



United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-260468

February 21, 1995

The Honorable John A. Koskinen
Deputy Director for Management
Office of Management and Budget

Dear Mr. Koskinen:

This letter is in response to a December 19, 1994, request for comments on the Office of Management and Budget's (OMB) proposed criteria and the tentative designation of agency components that should submit separate audited financial statements beginning with fiscal year 1996. We support the overall thrust of OMB's proposed guidance, but we believe that the criteria should be strengthened to direct that agency components be designated in a manner consistent with agency management operations and responsibilities. Consistent with this change in criteria would be the addition of the Army, Navy, and Air Force components of the Defense Business Operations Fund (the Fund) to the final list of organizations required to submit audited financial statements.

OMB's proposed guidance, if it incorporates our suggested modifications, would go a long way toward ensuring that appropriate military service support components are identified for financial statement preparation and audit. As we have discussed with OMB staff, we are very concerned about the Department of Defense's (DOD) plans to abandon its current approach of having audited financial statements for the military services' support organizations that the Fund finances. In our view, this planned approach is clearly inconsistent with (1) DOD and congressional views on the Fund's operational and financial management alignment and (2) the Federal Accounting Standards Advisory Board's (FASAB) proposed recommendation setting out criteria to be used in defining entities that should submit audited financial statements. Further, we believe that this change to DOD's audit approach would greatly diminish the potential value of the audits in improving financial management within DOD.

GAO/AIMD-95-91R Agency Component Criteria

153573

BACKGROUND

The Fund was established in fiscal year 1992 to focus attention on and improve control over the costs of DOD's administrative and logistical support operations. These administrative and logistical support services include ship and aircraft overhaul, equipment repair, base support, and the sale of inventories and supplies. The Fund consolidated financing for these services from the military services' and DOD agencies' nine separate stock and industrial funds into a single revolving fund account.¹ However, while DOD's support operations are now financed through the Fund, each military service or DOD agency retained management responsibility for its own support operations. For both the Fund and the preceding separate revolving funds, the underlying principle was to set the rates charged to customers for the goods and services used based on the costs incurred to produce them.

As shown in the following table, in its reports under the Chief Financial Officers (CFO) Act of 1990, DOD reported almost \$83 billion² in Fund revenues in fiscal year 1993. The military services' support operations reported revenues of \$29 billion for Navy, \$14 billion for Army, and \$12 billion for Air Force--amounts which exceeded the budgets of 11 out of the 24 agencies covered by the CFO Act of 1990, as amended by the Government Management Reform Act of 1994.

¹Several other activities have been added since the Fund's establishment.

²The total DBOF revenue reported in the Fund Budget Overview for fiscal years 1993 and 1994 was approximately \$77 billion.

Table 1: Reported Revenues for Fund Financed Operations by Component in Fiscal Year 1993

(Dollars in thousands)

Component/Support Operation	Reported Revenues
Army	\$13,915,866
Supply Management	
Depot Maintenance	
Navy	29,288,806
Supply Management	
Distribution Depots	
Depot Maintenance	
Transportation	
Research and Development	
Printing and Publication	
Navy Information Services	
Base Support	
Air Force	12,252,855
Supply Management	
Depot Maintenance	
Distribution Depot	
Base Support	
Transportation	
Defense	27,515,449
Defense Logistics Agency	
Defense Information Systems	
Defense Finance and Accounting	
Commissary	
Joint Logistics System	
Defense Technical Information Center	
Transportation Command	
Total	\$82,972,976

These amounts are also significant in comparison to each of the military service's total budget. For example, funding for the Navy's support operations represented about 33 percent of the Navy's total fiscal year 1993 budget.

For fiscal years 1992 through 1995, DOD was required to have annual audited financial statements for all of its

revolving funds, including the Fund.³ For fiscal years 1992 and 1993, DOD's Inspector General, with the assistance of the military service audit organizations, attempted to audit most of the military service support operations financed through the Fund. For fiscal year 1994, we understand that DOD's Inspector General is following a similar audit approach. For fiscal year 1995, however, DOD has announced that it will have audited financial statements only at an overall Fund level.

SELECTION OF COMPONENTS FOR AUDIT
SHOULD REFLECT MILITARY SERVICES'
OPERATIONS AND MANAGERIAL RESPONSIBILITIES

We are concerned that OMB's draft criteria, and more specifically the inclusion of only the consolidated Fund in the tentative list of components that should submit audited financial statements, would misrepresent the Fund as a separate operating entity. In this regard, we are particularly concerned that the guidance, if finalized in its present form, would appear to explicitly sanction DOD's decision to audit only the Fund's consolidated financial statements. DOD's proposed audit approach--which would treat the Fund as a single, independent operating entity--is clearly inconsistent with the Fund's operational and financial management alignment or the proposed FASAB recommendation setting out criteria for defining entities that submit audited financial statements.

In establishing the Fund, DOD officials clearly conveyed their intention that the support operations financed by the Fund would be managed by the cognizant military service or DOD agency. Specifically, in discussing their intention to establish the Fund, DOD officials assured the House Armed Services Committee in April 1991 that the Fund's activities would "be managed by the Military Departments and Defense Agencies just as they have in the past." More recently, DOD's explanatory material accompanying its fiscal year 1993 financial statements acknowledged that Fund management

³These audit requirements result from the Chief Financial Officers' Act of 1990 for fiscal years 1992 and 1993, and the Government Management Reform Act for fiscal years 1994 and 1995.

responsibilities have continued to be aligned with the cognizant military service or DOD agency.

With respect to financing, DOD recently transferred responsibility for managing the Fund's cash to the military services and DOD components. When it established the Fund, DOD consolidated the individual services' cash management under the Office of the Secretary of Defense (Comptroller), a policy that we continue to support. However, as of February 1, 1995, DOD placed the management of the Fund's cash back at the military service and component level. Thus, in addition to operational responsibility, the military services and DOD components have substantial financial management responsibilities. Consequently, DOD's planned audit approach is clearly inconsistent with the Fund's current operational and financial management environment.

Moreover, the statutory authorization for the Fund in the National Defense Authorization Act for Fiscal Years 1992 and 1993 provides that DOD may manage its existing working capital funds "through the use of a single Defense Business Operations Fund." This reflects the Congress's understanding that operational management responsibility for control of the military services' support organizations would not be altered by creating the Fund.⁴

Finally, DOD's proposal to audit the Fund only at the DOD level is inconsistent with FASAB's December 19, 1994, Exposure Draft: Statement of Recommended Accounting and Reporting Concepts Number 2: Entity and Display. In summary, FASAB's recommendation for defining "components" that should submit audited financial statements focused on the concepts of (1) consistency with existing management responsibilities, (2) ensuring that the identified components are of sufficient size and significance so that

⁴In this regard, the Congress has expressed a direct interest in DOD conducting separate audits of military support service organizations financed through the Fund. The National Defense Authorization Act for Fiscal Year 1993 provides that for "purposes of accounting, financial reporting, and auditing, the Secretary of Defense shall maintain the separate identity of each fund and activity managed through the Fund that . . . was managed as a separate fund or activity."

entity's financial statements would be meaningful, and (3) whether the entity was likely to have users whom the information provided in the financial statements could assist in resource allocation or other decisions. We believe the concepts presented in FASAB's recommendation, when applied to the Fund, also argue strongly for separate audits of the military services' support operations.

FINANCIAL AUDITS OF THE FUND
AT ONLY THE CONSOLIDATED LEVEL
WOULD BE OF LIMITED VALUE

In addition to the question of whether the consolidated, Fund-level financial statements for the service support organizations represent a conceptually appropriate "component" for audit, the continuing serious problems plaguing the services' support organizations severely limit the value of such an audit at this time. The service support organizations have had a long history of problems in financial management and reporting. To date, all audited financial statements of the service support organizations were found to be materially misstated.

Numerous reports by GAO and others document continuing and extremely serious weaknesses throughout the support organizations' financial management operations. These weaknesses include (1) the lack of comprehensive and detailed operating and fiscal procedures, (2) not having reliable cost accounting systems to capture and report cost data, (3) not ensuring that customers are accurately billed for the full costs incurred, (4) inaccurate accounting for, and recording of, intrafund transactions, (5) the lack of goals and corresponding performance measures to evaluate resources used, and (6) the inability to produce useful and auditable financial statements. Until, and unless, these conditions have been substantially corrected, the military services' managerial responsibilities in each of these areas need greater--not reduced--audit focus.

We recognize that DOD's planned audit approach--limited to a single audit opinion for the consolidated financial statements of the Fund--permits separate reports on internal controls to the military service components. However, we are concerned that the audit work carried out under that approach could adversely affect DOD's ability to

use these audits to target the root causes of the serious weaknesses discussed above.

Specifically, the depth of the audit work conducted to render a single consolidated opinion on DOD's support operations is likely to be far less than that of work to be done as a basis for issuing additional separate opinions on each of the military service components. Consequently, the audit work conducted under DOD's planned approach is also likely to be of limited value in identifying the specific, detailed actions needed by each of the military services to address the underlying causes of the persistent problems plaguing their operations.

We believe that audits of financial statements for the Army, Navy, and Air Force components of the Fund, in addition to a DOD-level audit, will enable top DOD management to better establish accountability. The results of such military service component-level audits can be used both to reward those component managers that perform well, or alternatively, to take appropriate actions against those managers who do not effectively carry out their financial responsibilities.

Finally, in our view, a financial statement audit limited to the consolidated DOD level for support operations would not pinpoint specific component accountability and identify root causes of persistent financial management problems. Consequently, such a consolidated audit focus would diminish the military services' accountability for the financial reporting of the operations they manage. Unreliable financial reporting resulting, at least in part, from a lack of clear accountability for financial reporting has been a critical problem we identified in our financial audits of the military services.

We strongly believe that incorporating our suggested changes will significantly strengthen OMB's guidance by helping to ensure that appropriate agency components submit audited financial statements. While we support auditing the Fund's consolidated financial statements, it is also critical that appropriate financial audits are conducted of the military services' support operations in light of the billions of dollars at risk. We look forward to continuing to work with OMB in pursuing our mutual goal of improving agencies' financial management operations.

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We are providing copies of this letter to the Acting Deputy Controller of the Office of Federal Financial Management, Office of Management and Budget, and the Comptroller and Acting Inspector General of the Department of Defense. This report was prepared under the direction of David M. Connor, Director, Defense Financial Audits, who may be reached at (202) 512-9095 if you have any questions, or need further information.

Sincerely yours,



Gene L. Dodaro
Assistant Comptroller General

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