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General Accounting Office
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Accounting and Information
Management Division

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May 3, 1994

Ms. Nancy L. Hendricks
Director, Financial Management Directorate
Office of Inspector General
Department of Defense

Dear Ms. Hendricks:

This letter responds to your request that the General Accounting Office provide you its views on whether real property used by the Defense Business Operations Fund (DBOF), but under the jurisdiction of the military department, should be reported on DBOF's financial statements. Pursuant to the Chief Financial Officers Act of 1990, Public Law 101-576, the Department of Defense's Inspector General (IG) is completing its audit of DBOF's fiscal year 1993 financial statements. The IG's audit report on DBOF's fiscal year 1992 financial statements took exception to the treatment of about \$2.3 billion of real property.

As your letter pointed out, the IG and the Defense Comptroller--the Comptroller's Office is responsible for DBOF's financial statements--have taken different positions on this matter. To supplement the descriptions of the accounting treatment in your letter, we met with your staff to obtain more information about the IG's report and contacted Defense Comptroller officials to obtain additional information about the reasons behind DBOF's accounting treatment.

The IG has taken the position that the real property used by DBOF should not be reported in its financial statements for two principal reasons. First, under 10 U.S.C. 2682, real property used by Department of Defense activities, such as the activities included in DBOF, is "under the jurisdiction of a military department designated by the Secretary of Defense." Also, the funds necessary to acquire or construct the property came from the military

departments' military construction appropriations, as do all betterments made to the property equaling or exceeding \$300,000. The IG thus took the position that the property involved is "owned" by the military departments, not DBOF.

Second, the IG believes that since DBOF does not own the real property, such property does not meet the accounting criteria for reporting it as a DBOF asset. The IG takes this position even though DBOF occupies and uses real property at many military bases under agreements that granted DBOF unrestricted use of the property. The IG's position is that DBOF does not have any control or authority over the property in the event that a service removes DBOF from a location or the Congress closes a base where DBOF operates. Thus, if DBOF must vacate a location, the IG asserts that DBOF does not have normal rights of an owner to retain the property or otherwise realize a benefit from it.

On the other hand, the Defense Comptroller's staff maintains that the property is reported on DBOF's financial statements to show the full costs of all resources and assets of DBOF activities. While in use, the real property is under DBOF's complete control, as if it were an owner. DBOF pays for all utilities, maintenance, and upkeep to the property, and for all improvements or modifications to the property if the amounts are below \$300,000 per project. For its accounting standards, DBOF has adopted Title 2, "Accounting," of GAO's Policy and Procedures Manual for Guidance of Federal Agencies.

Under Title 2, an item must normally meet three criteria to qualify as an asset and be reported in an entity's financial statements.¹ First, it must embody a probable future benefit that will contribute to the entity's operations. Second, the entity that reports the asset must be able to obtain the benefit and control access to the benefit inherent in the asset. Lastly, the transaction or event giving the entity a right to and control over the benefit must have already occurred.

¹The Financial Accounting Standards Board's, "Concept Statement 6," defines an asset as having the same three characteristics.

In applying the first criteria, the concept of benefit has traditionally been referred to as "service capacity," which is the ability of an item to directly assist an entity in achieving its mission. Service capacity has value because it is consumable or exchangeable for other benefits. The real property in question is the building space and grounds in which DBOF operates and, as such, it provides a current and will provide a future service capacity to DBOF. It houses DBOF's operations, allowing it to achieve its mission. Also, DBOF is responsible for assuring that the maximum benefit is always available since it pays for utilities, maintenance, and upkeep. The exchangeability part of the benefit criteria (the ability to sell, trade, or donate property) need not be present for an item to qualify as an asset in the federal sector if consumption of the item provides benefit to the entity. The inability of DBOF to exchange the benefit for other benefits does not preclude the property from meeting the first criteria of an asset.

The second criteria of an asset, control over the benefit, refers to an entity's ability to direct who derives the benefit, the timing of when the benefit is derived, and under what conditions it is derived. Directing the use of the benefit has traditionally been based on (1) possession or (2) the ability to exert significant influence over the benefits; either of which is obtained through legal ownership or an agreement with the owner. DBOF maintains possession of the real property in question through agreements which provide for DBOF's possession for as long as needed, without a termination date and without reimbursement.² Such arrangements are generally considered as providing sufficient influence over the use of the property in the federal government to satisfy the control

²Legal ownership is not the determinant factor in the federal sector to assess whether the control criteria of an asset is met. The IG's position is based in part on the fact that DBOF does not own the property in question and thus does not control the rights to receive benefits when the property is vacated, sold, or transferred. In the federal sector, however, ownership rights generally rest with the federal government as a whole, rather than any individual agency.

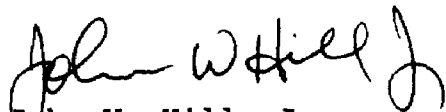
criteria. Once termination occurs, however, as in the case of a base closing where DBOF conducts operations, control no longer exists; hence, the property will no longer meet the control criteria of an asset. Therefore, until termination of the agreement occurs, the real property in question meets the control criteria.

The third criteria, a transaction or event giving DBOF control over the benefit derived from the real property, has already occurred. An agreement between the services and DBOF exists that allows DBOF to occupy the real property without reimbursement for as long as needed. DBOF and its predecessors have occupied the property for years.

Based on the foregoing analysis of the three criteria necessary for an item to qualify as an asset, we believe that the property in question represents an asset of DBOF. Accordingly, this property should be reported as such in DBOF's financial statements to show the full costs of all resources and assets used in DBOF's operations. Since the real property is under the jurisdiction of a military department, a note should be added to the statements explaining DBOF's reasons for reporting the property.

We have discussed our position regarding reporting the property on DBOF's financial statements with Mr. Seeba and others on your staff. We hope this response is helpful. Should you have any questions, please contact Bruce Michelson, Assistant Director, of my staff, at (202) 512-9366.

Sincerely yours,



John W. Hill, Jr.
Director, Audit Support and
Analysis Group

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