UNITED STATES
GENERAL ACCOUNTING OFFICE

Navy Needs To Insure That Improper Cost Transfers Stop

Department of Defense

Many Navy organizations improperly transfer costs from one project to another. This has resulted in

- --distortion of costs of products and services,
- --unauthorized reprograming actions, and
- --illegal charging of costs.

Navy has prescribed new controls to stop the improper transfers. GAO recommends that steps be taken to insure that the new controls are implemented and effectively used.

FGMSD-76-48

NOV. 29, 1976

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

DIVISION OF FINANCIAL AND
GENERAL MANAGEMENT STUDIES

B-159797

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

This is our report on the need for the Navy to insure that improper cost transfers stop.

This report contains a recommendation to you on page 8. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House and Senate Committees on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of the Navy; the Chairmen, House and Senate Committees on Appropriations; the Chairmen, House and Senate Committee on Government Operations; and the Chairmen, House and Senate Committees on Armed Services.

Sincerely yours,

D L Scantlebury

D. L. Scantlebury
Director

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OF DEFENSE

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Department of Defense

D I G E S T

Many Department of Defense organizations, including the Naval Air Test Center, Patuxent River, Maryland, have industrial fund accounting systems. These systems are revolving funds. This means Defense organizations (called customers) ordering goods or services from industrially funded organizations must reimburse them for the costs of producing the goods or services.

When the industrially funded organization accepts an order, the customer obligates its appropriation for the amount authorized in the order. This amount is the maximum cost the industrially funded organization is authorized to bill, unless both parties later agree to a change.

The industrially funded organization uses its own resources to do the work, billing the customer biweekly. When reimbursed by the customer, the revolving fund is replenished.

IMPROPER COST TRANSFERS

In the past several years the Naval Audit Service issued 11 reports on 14 industrial fund organizations regarding costs improperly transferred between customer orders. The Service found that 40 percent of the $6 million in transfers examined were prohibited by Navy regulations. Another 46 percent did not have sufficient documentation to support why the transfers were made. (See pp. 2 and 3.)

The Naval Air Test Center, which GAO reviewed, improperly transfered $269,000 in costs between customer orders during the 6 months ended December 31, 1974. Cost transfers are prohibited by Navy regulations, except to correct an erroneous charge. (See p. 4.)

The cost transfers were improper because they were made to

--reduce the balance of customer orders which exceeded the authorized amounts by charging other orders rather than by absorbing a loss in the industrial fund and

--charge orders that were about to expire with costs from other orders, to use funds that otherwise would have to be returned to the customer.

In some instances the Center did work before receiving an order and improperly charged the costs incurred to orders on hand. Navy regulations generally require that industrial fund organizations receive and accept a customer's order before starting any work.

Center management generally did not prevent improper cost transfers because the written requests made for cost transfers did not contain enough information to evaluate the justification for the transfers.

The improper transfers distorted the costs of products and services and, in some cases, resulted in illegal expenditures for objects not authorized by the financing appropriation. (See p. 5.)

For example, $15,000 in costs incurred by the Center for work on the S-3A aircraft under an order citing the Navy's Procurement of Aircraft and Missiles Appropriation were transferred to an order citing the Navy's Research, Development, Test and Evaluation Appropriation for work on equipment of the A-7 aircraft. As a result, costs were distorted for the two projects and illegal expenditures were made for goods and services not authorized by the financing appropriation. According to the Center management technician who prepared the request for the cost transfer, the order for the A-7 would have expired in 4 days and the unused funds would have been returned to the customer. The $15,000 in costs incurred for work on the S-3A aircraft were transferred to the A-7 order so the funds would not have to be returned.

NAVY ACTIONS AND GAO RECOMMENDATIONS

After GAO's review, the Comptroller of the Navy issued instructions to all industrial fund organizations indicating that "malpractices" had occurred due to improper transfer of costs between customer orders. The instructions reiterate the Navy's policy that cost transfers between orders are prohibited except to correct an erroneous charge. The instructions require that any erroneous charge be substantiated, by the unit doing the work, with documented evidence that a particular labor, material, or other cost was initially erroneously charged. Also, the instructions require that a specific individual in the Comptroller's Office of each industrially funded organization be given authority to approve or disapprove cost transfers between customer orders.

The Navy Comptroller's instructions could prevent improper cost transfers from recurring. However, improper cost transfers have been a widespread and longstanding problem that will take continual vigilance to eliminate. Further measures are needed to see that Navy installations adopt appropriate procedures for implementing the Navy Comptroller's instruction.

GAO recommends that the Secretary of Defense have the Secretary of the Navy ask the Naval Audit Service to review--and continue to review--a sufficient number of Navy's industrially funded organizations to ascertain whether Navy Comptroller instructions on controls over cost transfers have been--and continue to be--implemented effectively.

The Department of the Navy agreed with GAO's recommendation and stated that (1) the Naval Audit Service plans to audit 14 industrially funded organizations during fiscal year 1977 and (2) the audits will cover the costing of customer orders and compliance with new controls over cost transfers prescribed by the Navy Comptroller.

CHAPTER 1

INTRODUCTION

Many Department of Defense organizations operate under industrial fund accounting systems. The Navy Industrial Fund is a revolving fund used to finance the operations of designated industrial and commercial-type activities.

An industrially funded organization receives orders from its customers for goods or services. Upon acceptance of an order by the industrially funded organization, the customer obligates its appropriation for the amount provided to do the work requested. This amount is the maximum cost the industrially funded organization is authorized to bill in performance of the work, unless both parties subsequently agree to a modification. After receiving and accepting an order, the industrially funded organization applies its own resources and funds in performing the work required. Costs incurred are accumulated and generally billed to the customer on a biweekly basis. Upon reimbursement by the customer, the fund is replenished and the customer's previously obligated appropriation is charged with an expenditure.

CHAPTER 2

IMPROPER TRANSFER OF COSTS

BETWEEN CUSTOMER ORDERS

For some years, the Naval Audit Service has reported the improper transfer of costs between customer orders at many Navy organizations. At the Naval Air Test Center, we found that improper cost transfers distorted the cost of products and services and, in some cases, resulted in illegally financing goods and services which were not authorized by the financing appropriation. In addition, some transfers resulted in the unauthorized reprograming of funding authority.

COST TRANSFERS AT NAVY INSTALLATIONS

During the 4-year period ended June 30, 1975, the Naval Audit Service issued 11 reports identifying improper transfers of costs between reimbursable orders at 14 industrial fund organizations.

Navy regulations state that installations operating under the Naval Industrial Fund are:

--Required to maintain a detailed cost accounting system which accumulates actual costs by customer order.

--Prohibited, except in limited circumstances, from initiating work before the receipt and acceptance of a valid reimbursable order.

--Prohibited from transferring costs from one customer order to another, unless a previously recorded erroneous charge is being corrected.

Navy regulations also provide that when a fund installation anticipates a loss or overexpenditure on a reimbursable order, it must renegotiate the order with the customer. If additional funds cannot be obtained and costs exceed the limitation noted on the order, the overexpenditure must be recorded as a loss to the installation's operations.

FINDINGS OF THE NAVAL AUDIT SERVICE

One of the most comprehensive of the Naval Audit Service reports, "Service-wide Audit of the Financial Management of the Reseach, Development, Test and Evaluation, Navy Appropriation," was issued on September 30, 1974.

During the audit, the Service selected 313 cost transfers for review which were valued at $6.1 million and made by 5 fund research installations. The Service found that 40 percent of the transfers were prohibited by Navy regulations and that the validity of an additional 46 percent could not be determined because of insufficient records, as summarized in the following table.

Transactions reviewed	Number	Amount	Percent
Valid transfers adjusting incorrect initial charges	64	$ 834,[illegible]5	[illegible]
Transfers with insufficient documentation to determine their propriety	112	2,82[illegible],049	4[illegible].2
Invalid transfers made to reduce overexpended customer orders to the amount of funds authorized	46	1,104,882	18.1
Invalid transfers of costs to utilize expiring funds	44	700,560	11.5
Invalid transfers to repay loans between customer orders	47	641,388	10.5
Total transactions reviewed	313	$6,10[illegible],434	100.0

The Service noted that the transfers generally distorted the cost of the projects financed by the orders and resulted in expenditure of appropriated funds for purposes not provided in the authorizing legislation.

We noted that at 3 of the sites the Service found 26 improper cost transfers amounting to $357,000 which involved different program elements 1/ within the same appropriation. These transfers resulted in unauthorized reprograming actions and were not disclosed, as required, to the Congress. (See pp. 6 and 7.)

A followup review effort by the Service and a review by the Naval Material Command Study Group confirmed the con-

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1/A program element is an integrated activity; an identifiable military capability; a force, support activity, or research activity comprising men, equipment, and facilities.

tinued existence of the problems at several fund research installations. The Study Group, for example, visited several laboratories during the 4-month period ended January 1975. The Study Group later issued a report which indicated that numerous indiscriminate and often apparently illegal cost adjustments were made that were obvious manipulations to make incurred costs fit into the amounts of unbilled balances contained in various customer orders.

IMPROPER COST TRANSFERS AT THE NAVAL AIR TEST CENTER

As part of our review of the accounting system in opertion at the Naval Air Test Center, we tested 35 of the 257 recorded cost transfers between customer orders which were processed during the 6-month period ended December 31, 1974. These transfers involved orders financed by different appropriations and amounted to $355,556, or 36 percent of about $1 million in recorded costs which were transferred by the Center during the period. Our findings were similar to those of the Naval Audit Service. Of the 35 transfers, 23, or about 66 percent, totaling $268,835, were improper.

In most cases, costs incurred by the Center were initially charged to the correct order. Subsequently, the costs were improperly transferred to another customer order to (1) reduce the costs charged to an order that had been overexpended or (2) use funds before expiration of an order that should have otherwise been returned to the customer. In other cases, the incurred costs were charged directly to the wrong order because the order authorizing the work had not been received.

The improper cost transfers were not precluded by Center management because, generally, the written requests made by operating personnel for cost transfers did not contain sufficient information to evaluate the justification for the transfers.

The amounts charged against customer orders are used in determining the costs of products and services provided to customers. The Center's practice of making improper transfers, therefore, distorts these costs and diminishes the benefits available through industrial fund accounting.

One of the objectives of industrial funds is to provide an incentive for efficient and economical operations by identifying the cost of producing each product or service. This allows the customer to compare the cost of the product or service to its anticipated benefits and to place his order with the organization or outside agency which will provide the product or service at the lowest cost. Managers of industrially funded installations, in turn, have an incentive to improve cost estimating and cost control and to identify reasons for excessive costs.

Improper transfers of costs decrease the customer's ability to compare costs between competing fund and commercial sources and compare estimated costs to anticipated benefits. In addition, fund managers cannot identify (1) cost overruns, (2) work initiated by subordinates before the receipt of funds, or (3) work which was not completed before the expiration of the customer order.

In addition to distorting the costs of products and services, some cost transfers resulted in illegal expenditures for goods and services not authorized by the financing appropriation. Further, certain other transfers resulted in the unauthorized reprograming of fund authority.

Costs incurred for the purposes authorized by one appropriation were illegally charged to another appropriation

Of the 35 transfers we reviewed, 15 resulted in illegally charging $138,444 in costs authorized by 1 appropriation to reimbursable orders funded by a different appropriation. By making these cost transfers the Center received reimbursements from customer appropriations for work which was not carrying out the purpose of the appropriations.

In accordance with 31 U.S.C. 628, each appropriation is available only to finance obligations and expenditures for specific products or services. This restriction is applicable even though the obligations and/or expenditures charged against customer appropriations are for reimbursements to an industrially funded organization for costs it incurs.

An example of illegal transfer of costs follows. The Center illegally transferred $15,000 in costs incurred in conducting service acceptability tests of the S-3A aircraft to a reimbursable order for evaluating failures of certain equipment on the A-7 aircraft. The S-3A aircraft order was funded under the Procurement of Aircraft and Missiles, Navy appropriation, and the A-7 aircraft order was funded under the Research, Development, Test and Evaluation, Navy appropriation. The Center management technician who prepared the request for the cost transfer stated that the reimbursable order for work on the A-7 aircraft would have expired in 4 days and that the unused funds authorized by the order would have been returned to the customer. The costs, therefore, were transferred to the A-7 order so that the unused funds would not have to be returned.

Unauthorized reprograming actions

Of the eight transfers included in our review which involved transfers between orders financed by the same appropriation, four involved transfers of cost between appropriation program elements. These transfers, totaling $24,616, resulted in unauthorized reprograming of the customer fund authority. As noted on page 3, the Naval Audit Service disclosed numerous instances of improper cost transfers to customer orders involving different program elements within the same appropriation. At three of the sites included in their audit, such transfers, amounting to $357,000, were found.

Reprograming is defined as the application of financial resources for a purpose other than that orginally budgeted for, testified to, and submitted to the Congress. Although there are no legal restrictions on reprograming funds within the same appropriation, the Department of Defense and the Congress have agreed to limit reprograming of funds without congressional approval or notification. Reprograming actions which individually or cumulatively exceed $2 million between program elements within the Research, Development, Test and Evaluation appropriation and certain reprograming actions of any amount as provided in Department of Defense Instruction 7250.10 ("Implementation of Reprograming of Appropriated Funds") must be approved by the Secretary of Defense and the Congress. Other reprograming actions must be approved by the military services, and the amounts reprogramed are accumulated and are required to be reported to the Congress semiannually.

The transfer of costs between program elements by the Center are unauthorized reprograming actions. They resulted in the use of financial resources for program elements other than originally budgeted and were neither approved within the Department of Defense nor reported to the Congress semiannually contrary to Department of Defense Instruction 7250.10.

ACTION TAKEN BY THE NAVY COMPTROLLER

On September 5, 1975, the Comptroller of the Navy issued instructions to all industrial fund activities indicating that "malpractices" have occurred due to improper transfers of costs between customer orders. The instructions reiterate the Navy's policy that cost transfers between orders are prohibited except to correct an erroneous charge. Further, the instructions require that any erroneous charge will be substantiated by the unit performing the work through documented evidence that a particular labor, material, or other cost was initially erroneously charged. Also, the instructions require that a specific individual in the Comptroller's Office of each industrially funded organization will be given authority to approve or disapprove cost transfers between customer orders.

CONCLUSIONS

Improper cost transfers have been made by many organizations in the Navy. These transfers, which are prohibited by Navy regulations, have distorted the accuracy of cost data, thereby diminishing benefits available through industrial fund accounting. In some cases, improper cost transfers have violated the provisions of 31 U.S.C. 628 because expenditures charged to appropriated funds were not made for the goods and services authorized by the financing appropriation. Furthermore, those cost transfers between orders pertaining to different program elements within the same appropriation resulted in unauthorized reprograming actions.

The Navy Comptroller instructions requiring documentation of cost transfers and pinpointing of responsibility for reviewing and approving cost transfers provide a mechanism that could prevent recurrence of the situations we have reported. However, the making of improper cost transfers has been a widespread problem and one of longstanding that will take continual vigilance to eliminate. We believe that further measures are indicated to see that the Navy installations affected have adopted appropriate procedures for implementing the Navy Comptroller's instruction.

RECOMMENDATION

We recommend that the Secretary of Defense have the Secretary of the Navy ask the Naval Audit Service to review--and continue to review--a sufficient number of Navy's industrially funded organizations to ascertain whether Navy Comptroller instructions on controls over cost transfers have been--and continue to be--implemented effectively.

AGENCY ACTIONS

The Department of the Navy agreed with our recommendation and stated that the Naval Audit Service plans to audit 14 industrial fund organizations during fiscal year 1977 and that the audits will cover the costing of work orders and compliance with new controls over cost transfers prescribed by the Navy Comptroller.

We believe that if the Naval Audit Service performs the reviews planned, they will assist management in insuring proper costing of work projects.

CHAPTER 3

SCOPE OF REVIEW

In performing our review, we examined Naval Audit Service reports involving audits of cost transfer for a 4-year period ended June 30, 1975. We also made a review of the accounting system operated at the Naval Air Test Center, Patuxent River, Maryland. Our review of that system included a study of cost transfers and related matters for the period July 1 to December 31, 1974. In this report only findings relating to cost transfers have been included. Other matters disclosed by our review were reported separately to the Commander, Naval Air Test Center.

The Accounting and Auditing Act of 1950 (31 U.S.C. 66(b)) requires that executive agency accounting systems be approved by the Comptroller General if they are determined adequate and in conformity with the principles, standards, and related requirements prescribed by the Comptroller General. Agency requests for approval of their accounting systems are made in two stages:

--The agency submits a statement of accounting principles and standards.

--The agency submits documentation describing the design of the accounting system.

On June 30, 1972, we approved the accounting principles and standards applicable to 15 installations, including the Center, which operated under the "Navy Industrial Fund Handbook for Research, Development, Test and Evaluation Activities." At the same time we approved the accounting system design at the Center.

In reviewing the design of an accounting system for approval we determine whether the system will produce sound financial information if operated effectively. Our approval, however, does not and cannot insure that the system will be so operated. It is agency management's responsibility to assure that operating personnel adhere to the requirements of the approved system. In this case, management did not prevent practices which produced incorrect data and use of funds for purposes other than that for which they had been provided.

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D. C 20350

13 OCT 1976

Mr. D. L. Scantlebury
Director, Financial and General
Management Studies Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Scantlebury:

This is in reply to your letter to Secretary Donald Rumsfeld of 27 July 1976 regarding the need for Navy to insure that improper costing of work projects is stopped (OSD Case #4418).

As discussed in the subject GAO draft report, the costing of work projects has been, and will continue to be, a subject of interest to Navy management and to the Naval Audit Service. In today's environment of increasing costs, it is imperative that all possible efforts be employed to insure that ultimate proper returns are realized from available funding.

The GAO draft report states that the Naval Audit Service has devoted considerable effort in the area of costing of work projects, and has made recommendations for improving and/or alleviating improper or unsatisfactory conditions. The Naval Audit Service plans to continue audit coverage of the costing of work orders and provide assistance to management in ensuring compliance with new controls over cost transfers prescribed in Navy Comptroller Instruction 7600.21 dated 5 September 1975.

During Fiscal Year 1977, the Naval Audit Service plans include audit coverage of cost accounting and rate stabilization at the following industrial fund activities:

Philadelphia Naval Shipyard
Portsmouth Naval Shipyard
Norfolk Naval Shipyard
Charleston Naval Shipyard
Naval Air Rework Facility, Norfolk
Naval Air Rework Facility, Jacksonville
Naval Air Rework Facility, Pensacola
Naval Air Rework Facility, Cherry Point
Naval Air Rework Facility, North Island
Mare Island Naval Shipyard
Puget Sound Naval Shipyard
Pearl Harbor Naval Shipyard
Naval Air Rework Facility, Alameda
Long Beach Naval Shipyard

In addition audits at other industrial fund activities will include review of the costing of work projects for compliance with the Navy Comptroller Instruction 7600.21.

J. T. McCullen Jr.

[illegible] ULLEN, JR.
[illegible] of the Navy
[illegible] Affairs)

PRINCIPAL OFFICIALS RESPONSIBLE FOR

MATTERS DISCUSSED IN THIS REPORT

	Tenure of office From	To
DEPARTMENT OF DEFENSE		
SECRETARY OF DEFENSE:		
Donald H. Rumsfeld	Nov. 1975	Present
William P. Clements, Jr. (acting)	Nov. 1975	Nov. 1975
James R. Schlesinger	July 1973	Nov. 1975
DEPUTY SECRETARY OF DEFENSE:		
William P. Clements, Jr.	Jan. 1973	Present
ASSISTANT SECRETARY OF DEFENSE: (COMPTROLLER)		
Fred P. Wacker	Sept. 1976	Present
Terence E. McClary	June 1973	Aug. 1976
DEPARTMENT OF THE NAVY		
SECRETARY OF THE NAVY:		
J. William Middendorf II	June 1974	Present
J. William Middendorf II (acting)	Apr. 1974	June 1974
John W. Warner	May 1972	Apr. 1974
ASSISTANT SECRETARY OF THE NAVY: (FINANCIAL MANAGEMENT)		
Gary D. Penisten	Oct. 1974	Present
Rear Adm. Sam H. Moore (acting)	Apr. 1974	Oct. 1974
Robert D. Nesen	May 1972	Apr. 1974
CHIEF OF NAVAL OPERATIONS:		
Adm. James L. Holloway III	July 1974	Present
Adm. Elmo R. Zumwalt, Jr.	July 1970	July 1974
CHIEF OF NAVAL MATERIAL:		
Adm. F. H. Michaelis	Apr. 1975	Present
Adm. I. C. Kidd	Dec. 1971	Apr. 1975
DIRECTOR OF NAVY LABORATORIES:		
James H. Probus	July 1974	Present
Dr. Joel S. Lawson, Jr.	Sept 1968	June 1974

	Tenure of office From	To
DEPARTMENT OF THE NAVY (cont'd)		
COMMANDER, NAVAL AIR SYSTEMS COMMAND:		
Vice Adm. Kent L. Lee	Sept. 1973	Present
Rear Adm. Thomas R. McClellan	Apr. 1971	Sept. 1973
NAVAL AIR TEST CENTER: (COMMANDER)		
Adm. F. T. Brown	Aug. 1974	Present
Adm. R. M. Isaman	Aug. 1971	Aug. 1974