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DEFENSE WORKING CAPITAL FUNDS

DOD Faces Continued Challenges in Eliminating Advance Billing

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the Department of Defense's (DOD) working capital funds, formerly known as the Defense Business Operations Fund (DBOF), which both collect and disburse over $65 billion annually. Specifically, our testimony will provide a (1) brief overview of fund operations and objectives, (2) a more detailed perspective of cash management operations, and (3) our concerns with the cash situation through fiscal year 1998.

Working Capital Funds

In 1991, the Department established DBOF in order to foster a more business-like culture within selected Defense operations—including depot maintenance, transportation, supply management, and finance and accounting. In creating DBOF, DOD consolidated the nine existing industrial and stock funds operated by the military services and Defense components into a single financial structure. The military services and Defense components continued to be responsible for managing and operating business activities within the financial structure. In late 1996, the Under Secretary of Defense (Comptroller) reorganized DBOF and created four working capital funds: Army, Navy, Air Force, and Defense-wide. This was done in order to clearly delineate the responsibilities of the military services and Defense components for managing the functional and financial aspects of their respective business areas. The recently established working capital funds continue to operate the same way they did under DBOF.

The primary goal of the working capital funds is to focus the attention of all levels of management on the total costs of carrying out certain critical DOD business operations and the management of those costs in order to encourage support organizations, such as depot maintenance facilities, to provide quality goods and services at the lowest costs. Focusing attention on costs is important, given the size of the working capital funds. For fiscal year 1998, the four funds are expected to generate about $69 billion in revenue and employ about 220,000 civilians and 24,000 military personnel.

The working capital funds are supposed to generate sufficient revenues to recover expenses incurred in their operations and to operate on a break-even basis over time. Essentially, each business area establishes prices prior to the start of each fiscal year and applies these predetermined (stabilized) prices to most orders and requisitions received during the year. Prices reflect expected workload (based on customer input), costs of labor and material, and productivity projections. To the extent these estimates are accurate, revenues should cover cost. Higher-than-expected costs or lower demand can lead to losses while the converse can lead to profits. Since the funds are to operate on a break-even basis over time, profits effectively reduce prices in later years while losses result in higher prices or surcharges.

To date, the working capital funds have not yet accomplished their goal of operating on a break-even basis and DOD estimates that they will have an accumulated operating loss of $1.7 billion at the end of fiscal year 1997. Over the last several years, various congressional Defense oversight and appropriations committees have expressed concern with these losses and the management and operations of the funds. To address these concerns, Defense was required to conduct a study of its working capital funds as directed in the National Defense Authorization Act for Fiscal Year 1997. Not later than September 30, 1997, the Secretary of Defense is required to submit to the Congress a plan to improve the management and performance of the industrial, commercial, and support type activities that are currently managed in the working capital funds.

We remain very supportive of the concept behind the working capital funds. We believe the funds, even under DBOF, have achieved a measure of success because they are doing a better job of identifying the costs of doing business and including those costs in the prices charged to customers. This gives DOD managers a window into the costs of Defense support operations—including costs for direct labor, material, overhead, and contracts. With a more complete cost picture, managers can account for past activities, manage current operations, and assess progress toward planned objectives. In addition, more accurate identification of costs enables those responsible for providing oversight to make more informed policy decisions by highlighting the cost associated with those decisions. We are hopeful that DOD will use its forthcoming plan as a mechanism to continue to strengthen its commitment to improving the management and operations of the working capital funds as well as identifying the total costs of providing goods and services to customers and including those costs in the prices charged customers.

Working Capital Fund Cash Management

Since 1993, the working capital funds have experienced a cash shortage and have had to advance bill customers for work not yet performed in order to ensure that the funds' cash balances remain positive. In

February 1995, DOD devolved the responsibility for cash management to the military services and the Defense components to better align accountability and responsibility for management; however, advance billing continues and may well continue through the next fiscal year.

The Importance of Cash for Working Capital Funds

Cash plays an extremely important role for DOD's working capital funds. Cash generated from the sale of goods and services is the primary means by which the working capital funds pay their bills. Where the cash balances start each year depends on the outcome of many decisions made during the budget process with regard to (1) projecting workload, (2) estimating costs, and (3) setting prices to recover the estimated full cost of the goods and services. During the execution of the budget, they operate much like a checking account: collections increase the funds' account balances and disbursements (such as salaries and purchases of inventory) reduce the account balances. To the extent that the decisions made during the budget process are reasonably accurate, the funds' cash balances should fall between the minimum and maximum amount required by DOD. However, if the decisions are not accurate, the funds could have too much or not enough cash.

DOD's policy requires the funds to maintain cash levels to cover 7 to 10 days of operational costs and 4 to 6 months of capital asset disbursements, which is about $2.3 billion to $3.4 billion for the four funds. If the level of cash becomes low and there is a possibility of incurring an Antideficiency Act[1] violation, immediate actions will be taken to resolve the cash shortages by advance billing customers.

When DBOF was established, DOD consolidated the cash balances of the nine industrial and stock funds into a single account that was managed centrally by the Office of the Secretary of Defense (Comptroller). DOD believed that managing cash at a central level would be more effective. However, in practice this did not work as expected, and, in February 1995, DOD devolved responsibility for cash management as well as Antideficiency Act responsibilities to the military services and the Defense components. According to DOD officials, the cash management responsibility was devolved to the Army, Navy, Air Force, and Defense components to better align accountability and responsibility for managing cash. DOD pointed out that the operational control of actions taken by each fund activity, which

[1]The Antideficiency Act, 31 U.S.C. 1341(a)(1) provides that no officer or employee of the government shall make or authorize an expenditure or obligation exceeding the amount of an appropriation of funds available for the expenditure or obligation.

results in cash disbursements and collections, always has resided and continues to reside with the individual Defense components.

We agree with DOD's decision to place the responsibility for managing the working capital funds' cash at the military service and Defense component level and to likewise devolve the Antideficiency Act responsibility. Decentralized cash management should result in a number of benefits. For example:

- Decentralization makes each individual Defense component directly accountable for its respective cash balance as well as its decisions that affect cash, including any violation of the Antideficiency Act. Each component now has an incentive to more accurately price the goods and services that its working capital fund charges customers since inaccurate prices could lead to insufficient cash to cover daily operating expenses.
- One Defense component cannot spend money generated by another component. When cash management was centralized, DOD did not have reports that showed the cash balances for the individual Defense components—the reports only provided information on (1) DBOF's overall cash balance and (2) collection and disbursement data for each of the Defense components. With the decentralization of cash management, the Department of the Treasury provides DOD with a cash balance for each of the five components.
- The Office of the Secretary of Defense (OSD) and the Defense components have started working more as a team to resolve cash problems. Under centralized cash management, there was less incentive for the components to respond to cash problems as OSD had responsibility for maintaining the balance and for avoiding an Antideficiency Act violation. When the components became responsible for their individual cash balances, they raised more questions on the accuracy and timeliness of the information on collections and disbursements. Such increased attention should help improve the accuracy of collection and disbursement data reported in the working capital funds' financial statements prepared under the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994.[2]

DOD Has Advance Billed Customers to Alleviate Cash Shortages

Since 1993—with the transfer of $5.5 billion from DBOF as required by the National Defense Authorization Act for Fiscal Year 1993—the funds have been advance billing customers because they have not been able to

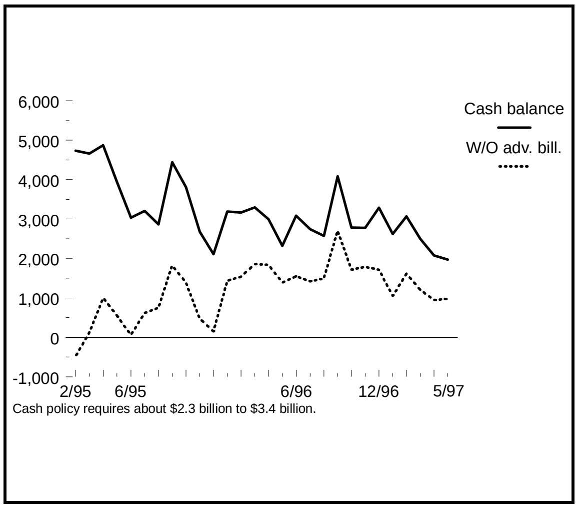
[2]Since the inception of DBOF in fiscal year 1992, the DOD Inspector General has not been able to render a favorable audit opinion on the fund's financial statements.

generate enough cash to pay their bills. In July 1994, the Comptroller of Defense stopped the advance billing at all activities except for the Naval shipyards and research and development activities, which had been tentatively scheduled to stop advance billing in January 1995. However, DOD officials informed us that when the responsibility for cash management was returned to the components in February 1995, the amount of cash returned to the services was not sufficient to cover outstanding DBOF liabilities. DBOF's financial reports indicate that this was the case with each service facing cash shortages. Therefore, according to DOD, it was necessary for the Army, Navy, and Air Force to continue to advance bill customers so that their cash portion of DBOF would not go negative.

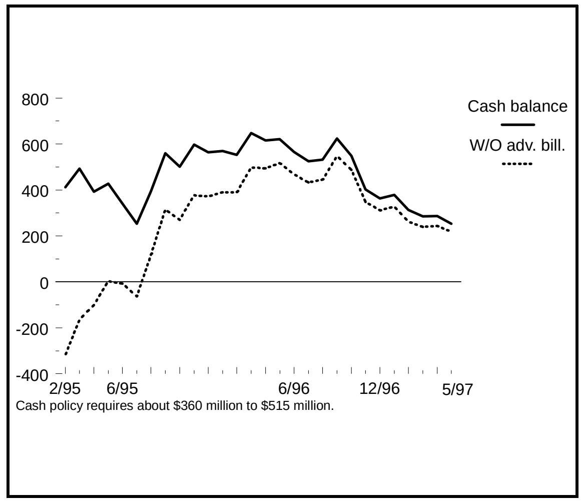
Since 1995, the military services have made some progress in liquidating (working off) their outstanding advance billing balances. However, the Navy and Air Force had to advance bill customers again during calendar years 1996 and 1997 to ensure that their cash balances remained positive. Specifically, the Navy advance billed customers about $1.7 billion and the Air Force advance billed customers $1.2 billion during calendar year 1996. For calendar year 1997, the Navy and Air Force have advance billed their customers about $400 million and $695 million, respectively, with most of the billings occurring in June 1997—$230 million for the Navy and $565 million for the Air Force. Figure 1 shows (1) the reported cash balances for the Army, Navy, and Air Force portions of the funds and (2) cash balances for these components if they did not advance bill their customers from February 1995—when DOD returned the responsibility for cash to the military services and Defense components—through May 1997 (the charts in figure 1 only depict data through May 1997 because working capital fund outstanding advance billing balance data for June 1997 were not yet available). (The charts in figure 1 are also provided in full-page view in appendix I.)

Figure 1: Working Capital Fund Cash Balances (Dollars in Millions)

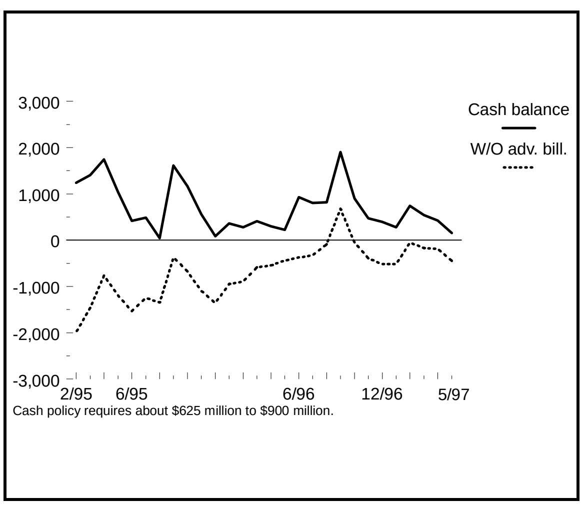
Overall Working Capital Fund



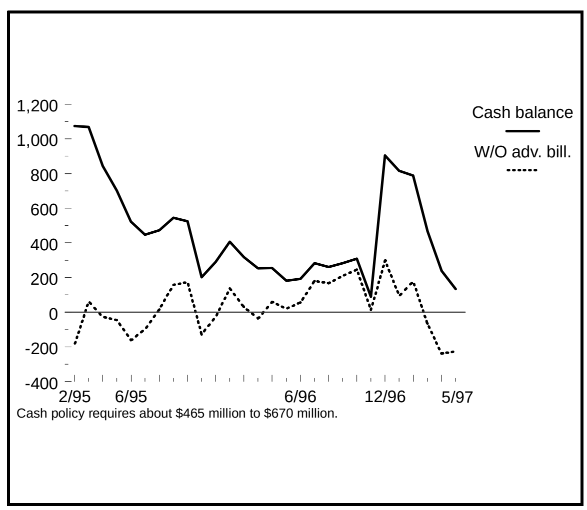
Army Working Capital Fund



Navy Working Capital Fund



Air Force Working Capital Fund



Note: We did not independently verify the financial information shown in the figure, which was taken from DOD and Treasury reports.

As figure 1 shows, the Army, Navy and Air Force would have had negative cash balances when they received the responsibility for cash in February 1995 had they not advance billed customers. The figure also shows the following.

- The three military services have liquidated $4.2 billion of outstanding advance billings from February 1995 through May 1997. However, because of Navy and Air Force advance billings in June 1997, we are unsure of the effect these billings will have on the liquidation on the outstanding advance billings to date.
- As of May 1997, the outstanding advance billing balance was about $1 billion. Again, because of Navy and Air Force advance billings in June 1997, we are unsure of the effect these billings will have on the outstanding advance billing balances to date.
- The Army has liquidated almost all of its outstanding advance billing balance.
- The Navy's cash balance would have been negative for most of the period from February 1995 through May 1997 if it had not advance billed customers.
- The Air Force liquidated most of its outstanding advance billing balance until it again started advance billing customers over a billion dollars in December 1996 to ensure that its cash balance would remain positive.

According to Army and Air Force officials, they plan to liquidate all their outstanding advance billing balances by the end of fiscal year 1998. Navy officials informed us that they now plan to liquidate the Navy's outstanding advance billing balance by the end of fiscal year 1999.

Cash Outlook for Fiscal Years 1997 and 1998

DOD's cash plans, dated January/February 1997, show that the working capital funds will disburse about $2.3 billion more than they collect during fiscal year 1997. To offset most of the cash drain that DOD expects to occur during fiscal year 1997, DOD plans to increase fiscal year 1998 prices to recoup losses and generate cash. DOD plans also show that it expects to collect about $2.2 billion more than it disburses during fiscal year 1998. This information is summarized in table 1.

Table 1: DOD's Working Capital Fund Annual Cash Plans Dated January/February 1997

Dollars in millions

Component	Estimated fiscal year 1997 collections less disbursements	Estimated fiscal year 1998 collections less disbursements
Army	$ (173.4)	$ 27.2
Navy	(1,427.7)	984.5
Air Force[a]	(154.5)	493.4
Defense agencies	(511.0)	669.4
Total	**$(2,266.6)**	**$2,174.5**

[a]Air Force fiscal year 1998 figure includes United States Transportation Command's net collections of $102.6 million.

Based on our analysis of cash and outstanding advance billing balances, as well as past trends, we believe that the Navy and Army may have to advance bill customers during the remainder of fiscal year 1997 in order to ensure that their cash balances remain positive. This is primarily because these services' recently reported cash balances are below the minimum required cash level.

Further, as we have previously testified,[3] our review of five working capital fund business areas and the assumptions used to develop their fiscal year 1998 prices (which could change as fiscal year 1998 approaches) indicated that the prices for four of the five business areas may not be high enough to cover estimated fiscal year 1998 operating costs and eliminate accumulated operating losses by over $300 million. In developing their fiscal year 1998 prices, our review showed that the business areas (1) overestimated productivity, (2) set unrealistic cost-reduction goals, and (3) overestimated workload.

These problems are not unique to the development of the fiscal year 1998 prices. We have previously reported[4] that these problems have been the primary cause of some business areas reporting operational losses. Until DOD acts to resolve these problems, some business areas will continue to incur losses from day-to-day operations, which could impede DOD's ability to eliminate the practice of advance billing.

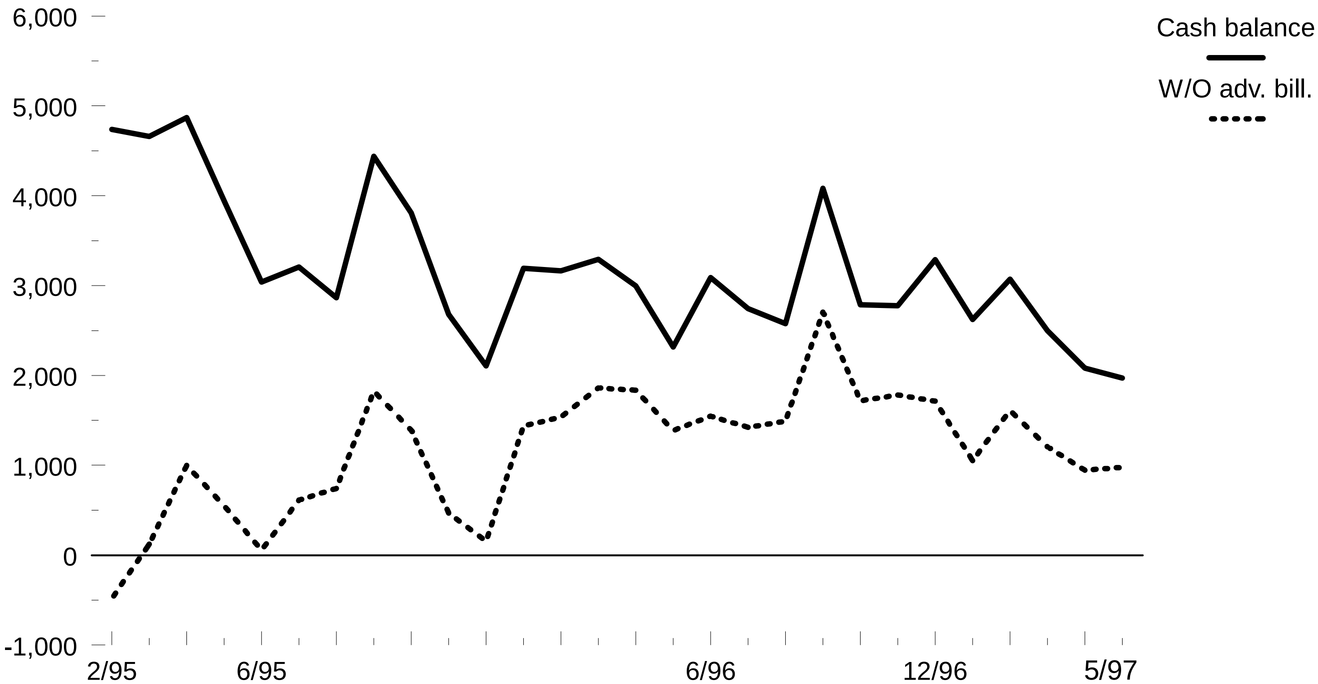
[3]Defense Depot Maintenance: Challenges Facing DOD in Managing Working Capital Funds (GAO/T-NSIAD/AIMD-97-152, May 7, 1997).

[4]Air Force Depot Maintenance: Improved Pricing and Financial Management Practices Needed (GAO/AFMD-93-5, Nov. 17, 1992); Defense Business Operations Fund: Improved Pricing Practices and Financial Reports Are Needed to Set Accurate Prices (GAO/AIMD-94-132, June 22, 1994); and Navy Ordnance: Analysis of Business Area Price Increases and Financial Losses (GAO/AIMD/NSIAD-97-74, Mar. 14, 1997).

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

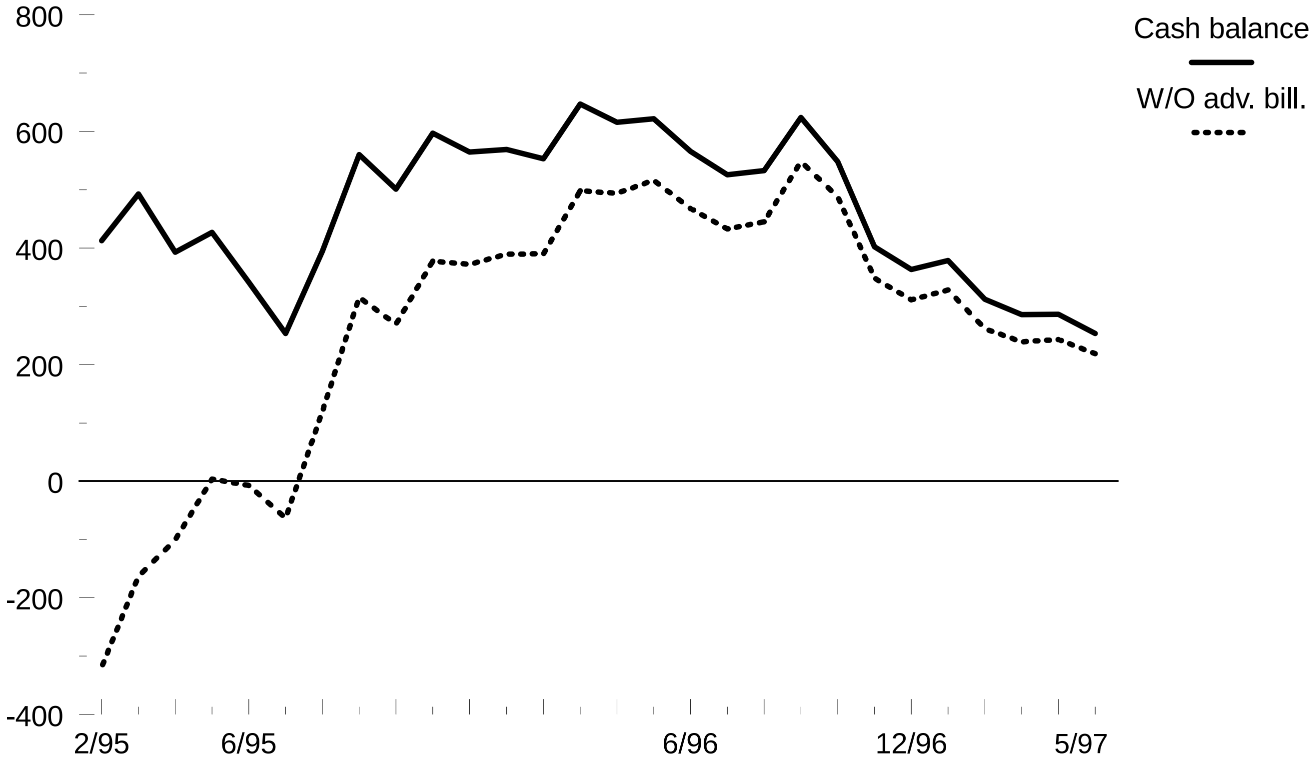
Working Capital Fund Cash Balances (Dollars in Millions)

Figure I.1: Overall Working Capital Fund



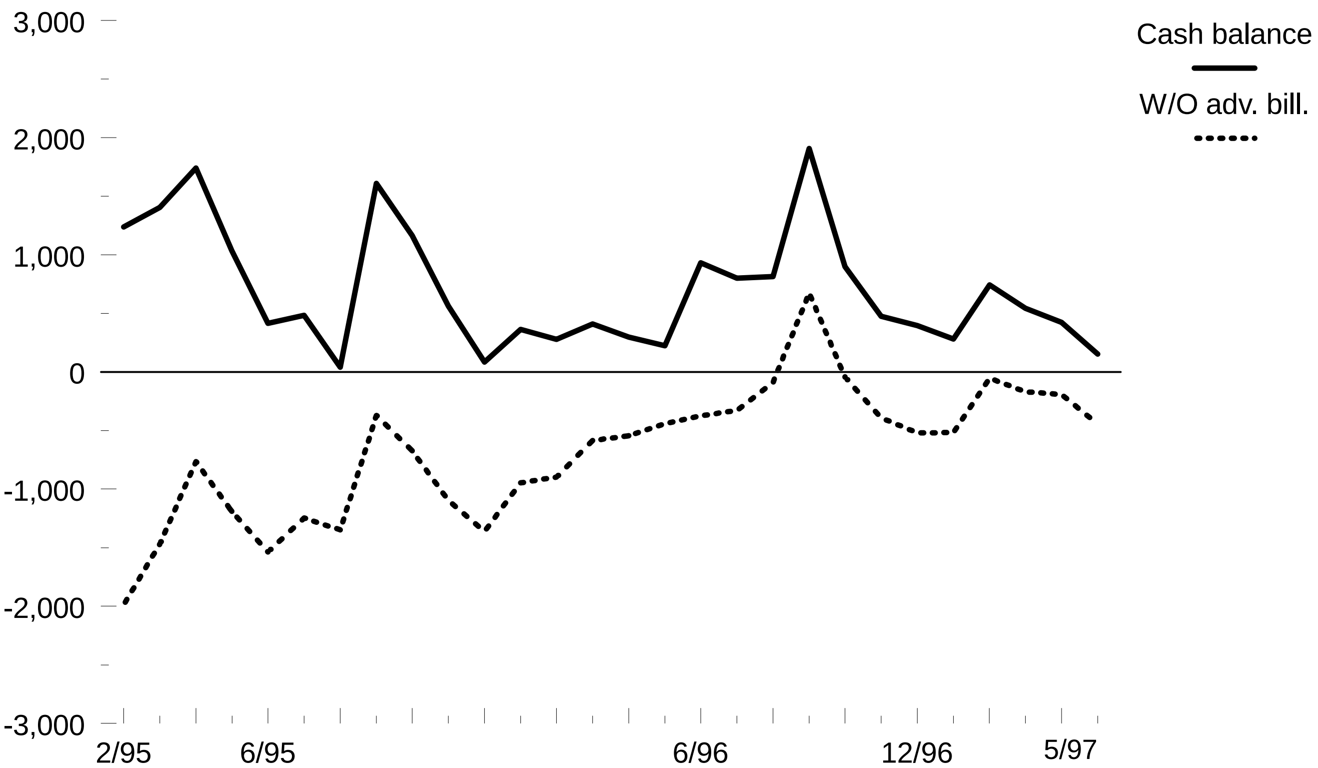
Note: Cash policy requires about $2.3 billion to $3.4 billion.

Figure I.2: Army Working Capital Fund



Note: Cash policy requires about $360 million to $515 million.

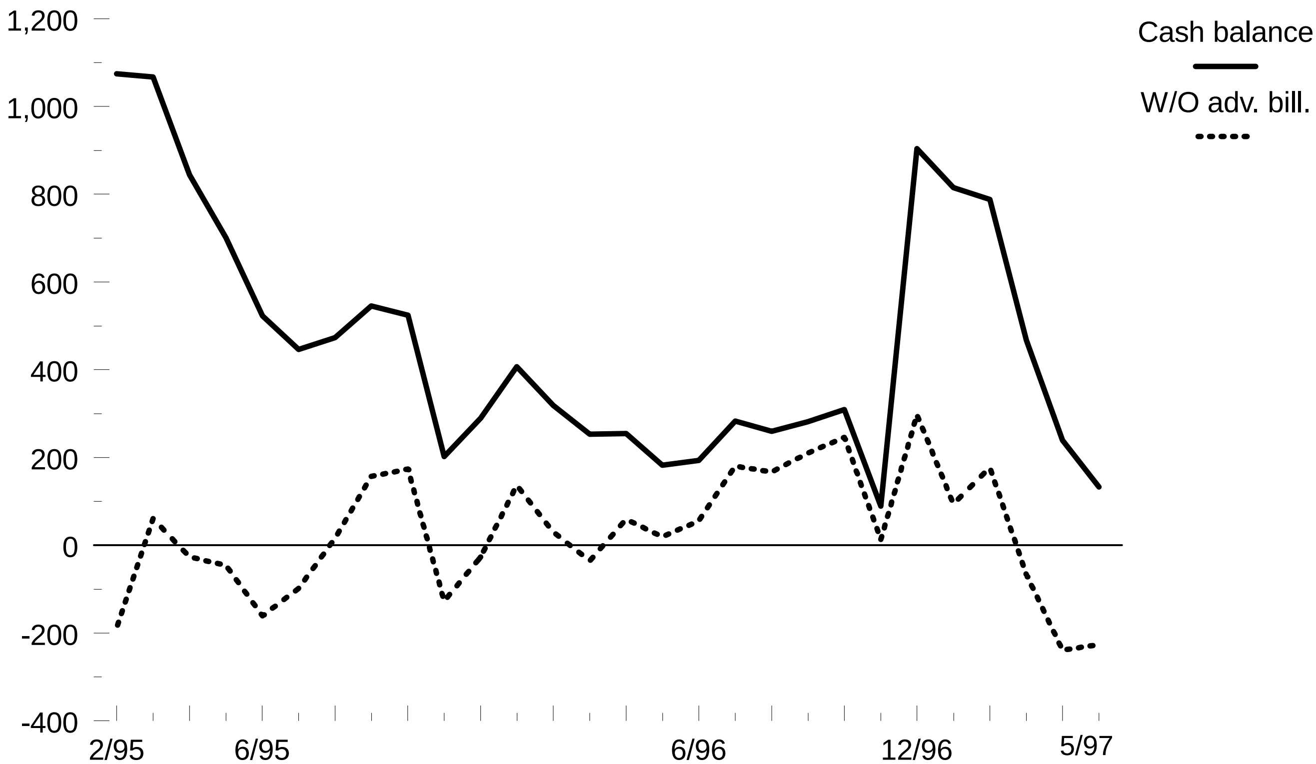
Figure I.3: Navy Working Capital Fund



Note: Cash policy requires about $625 million to $900 million.

Working Capital Fund Cash Balances
(Dollars in Millions)

Figure I.4: Air Force Working Capital Fund



Note: Cash policy requires about $465 million to $670 million.

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