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General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-257410

July 26, 1994

Ms. Alice C. Maroni
Principal Deputy Comptroller
Office of the Comptroller
Department of Defense
Room 3E822, Pentagon
Washington, D.C. 20301-1100

Dear Ms. Maroni:

In your letter dated April 11, 1994, you requested that we comment on the proposed Defense Business Operations Fund Management Report (called the 1307 report). We appreciate the opportunity to comment and fully support DOD efforts to improve the Fund's monthly financial reporting by requiring a business-type report including a monthly statement of operations, balance sheet, and cash flow statement. The new reporting requirements, if implemented uniformly by all Fund components, should help provide a monthly snapshot of the Fund's overall financial status. The proposed report could also serve as a building block for preparing the year-end CFO reports.

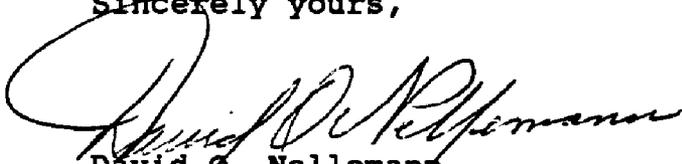
Our comments on the proposed 1307 report are based on our past and current audit work on the Fund's accounting systems and financial reports. Since the DOD components have not yet attempted to complete the proposed 1307 report, we could not perform tests to determine if they could complete the report accurately. We have discussed our comments with representatives of the Office of the Secretary of Defense (Comptroller).

The existing accounting systems are key to ensuring the accuracy of the proposed report since these systems will be used as the data source. 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 be a challenge because (1) the Fund has 80

disparate, unlinked financial systems and approximately 200 ancillary systems that provide financial data and (2) the military service and DOD component accounting systems do not all use the same general ledger. To deal with these challenges, DOD will need to ensure that all Fund activities are trained in the new and expanded reporting requirements and are able to carry out their roles. Further, where data are not readily available in the existing systems, guidance will need to be developed and implemented to ensure the consistent and accurate reporting of information on the Fund's operating results.

Our detailed comments on the proposed guidance are enclosed. If you have any questions or would like to discuss those comments further, please contact me at (202) 512-2666 or Darby Smith and Greg Pugnetti of my staff at (703) 695-6922.

Sincerely yours,



David O. Nellemann
Director, Information Resources
Management/National Security and
International Affairs

Enclosure

GAO COMMENTS ON PROPOSED CHAPTER 6,
"BUSINESS OPERATIONS FUND MANAGEMENT REPORTS"
VOLUME 6,
"REPORTING POLICY AND PROCEDURES"
DOD 7000.14-R
DOD FINANCIAL MANAGEMENT REGULATION
1307 REPORT

- (1) The proposed 1307 document describes the report as a "Management Report." However, the proposed report lacks performance measurements, one of the basic ingredients found in typical management reports. We believe that DOD should consider incorporating performance measures in the monthly financial report so that management can have the information necessary to track performance and assess operational effectiveness and efficiency.
- (2) The summary preceding the table of contents states that the proposed document "parallels" OMB's form and content guidance but the summary does not clearly identify the overall accounting standards to be followed in preparing the Fund's financial statements. Normally, Note One to financial statements would state the accounting standards that are followed. As you know, in March 1993, the Secretary of the Treasury, the Director of OMB, and the Comptroller General (the co-principals of the Joint Financial Management Improvement Program) agreed that, until a comprehensive set of accounting standards can be agreed to, Federal agencies should adhere to an "other comprehensive basis of accounting" in the following hierarchy: (1) individual standards agreed to by the JFMIP principals, (2) OMB's form and content guidance, (3) agency accounting policy, and (4) accounting policies published by authoritative standard-setting bodies or other authoritative sources. While adopting OMB's form and content guidance, the proposal makes no mention of standards agreed to by the JFMIP principals or current guidance in the overall DOD accounting manual, which incorporates GAO Title 2. We suggest that (1) the proposal clearly state that the financial statements are intended to follow the "other Comprehensive basis of accounting" agreed to by the JFMIP principals and (2) Note One to the financial statements clearly state the basis of accounting used in the preparation of the statements.
- (3) Throughout the proposed document, the reporting entity is directed to report "net information" regarding key financial

management information. For example, on page 11, the entity is instructed to report the balance of its Accounts Receivable (both Current and Noncurrent), Refunds Receivable (Public), Allowance for Loss on Accounts Receivable, and Claims Receivable (Public) general ledger accounts as a single, net dollar amount. We believe a report that discloses the total net amount of several significant general ledger account balances often does not provide the information management needs to assess its operations. For reporting purposes, (1) the total balance of an account and related allowance account could be shown on the financial statements or (2) the net amount could be reported, with an appropriate note to the financial statements that discloses the composition of the net amount.

- (4) The instructions on page 3 of the document permit the reporting entity to determine the correlation of its accounts to the DOD Uniform Chart of Accounts if the entity's existing systems do not utilize the DOD accounts. As we have previously mentioned, we believe DOD should 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 many disparate, unlinked financial systems and (2) the military services and DOD components do not operate off the same general ledger.

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 are also necessary to enable the Congress to exercise its oversight responsibilities. As discussed in our June 1994 report,¹ because the Fund's existing reports are unreliable, 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.

Unless all the Fund's business areas report information in a consistent manner, the usefulness of the reported information is questionable. Consistent reporting of key financial data is critical to ensuring reliable financial reporting.

¹Defense Business Operations Fund: Improved Pricing Practices and Financial Reports Are Needed to Set Accurate Prices (GAO/AIMD-94-132, June 22, 1994).

Inconsistent reporting can obscure the Fund's actual financial condition and reported results of operations. Thus, unless all the Fund's business areas report information in a consistent manner, the usefulness of these reports to management will be significantly reduced.

- (5) The Statement of Financial Position provides information on the fund balance with Treasury (page 4 of proposed 1307 report document). While pages 8 and 9 of the document describe how the "funds collected" are to be divided between accounts "Fund Collected-Operating Program" and "Fund Collected-Capital Program," the document does not state that a legitimate reason exists for separately identifying the operating program from the capital program. We suggest that the document include a statement that the operating program and capital program have been separately identified to comply with the National Defense Authorization Act of Fiscal Year 1993, which requires DOD to establish a capital asset subaccount.

With regard to reporting on the funds collected, funds disbursed, and funds with Treasury, the guidance contained in the proposed 1307 document needs to be clarified. It is unclear if the information on funds collected and disbursed in a Fund activity's Statement of Financial Position are to reflect results for a single fiscal year or a cumulative total. According to a May 12, 1993, DOD memorandum, DOD requires that (1) the installation-level cash balance being reported throughout a fiscal year and as of September 30 each year be equal to the net of cash collections and disbursements accomplished during that year and (2) DFAS-Cleveland be the accounting entity for the entire fund balance with Treasury. We suggest that the guidance contained in the May 12, 1993, DOD memorandum be included in the proposed 1307 document to clarify the reporting requirements.

- (6) The Statement of Financial Position includes a section for NonDefense Business Operations Fund assets (page 5 of proposed 1307 report document). Structures, facilities, and lease improvements are included in the account. To the extent that this account represents real property used by Fund activities, these should be reported as Fund assets, not nonFund assets. In a May 3, 1994, letter to the DOD's Inspector General (GAO/AIMD-94-107R), we stated that real property used by Fund activities represents a Fund asset. As such, it is appropriate that this property be reported as an asset on the Fund's financial statements to show the full costs of all resources used in the Fund's operations.

Further, it is unclear why the Fund's Statement of Financial Position would contain information on assets, whether real or personal property, that do not belong to the Fund and why nonFund assets are included in the Fund's total reported assets. If these are truly nonFund assets, they should be excluded from the Fund's Statement of Financial Position and reported by the DOD entity that actually owns them. Conversely, if these assets are used primarily by Fund activities, then DOD needs to ascertain if they should be reported as Fund assets, thus providing more accurate disclosure and accountability.

- (7) The Statement of Operations and Changes in Net Position includes information on the Fund's net operating results (page 31 of proposed 1307 report document). There are significant differences in the fiscal year 1993 net operating results shown in the 1307 report, the year-end CFO report, and the Defense Business Operations Fund Budget Overview. The guidance on preparing the proposed 1307 report does not state whether the net operating results shown on the proposed 1307 report will also be used (1) for budgetary purposes and (2) as a factor in setting the prices that the Fund charges its customers. If the net operating results in the proposed 1307 report are not used for budgetary purposes, we suggest that additional information be provided in the proposed 1307 report document or the Defense Business Operations Fund Budget Overview to show the relationship between net operating results in the 1307 report and the net operating results used for budgetary purposes.
- (8) The Statement of Operations and Changes in Net Position includes information on the Fund's net operating results (page 31 of proposed 1307 report document). Revenue and expense information, including the net operating results, are also shown each year in the Defense Business Operations Fund Budget Overview, which is submitted to the Congress. However, the type of information (lines on the reports) presented to the Congress is different than the information on the 1307 report. We suggest that DOD ensure that the data shown in the accounting reports are consistent with the data in the budget reports, as discussed in volume 1 of the DOD Financial Management Regulation.
- (9) The Statement of Operations and Changes in Net Position includes information on the Fund's operating expenses (page 31 of proposed 1307 report document). Pages 34 and 47 to 49 of the proposal require the reporting entity to report expenses

by object class. The proposed document also provides that the object class numbers shown on the Part IV exhibit are those currently prescribed by OMB. The object class data are based on obligation amounts, which may be significantly different from actual expenses. Accordingly, we are concerned that activities may use obligation data instead of actual expenses in completing Part IV. We suggest that additional guidance be issued requiring that actual expenses be used in completing Part IV.

- (10) Part VI of the Fund's Statement of Operations (page 36 of proposed report document) is designed to compare the Supply Management and Commissary Resale general ledgers with the approved operations program to monitor the execution of current year Supply Management and Commissary Resale budgets. This information is comparable to the old statement 7 and the 1302 report. We do not believe that this statement can be considered a Statement of Operations since it does not disclose the results of the entity's operations. While it discloses data on supply operations, it does not include any information regarding incurred costs and projected unit cost targets. We suggest that DOD change the name of Part VI of this statement to more clearly reflect its content. Since the information contained in Part VI focuses on DOD inventories, DOD could call it the Inventory Management Report.
- (11) Beginning on page 63, the instructions describe the accounting for inventory valuation when an entity uses standard price as the valuation methodology. DOD's proposal is to value inventory at the latest acquisition cost and establish an allowance account on holding gains and losses. In determining the latest acquisition cost, the proposal provides that DOD will use the standard price, which incorporates selected cost recovery factors for operating costs and anticipated inflation. Since the instructions for converting from standard price to latest acquisition cost are very complex and have not been used before by DOD, we suggest that DOD establish a task force to ensure that the instructions can be implemented by each DOD component.

In addition, as we stated before FASAB in April 1993, we believe that DOD should use replacement cost instead of latest acquisition cost in reporting the value of its inventory. A standard replacement cost system provides a number of significant benefits, such as (1) assisting managers in formulating their budget requests for inventory purchases and (2) establishing costs for determining realistic prices.

ENCLOSURE

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- (12) On page 58 of the proposal, part "E" shows a general journal entry indicating the use of, or the reduction of, appropriated capital. The entry is a debit to "Net Results of Operations" and a credit to "Appropriated Capital Used." A similar entry appears on the bottom of page 61 for invested capital used. The entry is a debit to "Net Results of Operations" and a credit to "Invested Capital Used."

Although the use of the Appropriated Capital Used and the Invested Capital Used accounts is in accordance with the governmentwide Standard General Ledger (SGL) and Title 2, the debit to Net Results of Operations is incorrect. The debit should be to the Appropriated Capital and Invested Capital accounts, according to the SGL and Title 2. If this is not done, the Appropriated Capital and Invested Capital accounts will be overstated and the Net Results of Operations and the Cumulative Results of Operations will be understated by an equal amount.

We suggest that the proposal be revised to reflect the debit of Appropriated Capital and Invested Capital as required by the SGL and Title 2.

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