bill them for the goods and services they buy from the Fund. In addition, the cost data must be accurate for the Congress to exercise oversight and control over the customers' budget requests. Further, accurate cost data are critical for budgeting purposes since these data should be the basis for the customers developing their budget requests.

However, as mentioned above, our reviews of Defense's industrial and stock fund accounting systems have disclosed serious weaknesses. Therefore, since cost data to be used by the Fund would be developed from these systems, the accuracy and reliability of that data would be, at best, questionable.

Billing System Based on Cost

A system that accurately bills customers for the full costs incurred in providing goods and services is critical to the success of the Fund. As previously discussed, Defense's existing revolving fund systems have not always properly billed customers. If the Fund does not establish an accurate and reliable billing system, with adequate internal controls to ensure the proper receipt of funds from customers, the solvency of the Fund would be jeopardized. An inaccurate system may result in the Fund's not receiving sufficient cash from its customers to cover the full costs incurred in producing goods and services.

In our view, it is equally important that the prices charged to the Fund's customers reflect the actual cost incurred in providing the goods and service. Therefore, the prices should not be adjusted by factors that are not directly related to costs incurred, such as adding a surcharge to the prices in order to maintain a specific cash balance with Treasury. Rather than adjusting the surcharge, as is the current practice if additional cash is needed, Defense should request the funding from the Congress. We believe the requirement to request funds from the Congress when cash levels are low would be an important part of congressional oversight. Another means of maintaining an adequate cash level would be to slow the reinvestment in

inventory. This could enable Defense to reduce excess inventories because the Fund would procure fewer items than it sold to customers.

Recording and Accounting for
Intrafund Transactions

Defense also needs to have in place a system to record and account for intrafund transactions. Of the \$77 billion of goods and services that would be consolidated into the Fund in fiscal year 1992, Defense has indicated that approximately \$19 billion--25 percent--of its operation would result from transactions among business areas within the Fund. For example, an industrial fund activity may obtain a fuel pump from the stock fund to be used in repairing an aircraft. When business transactions occur within the Fund's various business, Defense has indicated that a "bill" would not be issued. Rather, the cost incurred would be transferred within the Fund. In the above example, the costs would be transferred from the stock fund to the industrial fund.

Individual customers would need to know when they are being charged for something and how much they are being charged. If a customer is not provided this information on a timely basis, there will be little or no incentive to control costs or even attempt to reduce them.

Defense officials have acknowledged that the systems and procedures are not yet in place to ensure that the "transfer of costs" is captured and recorded. Given that these types of transactions will account for 25 percent of the Fund's business in its first year of operation, Defense needs to ensure that an accurate and reliable system is in place and working properly before the Fund begins operation. Since bills will not be issued, it is also uncertain how this "transfer of costs" would be disclosed in various account balances, such as cash, accounts receivable, and accounts payable for individual activities.

Developing and Reporting on
Performance Measures

Defense financial management systems must provide for a systematic measurement of performance that can be used by managers and the Congress to objectively evaluate management's stewardship over the resources and operations for which it is responsible. For an industrial fund activity, a variance analysis comparing estimated cost to actual cost incurred would be a useful performance indicator. For a stock fund operation, a trend analysis of inventory and receivable turnover ratios would be beneficial.

Defense has developed performance measurements for some business areas. For example, it has determined that one of the measurements for DFAS would be the number of pay accounts maintained by the finance centers. However, Defense has not accumulated the data necessary to determine the unit cost of maintaining those pay accounts. Without the cost data, Defense would not be able to measure the performance of its finance centers' operations.

Properly designed and reported, performance indicators can be early warning signals that identify a problem as it develops and before it reaches critical proportions. Further, measures of performance can be useful to Defense decisionmakers in assessing the implications of alternative choices and fostering economy and efficiency. Performance measures also can be used to objectively evaluate Defense's stewardship of the resources with which it is entrusted.

Capturing Cost for Capital

Investment Projects

As part of the Fund, Defense plans to include Fund-related capital investment projects, such as the buying of equipment and the construction of facilities. According to Defense, capturing these costs, along with the operating costs of the Fund's 12 businesses, will provide the total cost of operating the Fund.

We agree that the cost elements of capital investments should be included in the Fund and reflected in the prices charged customers.

At the present time, however, it is not clear how depreciation recovered from customers would provide enough budget authority for new capital investment obligations each year. For example, in fiscal year 1993, the Fund anticipates recovering \$234 million in depreciation from its customers. However, planned capital investment program for the year is \$595 million. Defense officials indicated that, in the long run, they plan to cover such shortages through surcharges to customers prices. I should note that any such adjustment would distort the actual annual costs associated with the Fund.

Part of the problem with the Fund's capital budgeting proposal lies in its definition of the depreciable base. The amount of depreciation included in the customers' O&M funds would be based on the capital assets placed into service after September 30, 1991. In our opinion, in keeping with the full cost concept, the Fund should charge customers the actual depreciation cost for all assets used by the fund, not just those put into service after September 30, 1991. This would result in the Fund recovering greater amounts for depreciation expense from the customers.

To ensure adequate congressional oversight, the Congress should approve the Fund's capital investment budget in conjunction with reviewing the Fund's anticipated depreciation amounts provided by customers. In a given year, the Congress should provide budget authority to cover any shortfall between the depreciation recovered from customers and the approved capital investment program. The Fund should separately account for depreciation to avoid problems we identified in Defense's management of a similar program for capital equipment--the Asset Capitalization Program.

We recently reported⁵ that the Program needed stronger management involvement and support, a more systematic approach for identifying projects needed to satisfy technology and strategic long-range planning requirements, and improved procedures to measure Program benefits. We also found that the Program lacked adequate accounting policies and internal control procedures.

In addition, we found that Defense's industrial fund accounting procedures did not prevent the industrial funds from using Program revenue to pay for non-Program expenses. Since Defense used these funds for the industrial funds' non-Program operations, the industrial funds had about \$1 billion worth of

⁵Industrial Funds: Weaknesses Remain in the Department of Defense's Capital Equipment Program (GAO/NSIAD-91-175, April 17, 1991).

unliquidated Program obligations as of September 30, 1989, without any Program cash reserves to pay for these obligations. As a result, the industrial fund activities had to use general operating revenues to pay for these obligations.

Financial Statements That Can Be
Audited and Are Useful to the Congress

Since the Defense Business Operations Fund would be a revolving fund, Defense would be required to prepare annual financial statements for the Fund and have them audited in accordance with the provisions of the Chief Financial Officers Act of 1990. In addition, we believe that each business area should be required to have a financial audit before being placed in the Fund, and each year thereafter.

Audited financial statements can be viewed as a report card on agency financial management which points out deficient systems, helps quantify the extent of problems, and highlights what needs to be done to improve the systems. In addition, the financial statements can highlight critical information, such as the significance of accounts receivables, inventories, and accounts payables. The financial statements can also be used to develop trends, make comparisons, and provide a basis for evaluating the Fund's performance. Further, financial statement audits would help instill the organizational discipline needed to

develop and maintain accurate and timely systems of internal controls and accounting.

The preparation and audit of annual financial statements would disclose meaningful and useful information for assessing programs and providing a clear picture of the Fund's financial status to the Congress. This kind of financial disclosure can (1) provide the Congress greater insight into and understanding of the Fund's financial affairs, (2) reflect accountability for the Fund's businesses and resources, and (3) be useful to the Congress in exercising its oversight and control over the Fund and the appropriations provided to customers to buy goods and services from the Fund.

Because of the Fund's size and complexity, preparing annual financial statements and having them audited will be no easy task. Defense is currently conducting its first financial statement audits of its revolving fund activities, as required by the CFO Act. These audits could be expanded to assess the progress being made in addressing the key elements discussed in this section. We believe these elements are necessary for the successful implementation of the Fund.

ALTERNATIVES TO IMMEDIATE IMPLEMENTATION

We believe there are a number of alternatives that Defense could pursue in its efforts to develop its total costs, including support costs, and to manage its resources in a more efficient and effective manner. Each alternative would provide for a pilot program to assist Defense in addressing the concerns we have raised. A pilot program could be a building block toward implementing the proposed \$77 billion Defense Business Operations Fund. Several alternatives are outlined below.

- Continue the development of cost data and performance measurements for the identified business areas without combining the businesses into one fund. In addition, Defense should address the identified accounting system weaknesses.

- Combine the existing industrial fund and stock fund for one military service into one fund. This would provide for the development of (1) policies and procedures on how the fund would operate, (2) cost data and performance factors to measure the efficiency of the fund, (3) a system for accounting for and recording intrafund transactions, and (4) a prototype billing system.

- Combine the existing Naval research and development

industrial fund activities with the Army and Air Force research and development activities that are currently financed with direct appropriations. This would provide the benefits of combining two different organizations into one fund, but would involve a relatively small volume of intrafund transactions. However, it would provide for the development of cost data and performance measurements for Army and Air Force activities that do not currently operate on a revolving fund basis.

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In summary, developing the total costs of Defense's support operations is a sound, desirable goal. Being aware of the total cost could help instill a more businesslike approach to the management and control of resources. In addition, the Congress could have improved oversight over the Fund and its customers through improved financial reporting provided by audited financial statements and better cost data.

However, Defense needs to clearly explain how the Fund would operate and clearly show how the Congress would maintain its oversight and control over the Fund's activities and over the appropriations of the Fund's customers. Defense needs to initiate actions to correct existing weaknesses in the military services' industrial and stock fund systems. In addition, the

Fund must be in a position to accurately bill all customers. Customers must have confidence that the costs being charged are accurate and reliable. Without this confidence, they will have little or no incentive to reduce their cost of operations.

Mr. Chairman, this concludes my formal statement. We will be pleased to answer questions you or other members of the Subcommittee may have at this time.

VALUE OF GOODS AND SERVICES FINANCED
BY THE DEFENSE BUSINESS OPERATIONS FUND

<u>Business area</u>	<u>Value for fiscal year</u>		<u>Component^a</u>			
	<u>1992</u> (Dollars in millions)	<u>1993</u>	<u>Army</u>	<u>Navy</u>	<u>Air Force</u>	<u>Defense Agencies</u>
Supply Operations	\$40,711	\$38,483	x	x	x	x
Depot Maintenance	13,891	14,053	x	x	x	x
Base Support	1,367	1,434		x	x	
Transportation	5,243	5,282	x	x	x	
Research and Development	4,781	4,868		x		
Reutilization and Marketing	268	256				x
Industrial Plant Equip. Services	60	63	x			x
Printing and Publications	673	659		x		
Contract Audit	N/A	403				x
Contract Management	N/A	1,128				x
Technical Information Services	45	46				x
Financial Operations	944	968				x
Information Services	1,536	1,600		x		x
Commissary Operations	<u>7,452</u>	<u>7,653</u>				x
Total	<u>\$76,971</u>	<u>\$76,896</u>				

^aAn x indicates that an Army, Navy, Air Force, and/or Defense Agency business area will be part of the Defense Business Operations Fund.