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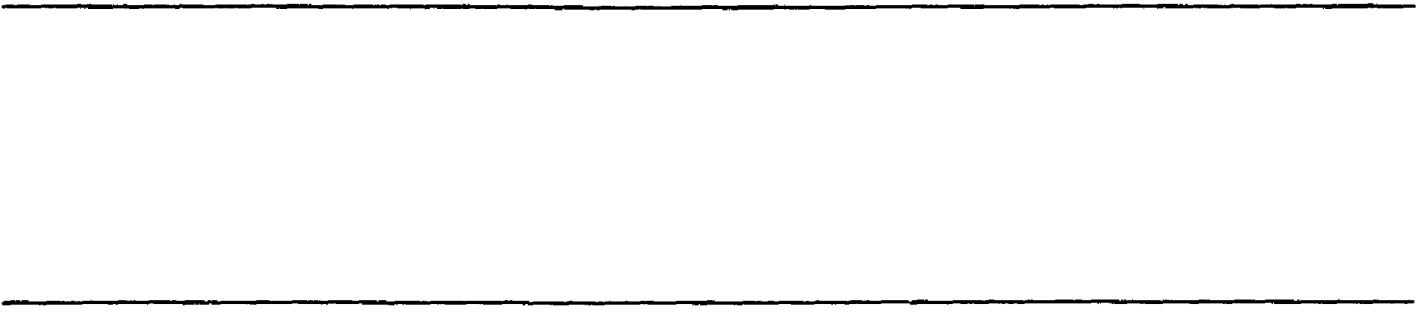
**FINANCIAL
MANAGEMENT**

**DOD's Efforts to Improve
Operations of the Defense
Business Operations Fund**

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to present our views on the Department of Defense's (DOD) operation and management of the Defense Business Operations Fund. Specifically, we will discuss DOD's (1) progress in improving the operations of the Fund, (2) development of the fiscal year 1995 prices the Fund will charge its customers, and (3) management of the Fund's capital asset program.

In October 1991, DOD implemented the Fund, which consolidated the nine existing industrial and stock funds operated by the military services and DOD, as well as the Defense Finance and Accounting Service (DFAS), the Defense Industrial Plant Equipment Services, the Defense Commissary Agency, the Defense Reutilization and Marketing Service, and the Defense Technical Information Service.

The Fund's primary goal is to focus the attention of all levels of management on the total costs of carrying out certain critical DOD business operations and the management of those costs. Better information on business operations should enable DOD management and the Congress to make more informed policy decisions as DOD continues to adapt to a smaller military. Accomplishing these objectives will require DOD managers to become more conscious of operating costs and make fundamental improvements in how DOD conducts business.

The Fund has a business relationship with its customers, primarily the military services, modeled after private sector business operations. DOD estimates that in fiscal year 1995, the Fund will have revenue of about \$77 billion, making it equivalent to one of the world's largest corporations. However, unlike private sector enterprises which have a profit motive, the Fund is to operate on a break-even basis by recovering the full costs incurred in its operations. The Fund provides such goods and services as the (1) overhaul of ships, tanks, and aircraft and (2) sale of over 5 million types of vital inventory items, such as landing gears for aircraft. Many of these are essential to maintaining the military readiness of our country's weapon systems and military personnel.

Since the concept of the Fund was first put forth in February 1991, we have monitored and evaluated its implementation and operation. We continue to support the Fund's concept. If the Fund is operated in an efficient and effective manner, it can contribute to a significant improvement in DOD operations. However, as we previously reported,¹ DOD has not achieved the Fund's objectives because

¹See the attachment for a list of GAO products related to the Fund.

- policies critical to the Fund's operations either were not developed or needed to be revised;
- the Fund's financial reports were inaccurate; and
- the cost accounting systems were fragmented, costly to maintain, and did not provide the cost information necessary for managers to better control costs.

Although DOD is working on solutions, these problems continue today. Their resolution will require the continuous commitment of DOD's top management.

On April 20, 1993, the Secretary of Defense directed a comprehensive and detailed review of the Fund's operations. To accomplish this, DOD established a task force of 80 experts from varying levels of DOD operations and management with financial and functional experience to review the Fund. The task force endorsed the continuation of the Fund and DOD developed the Defense Business Operations Fund Improvement Plan. On September 24, 1993, the Deputy Secretary of Defense and the Secretaries of the Army, Navy, and Air Force approved the plan, which consists of 56 actions and 183 tasks aimed at improving the Fund's operations and addressing known deficiencies.

DOD HAS MADE SOME PROGRESS
IN IMPROVING FUND OPERATIONS

The National Defense Authorization Act for Fiscal Year 1994 requires that DOD report to the congressional Defense committees on its progress in implementing the plan and that we evaluate and report on that progress. DOD's February 1, 1994, progress report stated significant progress had been made in improving Fund operations. We are encouraged that some progress is being made.

However, on March 9, 1994, we reported that (1) DOD's report covers only the first 3 months of a plan that will require several years to complete and (2) DOD completed only 18 of the 44 tasks covering the Fund's policies, procedures, and systems that were scheduled to be completed by December 31, 1993. Some tasks not completed included (1) developing Fund draft policy guidance on headquarters cost, military personnel cost, economic analysis for capital projects, and adjustments to financial reports and (2) improving the monthly financial report, which provides information on revenue, costs, and profit/loss. It is critical that all tasks be completed within established time frames because undertaking many scheduled future tasks is contingent upon earlier tasks being completed promptly.

In our October 1993 letter to the Deputy Secretary of Defense, we expressed concern that DOD may not be able to meet the plan's

milestones. DOD has not successfully completed past actions to correct the Fund's problems on schedule. For example, in May 1992, DOD issued the Defense Business Operations Fund Implementation Plan. This document indicated that all but one of the Fund's policies would be completed by September 1992. However, as discussed earlier, key policies have yet to be finalized. In another case, the National Defense Authorization Act for Fiscal Year 1993 required DOD to develop performance measures and corresponding goals for each of the Fund's business areas by March 1, 1993. DOD has developed performance measures for the Fund but has just begun developing the required corresponding goals for some business areas, such as the Defense Logistics Agency's supply management and distribution depots.

As we pointed out in our March 9, 1994, report, completing the following critical actions within the milestones prescribed by the plan will provide check points on the progress DOD is making in completing the plan and improving the operations of the Fund.

- Complete all Fund policies by December 31, 1994. Subsequently, these policies need to be implemented in a uniform manner to help ensure that the Fund's business areas operate with standard policies and procedures. Given the immense size, complexity, and scope of the Fund's \$77 billion operations, the need for standard policies is particularly acute. Fund managers have lacked the necessary guidance to execute the day-to-day operations of the Fund's various business areas.
- Select the systems to account for Fund resources by September 30, 1994, and begin implementing these systems by December 31, 1994. Implementing these systems, which is a long-term effort, will reduce the number of Fund systems and serve as the foundation for implementing a fully integrated system that is necessary to achieve the Fund's full potential. Since DOD will have to continue to rely on existing systems and reports in the near term, it is imperative that DOD pursue short-term efforts to improve the accuracy and reliability of existing data.
- Improve the accuracy of the monthly financial reports that provide information on the financial results of each business area by December 31, 1994. The Fund's current reports do not accurately reflect its financial condition or provide reliable information to management. Meaningful and reliable financial information is also essential for the Congress and the Office of Management and Budget to exercise their oversight responsibility.

Until the actions and tasks related to policies, procedures, and systems are completed and fully implemented, DOD will not be in a

position to identify the total cost of operations, and managers will continue to lack the data needed to reduce these costs.

DOD INCREASED FUND CUSTOMERS' BUDGET
REQUESTS BY BILLIONS OF DOLLARS

Full cost recovery, a principle of the Fund, requires the Fund to recover both the value of the materials and the cost of operations, including overhead, through the sale of goods and services to customers. Our preliminary analysis shows that the Office of the Secretary of Defense-Comptroller increased the prices the Fund will charge customers in fiscal year 1995 by \$2.2 billion to recover the full cost of operations, including civilian pay increases, inflation, and costs incurred for voluntary early retirement separations for Fund employees.

To ensure that the Fund customers would have sufficient funds to cover these increased prices, DOD also increased the customers' fiscal year 1995 budget requests by a corresponding amount. Further, the Navy plans to transfer approximately \$535 million from its appropriations to the Fund rather than increasing prices by this amount in fiscal year 1995. We have discussed our analysis of the budget and rates for fiscal year 1995 with Office of the Secretary of Defense-Comptroller officials and they agreed with our assessment.

In the past, Fund business areas, especially supply management, have not recovered the full cost of operations. For example, in fiscal years 1993 and 1994, the Navy supply management business area provided rebates to its customers of approximately \$581 million and \$534 million, respectively. As a result, the Navy did not recover the total supply management cost. To recover the full cost of the Fund's supply management operations, DOD proposes to increase prices of supply items and the customers' budget requests by about \$762 million in fiscal year 1995.

One should not lose sight of the inherent value of the Fund which is to enhance cost control. Establishing prices based on total operating costs is essential to meet the Fund's objectives. As DOD identifies the Fund's total costs, DOD managers will have the information they need to begin to reduce these costs. Reducing costs will not be an easy task and DOD managers will have to make difficult decisions. However, in doing so, DOD should not transfer the Fund's day-to-day business costs out of the Fund.

For example, DOD is considering removing DFAS and the Joint Logistics Systems Center (JLSC) from the Fund in fiscal year 1996. In our October 1993 letter to the Deputy Secretary of Defense, we pointed out that not including DFAS and JLSC costs eliminates certain basic business costs from the Fund's operations, including developing systems and performing

accounting services that directly support the Fund and other activities. Excluding DFAS and JLSC costs from the prices charged will not eliminate or lower them, but merely shift these costs from the Fund to other appropriation account(s). This, in turn, will diminish the customer pressure on DFAS and JLSC to reduce the costs of their services. Subsequently, the National Defense Authorization Act for Fiscal Year 1994 directed DOD to include the operating costs of these two entities as part of the Fund. DOD should be required to continue including these costs in the prices charged customers for the goods and services provided by the Fund.

FISCAL YEAR 1995 PRICES INCLUDE
RECOVERY OF PRIOR YEAR LOSSES

DOD currently estimates that at the end of fiscal year 1994 the Fund will have approximately \$1.7 billion in accumulated operating losses. According to DOD's pricing policy, prices are to be adjusted to recover prior year losses.

However, setting prices to recover prior losses is inconsistent with a basic tenet of the Fund--that prices should reflect the actual cost incurred in providing goods and services. Recovering past losses in this manner distorts the Fund's actual results of operations in a given year, diminishes the incentive for the Fund to operate efficiently, and makes it difficult to evaluate and monitor the Fund's status. In contrast, charging prices that reflect only the cost expected to be incurred for each year will enable DOD and the Congress to determine the cost of that year's operations and measure the performance of the Fund's activities for that period.

In our June 1993 testimony before this Subcommittee, we recommended that DOD be required to justify recovering prior year losses as part of the appropriation process. Losses could occur because anticipated savings from (1) the Defense Management Review initiatives did not materialize or (2) anticipated productivity increases were not achieved. The justification should identify the specific reasons why a business area incurred a loss.

CAPITAL ASSET PROGRAM LACKS ACCURATE INFORMATION
AND IS NOT BEING EXECUTED AS PLANNED

DOD managers are not receiving accurate financial data on the Fund's annual \$1 billion to \$2 billion capital asset program. Consequently, it is extremely difficult, if not impossible, for DOD management and the Congress to monitor the execution of this program. In addition, the military services and DOD components do not appear to be executing the capital asset program in accordance with the budget presented to the Congress.

The monthly financial report, called the 1307 report, does not provide accurate information on the amount of (1) revenue earmarked for purchases of capital assets, (2) capital asset obligations, and (3) capital asset outlays. DOD acknowledges that the capital asset information on the monthly 1307 report is not accurate and has hindered its oversight of the program.

Based on our work to date, the nine activities we visited canceled or postponed 168 of the 273 capital projects (61.5 percent) included in the fiscal year 1994 capital budget. Fiscal year 1993 cancellations and postponements were even higher, 77.2 percent. According to military service and DOD component officials, some cancellations and postponements are unavoidable because priorities change between the time the budget is developed and finally submitted to the Congress. These officials also stated that the downsizing of the military and base closures have further exacerbated the problems. Although changes in priorities and base closures resulted in some projects being postponed and canceled, other projects were not adequately justified and supported by economic analysis, as required by the Fund Responsibilities and Policy statement. In addition, several other projects were not included in the activities' long-range modernization plans.

Many of the problems with DOD's management of the capital asset program are comparable to those identified during our reviews of the Asset Capitalization Program (ACP), a similar program that financed capital equipment in the industrial funds. In 1989, we reported² that ACP did not have all the essential elements of a sound capital investment management program. Activities lacked (1) systematic long-range plans that are needed to identify capital asset needs and (2) adequate accounting and internal control procedures. Further, activities did not always follow policies and procedures to justify, review, and approve capital projects. In 1991, we reported³ that DOD had not taken corrective actions to address the problems with ACP and that DOD's proposal to include capital investments in the Fund could result in many of the same problems being repeated.

DOD officials acknowledged that Fund activities have not always executed the capital asset program. To resolve this problem, DOD specifically listed the capital asset projects authorized for execution in the fiscal year 1994 annual operating budgets issued

²Plant Modernization: DOD's Management of the Asset Capitalization Program Needs Improvement (GAO/NSIAD-89-147, August 4, 1989).

³Industrial Funds: Weaknesses Remain in the Department of Defense's Capital Equipment Program (GAO/NSIAD 91-175, April 17, 1991).

to the Fund activities. The services and DOD components must report any deviation from the approved capital asset program to the DOD Comptroller's Office. Emphasizing the capital asset program in the annual operating budgets could help improve program execution.

BUSINESS-TYPE REPORTS COULD ENHANCE
REPORTING ON FUND OPERATIONS

DOD has acknowledged that Fund financial reports are inaccurate. Good financial reporting, which gives management reliable information on the operating results, is imperative for successful Fund operation. Financial reports used effectively are an important tool to determine, understand, explain, and justify operating costs. Accurate reports on the Fund's operation would allow the analysis of trends, the comparisons among similar business areas (such as depot maintenance for the military services), the measurement of budget execution, the formulation of budget requests, and the setting of realistic prices to charge customers. Meaningful and reliable financial reports are also essential for the Congress and the Office of Management and Budget in exercising their oversight responsibilities.

Our brief analysis of the fiscal year 1993 monthly financial reports disclosed that DOD is still experiencing difficulty in preparing accurate reports on the results of operations. For example, the Fund's fiscal year 1993 financial and budget reports show amounts that differ by \$6.1 billion for net operating results. If the gains and losses in individual business areas are not netted, the gross difference is \$7.5 billion. Since the fiscal year 1993 net operating results are a key factor in setting the fiscal year 1995 prices the Fund will charge its customers, this lack of accurate financial reports not only distorts the result of operations but also impairs budget preparation.

A \$77 billion enterprise requires accurate business-type reports on operating results. Such reports should include a monthly income statement, balance sheet, and cash flow statement, similar to the annual financial reports required by the Chief Financial Officers (CFO) Act. In order to prepare accurate monthly reports, DOD will need to determine the specific information to be included in the reports and identify appropriate data sources to ensure consistent reporting of operating results for the Fund's various business areas. Preparing these reports on a monthly basis could help to improve the accuracy of the CFO reports and instill the discipline that is currently lacking. Because the fiscal year 1992 year-end financial statements were incomplete and audit trails were inadequate, the DOD Inspector General was unable to express an

opinion on the Fund's financial statements in performing the audit required by the CFO Act.

IMPROVED SYSTEMS ARE KEY TO DOD
IMPROVING ITS FINANCIAL OPERATIONS

The Defense Business Operations Fund Improvement Plan states, and we agree, that the full achievement of the Fund's objectives "hinges on standardized and modernized finance and accounting systems." We are particularly concerned that the supply management business area systems do not report accurate data on the cost of goods sold.

By September 30, 1994, DOD plans to select from the existing Fund systems those that will be used to account for the Fund's costs and resources. DOD plans to begin implementing these systems for the Fund's operations by December 31, 1994. Many of the systems selected will have to be upgraded to produce useful and accurate cost information. Completing this process will take time. Given DOD's past history of difficulties in implementing systems, its planned time frames, though achievable, will have to be closely monitored.

DOD has cited its Corporate Information Management (CIM) initiative as the long-term solution to its system problems. One of CIM's objectives is to reduce or eliminate systems in the military services and DOD components that perform the same function. While CIM initially appeared to be a promising undertaking, it too has had limited success to date in enhancing DOD's systems,⁴ and it will be several years, at best, before the Fund's systems are fully implemented. Given today's environment of budget reductions, DOD cannot afford to let this critical effort fail.

Because of the pressing need for reliable data and the fact that the planned system improvement efforts will be a long-term venture, it is important for DOD, in the interim, to pursue short-term efforts to improve the quality of the information used to manage and prepare financial reports. During our financial audits and in previous reports on the Fund, we have stressed the need for DOD to improve existing operations and data quality and not wait for the implementation of new systems, which will take several years.

For example, the financial reports prepared during fiscal years 1992 and 1993 could have been improved if DOD had (1) exercised more discipline in following and enforcing existing policies and procedures, (2) routinely reviewed and analyzed its monthly

⁴Financial Management: Defense Business Operations Fund
Implementation Status (GAO/T-AFMD-92-8, April 30, 1992).

reports to identify inaccuracies, and (3) taken the steps needed, such as providing additional guidance to field activities, to correct the identified problems.

The problems confronting the Fund are symptomatic of long-standing weaknesses in DOD's financial management operations. In a January 1994 annual report to the President and the Congress, DOD acknowledged that in the past its top management considered accounting, business-type efficiency, and indirect support functions to be of secondary importance. The report further noted that limited attention to improving financial management threatens our nation's combat forces because it creates problems that waste money needed now more than ever to sustain sufficient military readiness. The report's recognition of financial management problems is candid and forthright and represents a marked change in DOD's financial management philosophy. This changed attitude is a step in the right direction and should contribute to the ultimate success of DOD's reform initiatives, such as the Defense Business Operations Fund.

STRONG LEADERSHIP AND MANAGEMENT
NEEDED TO ADDRESS FUND PROBLEMS

Correcting the problems that I have discussed today will require strong leadership. Top management will have to be involved and be accountable for results. This has not always been the case.

The Fund has been under the direction of the Office of the Comptroller since its inception. However, the Comptroller has not always had the DOD-wide support needed to effectively deal with and resolve the long-standing problems that the Fund inherited from the old stock and industrial funds and that have continued to impair the Fund operations. Nor has the DOD Comptroller always had the support necessary to institute and implement the Fund concept. DOD now appears to be recognizing the challenges it faces and the need to place priority on financial management improvements.

Because of the problems with the Fund operations, we suggested in our October 1993 letter to the Deputy Secretary of Defense that DOD appoint a Fund director. In response to that letter, DOD stated that it had an alternative management approach in place to resolve the Fund problems. Instead of a Fund manager, DOD has appointed the DOD Comptroller to oversee the implementation of the Fund's improvement plan. The Comptroller chairs the new Defense Business Operations Fund Corporate Board. The Corporate Board is comprised of functional and financial senior executives who represent the interest of the Fund and its customers-- primarily the military services. If DOD's managerial approach is to succeed, many components of DOD will have to work together without the leadership of a single manager with overall responsibility and authority.

This management approach is extremely difficult to manage, particularly in a highly structured entity like DOD, and it is similar to the structure used when the Fund first began operations--a structure that did not function well. Because of this, we believe that periodic assessments are critical for the Secretary of Defense to determine whether the current management approach is resolving the Fund's problems within the time frames set forth in the plan. If the anticipated results are not achieved, DOD should reconsider the option of using a high-level Fund director, as we suggested in October, to oversee the management of the Fund and the implementation of the Fund improvement plan.

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Mr. Chairman, this concludes my statement. I would be pleased to answer any questions you or other Members of the Subcommittee may have at this time.

ATTACHMENT

ATTACHMENT

GAO PRODUCTS RELATED TO THE DEFENSE BUSINESS OPERATIONS FUND

Defense Management Initiatives: Limited Progress in Implementing Management Improvement Initiatives (GAO/T-AIMD-94-105, April 14, 1995).

Financial Management: DOD's Efforts to Improve Operations of the Defense Business Operations Fund (GAO/T-AIMD/NSIAD-94-146, March 25, 1994).

Financial Management: Status of the Defense Business Operations Fund (GAO/AIMD-94-80, March 9, 1994).

Letter to the Deputy Secretary of Defense (GAO/AIMD-94-7R, October 12, 1993).

Financial Management: Opportunities to Strengthen Management of the Defense Business Operations Fund (GAO/T-AFMD-93-6, June 16, 1993).

Financial Management: Opportunities to Strengthen Management of the Defense Business Operations Fund (GAO/T-AFMD-93-4, May 13, 1993).

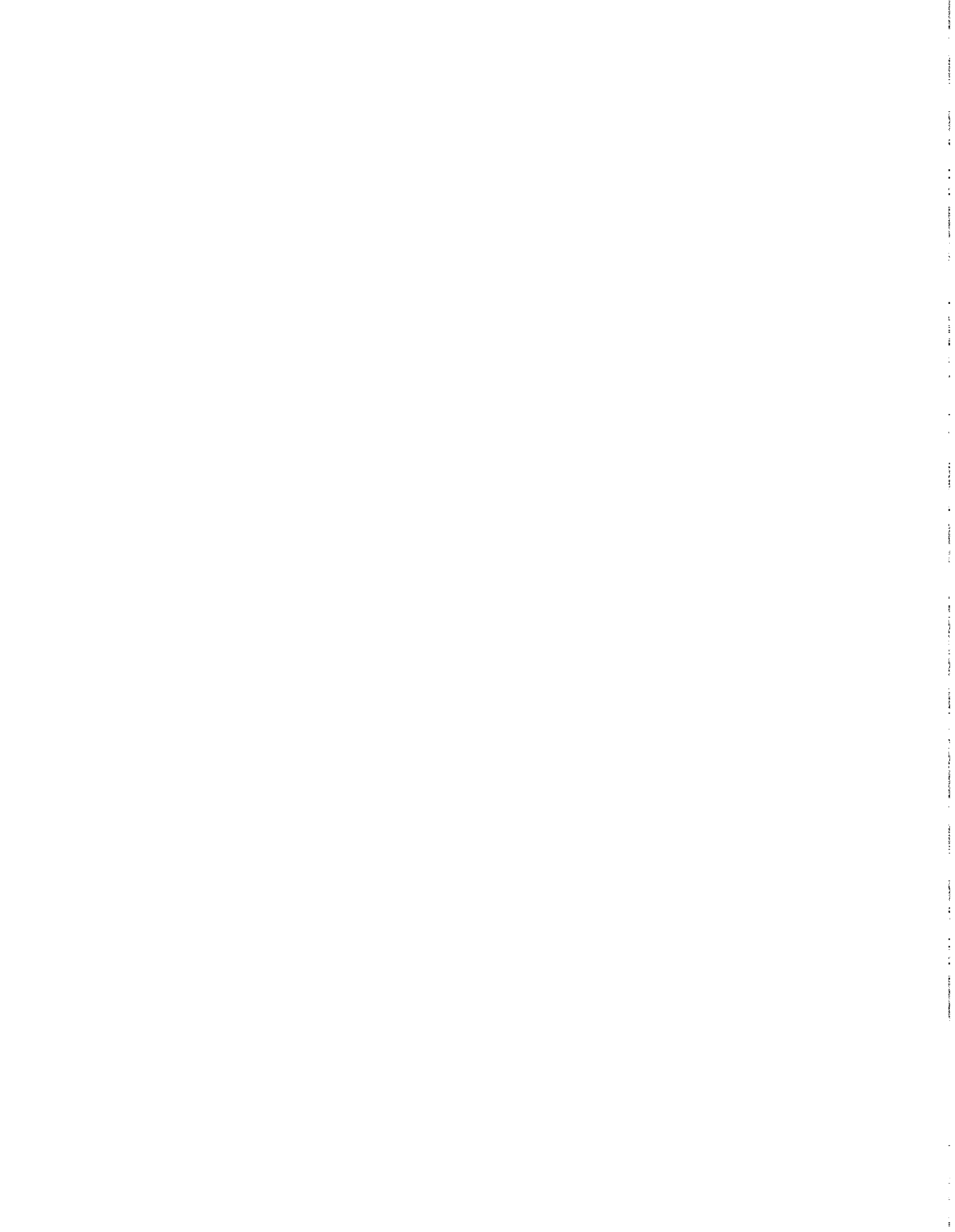
Letter to Congressional Committees (GAO/AFMD-93-52R, March 1, 1993).

Financial Management: Status of the Defense Business Operations Fund (GAO/AFMD-92-79, June 15, 1992).

Financial Management: Defense Business Operations Fund Implementation Status (GAO/T-AFMD-92-8, April 30, 1992).

Defense's Planned Implementation of the \$77 Billion Defense Business Operations Fund (GAO/T-AFMD-91-5, April 30, 1991).

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