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Report to Congressional Committees

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# DEFENSE BUSINESS OPERATIONS FUND

## Management Issues Challenge Fund Implementation

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Congressional Committees

The National Defense Authorization Act for Fiscal Year 1995[1] directed the Secretary of Defense to submit to the congressional defense committees a report on the progress made in implementing the September 1993 Defense Business Operations Fund Improvement Plan by February 1, 1995. The act further requires that we evaluate and report on the Department of Defense's (DOD) progress and make whatever recommendations for legislative or administrative action we consider appropriate. This report provides our (1) assessment of DOD's progress in correcting the ongoing problems that have hindered the Fund's operations and (2) recommendations to the Congress and DOD to address our concerns.

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[2] that DOD has not achieved the Fund's objectives because

- 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.

The Fund's problems are symptomatic of the weaknesses in DOD's overall financial management environment. GAO, congressional committees, and the DOD Inspector General have continually highlighted pervasive problems in DOD's financial operations, which we have designated as a high risk area.[3] To its credit, DOD's fiscal years 1993 and 1994 Federal Managers' Financial Integrity Act reports have presented a forthright assessment of its shortcomings in financial management.

To specifically address the serious problems affecting the operation of the Fund, on September 24, 1993, the Deputy Secretary of Defense and the Secretaries of the Army, Navy, and Air Force approved the Defense

[1]Public Law 103-337, October 5, 1994.

[2]See Related GAO Products list in the back of this report.

[3]High Risk Series: An Overview (GAO/HR-95-1, February 1995).

Business Operations Fund Improvement Plan, which consists of 56 actions aimed at improving the Fund's operations and addressing known deficiencies. On March 9, 1994, we reported that DOD had made some progress in completing the actions called for in the plan. However, we pointed out that much work remained to be completed since most of the actions that dealt with the Fund's policies, procedures, systems, and reports were scheduled to be completed by the end of fiscal year 1994 or in fiscal year 1995.

## Results in Brief

If properly implemented, the Fund can contribute to improvements in DOD's operations. However, DOD continues to face serious problems that have hindered its past management of the Fund. While DOD has made some progress over the past 16 months,[4] we disagree with DOD's assessment in its February 1, 1995, progress report to the congressional defense committees that it has made "tremendous progress in rectifying or reducing many of the problems in the Plan." After more than 3 years of operations, very little has changed in the day-to-day operations of the Fund's business areas. Specifically, we found the following:

- DOD does not have a systematic process in place to ensure that the Fund's policies are implemented consistently. Consequently, Fund managers lack the necessary guidance to execute day-to-day operations of the Fund.
- DOD has selected most of the Fund's interim migratory systems without first determining the total estimated cost to enhance and implement these systems across the Fund's business areas.
- DOD is still having difficulty preparing accurate financial reports on the Fund's operations. For example, the monthly reports show negative balances of hundreds of millions of dollars for certain accounts such as inventory, accounts receivables, and revenue.
- DOD has reversed its cash management policy by returning cash control to the DOD components. This is a major departure from the benefit of a single cash balance that DOD cited when it established the Fund.

In addition, we have concerns with several of the Fund's policies. For instance, DOD's policy calls for the recovery of prior year losses through an increase in subsequent years prices that the Fund will charge its customers. We have previously stated that DOD should seek additional funds through the appropriation process, thereby providing the Congress

[4] The period of time from the issuance of the Defense Business Operations Fund Improvement Plan in September 1993 to DOD's February 1995 Fund report to the congressional defense committees.

with critical information needed for effective oversight of the management and operations of the Fund.

## 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 Service, 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 DOD management on the total costs of carrying out certain critical DOD business operations and to manage those costs effectively. This goal is in accordance with the objectives of the National Performance Review (NPR), which is aimed at achieving cost efficiencies in the federal government.

The Fund is modeled after businesslike operations in that it maintains a contractual (buyer-seller) type of relationship with its customers, primarily the military services. In fiscal year 1995, the Fund will have estimated revenue of $77 billion, which would make it equivalent to one of the largest corporations in the world. The Fund provides such essential 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 services are essential to maintaining the military readiness of our country's weapon systems. Unlike a private sector enterprise which has a profit motive, the Fund is to operate on a break-even basis by recovering the current costs incurred in conducting its operations.

## Scope and Methodology

To accomplish our objectives, we reviewed DOD's quarterly progress reports on the implementation of the plan and DOD's February 1, 1995, progress report to the congressional defense committees on the Fund. We also met with DOD officials to determine if DOD had completed the following three actions within the milestones established in the plan: (1) complete all Fund policies by December 31, 1994, (2) select the systems to account for Fund resources by September 30, 1994, and begin implementing those systems by December 31, 1994, and (3) improve the accuracy of the financial data in the Fund's monthly financial reports by December 31, 1994.

To evaluate DOD's efforts to select the Fund's financial systems, we reviewed the system evaluation reports prepared for the 28 systems reviewed by DOD. We also met with representatives from DFAS, as well as representatives from other DOD components involved in the system selection process, to determine the system selection criteria and their appropriateness. We also determined what plans DOD has in place to (1) implement/enhance the selected systems, (2) estimate the costs to improve the selected systems, and (3) eliminate the systems not selected.

To determine whether DOD has improved the data accuracy in the Fund's monthly financial reports, we met with officials in DFAS to ascertain and evaluate actions taken (or planned) to improve data accuracy, including actions to enable reconciliation between the Fund's cash balance and the corresponding balance maintained by Treasury. We also analyzed the Fund's monthly financial reports to determine whether the systems are producing accurate and complete financial data. Further, we obtained the reports of the DOD Inspector General's audit of the Fund's fiscal years 1992 and 1993 financial statements required by the Chief Financial Officers (CFO) Act of 1990.

We performed our work at the Office of the Secretary of Defense (Comptroller); the Departments of the Army, Navy, and Air Force; the Defense Logistics Agency (DLA); DFAS headquarters; and the Cleveland, Columbus, Denver, and Indianapolis DFAS Centers. Our review was performed from July 1994 through February 1995, in accordance with generally accepted government auditing standards.

We discussed the facts, conclusions, and recommendations in our report with cognizant DOD officials and have incorporated their comments where appropriate.

## Little Improvement Made in the Day-to-Day Operations of the Fund

DOD has made some progress in addressing the problems that have plagued the Fund's operations. During the past 16 months, DOD has made decisions such as developing and approving Fund policies, revising the format of the Fund's financial reports, and selecting 12 interim migratory financial systems to account for the Fund's resources. However, we disagree with DOD's assessment in its February 1, 1995, progress report on the Fund that it had made "tremendous progress in rectifying or reducing the problems in the Plan."

Little improvement has yet been made in the actual day-to-day operations of the Fund. Since the Fund began operations in October 1991, it has not been able to meet its financial goal of operating on a break-even basis. The reported loss for fiscal year 1994 will mark the third consecutive year of operating losses. A key element in reducing the cost of operations is the ability to accurately identify total costs. However, DOD lacks the management tools to accomplish this task. Specifically, DOD has not (1) developed a process to ensure the Fund's policies are consistently implemented, (2) improved the accuracy and reliability of the Fund's systems, (3) improved the Fund's monthly financial reports, (4) adequately managed the Fund's cash, and (5) developed performance measures and goals. These problems are discussed below.

## Process to Ensure Policy Implementation Not in Place

DOD has acknowledged that its failure to develop policies and procedures has been one of the most significant weaknesses of the Fund's implementation. In its September 1993 plan, DOD identified several actions to address this problem. In December 1994, DOD completed and issued the Financial Management Regulation (FMR) on the Fund, which contains the Fund's financial policies.[5] This regulation is a major step toward standardizing the Fund's operations. It consolidates all policies of the old industrial and stock funds, changes that have been made to those policies, and new policies that have been issued since the Fund was established.

However, confusion exists within DOD regarding the need for implementing procedures to accompany the various policies that have been issued. As a result, the five policies[6] that the Deputy Comptroller for Financial Systems stated were to be effective October 1, 1994, had not been implemented throughout DOD as of January 1995. According to DFAS officials, they are responsible for developing implementing procedures for each Fund policy approved by the DOD Comptroller. DFAS' position is supported by a memorandum from the Deputy Comptroller for Financial Systems that states that DFAS is developing accounting procedures as necessary to ensure the policies can be implemented.

DOD Comptroller officials informed us that it was not necessary for DFAS headquarters to develop implementing procedures because the FMR

[5]As of January 1995, DOD was still developing or reviewing the following policies: (1) capital assets, (2) accounting for miscellaneous items, (3) intrafund transactions, (4) cost comparison for competed workloads, (5) full funding, and (6) dual funded organizations.

[6]These policies pertain to (1) cash management, (2) major real property maintenance and repair, (3) military personnel pricing, (4) customer mandated schedule changes, and (5) management headquarters costs.

already contains them. The officials further stated that DOD is trying to avoid the proliferation of procedures by DFAS and its field activities so that the Fund's policies will not be implemented inconsistently as a result of different interpretations, as has happened in the past. In fact, the improvement plan notes that the Fund's financial reports reflect the results of applying policies inconsistently across business areas. Given the October 1994 memorandum, other DOD documents on Fund policy implementation, and the opinion of DOD Comptroller officials, it is evident that DOD has not resolved this issue. Until it does so, the FMR may not be implemented in a timely manner.

Given the immense size, complexity, and scope of the Fund's $77 billion operation, the need to complete the development of the policies and consistently implement them is particularly acute. Until consistent implementation is achieved, the benefits of the new policies will not be realized. Without standard policies and procedures, Fund managers are forced to make their own interpretation regarding how to report on the respective operations of their business areas. Therefore, it is imperative that DOD put in place a process which will provide a mechanism for ensuring that Fund policies are implemented in a timely, consistent manner.

In addition to implementation issues discussed above, we have concerns about the provisions in several Fund policies that DOD has developed and approved thus far. These concerns are highlighted below and discussed in detail in appendix I.

- DOD's policy requires that prior year losses be recovered by increasing the prices charged customers. DOD increased fiscal year 1995 Fund prices by $1.7 billion to recover prior year losses. We have previously stated that the Fund, not the customers, should be required to request additional funds through the congressional appropriation process to recover losses. As part of the justification, DOD should explain differences such as the variances between the budgeted and actual results of operations for each business area. The explanation should also include the causes for the reported gain or loss and the actions being taken to avoid similar gains or losses in the future. Our approach would give the Congress an opportunity to review the Fund's operations, determine if additional funds are actually needed, and evaluate the effectiveness of DOD's management of the Fund. It would also provide a strong incentive to properly set prices and would help focus attention on the current costs of operations.

- DOD's policy allows for two methods of recognizing revenue for the depot maintenance area: the completed contract method and the percentage of completion method. We disagree with the use of the completed contract method when work done on an order crosses fiscal years. Using the completed contract method for such orders defers the recognition of revenue and related expenses to the period in which they were completed. Therefore, the financial reports distort the financial results of operations for each fiscal year.
- The military personnel policy provides that the cost of military personnel will be at the civilian equivalent rate, not the actual cost of military personnel. This practice will understate the total military personnel costs since the civilian equivalency rate is 23 percent less than the military personnel cost. This practice also will not further the objectives of the NPR, which stipulates that the full costs be included in the prices that providers, such as the Fund, charge customers so that the total cost of what the government produces can be determined. However, the National Defense Authorization Act for Fiscal Year 1994 directs DOD to base its recovery of military personnel costs on something other than actual costs.[7] We believe the act should be amended to provide for recovering the full cost of military personnel.
- The policy on management headquarters costs does not specify which costs should be allocated in the prices the Fund charges customers. Because DOD has a complex organization structure—including activities such as headquarters, major commands, and depots—the military services and DOD components could interpret the guidance differently.

## Accuracy and Reliability of Financial Systems Not Improved

One of the primary challenges still confronting DOD is the improvement and standardization of the Fund's financial systems. Currently, about 80 disparate and unlinked systems are producing accounting data. DOD has stated that it needs to apply adequate funds, personnel, and time to solve existing problems with its financial systems, which continue to produce inaccurate, inconsistent, and untimely reports on the Fund's operations. Systems that produce credible cost data are essential for the successful operations of the Fund. The ability to charge the Fund customers the total cost of operations is predicated upon the assumption that the total costs are known. Accurate cost data are also critical in order to develop systematic means to reduce the cost of operations.

[7]Specifically, the act directs that Fund prices will recover military personnel costs "as computed by calculating, to the maximum extent practicable, such costs if employees of the Department of Defense were used in the provision of goods and services."

Over the past 16 months, DOD has made some progress towards accomplishing the actions outlined in the plan. Specifically, DFAS developed functional[8] and technical requirements for the Fund's financial systems, completed the evaluation of 28 systems nominated by the military services and DOD components, and recommended interim migratory systems. However, DOD has neither developed conversion plans and procedures nor begun implementing the interim migratory systems for the Fund's operations by December 31, 1994, as called for in its plan.

Based on DFAS' analyses, 17 systems were recommended by DFAS as the Fund's interim migratory systems. The highest score a system could receive was 100 and a score of 75 was needed by the system to meet minimum Fund functional and technical requirements. None of the 17 systems received the minimum functional score of 75 with the scores ranging from 22 to 60. Only 3 systems received the minimum technical score of 75.

According to DOD's preliminary estimate, it will cost $94.5 million to enhance the 17 systems to meet the minimum Fund functional requirements. However, this estimate does not include the following significant costs: (1) improvements needed to meet the minimum technical requirements, (2) data conversion from the existing systems to the interim migratory systems, (3) development of interfaces with nonfinancial systems, such as logistics and personnel, that generate most of the financial data, (4) training of personnel who will operate and enter data into the interim migratory system, and (5) replacement of 63 existing systems with the interim migratory systems.

DOD acknowledges that these costs will probably be higher than the estimated costs to enhance the systems' functionality. However, as of February 1995, DOD had not completed a functional economic analysis[9] for the interim migratory systems, which was to have been completed by March 31, 1994. Although DOD stated that the analysis should be completed before a system is selected, DOD had already selected 12 of the 17 systems. To obtain this critical information on the interim migratory systems, on

[8]DOD developed a functional requirements document based on the Core Financial Systems Requirements, which was approved by the Joint Financial Management Improvement Program. DOD then modified it for revolving fund operations. The document lays out the following 10 major areas: (1) fund distribution, (2) general ledger, (3) fixed assets, (4) cost accounting, (5) payables, (6) receivables, (7) billing, (8) disbursing/collections, (9) inventory accounting, and (10) travel.

[9]A functional economic analysis includes an evaluation of process requirements or problems, proposed solutions, alternatives, assumptions, constraints, life cycle costs, benefit/cost analysis, and investment risk analysis.

December 19, 1994, the Under Secretary of Defense (Comptroller) required that a functional economic analysis be prepared for the depot maintenance and transportation business areas and a cost analysis[10] be prepared for the other business areas before the expenditure of funds to enhance the systems is authorized. The analyses were to be completed by the end of March 1995. However, when we discussed our report with DOD officials, they stated that such an enormous task could not be completed by that date and had not determined when the analyses would be completed. Given the relatively low scores the systems received and the magnitude of the total cost to upgrade them to meet the minimum functional and technical requirements and implement the selected systems, we believe a functional economic analysis should be performed for each of the systems selected as a Fund interim migratory system.

## Problems Continue in Preparing Accurate Fund Financial Reports

Meaningful and reliable financial reports are essential to enable the Congress to exercise its oversight responsibilities. Reliable financial reports are also imperative for DOD management to make informed decisions on the Fund's operations and set realistic prices to charge customers. DOD has acknowledged several times that the Fund's financial reports are inaccurate. Accordingly, DOD's plan for improving Fund operations identifies a number of actions aimed at improving the accuracy and usefulness of the Fund's financial reports.

One of these actions was to revise the Fund's Monthly Report of Operations—the 1307 report. Although DOD's February 1, 1995, report stated that this action had been completed, we do not agree. DOD issued a revised 1307 report format in September 1994 that provides for a monthly income statement, balance sheet, and cash flow statement, which we have previously suggested. The new reporting format was to be used for the first time in reporting the December 1994 results of operations. However, the December data for the Air Force, Navy, Marine Corps, Transportation Command, and the Defense Information Service Agency was reported in the old format. When we discussed this report with DOD officials, they stated that these activities had been directed to submit the December 1994 financial data in the new report format. Improving the accuracy of this report will require that DFAS headquarters, the DFAS Centers, and the DOD components work together and agree on the actual source of information to be used to produce the financial reports.

[10]A cost analysis is not as detailed as a functional economic analysis. It includes estimates of the costs to (1) enhance the system to meet minimum functional and technical requirements, (2) develop interfaces, (3) deploy the systems, and (4) develop implementation milestones. It does not include an analysis of (1) alternatives, (2) benefits/costs, or (3) life cycle costs.

Officials responsible for completing the new 1307 report at several DFAS Centers, told us that the report could not be properly prepared because the current financial systems did not contain or accumulate all the necessary data. As a result, the Centers had to use manual workarounds, in some cases, to obtain the necessary data. Some Center officials were doubtful that all the data could be obtained. The officials stated that because of the variety of different data sources that will be used as a result of the workarounds, the 1307 data will not be consistent and, therefore, not comparable between similar business areas. In addition, manual workarounds increased the chance that errors could occur through the transposition of numbers.

In part, this problem resulted from the Fund's systems use of 15 different general ledgers. DOD issued crosswalks that translate the 15 different general ledgers in use for the Fund to the DOD Standard General Ledger. The crosswalks were issued with the requirement that they be used in the formulation of the Fund's financial reports, including the 1307 report. However, the crosswalks contained general ledger accounts for which there were no corresponding accounts in the Centers' current systems' general ledger structure. The converse is also true: the Centers' current systems' general ledger structure contained accounts for which no corresponding account existed in the crosswalks. The Centers had not received guidance regarding what to do for these situations. Because of this, officials at one DFAS Center told us they "have no plans to use the crosswalks anytime soon." We do not consider this action complete until DOD can demonstrate that the revised 1307 report is giving DOD management and the Congress accurate, reliable, and consistent financial information on the results of the Fund's operations.

Since March 1993, we have reported that the Fund's financial reports are error prone and cannot be relied upon for decision-making purposes. Further, because of significant deficiencies in the internal controls, the DOD Inspector General was unable to express an opinion on the Fund's fiscal year 1992 and 1993 financial statements, in performing audits required by the CFO Act. After approximately 3 years of operating the Fund, DOD is still experiencing difficulty in preparing accurate reports on the Fund's operations.

For example, the Fund's Army supply management business area reported a fiscal year-end 1994 operating loss of $8.5 billion on a program that had revenue of $7 billion. After we visited the DFAS-Indianapolis Center, where we discussed the loss with Center officials, it was determined that a clerical error of about $6 billion had been made on the fiscal year-end 1994 financial report for Army supply management and the report was revised to show a fiscal year 1994 loss of over $2.6 billion. Our analysis of the Fund's fiscal year 1994 monthly financial reports disclosed numerous other instances in which the reports were inaccurate. Because of these reporting problems, 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. Until DOD and the Fund can achieve an integrated financial management system, financial reports will continue to be error prone. These problems are discussed in appendix II.

## DOD Has Reversed Fund's Cash Management Policy

Since the Fund was established, its cash balance has been centrally managed by the Office of the Secretary of Defense (Comptroller). On February 1, 1995, DOD returned the management of the Fund's cash and related Antideficiency Act[11] limitations to the military service and DOD component level. When we discussed our report with DOD officials, they stated that the policy had been changed to better align accountability and responsibility for cash management. However, there is no assurance that this policy change will enhance DOD's cash accountability. This policy change is a major departure from the benefits of a single cash balance DOD cited in establishing the Fund. In our prior testimony, we pointed out that by consolidating the cash balances of the old industrial and stock funds, DOD reduced by several billion dollars the Fund's cash requirement needs.[12] DOD's action may increase the Fund's cash requirements and, therefore, increase the need for appropriated funds to implement the change or the continued advance billing of customers for goods and services they are to receive.

In the March 1991 Defense Business Operations Fund Overview Book on the budget, DOD informed the congressional defense committees that

> "the single DBOF fund balance provides flexibility during execution necessary to absorb varying financial conditions. Combining previously separate appropriations into one account, united by support and business function aspects, allows lower total fund balances through a form of self-insurance not previously available. Operating fund balances for the former stock and industrial funds are significantly reduced in this budget."

[11]The Antideficiency Act provides in part that, unless otherwise authorized by law, no officer or employee of the United States shall make expenditures or incur obligations exceeding the level of the available appropriation, an apportionment, or specific other limits set by agencies (31 U.S.C. 1517 and 1341).

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

In February 1992, DOD again reiterated the benefits of maintaining a single cash balance for the Fund. Further, the September 1993 plan specifically provided that the Antideficiency controls would remain at the Office of the Secretary of Defense (Comptroller) level.

DOD has been experiencing a cash shortage problem since about June 1993. Because of this shortage, the DOD Principal Deputy Comptroller directed in June 1993 that all depot maintenance activities and selected research and development activities advance bill customers for goods and services to be provided. In July 1994, the Comptroller of Defense stopped the advanced billing at all activities except the Naval shipyards and research and development activities. Although these remaining activities had been tentatively scheduled to stop advance billing in January 1995, they had not done so as of February 1995. As we have stated in the past, we believe that advance billing is a stopgap measure and not a sound business practice.

The policy change placing the management of cash at the military services and DOD component level could increase the Fund's cash needs, resulting in the possibility that other Fund activities will advance bill their customers to remain solvent. Further, officials at two DFAS Centers raised concerns that if the amount of cash returned to the Army and Air Force Fund business areas was not commensurate with their normal operating needs, they could have a negative cash balance in the near future resulting in a violation of the Antideficiency Act. In addition, in a November 1994 memorandum to the Principal Deputy Under Secretary of Defense (Comptroller), the Assistant Secretary of the Navy (Financial Management) pointed out that the Fund was "not in a healthy financial condition" and that the Navy would have to determine the cash requirements of operating their portion of the Fund and the amount of advance billing necessary to achieve this cash requirement.

## Fund Performance Measures and Goals Still Being Developed

Performance measurements are a valuable tool for managers because they provide information on an organization's operation. Managers can use the data that performance measures provide to help them account for past activities, manage current operations, assess progress toward planned objectives, or better justify budget requests to the Congress and the impact that budgetary decisions have on an entity's operations. However, performance measures and goals are useful as a management tool only if management makes a commitment that supports their use. One of the actions in its plan that DOD reported as being complete calls for the DOD CFO to "re-energize" performance measure development.

In our March 9, 1994, report,[13] we pointed out that DOD had (1) included performance measures in the Fund's fiscal year 1994 annual operating budgets and (2) begun developing the corresponding goals for some business areas, such as DLA supply management and distribution depots. However, almost a year later, DOD had developed only 14 goals for the Fund's 69 performance measures. For example, for the Navy Fund business areas, DOD had identified 25 performance measures but had developed only 4 corresponding goals as of February 1995.

When we discussed the report with DOD officials, they stated that with the passage of the Government Performance and Results Act of 1993, they were devoting their efforts to developing performance measures to accomplish the objectives of the act. DOD also stated that the performance measures developed for the Fund were "one-liners" and were not sufficient to meet the criteria set forth in the act. DOD further noted that one of its pilot programs under the act is the Defense Logistics Agency, which is a Fund activity.

## Conclusions

DOD faces formidable challenges in resolving the Fund's problems. However, many of these problems, such as inadequate systems, are the result of years of neglect and date from the old industrial and stock funds. As we have pointed out and DOD has recognized, the Fund's financial systems cannot produce accurate and reliable information on the results of the Fund's operations. Until these antiquated systems are eliminated, (1) the infrastructure costs of maintaining multiple systems for the same purpose will continue and (2) DOD decisionmakers and the Congress will continue to receive inaccurate and unreliable information on the Fund's results of operation. Also, the recent decision to devolve cash management abandons one of the goals of the Fund.

Further, DOD can reduce the costs of operations only if it is more conscious of operating costs and makes fundamental improvements in the way it conducts business. Although the Fund is to operate on a break-even basis, it has not been able to meet this financial goal. Fiscal year 1994 marked the third consecutive year of reported losses. If top management does not place a priority on reversing this trend, the status quo will be perpetuated and potential savings from the Fund will not be realized.

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

## Recommendations

We recommend that the Congress enact legislation to

- require that the Fund's prices recover the full costs of using military personnel in providing goods and service and
- prohibit DOD from including amounts in the Fund's prices for recovering prior year losses.

We further recommend that the Under Secretary of Defense (Comptroller)

- ensure that a functional economic analysis is prepared for each of the recommended Fund interim migratory systems prior to authorizing the expenditure of funds to enhance and implement the systems;
- reverse the decision to transfer the management of the Fund's cash to the military services and DOD components;
- develop a systematic process to ensure the uniform implementation of the Fund's policies; and
- revise the revenue recognition policy to require that the percentage of completion method be used for work done on orders that cross fiscal years, and clarify the management headquarters policy to specifically identify the costs to be included in the prices.

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 Reform and Oversight; and other interested parties. We will make copies available to others upon request.

Please contact me at (202) 512-6240 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix III.

Jack L. Brock
Director, Information Resources
Management/National Security and
International Affairs

## List of Addressees

The Honorable Strom Thurmond
Chairman
The Honorable Sam Nunn
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Ted Stevens
Chairman
The Honorable Daniel K. Inouye
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable Floyd D. Spence
Chairman
The Honorable Ronald V. Dellums
Ranking Minority Member
Committee on National Security
House of Representatives

The Honorable C.W. Bill Young
Chairman
The Honorable John P. Murtha
Ranking Minority Member
Subcommittee on National Security
Committee on Appropriations
House of Representatives

# Contents



**Abbreviations**

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| CFO | Chief Financial Officer |
| DFAS | Defense Finance and Accounting Service |
| DLA | Defense Logistics Agency |
| DOD | Department of Defense |
| FMR | Financial Management Regulation |
| NPR | National Performance Review |

# Concerns Regarding Fund Policies

DOD has issued the accounting and financial management policies to govern the operations of the Fund in the December 1994 DOD Financial Management Regulation, Volume 11B, Reimbursable Operations, Policy and Procedures—Defense Business Operations Fund. This is the first time that the Fund's policies have been published in a single document.

We disagree with the following five Fund policies: (1) increasing prices charged customers to recover prior year losses, (2) revenue recognition, (3) military personnel pricing, (4) mobilization, and (5) economic analysis for Fund capital investments. We also believe that the policy on management headquarters costs needs to be clarified.

## Recovery of Prior Year Losses

According to DOD's pricing policy, prices will be increased to recover losses. For example, DOD increased fiscal year 1995 Fund prices by $1.7 billion to recover prior year losses. This policy is inconsistent with the basic tenet of the Fund—that prices should reflect the actual cost incurred in providing goods and services. It also 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 that period will enable DOD and the Congress to determine the cost of each year's operations and measure the performance of the Fund's activities for that period. DOD should be required to justify recovering prior year losses as part of the appropriation process. The justification should identify why a business area, such as depot maintenance, incurred a loss. For example, losses could occur because anticipated savings from productivity increases were not achieved.

## Revenue Recognition Policy

DOD's policy standardizes the recognition of revenue throughout DOD by allowing two methods of recognizing revenue for the depot maintenance business area:

- The completed order method is used for all orders that have an estimated value of less than $1 million or a planned production cycle of less than 1 year.
- The percentage of completion method is used for all orders that have an estimated value of $1 million or more and a planned production cycle of 1 year or more.

Although generally accepted accounting principles recognize both of these methods, they also specify the different circumstances under which it is appropriate to use one method or the other. Selecting the appropriate method is important because operating results reported in an entity's financial reports can vary considerably depending upon which method is used. For example, in 1993 we reported[1] that because Navy industrial fund activities used the completed contract method for recognizing revenue, the accumulated operating results at the end of fiscal year 1991 were understated by about $71 million. This understatement occurred because the activities deferred recognizing revenue and related expenses until the work was completed.

In the past, we have supported the use of the percentage of completion method since income on long-term projects is recognized when the work is actually performed. In 1991, we reported[2] that the percentage of completion method is required for long-term projects in order to present operating results more accurately for the period. Therefore, we believe that unless the work is completed within the fiscal year in which the order was accepted, the Fund should account for its revenue under the percentage of completion method.

## Military Personnel Pricing

Under this policy, the cost of military personnel will be the civilian equivalent rate, not the military personnel rate. This policy will understate the total military personnel costs since the civilian equivalency rate is less than the military personnel cost. DOD estimates about 27,000 military personnel are working in the Fund's various business areas during fiscal year 1995.

One objective of the National Performance Review (NPR) is to include the full costs in the price that providers, such as the Fund, charge customers so that the total cost of what the government produces can be determined. Charging Fund customers the military rate for military personnel, rather than the civilian equivalent rate, would be more consistent with the full costing concept of the NPR and with the Fund's basic intent.

Our concerns about the pricing of military personnel also apply to the Fund's mobilization policy. The intent of the Fund is to operate on a

[1]Financial Management: Navy Industrial Fund Has Not Recovered Costs (GAO/AFMD-93-18, March 23, 1993).

[2]Letter to the Comptroller of Defense (GAO/AFMD-92-5ML, October 22, 1991).

break-even basis for peacetime operations. However, some Fund activities incur costs to maintain a mobilization capability for combat situations, such as the costs to (1) maintain a surge capability and (2) procure and maintain approved war reserve levels. According to the Fund's policy, mobilization efforts are to be funded separately outside the Fund prices charged customers. While we agree with most of the provisions contained in the mobilization policy, as discussed above, the military personnel costs should not be recorded at the civilian equivalency rate.

## Economic Analysis for Fund Capital Investments

DOD policy requires components to prepare an economic analysis for all Fund capital investment projects over $100,000. The analysis is to describe the need for the project, total project costs, and savings expected over the life of the project. The analysis package for the project selection process should include

- the net present value, which is the difference between the discounted present value of benefits and the discounted present value of total costs;
- the "payback" period, which is the time necessary for an alternative to repay its investment cost; and
- the benefit to investment ratio, which is the total present value of benefits divided by total present value of costs.

The use of the payback period and the benefit to investment ratio is contrary to Office of Management and Budget criteria,[3] recent GAO reports,[4] and current economic literature that advocates net present value as the appropriate criterion in choosing between competing investment projects. Net present value is favored over the other indicators because it more consistently results in the selection of projects with the greatest benefits, net of cost. Furthermore, DOD would not need any additional information, beyond that necessary to calculate payback and benefit-to-investment ratios, to calculate net present value.

## Management Headquarters Costs

The Fund's plan required clarification of the existing policy on including management headquarters costs in the prices the Fund charged its customers. This policy states that (1) each Fund activity, or group of activities, is under the management control of a designated DOD

[3]U.S. Office of Management and Budget, Circular No. A-94 (revised Oct. 29, 1992).

[4]Defense Budget: Capital Asset Projects Undergo Significant Change Between Approval and Execution (GAO/NSIAD-95-20, December 28, 1994) and Federal Budget: Choosing Public Investment Programs (GAO/AIMD-93-25, July 1993).

component, (2) the costs for discrete Fund management headquarters organizations, and parts of organizations that perform Fund management headquarters functions, should be financed by the Fund, and (3) significant costs for common support, such as general counsel and personnel, used by Fund activities should be allocated to the Fund, if feasible. Significant management headquarters costs are defined as exceeding 1 percent of the total business area costs, or $1 million, which ever is greater.

We agree that management headquarters costs should be included in the prices the Fund charges customers for the goods and services it provides. However, we do not believe that the two paragraph policy clarifies which costs should be included in the Fund for DOD's complex organizational structure that includes depots, inventory control points, major commands, and headquarter components. As a result, the services and DOD components could interpret the policy differently. Procedures need to be developed so that this policy can be implemented consistently throughout DOD.

# Inaccuracies in the Fund's Fiscal Year 1994 Monthly Financial Reports

Our analysis of the fiscal year 1994 financial reports disclosed numerous instances in which the reports were inaccurate and, therefore, of questionable value. Because the Fund's financial management systems can neither provide complete and reliable financial data nor report accurately on the resources entrusted to its managers, the Fund financial reporting and management at all levels has been impaired. Financial information requires constant analysis to ensure its validity. However, in many instances, DOD has allowed obvious erroneous data to remain in the accounting records, and these data are ultimately included in the Fund's financial reports. Some examples follow.

- Significant differences exist between Fund disbursements reported in DOD Report of Budget Execution (the 1176 report) and those reported by Treasury. These differences represent disbursements which DOD cannot allocate to specific business areas or military services. As of September 30, 1994, the difference between the two sets of records was approximately $528 million. Previously, we reported[1] a similar problem—the difference between the Fund disbursements reported by DOD and those reported by Treasury had been $558 million at September 30, 1992.
- The amount of revenue shown on DOD's monthly 1307 report for the Navy's supply management, distribution depots, and logistic support activities business areas is inaccurate. The inventory prices that the supply management business area charged customers include the revenue for the three above business areas, and the revenue amount is not allocated to the specific business area that earned the money. As a result, the amount of revenue applicable to the distribution depots and logistic support activities is not shown on the monthly report of operations, resulting in these two activities showing a loss.
- On its 1307 report, the Navy shipyard business area showed negative revenues ranging from $178 million to $902 million for 4 consecutive months at the beginning of fiscal year 1994. According to DFAS-Cleveland officials, this occurred because they were required to close the work-in-process account at the end of fiscal year 1993 and reverse the entry at the beginning of fiscal year 1994. As a result, the revenue for fiscal year 1993 was overstated by about $2.3 billion and fiscal year 1994 revenue was understated by the same amount.
- According to the Air Force's 1994 fiscal year-end report on supply management operations, the value of inventories in transit was a negative $1.7 billion. The Air Force also reported negative balances for inventories in transit for 4 other months in fiscal year 1994. Since inventories in transit are items that, for various reasons, are being shipped from one location to

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

another, a negative inventory in transit balance is an abnormal or misstated account balance indicating that (1) an error was made in recording inventory data or (2) a problem exists with the procedures used to account for inventory. DFAS has recognized that it cannot accurately account for Air Force inventories in transit. To remedy this situation, DFAS-Denver and the Air Force Audit Agency are working together to identify and correct the problem.

- On DOD's monthly management report (the 1302 report), the amount of Navy supply management accounts receivable and accounts payable at September 30, 1994, were a negative $336 million and a negative $625 million, respectively. These accounts normally have positive balances. According to officials at the DFAS-Cleveland Center, this occurred, in part, because the balances were reduced for undistributed collections and disbursements.

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# Related GAO Products


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