

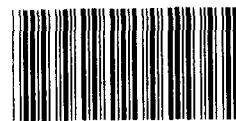
**GAO**

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

June 1991

**FINANCIAL  
MANAGEMENT**

**Uniform Policies  
Needed on DOD  
Financing of  
Repairable Inventory  
Items**



144201

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United States  
General Accounting Office  
Washington, D.C. 20548

Accounting and Financial  
Management Division

B-240188

June 21, 1991

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

Dear Mr. Chairman:

In a January 22, 1990, letter, you requested that we review Department of Defense (DOD) efforts to improve management of its repairable inventory items by financing these items through the military services' stock funds. A repairable is an item that, if damaged, can be repaired for less than the cost of a new item. DOD refers to these items as repairable whether they are new or used. DOD currently estimates that these items are valued at \$73 billion.

In June 1990, we briefed your office on the services' plans to finance repairable items through the stock fund. At that time, your staff expressed concern about the inconsistencies of the services' plans. These concerns were reiterated in the Committee's October 1990 report. In its report (House Report 101-822), the Committee expressed concern about the services having different practices and procedures related to (1) the prices that the stock funds will charge their customers for repairable items and (2) the ownership and control that the stock funds will have over repairable items at the installations.

The need to have reasonably consistent policies and procedures becomes increasingly important in view of several recent congressional and DOD initiatives. First, the Chief Financial Officers Act of 1990 provides for the preparation and audit of financial statements for revolving funds, which include stock funds. Second, DOD has initiated a comprehensive long-term effort, known as the Corporate Information Management (CIM) project, which is intended to improve financial and management information systems. As agreed with your office, we plan to continue monitoring DOD's efforts to improve management of repairable items.

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## Results in Brief

Although DOD has taken steps to standardize the way the military services finance repairable items, the Department is allowing the services to implement differing policies regarding the pricing and ownership of these items. In addition, DOD has not developed a policy for valuing repairable items on financial reports. This lack of uniform policies

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regarding repairables will preclude uniform financial reporting by the military services' stock funds.

The Army and the Navy stock funds do not own or control repairable items in the installation-level supply systems. Conversely, the Air Force stock fund will own and report on repairable items in both the depot and installation-level supply systems. According to Air Force officials, this will allow the Air Force to centrally monitor inventory levels and direct the movement of items from one installation to another, as needed.

In addition, inconsistencies among the services' plans regarding repairable items appear to undermine the CIM project. CIM is intended to standardize policies, data elements, and systems, as well as to reduce duplicative systems by consolidating similar service operations and facilitating future system improvements.

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## Background

Prior to 1981, all three military services used procurement appropriations to purchase repairable items, such as carburetors, fuel pumps, and helicopter blades. These items were provided free of charge to customers. In general, customers are the military services' maintenance activities. When an item became damaged or worn and needed repair, the customer sent it to the supply system and, in exchange, received a replacement item, again free of charge. The military services used Operation and Maintenance appropriations to pay for repair of the broken items.

In 1981, the Navy began testing the feasibility of financing the purchase and repair of shipboard repairable items through its stock fund, which had previously been used primarily to purchase and distribute consumables, such as fuel. Under this concept, the Navy stock fund buys new items and sells them to customers. The stock fund also receives items in need of repair from customers, pays for their repair, and sells the repaired items back to the customers. Sales of stock fund inventory generate cash that is used to replenish inventory and cover repair costs.

The Navy's use of its stock fund to finance repairable items was determined to be an effective way to provide for the financial management, inventory control, and distribution of these items. In addition, the demand for items was reduced because customers had to buy needed items rather than receive them free of charge. Therefore, they were more careful to maintain their inventory and thus limit orders for

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replacement items. In 1985, the program was expanded to include aviation repairable items.

In December 1989, the Office of the Secretary of Defense directed the Army and Air Force to also begin financing the purchase and repair of repairable items through their stock funds. DOD estimated that such a change would save the Army and Air Force over \$2 billion from fiscal year 1991 through fiscal year 1995 due to reduced demand for replacement items. This estimate is based on the Navy's experience of financing repairable items through the stock fund. According to DOD budget documents, the Navy had a 20-percent reduction in the demand for repairable items because customers now had to pay for the items instead of receiving them free.

The Army and the Air Force began implementing the financing of repairable items through their stock funds in 1990 and plan to complete implementation by 1993. The following steps are either underway or scheduled.

- In October 1990, the Army and Air Force stock funds began to buy new repairable items. The Army's purchases included repair parts to support newly fielded weapon systems during their initial period of service. The Air Force stock fund plans to begin buying such parts, referred to as initial spares, in October 1993.
- In July 1991, the Army and Air Force stock funds plan to begin financing the repair of repairable items.
- In April 1992, customers plan to begin buying repairable items from both the Army and Air Force stock funds.

The Air Force has estimated that it will spend \$25 million in nonrecurring costs and \$24 million in annually recurring costs, primarily on automated system modifications and related personnel costs. The Army has estimated that it will spend about \$54 million in fiscal year 1991 to change its systems and procedures. However, as of March 1991, the Army had not determined the additional cost it will incur in future years. For fiscal year 1991, DOD estimates that the stock funds will obligate about \$5.7 billion for repairable inventory items. This includes the amount needed to buy new items and repair damaged items.

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## Objective, Scope, and Methodology

The objective of our review was to assess DOD's plans to expand the military services' use of stock funds to finance repairable items. We focused on whether the military services were implementing consistent policies

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related to (1) the prices the stock funds charge customers for repairable items, (2) the ownership and control that stock funds have over repairable items at installations, and (3) the dollar value of repairable items shown on stock fund financial reports.

To gain an understanding of current practices and planned changes in stock fund operations, we discussed these issues with officials from the offices of the Secretaries of Defense, the Army, the Navy, and the Air Force. We analyzed DOD and Navy stock fund regulations, as well as the Army and Air Force plans for financing repairable items through the stock fund, to determine if the services' policies complied with DOD regulations. When differences occurred, we obtained officials' explanations as to whether the particular service plans to modify its policy to comply with the DOD regulation in the future.

We also reviewed the military services' stock fund financial reports and related records to determine the value of repairable items and to obtain explanations for adjustments. We did not verify the accuracy of the reported inventory values.

We performed our work at the Office of the Secretary of Defense, Washington, D.C.; Headquarters, Departments of the Army, Navy, and Air Force, Washington, D.C.; Army Materiel Command, Alexandria, Virginia; Air Force Logistics Command, Dayton, Ohio; and the Navy Aviation Supply Office, Philadelphia, Pennsylvania. We conducted our review from March 1990 through April 1991, in accordance with generally accepted government auditing standards. The Department of Defense provided written comments on a draft of this report. These comments are included in full in appendix I.

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## Standard Policies Can Facilitate Financial Management

DOD's directive that all three military services finance repairable items through their stock funds is consistent with the Department's efforts to standardize financial operations. DOD's Report on the Consolidation and Improvement of Financial Operations Within the Department of Defense, dated April 1990, states that the lack of standardization in the Department's financial operations has resulted in a costly proliferation of similar, but not identical, policy and procedural issuances. The report further states that "standardization of policies, operating procedures, and terminology is essential to implementing DOD-wide standard operations and systems."

We agree that DOD could benefit from greater standardization. In our July 1990 testimony,<sup>1</sup> we stated that DOD needs to improve inventory and financial management and pointed out that duplication and wasteful DOD organizations and systems needed to be eliminated or streamlined. We also believe that standardization may

- facilitate central data consolidation and reporting to support financial reporting and central oversight and monitoring of items, such as inventory levels;
- reduce duplicative operations and system development efforts by allowing all three military services to use identical systems for similar operations or consolidating similar operations on a DOD-wide basis; and
- facilitate future improvements in systems, data reliability, and reporting since separate plans would not be needed to accommodate differing service systems and procedures.

To achieve greater standardization, DOD tasked the Corporate Information Management project to develop uniform financial policies that will serve as the baseline for future DOD financial systems. The overall objective of the CIM project is to improve standardization, quality, and consistency of data in DOD's various information systems, as well as to consolidate operations and related systems to reduce operational redundancies. The project covers eight functional areas within DOD, two of which pertain to financial and materiel management.

DOD provided the Army and the Air Force approximately \$80 million in fiscal year 1991 from the CIM Central Fund to change their respective financial and logistical systems. Achieving the full benefits of standardizing the financing of repairable items through the stock funds requires that the services follow uniform policies regarding the pricing, ownership, and valuation of these items.

## Planned Pricing Policies Will Not Be Uniform

Although the Navy complies with DOD's uniform policy for pricing repairable items, DOD has authorized the Army and the Air Force to deviate from this policy. DOD issued a uniform stock fund pricing policy in July 1990, which provided that customers are to be charged the exchange price when they purchase a repairable item and plan to turn in the damaged item. The exchange price is the repair cost plus a stock fund surcharge. If the item in need of repair is not received by the stock

<sup>1</sup>Department of Defense: Improving Management to Meet the Challenges of the 1990s (GAO/T-NSIAD-90-57, July 25, 1990), pp. 5, 21, 30, 31, and 32.

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fund within the period established by each military service, the policy provides that a customer will be charged an additional amount. This amount is to equal the difference between the exchange price and the standard price. The standard price is the acquisition cost of a new item plus a stock fund surcharge.

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**Navy Complies With DOD Policy**

Navy regulations specify that the Navy stock fund charge the exchange price for a repairable item with the understanding that the customer turn in the broken item. If the stock fund does not receive the broken item within 116 days, the customer is charged the difference between the exchange price and the standard price. According to Navy officials and a 1983 evaluation report on financing shipboard repairable items, if customers were charged the standard price, some of their funds would be unavailable for use until they received the credit from the stock fund.

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**Air Force Stock Fund Will Charge Standard Price Indefinitely**

The Air Force requested and was granted a waiver from DOD's pricing policy. In October 1990, the DOD Deputy Comptroller modified DOD's policy of requiring that the exchange price be charged by authorizing the Air Force to charge customers the standard price. Air Force officials believe that charging the standard price provides a financial incentive for the customer to quickly return the broken repairable item since the customer does not receive a credit until the broken item is received by the stock fund.

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**Army Stock Fund Will Charge the Standard Price Until 1993**

To allow time for the Army to modify its financial systems, the DOD Deputy Comptroller authorized the Army to delay compliance with the Department's uniform pricing policy until 1993. Prior to that date, the Army is authorized to charge customers the standard price and provide a credit when broken items are returned. The Army's September 1990 stock fund policy reflects these plans and specifies that when the Army begins charging the exchange price, customers must return broken items within 120 days to avoid an additional charge.

Until the Army modifies its systems, it will process more transactions than either the Navy or the Air Force and will have to maintain additional records. This is because the Army has a two-tiered stock fund,



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consisting of 1 wholesale division and 10 retail divisions,<sup>2</sup> and because these two tiers do not follow consistent policies.

Because the Army's stock fund organization consists of wholesale and retail divisions, the Army will process four financial transactions when a customer buys a repairable item and returns a broken one. Two transactions will occur when the customer buys a repairable item from the retail stock fund and receives credit for the broken item. Two more transactions will occur when the retail stock fund buys that item from the wholesale stock fund and receives credit for the broken item.

The Army's plan also calls for the retail and wholesale stock funds to have two different policies on crediting funds to customers for broken items. The retail stock fund will issue a credit when it receives the broken item, while the wholesale stock fund will issue a credit when the related shipping document is processed. Army budgeting officials informed us that this credit policy was intended to speed credits and the related fund availability to the retail stock fund. By receiving credit based on the shipping document, the retail stock fund will receive the credit sooner because it will not have to wait until the wholesale stock fund receives the broken item. However, the wholesale stock fund will have to maintain records of shipped items until they are received and bill the retail stock fund if a shipped item is not received within a specified period.

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## Plans for Ownership and Control of Repairable Items Vary

In addition to differing pricing policies, the military services will have different practices regarding the ownership and control of repairable inventory items in the installation-level supply systems. The Navy stock fund does not own and control items in the installation-level supply systems. Currently, the Army's wholesale stock fund will not have ownership and control of repairable items in the installation-level supply systems. However, its long-term plan to develop a single, integrated stock fund provides for central ownership and control. The Air Force implementation plan indicates that its stock funds will own and control repairable items in both the installation-level supply systems and the depots.

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<sup>2</sup>The wholesale division consists of six major subordinate commands which procure supplies directly from vendors and hold stock to meet demands from their customers. The wholesale division sells inventory to the 10 retail divisions which consist of 8 major commands, such as the U.S. Army Forces Command, and 2 functional areas. The retail divisions sell repairable items to customers, such as Operation and Maintenance activities.

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DOD does not have a policy on stock fund ownership and control of the repairable items in installation supply systems. However, Office of the Secretary of Defense budgeting officials stated that they believe stock funds should own and control all repairable items regardless of whether they are in the depot or in the installation-level supply systems. DOD officials stated that if the stock fund owned the repairable items in both the depot and the installation-level supply systems, the stock fund could better monitor inventory levels and direct the movement of items from one installation to another, as needed.

Prior to 1986, the Navy stock fund owned the repairable items in the installation-level supply systems. According to Navy documents, this policy changed in 1986 when ownership of such items began transferring to the customers. From 1986 through 1990, the Navy stock fund transferred about \$5 billion in repairable items from its own accounts to those of its customers. The Navy is currently performing a study to determine whether the stock fund should again own and control repairable items in the installation-level supply systems. The Navy plans to complete this study in June 1991.

The wholesale division of the Army's stock fund initially will not have the ability to centrally monitor items and transfer them from one installation to another. However, the Army's long-term plans are to integrate its wholesale and retail stock funds into a single supply system with a single stock fund. In doing so, the stock fund will be able to centrally monitor and redistribute items that are located in the installation-level supply systems.

The Air Force's implementation plan indicates that its stock fund will own and control repairable inventory items located in the installation-level supply systems. In addition, Air Force officials stated that its stock fund will have information on the quantity and the condition (usable or needing repair) of repairable items. According to Air Force officials, this will enable the stock fund to redistribute repairable items, as needed, within the installation-level supply systems.

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## DOD Accounting Policy Does Not Address Valuation of Repairable Items

DOD's current policy on valuing stock fund inventory was developed for consumable items and does not provide any guidance on valuing repairable items. Officials from the three services stated that an expanded policy is needed, including guidance on how to value repairable items that are usable versus items that need to be repaired. Such a policy will help ensure that the services consistently and accurately value items

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included in stock fund financial reports, such as the monthly management report submitted to DOD and the SF 220 report, Statement of Financial Condition.

Title 2 of the GAO Policy and Procedures Manual for Guidance of Federal Agencies requires that the value of inventory items be reported at the lower of cost or market value. Consistent with the principles upon which that requirement is based, we have taken the position that (1) the value of broken repairable items should be reduced by the cost to repair the items and (2) the value of broken items that cannot be repaired and of obsolete items should be written off or reduced to their salvage value. As broken items are repaired, the inventory value should be increased for the repair cost.

Army and Air Force officials told us that they are currently valuing repairable items at standard price. These officials told us that DOD guidance is needed on how to value broken repairable items as well as items that cannot be repaired.

The Navy includes repairable items on stock fund financial reports and, in 1986, developed its own procedures for determining their value. The Navy stock fund accounting system automatically values inventory at standard price, regardless of its condition. As a result, the Navy manually adjusts the value of its repairable items so that they are more accurately represented on financial reports, according to a Navy official. This adjustment (1) eliminates the stock fund surcharge, (2) reduces the value of broken items by the estimated repair cost, and (3) eliminates the total cost of items that cannot be repaired. The Navy's 1989 inventory reports show that the repairable inventory value decreased from \$22.4 billion to \$19 billion after the inventory value was adjusted for items that were not usable.

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## Conclusions

The military services have taken or are taking different approaches to financing repairable items through their respective stock funds even though DOD has begun a major initiative to standardize policies, procedures, and systems. Policies concerning the pricing and ownership of repairable items, including authority to redistribute items in the installation-level supply systems, will differ. If the Army and Navy stock funds owned the repairable items in the installation-level supply systems, they could better monitor inventory levels and direct the movement of items from one installation to another, as needed. Further, DOD

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has not established a policy on valuing repairable items for financial reporting purposes.

Future efforts to standardize inventory operations regarding repairable items may be difficult and costly, because the services will have already established their own separate policies and procedures. Standardizing at the earliest possible date would help the military services avoid spending additional funds in the future to change their practices and modify their financial systems.

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## Recommendations

To ensure that the military services follow standard policies and procedures in the financing of repairable items through their stock funds, we recommend that the Secretary of Defense

- ensure that the military services follow a uniform pricing policy on how the stock funds should charge customers for repairable items;
- develop a uniform policy on the stock funds' ownership and control of repairable items in the installation-level supply systems; in this regard, the Navy should modify its ownership policy unless its ongoing study of this issue demonstrates compelling operational reasons not to centrally own the repairable items; and
- develop a uniform accounting policy on how to value repairable items that are usable versus items that need repairs; such policy should specify that (1) the value of broken items be reduced by the cost to repair them and (2) the value of items that cannot be repaired and of obsolete items be written off or reduced to their salvage value.

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## Agency Comments

In commenting on a draft of this report, the Department of Defense concurred with our findings and the substance of the recommendations. DOD stated it has started to develop a uniform policy on the pricing, ownership, and valuation of repairable inventory items and anticipates issuing the policy by September 1991.

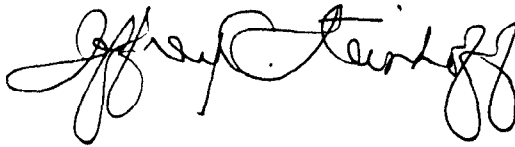
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We are sending copies of this report to the Secretaries of Defense, the Army, the Navy, and the Air Force and other interested parties. We will also make copies available to others upon request.

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Please contact me at (202) 275-9454 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Jeffrey C. Steinhoff". The signature is fluid and cursive, with the first and last names being more prominent.

Jeffrey C. Steinhoff  
Director, Civil Audits

# Comments From the Office of the Comptroller of the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

(Management Systems)

APR 26 1991

Mr. Jeffrey C. Steinhoff  
Director, Civil Audits  
Accounting and Financial  
Management Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Steinhoff:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report entitled -- "FINANCIAL MANAGEMENT: Uniform Policies Needed on DoD Financing Repairable Inventory Items," dated March 14, 1991 (GAO Code 903118/OSD Case 8362).

The DoD concurs with the findings and recommendations in the draft report as they relate to the desirability of uniform policies for the future development of standardized systems. However, although the Department will develop such uniform policies, it must be recognized that the objective is neither achievable in the short-term, nor is it necessarily achievable for all DoD Components at the same time. To achieve the desired benefits, the Department must continually make reasoned choices between the (1) future benefits of implementation and (2) current disruption of operations in individual DoD Components.

Regarding the uniformity of pricing policies, it is important to note that the policies of the Army and the Air Force would not result in the shift of funds estimated by the Navy, because credits are granted significantly sooner than in the Navy. Due to organizational differences with the Navy, both the Army and the Air Force experience a more rapid receipt of and, therefore, credit for, broken items. In addition, incentives established by charging the standard price in the Army and the Air Force also assure quick return of broken items. It should be further noted that, under the exchange pricing policy, similar records to those maintained by the Army are required to track unserviceable items.

The Department also emphasizes that current supply operations are not affected adversely by the current organization and policies of the Military Departments.

**Appendix I  
Comments From the Office of the  
Comptroller of the Department of Defense**

The detailed DoD comments on the GAO recommendations are provided in the enclosure. The Department appreciates the opportunity to comment on the draft.

Sincerely,

*for Alvin Tucker*  
Alvin Tucker  
Deputy Comptroller  
(Management Systems)

Enclosure

GAO DRAFT REPORT - DATED MARCH 14, 1991  
(GAO CODE 903118) OSD CASE 8632

"FINANCIAL MANAGEMENT: UNIFORM POLICIES NEEDED ON DOD  
FINANCING REPAIRABLE INVENTORY ITEMS"

DEPARTMENT OF DEFENSE COMMENTS

\* \* \* \* \*

RECOMMENDATIONS

- **RECOMMENDATION 1:** The GAO recommended that the Secretary of Defense ensure the Military Services follow a uniform pricing policy on how the stock funds should charge customers for repairable items. (p. 18/GAO Draft Report)

**DoD Response:** Concur. The Department has initiated development of a uniform policy on how the stock funds should charge customers for repairable items. Promulgation of that policy is expected in September 1991. However, implementation of a uniform policy is not achievable in the short-term nor is it necessarily achievable for all DoD Components at the same time. To achieve the desired benefits, the Department continually must make reasoned choices between (1) future benefits of implementation and (2) current disruptions of operations in individual DoD Components.

See comment 1.

- **RECOMMENDATION 2:** The GAO recommended that the Secretary of Defense develop a uniform policy on the stock fund ownership and control of repairable items in the installation level supply systems. (p. 18/GAO Draft Report)

**DoD Response:** Concur. Integration of wholesale and installation levels is a long-term goal of the Department and has been addressed in Defense Management Review decisions. Currently, the Department is developing such a policy. Promulgation of that policy is expected by September 1991.

See comment 1.

- **RECOMMENDATION 3:** The GAO recommended that the Secretary of Defense develop a uniform accounting policy on how to value repairable items that are usable, versus items that need repairs. (p. 18/GAO Draft Report)

**DoD Response:** Concur. The Department will research methods to determine the proper value for financial statement presentation of repairable items that are usable -- versus items that need repairs. The research is expected to be completed in September 1991.

Enclosure



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## GAO Comment

1. Recommendations 2 and 3 contain language not included in the draft report originally provided to DOD for comment. The additional language expands on the original recommendations, which are still included in this report, and provides more specific guidance on the ownership of items in the installation-level supply systems and the valuation of items for financial reporting purposes. We discussed the added language with DOD officials, and they raised no concerns.

# Major Contributors to This Report

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