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DEFENSE BUSINESS OPERATIONS FUND

Improved Pricing Practices and Financial Reports Are Needed to Set Accurate Prices

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Congressional Requesters

The conference report accompanying the National Defense Authorization Act for Fiscal Year 1994 (House Report 103-357) requires that we report to the congressional Defense committees on the Department of Defense's (DOD) process for developing the prices that the Defense Business Operations Fund will charge its customers. This report (1) describes the process used to develop the Fund's fiscal year 1995 prices, (2) identifies major reasons Fund prices have increased, (3) identifies major reasons the Fund has continued to incur operating losses, and (4) provides information on the adequacy of the Fund's budget and financial reports. Our scope and methodology are discussed in appendix I. As discussed in this report and illustrated in appendixes II and III, the quantitative financial information used in this report on the Fund's operating results was produced from DOD's systems. DOD has acknowledged that this information is not totally reliable.

As agreed with the congressional Defense committees, we limited the scope of our review to depot maintenance and supply management operations, the Fund's largest business areas. DOD estimates that these two business areas will account for about $51 billion, or 66 percent, of the Fund's estimated revenue of $77 billion in fiscal year 1995.

Results in Brief

The primary goal of the Fund is to focus the attention of all levels of management on the total cost of carrying out certain critical DOD business operations and the management of those costs. A basic principle of the Fund is to establish prices that recover the total costs of providing goods and services to its customers.

The Fund's prices have increased, in part, because of DOD's efforts in recent years to charge customers the Fund's total operating costs—labor, material, and overhead. Before the Fund was established in October 1991, some costs (such as headquarters costs) were funded with direct appropriations and not included in revolving fund prices. The prices have also increased because DOD's policy requires the Fund to recover prior year losses by increasing subsequent year prices. For example, the Fund plans to recover approximately $1.7 billion in fiscal year 1995.

The Fund has not broken even since its inception in fiscal year 1992, and its estimated loss in fiscal year 1994 will mark the third consecutive year of operating losses. Various factors contributed to these losses: (1) planned productivity increases were not achieved, (2) changes in estimated workload resulted in less revenue than had been planned in the price calculation, (3) workload was carried over from one fiscal year to the next and billed at the generally lower prices in effect when the work was ordered, and (4) ongoing depot closures resulted in additional costs and lower productivity than planned. Some of these problems also caused the old industrial funds to incur significant losses.

Fund net operating results play a key role in developing prices. However, financial reports on Fund operations are not totally accurate and thus cannot be relied upon to provide DOD all the information needed in developing the Fund's prices. For example, the Fund's reported fiscal year 1993 net operating results in two reports differed by $5.9 billion.

Background

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 has a business relationship with its customers, primarily the military services. The Fund's estimated fiscal year 1995 revenue of about $77 billion would make it equivalent to one of the largest corporations in the world.

However, unlike a private sector enterprise which has a profit motive, the Fund's objective is to operate on a break-even basis by recovering the costs incurred in conducting its operations. The Fund provides essential goods and services including 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 readiness of weapon systems.

Since the concept of the Fund was first put forth in February 1991, we have monitored and evaluated its implementation and operation. We have previously reported[1] that DOD has not achieved the Fund's objectives because

[1]See Related GAO Products list at the end of this report.

- 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.

Fund Budget and Price Setting Process

Present DOD policy requires the Fund's business areas to establish prices that allow them to recover from their customers the expected costs, including any prior years' losses. Fund business areas are to establish prices prior to the start of each fiscal year and apply these predetermined (stabilized or standard) prices to most orders and requisitions received during the year. Because sales prices are based on expected costs and workload, (1) higher than expected costs or lower than expected customer demand for goods and services can cause the Fund to incur losses and (2) lower than expected costs or higher than expected customer demand for goods and services can result in profits.

Establishment of Predetermined Prices to Charge Industrial Fund Customers

Prior to fiscal year 1975, industrial funds were permitted to adjust the prices charged customers on a quarterly basis for cost increases. However, frequent changes in the industrial funds' prices made it difficult for customers to budget effectively because they were uncertain what the industrial fund would charge for the goods and services provided.

DOD established the price stabilization policy in 1975 to protect customers from unforeseen inflationary increases and other cost uncertainties. The intent of the policy is to ensure that customers will not have to reduce their programs because of higher than expected prices. Guaranteeing prices in this manner allows customers to provide more reliable workload estimates to industrial fund activities, which, in turn, should allow activities to better plan for the efficient use of their resources.

The process that the depot maintenance business area uses to develop its stabilized prices begins as long as 2 years before the prices go into effect, with each depot developing workload projections for the budget year. After the depot estimates its workload based on customer input, it (1) uses productivity projections to estimate how many people it will need to accomplish the work, (2) prepares a budget that identifies the labor, material, and other expected costs, and (3) develops prices that, when applied to the projected workload, should allow it to recover operating costs from its customers.

Major commands review and consolidate individual depot budget estimates. Headquarters and the Office of the Secretary of Defense review the consolidated estimates before they are submitted to the Congress as part of the Defense Business Operations Fund Budget Overview. Any changes made during the DOD budget review process are incorporated into the depot's prices before the start of the fiscal year.

Significant Change Made in Developing the Supply Management Business Area Prices

Since fiscal year 1991, DOD has made two significant changes to the supply management business area. First, beginning in fiscal year 1991, DOD included support costs, such as civilian personnel salaries, in the supply management business area.

Second, prior to fiscal year 1993, DOD policy required that the supply management business area maintain a certain level of cash with the Department of the Treasury. To develop prices, DOD managers needed data on the supply management business areas' estimated cash balance, estimated collections from inventory sales, and estimated cash disbursements. To accommodate fluctuations in cash received from customers and payments made to purchase or repair inventory items and to maintain a certain level of cash, DOD factored in a surcharge, positive or negative, to the acquisition cost of inventory items in setting prices.

In fiscal year 1993, DOD significantly changed the price setting policy for the supply management business area from the cash basis to a cost basis. Maintaining a specific balance with Treasury is no longer the primary criteria in the setting of prices. Prices are now developed—similar to the depot maintenance business area—to recover the full costs of its operations and operate on a break-even basis.

Several Factors Have Caused Prices to Increase

For the Fund's two largest business areas—depot maintenance and supply management—prices charged customers have generally increased since fiscal year 1991. Over the last several years, the largest increases were generally in the fiscal year 1995 prices that the Fund plans to charge its customers. Table 1 shows the annual percentage change in prices for the depot maintenance and supply management business areas from fiscal years 1991 through 1995.

Table 1: Percentage Changes in Customer Prices for Fiscal Years 1991 Through 1995

	Fiscal year				
Business area	**1991**	**1992**	**1993**	**1994**	**1995**
Depot maintenance					
Army ordnance	.4	7.0	17.6	–7.0	25.8
Army other[a]	9.5	23.1	10.9	2.3	15.6
Navy aviation	20.5	1.3	–1.7	4.6	27.6
Navy ordnance	5.2	9.9	10.0	–14.7	16.4
Navy shipyards	10.3	7.0	–2.9	9.1	18.7
Marine Corps	6.2	2.0	–9.7	27.2	34.3
Air Force	4.2	6.2	19.1	9.6	20.5
Supply management					
Army	7.6	–1.9	–1.6	.2	8.0
Navy	14.9	1.2	10.4	6.0	22.7
Air Force	7.8	–26.2	20.7	26.7	–9.9
Defense Logistics Agency	21.0	10.8	–3.8	1.8	3.2

[a]The percentages for fiscal years 1991, 1992, and 1993 apply only to depot maintenance. For fiscal years 1994 and 1995, the Army other business area included several types of Army activities, including depot maintenance.

Our analysis showed that prices are increasing primarily for the following reasons:

- Fund prices include costs, such as headquarters costs, that customers did not have to pay for previously.
- DOD policy requires the Fund's business areas to recoup prior year losses by increasing their prices. DOD estimates that the Fund will have cumulative losses of approximately $1.7 billion at the end of fiscal year 1994.
- Depot maintenance activities are allocating their fixed overhead costs over a steadily declining workload.

Fund Attempting to Identify and Charge Total Cost of Operations

Full cost recovery, a principle of the Fund, requires that the cost of both materials and operations, including overhead, be recovered through revenue from the sale of goods and services to customers. Our analysis showed 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. 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.

To a large extent, the price increases can be attributed to DOD's efforts to more accurately and completely charge Fund customers the total cost of providing goods and services. For example, Air Force Materiel Command budget officials estimated that the additional cost categories that have been incorporated into Air Force depot maintenance activities' sales prices since fiscal year 1991 account for $31.15, or 28 percent, of their fiscal year 1995 hourly composite sales price.[2] As shown in table 2, these "new" costs include (1) military personnel, (2) injury compensation, (3) hazardous waste disposal, (4) depreciation, (5) depot level repairables, (6) a share of higher headquarters costs, (7) system development efforts by the Joint Logistics Systems Center, and (8) implementation of a voluntary early retirement program.

Table 2: New Costs Included in Air Force Depot Maintenance Activities' Fiscal Year 1995 Composite Sales Prices

Costs	Fiscal year added	Total dollars (in millions)	Impact on composite sales price[a]
Military personnel	1991	$ 15.804	$ 0.53
Injury compensation	1991	26.783	0.90
Hazardous waste disposal	1991	17.329	0.58
Depreciation	1992	94.167	3.17
Depot level repairables	1993	690.424	23.22
Headquarters costs	1994	7.099	0.24
Joint Logistics Systems Center	1994	51.600	1.74
Retirement program	1995	22.900	0.77
Total		**$926.106**	**$31.15**

[a]Based on a projected workload of 29,730,000 direct labor hours.

Prior Year Losses Increase Fiscal Year 1995 Sales Prices

DOD has increased fiscal year 1995 prices by $1.7 billion[3] to recover prior year losses. Although the $1.7 billion total represents only 2.2 percent of the Fund's expected $77 billion of revenue for fiscal year 1995, our analysis showed that the impact on some prices was considerably greater.

[2]A composite sales price is the average cost per direct labor hour for all work that is accomplished. Each depot has its own composite sales price and, within a depot, there will be a different composite sales price for different categories of work.

[3]Although the Fund is projected to have total accumulated operating losses of $2.2 billion at the end of fiscal year 1994, the Navy plans to offset some of these losses with a $535 million transfer of funds from its appropriation accounts to the Fund during fiscal year 1994.

For example, the $253 million added to Naval aviation depots' fiscal year 1995 prices accounted for $16.35, or 12 percent, of the depots' composite sales price. In addition, the Army ordnance depots' fiscal year 1995 prices increased by $20.26, or 25.8 percent, over the fiscal year 1994 prices. Eighty-two percent, or $16.61 of this increase, was to recover prior year losses.

We have testified and reported that increasing 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. In our opinion, 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. 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 Fund activities for that period. We previously recommended[4] that industrial fund prices be set based on realistic estimates of the actual costs to be incurred in providing goods and services.

We also previously recommended[5] that DOD be required to justify recovering prior year losses as part of the appropriation process rather than by adding a surcharge to industrial fund prices for goods and services. In discussing DOD's policy on recovering prior year losses with DOD officials, they stated that their position of imposing surcharges was an acceptable practice for recovering prior year losses. They stated that including prior year losses in the prices charged customers was an incentive to reduce costs. These officials also noted that various congressional committees have not agreed on the method to be used to recover prior year losses.

The conference report accompanying the National Defense Authorization Act for Fiscal Year 1994 (Report 103-357) directs DOD to explain the variances between the budgeted and actual results of operation for each business area, starting with the fiscal year 1995 budget request. DOD was to include the cause of the gain or loss; remedies taken to address the gain or loss; and the actions taken to avoid similar losses in the future. As part of

[4]Air Force Depot Maintenance: Improved Pricing and Financial Management Practices Needed (GAO/AFMD-93-5, November 17, 1992) and Financial Management: Navy Industrial Fund Has Not Recovered Costs (GAO/AFMD-93-18, March 23, 1993).

[5]Air Force Depot Maintenance: Improved Pricing and Financial Management Practices Needed (GAO/AFMD-93-5, November 17, 1992) and Financial Management: Army Industrial Fund Did Not Recover Costs (GAO/AIMD-94-16, November 26, 1994).

the explanation, DOD was also to indicate the extent to which the gain or loss will be offset by the adjustment to the prices in the coming fiscal year.

In the fiscal year 1995 Fund Budget Overview, dated February 1994, DOD compared the budgeted and actual fiscal year 1993 operating results and explained the reasons for the variances in the business areas that incurred the most significant increases in losses. However, DOD explanations covered only 7 of the Fund's 29 business areas and did not include any explanations for business areas that made a profit, such as the Army, the Navy, and the Air Force supply management business areas. Combined, they had a reported gain of about $396.3 million during fiscal year 1993.

Declining Workload Creates Pressure to Increase Prices

Efforts to downsize the military forces are causing the Fund's business areas to allocate their overhead costs over a steadily declining workload base. The magnitude of these workload reductions is illustrated in table 3.

Table 3: Comparison of Planned Workload and Sales Prices for Fiscal Years 1994 and 1995

Depot maintenance business area	Workload[a] 1994	Workload[a] 1995	Workload[a] Percent change[b]	Composite sales price 1994	Composite sales price 1995	Composite sales price Percent change
Army other	19.3	18.4	-4.7	$ 94.73	$109.51	15.6
Army ordnance	6.9	6.6	-4.2	78.47	98.73	25.8
Navy aviation	18.7	15.5	-17.4	104.99	133.92	27.6
Navy ordnance	5.9	4.8	-17.7	80.52	93.76	16.4
Navy shipyards	53.9	43.5	-19.4	70.80	84.04	18.7
Marine Corps	2.8	2.5	-7.7	57.66	77.46	34.3
Air Force	34.7	29.7	-14.4	92.57	111.53	20.5

[a]Workload expressed in millions of direct labor hours.

[b]Workload percentages may not calculate precisely due to rounding.

The impact of this declining workload is further illustrated by comparing overhead costs and production levels over time. For example, Air Force depot maintenance activities' overhead costs increased from $986 million in fiscal year 1991 to a projected $1.11 billion in fiscal year 1994—an increase of 12.6 percent. However, because of the large reduction in workload, the amount of overhead costs allocated to each direct labor hour of work increased even more—from $27.23 to $39.10, or 44 percent.

One of the most critical challenges DOD currently faces is the need to reduce overhead and infrastructure costs in the face of shrinking budgets. In recent testimony before various congressional committees, the DOD Comptroller referred to the Fund's current operating environment as a "vicious circle" and said it was the single largest threat to the Fund. According to the DOD Comptroller, DOD's inability to eliminate infrastructure costs as fast as customer budgets are being reduced is at the center of this dilemma. Since Fund customers are paying higher prices for needed goods and services, they are reducing their overall demand. However, Fund business managers are constrained in reducing their costs to coincide with the reduced demand, resulting in the Fund incurring a loss. DOD's policy to recover these losses in future periods causes customer prices to increase in subsequent fiscal years.

DOD has initiated actions to reduce its overhead costs. First, the military services are currently closing some of their depot maintenance facilities, and additional depots are expected to be considered for closure during the 1995 round of base closures. Second, DOD established a special committee that has been directed to recommend policies and actions that will allow the Fund to reduce its costs. Until DOD is able to reduce its infrastructure costs, the "vicious circle" will continue and DOD's ability to better estimate the Fund's results of operations may not be much better in the future than it was in the past.

Multiple Causes for Recurring Fund Losses

DOD estimates that the Fund will lose about $1.7 billion[6] during its first 3 years of operations. Our analysis of the net operating results reported for depot maintenance and supply management for fiscal years 1992 and 1993 showed that (1) the depot maintenance business areas lost a total of $820.5 million during these fiscal years while the supply management business areas had a profit of $20.6 million and (2) losses incurred by the Army and Navy depot maintenance business areas were partially offset by a profit in the Air Force depot maintenance business area.

While many factors have contributed to the losses, DOD's February 1994 Fund Budget Overview cited the following as major causes of the Fund's fiscal year 1993 losses:

- estimated results of operations were overly optimistic because (1) planned productivity improvements did not occur and (2) changes in planned workload resulted in less revenue than anticipated;

[6]See footnote 3.

- workload carried over from one fiscal year to the next was billed at generally lower prices in effect when the work was ordered; and
- ongoing depot closures resulted in added costs.

Our prior reports on Air Force and Navy depot maintenance activities[7] cited the first two problems as the cause of significant losses in the old industrial funds. Specifically, we reported that these problems were the primary reason why Air Force in-house depot maintenance operations lost $459 million during fiscal years 1988 through 1991 and the Naval aviation depots and shipyards lost $885 million during fiscal years 1989 through 1991.

Fund's Anticipated Results of Operations Have Been Optimistic

According to depot maintenance budget analysts, the delay and cancellation of planned work is a continuing problem. This can adversely affect the financial results of operations. For example, when customer prices were established for the fiscal year 1994 budget request, about 2 million man-days of work were estimated for four Navy ships. However, the Navy currently estimates that only 1.2 million man-days will be needed to repair the four ships, a reduction of about 39 percent. A substantial reduction in workload may result in the approved prices being too low to cover the actual costs incurred. As discussed below, some business areas have a backlog of work, but because the work is different or specialized (such as the repair of a ship versus an aircraft), it cannot be shifted from one depot to another.

In addition, not achieving planned productivity improvements has affected the Fund's financial results of operations. The fiscal year 1995 Fund Budget Overview stated that not achieving planned productivity improvements contributed to the Navy depot maintenance business area losing over $300 million more than anticipated.

Also, analysis of DOD budget documents disclosed that DOD's estimates of the Fund's operating results have been consistently overly optimistic.

- In February 1992, DOD estimated that the Fund would lose $296.8 million during fiscal year 1992. However, the April 1993 Fund Budget Overview showed that the Fund lost $845.7 million during fiscal year 1992. In February 1994, DOD revised the Fund's fiscal year 1992 loss to $995.6 million. This is a difference of $698.8 million.

[7] See footnote 4.

- In April 1993, DOD estimated that the Fund would make $200.3 million during fiscal year 1993; however, the February 1994 Fund Budget Overview shows that the Fund lost a reported $662.4 million during fiscal year 1993—a difference of $862.7 million.
- In April 1993, DOD estimated that the Fund would make $645.4 million during fiscal year 1994; however, the February 1994 Fund Budget Overview and related budget documents show that DOD now estimates the Fund will lose $568.6 million[8] during fiscal year 1994—a difference of more than $1.2 billion.

Because prices are based on assumptions that are made as long as 2 years before the prices go into effect, some variance between expected and actual costs is inevitable. However, when revenues are consistently lower than actual costs, it indicates that there may be systemic problems with the operation of the Fund, the methodology and assumptions used to estimate future costs or revenue, or a combination of both. In our earlier Air Force industrial fund report,[9] we recommended that more realistic productivity assumptions be used in preparing budget estimates.

Impact of Growing Backlog of Funded Work

While not achieving productivity improvements and the delay and cancellation of planned work unquestionably pose continuing problems, large backlogs of funded work in some business areas have lessened their impact. For example, as shown in table 4, the reported backlog of funded work[10] in the Air Force and Naval aviation depot maintenance business areas more than doubled from the end of fiscal year 1989 to the end of fiscal year 1993—from about $1.1 billion to about $2.3 billion.

Table 4: In-house Aviation Depot Maintenance Activities' Backlog of Work at the End of Fiscal Years 1989 Through 1993

Dollars in millions

	Fiscal year-end				
Business area	**1989**	**1990**	**1991**	**1992**	**1993**
Air Force	489	552	772	1,090	1,029
Naval aviation	641	988	1,215	1,300	1,314
Total	**$1,130**	**$1,540**	**$1,987**	**$2,390**	**$2,343**

[8]Although the Fund is projected to lose $568.6 million during fiscal year 1994, the Navy plans to offset most of these losses with a $535 million transfer of funds from its appropriation accounts to the Fund during fiscal year 1994.

[9]Air Force Depot Maintenance: Improved Pricing and Financial Management Practices Needed (GAO/AFMD-93-5, November 17, 1993).

[10]Funded backlog equals the estimated cost to complete ongoing work plus the price of funded work that has not been started.

However, these large backlogs of funded work create additional problems. Specifically, the Fund frequently loses money on work carried over from one fiscal year to another because it is required to charge customers the prices in effect when the work is ordered and cannot pass on increases between then and when the work is performed. Further, financing work in one fiscal year that cannot realistically be accomplished until well into the next fiscal year is not an effective use of scarce customer resources. In our report[11] on the Air Force depot maintenance industrial fund, we recommended that the Secretary of Defense limit customer funding to work that (1) is likely to be accomplished during the budget year or (2) is needed in order to ensure a continuous flow of work through industrial fund activities from one fiscal year to the next.

Depot Closures Will Impact Fund Sales Prices

While most of the Fund's losses have been caused by long-standing and well-documented problems, depot realignment and closure is a relatively new problem that is likely to become more significant. DOD has closed 1 of its 35 major maintenance depots that it maintained during the cold war era. However, it is in the process of closing 10 additional depots and DOD officials have indicated that additional closures may occur as part of the fiscal year 1995 Base Realignment and Closure (BRAC) process.

In the long term, these efforts to downsize the Fund's depot maintenance infrastructure should reduce fixed overhead costs and customer prices should, in turn, decline. However, in the short term, as depots that are closing reduce their operations, they frequently incur losses that must be recouped by the depots that will remain open. For example, the Naval aviation depots and Army depots that will remain open had to increase their fiscal year 1995 prices by $296 million to recoup operating losses of depots that are closing.

Depot maintenance officials cited two reasons for the adverse short-term impact that depot closures are having on operating results and, in turn, sales prices. According to Army depot maintenance officials, BRAC funds do not cover all of a depot's closure-related costs, such as the cost associated with the reduced productivity that inevitably occurs during that time. According to a Naval aviation depot maintenance official, a shortage of fiscal year 1994 BRAC funds prevented Naval aviation depots from initiating timely action to realign the size of their workforces with their changing workloads.

[11]See footnote 9.

Fund's Financial and Budgetary Reports Have Different Results of Operations

Meaningful and reliable financial reports on the Fund's operating results are essential to allow DOD management to monitor the Fund's operations and set realistic prices to charge customers. Reliable financial reports also are necessary to enable the Congress to exercise its oversight responsibilities. However, DOD and the Congress have not always received accurate information on the Fund's net operating results (NOR). Because the Fund's 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 for fiscal year 1992 when performing the audit required by the Chief Financial Officers (CFO) Act. In addition, our comparison of the Fund's accounting and budgeting reports for fiscal years 1992 and 1993 identified billions of dollars of differences in the reported NORS. Given the results of the DOD Inspector General's work and the differences shown on the reports, DOD cannot be certain (1) of the actual operating results for the Fund or (2) if the prices the Fund will charge its customers are reasonable.

Results of Operations Vary Among Reports

Credible cost data on operating results are essential. These data are considered in setting the prices the Fund will charge its customers and, in turn, the basis for establishing the customer's budget request. Volume 1 of the Department of Defense Financial Management Regulation (DOD 7000.14-R) requires accounting results to be the basis for (1) preparing and supporting the agency budget and (2) providing financial information the President requires under the budget and appropriations authority. The Department of Defense Financial Management Regulation further states that a primary objective of DOD accounting systems is to provide needed actual accounting data for use in budget formulation. In addition, the financial management data are to be recorded and reported in the same manner throughout DOD components, and the accounting information is to be synchronized with budgeting information.

However, our comparison of the reported Fund NOR for fiscal years 1992 and 1993 disclosed significant differences among the Fund Budget Overview, the monthly Report of Operations (called the 1307 report), and the CFO report. Table 5 shows the differences for each fiscal year.

Table 5: Reported Net Operating Results for Fiscal Years 1992 and 1993

Dollars in millions

Fiscal year	Fund budget overview	Fund monthly report	CFO report
1992	$-845.7	$-3,506.0	$-465.5
1993	-662.4	5,233.0	2,009.6

Appendixes II and III provides additional detailed information on the NOR differences shown on the reports for Fund business areas for fiscal years 1992 and 1993, respectively.

Given the magnitude of the differences reported, it is difficult, at best, for DOD to know the Fund's actual NOR. According to DOD budgeting officials, they did not use the NOR in the accounting reports for budgeting purposes and for setting prices to charge customers. In discussing the difference between the accounting and budgeting reports, these officials pointed out that the three reports do not treat the following inventory practices consistently: (1) the revaluation of inventory from the standard price to the latest acquisition cost, (2) the value of inventory items sent to disposal, and (3) the value of inventory items returned to the supply management business area without the customer receiving monetary credit for the item. However, DOD budgeting officials could not reconcile the differences in the reports.

Without knowing the NOR, DOD is not in a position to know if the prices being charged the Fund's customers are reasonable, since the NOR is a key factor in setting the prices. Given the current environment, it is conceivable that some prices might be too high, while others might be too low to recover the costs of providing goods and services.

Supply Management Monthly Financial Reports Are Not Accurate and Not Used to Manage

Within the Fund, the supply management business area has had the most difficulty in trying to develop an accurate monthly 1307 report for reporting the NOR. In the Fund's September 1993 Improvement Plan and in footnotes to the Fund's 1307 report prepared for fiscal year 1993, DOD acknowledged that the 1307 report contained inaccuracies. Military service, Defense Logistics Agency (DLA), DFAS, and Office of the Secretary of Defense officials are concerned about the continued inaccuracies in the 1307 report for supply management. Some DOD components consider the 1307 report to be useless for management purposes and for setting customer prices.

The 1307 report is the official monthly report on Fund operations and should provide accurate information on the revenues, costs, and the NOR for the Fund's supply management business area. However, amounts reported on the 1307 reports for supply management are dubious, as illustrated by the following examples.

- Supply management 1307 reports for fiscal year 1993 contained multibillion dollar adjustments that had a significant impact on the NOR. Adjustments of $6 billion for inventory and miscellaneous gains were made to Army's report to change a $5.1 billion loss into a $920 million gain. Similarly, adjustments of $3.6 billion were made to Air Force's report for inventory gains, which turned a $2 billion loss into a $1.6 billion gain.
- DLA's official fiscal year 1993 report showed a gain of $1.2 billion, even though its accounting records showed a $1.2 billion loss. However, the DOD Comptroller's office directed DLA to have a fiscal year 1993 NOR loss of $10.9 million for price setting purposes and, accordingly, DLA made adjustments to arrive at this amount.

As previously discussed, DOD revised its supply management pricing guidance in fiscal year 1993 to recover the full costs of operations rather than developing prices to maintain a predetermined cash balance with the Treasury. While this change is in keeping with the Fund's full cost concept, supply management activities have continued to experience difficulty in making the transition from cash to full cost pricing because they cannot determine, with reasonable assurance, their full costs of operations, including the cost of inventory sold.

The cost of providing goods and services to Fund customers is a major factor affecting the NOR on the 1307 report. According to supply management officials in the military services and the Office of the Secretary of Defense, the cost of goods sold amount cannot be determined accurately because the services do not have an adequate cost accounting system in place to capture the necessary cost information.

Efforts to Improve Monthly Financial Reports

To improve the accuracy and usefulness of the monthly 1307 report, DOD is currently revising it to parallel the CFO Act annual report. The proposed report includes a monthly income statement, balance sheet, and cash flow statement similar to the financial reports required by the CFO Act. The proposed report gives managers additional information on the Fund's monthly operation, such as a monthly balance sheet, which is not currently required. This could serve as a building block towards the preparation of the year-end CFO reports.

We are encouraged that DOD is taking action to improve its monthly financial report on the Fund's $77 billion operations. However, this effort is approximately 6 months behind the estimated December 31, 1993, completion date. The existing accounting systems are key to improving the accuracy of these reports since these systems will be used as the source of data. DOD must identify the appropriate data sources in these systems to ensure consistent reporting of operating results for the Fund's various business areas. This will not be an easy task because (1) the Fund has 80 disparate, unlinked financial systems and approximately 200 ancillary systems that provide financial data and (2) the military services and DOD components accounting systems do not all operate on the same general ledger.

Because of the pressing need for reliable financial data, it is important for DOD to pursue short-term efforts to improve the quality of the information used to prepare the Fund's financial reports. In previous reports and testimonies 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 reports to identify inaccuracies, and (3) taken the steps needed, such as providing additional guidance to field activities, to correct the identified problems.

Conclusions

A basic premise underlying the establishment of the Defense Business Operations Fund was that the total costs of operations would be recovered through the prices charged the customers. We are fully supportive of the total cost concept, and it is one of the reasons the Fund's overall prices have generally increased. Price increases can also be attributed to DOD's difficulties in reducing its infrastructure costs while adapting to a new world environment of a smaller military fighting force. However, DOD's practice of increasing prices to cover prior year losses is inappropriate because it (1) distorts the NOR for a given year and (2) diminishes the incentive for the Fund to operate efficiently.

In addition, the Fund has not been able to meet its financial goal of operating on a break-even basis. The Fund has incurred losses in fiscal years 1992 and 1993, and DOD is estimating a third consecutive loss in fiscal year 1994. The losses have been incurred because the prices have not been commensurate with the cost incurred. While some variance between expected and actual revenue costs is inevitable, continued annual losses indicate that there may be a systematic problem.

Charging Fund customers the total cost of operations is predicated upon the assumption that the total costs are known. However, the Fund's financial reports cannot be relied upon to provide DOD management or the Congress totally accurate information on the Fund's results of operations. Reliable information on the Fund's results of operations is also critical because it is one element used to determine the prices the Fund will charge it customers. Although DOD has efforts underway to improve the accuracy of the reports, these efforts are experiencing slippage. The reported results of operations may not be any more reliable for fiscal years 1994 and 1995 than they have been in the past.

We are making no recommendations in this report. However, the Fund could improve its operations by implementing our previous recommendations regarding the Army, Navy, and Air Force industrial funds. Specifically, we recommended that

- prices be based on realistic estimates of the costs to be incurred in providing goods and services;
- more realistic productivity assumptions be used in preparing the budget estimate; and
- DOD seek a separate appropriation for the recovery of prior year losses.

We are sending copies of this report to the Secretary of Defense; the Director of the Office of Management and Budget; the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs and the House Committee on Government Operations; and other interested parties. We will make copies available to others upon request.

Please contact me at (202) 512-2666 if you or your staffs have any questions concerning this report. Major contributors to this report are listed in appendix IV.

David O. Nellemann
Director, Information Resources
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List of Requesters

The Honorable Sam Nunn
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The Honorable Strom Thurmond
Ranking Minority Member
Committee on Armed Services
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The Honorable Daniel K. Inouye
Chairman
The Honorable Ted Stevens
Ranking Minority Member
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The Honorable Ronald V. Dellums
Chairman
The Honorable Floyd D. Spence
Ranking Minority Member
Committee on Armed Services
House of Representatives

The Honorable John P. Murtha
Chairman
The Honorable Joseph M. McDade
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives

Contents

Abbreviations

BRAC	Base Realignment and Closure
CFO	Chief Financial Officer
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
DOD	Department of Defense
NOR	net operating results

Scope and Methodology

As agreed to with the congressional Defense committees, the scope of our review was limited to the depot maintenance and supply management business areas of the Fund. These two business areas make up approximately 66 percent, or $51 billion, of the Fund's estimated revenue of $77 billion in fiscal year 1995.

To evaluate how the customer prices for fiscal year 1995 were established for the depot maintenance and supply management business areas, we reviewed the policies and procedures DOD has developed for setting Fund prices. We also collected and analyzed workload, revenue, cost, and budget data from the Office of the Secretary of Defense; the Army, the Navy, the Air Force, and the Defense Logistics Agency headquarters; and major commands within the services and DOD agencies. We analyzed the data to determine changes or adjustments that had been made as the data moved from the originating business area through the various levels of review at the major command, the respective military service, and the Office of the Secretary of Defense (Comptroller).

To determine the relationship between changes in prices and workload, we compared the fiscal year 1995 workload estimates and prices to those of prior years. We also reviewed budget documents and obtained explanations from DOD officials to determine why Fund prices have generally increased since fiscal year 1991. In reviewing the Fund's fiscal year 1995 prices, we determined if the prices were adjusted for gains and losses and obtained DOD officials' explanations on why the Fund has incurred losses since fiscal year 1992.

To determine if the reports are providing consistent financial information on the Fund's operations, we analyzed the Fund's monthly reports of operations, budgetary reports, and CFO reports. In those instances where we identified differences in the reports, we met with DOD officials to obtain an explanation of the differences.

We performed our work at the Headquarters, Office of the Secretary of Defense (Comptroller); Departments of the Army, Navy, and Air Force; Defense Logistics Agency; Defense Finance and Accounting Service; and selected major commands. Our review was performed from February 1994 through May 1994 in accordance with generally accepted government auditing standards. We discussed the facts and conclusions in our report with cognizant DOD officials. Their views have been incorporated where appropriate.

Budget and Accounting Reports Differ for Fiscal Year 1992 Net Operating Results

Dollars in millions

Business area	Fund budget overview	Monthly financial report	CFO report[a]
Army			
Depot maintenance	$45.8	$233.0	$165.4
Supply management	–122.0	1,204.0	99.6
Other business areas	–35.0	–218.0	–216.4
Total	**–111.2**	**1,219.0**	**48.6**
Navy			
Depot maintenance	–559.2	–620.0	–696.2
Supply management	157.0	0.0	–1,439.8
Other business areas	–139.5	–29.0	–528.6
Total	**–541.7**	**–649.0**	**–2,664.6**
Air Force			
Depot maintenance	198.5	141.0	198.7
Supply management	–278.0	–8,608.0	3,384.6
Other business areas	–54.6	–156.0	–181.2
Total	**–134.1**	**–8,623.0**	**3,402.1**
DOD-wide			
Supply management	–121.8	4,711.0	–877.8
Other business areas	63.1	–164.0	–373.8
Total	**–58.7**	**4,547.0**	**–1,251.6**
Grand Total	**$-845.7**	**$-3,506.0**	**$-465.5**

[a]In comparing the NOR in the three reports, we adjusted the amounts, when necessary, for such items as prior year adjustments to make the amounts comparable.

Budget and Accounting Reports Differ for Fiscal Year 1993 Net Operating Results

Dollars in millions

Business area	Fund budget overview	Monthly financial report	CFO report[a]
Army			
Depot maintenance	$-218.2	$-216.0	$-214.7
Supply management	131.1	920.0	920.1
Other business areas	0.0	0.0	–11.2
Total	**–87.1**	**704.0**	**694.2**
Navy			
Depot maintenance	–302.6	1,212.0	–309.2
Supply management	114.7	1,509.0	3,175.9
Other business areas	121.8	–393.0	–412.1
Total	**–66.1**	**2,328.0**	**2,454.6**
Air Force			
Depot maintenance	15.2	85.0	14.6
Supply management	150.5	1,571.0	421.8
Other business areas	–147.1	–148.0	–148.7
Total	**18.6**	**1,508.0**	**287.7**
DOD-wide			
Supply management	–10.9	1,226.0	–653.1
Other business areas	–516.9	–533.0	–773.8
Total	**–527.8**	**693.0**	**–1,426.9**
Grand Total	**$-662.4**	**$5,233.0**	**$2,009.6**

[a]In comparing the NOR in the three reports, we adjusted the amounts, when necessary, for such items as prior year adjustments to make the amounts comparable.

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Related GAO Products

Financial Management: DOD's Efforts to Improve Operations of the Defense Business Operations Fund (GAO/T-AIMD/NSIAD-94-170, April 28, 1994).

Defense Management Initiatives: Limited Progress in Implementing Management Improvement Initiatives (GAO/T-AIMD-94-105, April 14, 1994).

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