

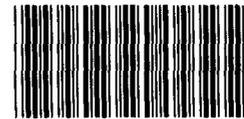
GAO

Report to the Chairman,
Subcommittee on Defense,
Committee on Appropriations,
House of Representatives

May 1990

FINANCIAL MANAGEMENT

Army Stock Fund Pricing and Refund Practices



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Accounting and Financial
Management Division

B-238448

May 9, 1990

The Honorable John P. Murtha
Chairman, Subcommittee on Defense
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

In an April 11, 1989, letter, you requested that we review and prepare separate reports on certain Army, Navy, and Defense Logistics Agency stock fund pricing and refund practices. You made this request following our April 1989 report¹ to you on the Air Force stock fund, which discusses the budgetary impact of reducing the operating cash balance of that stock fund. In responding to your most recent request, we reviewed the operating cash balances of the Army, Navy, and Defense Logistics Agency and briefed your staff on the status of our work. This, the third in our series of reports on stock fund cash balances, presents information on (1) whether the Army stock fund can operate with less than an 11-day operating cash balance, (2) how refunds made to stock fund customers affected the 11-day cash balance, and (3) how stock fund customers used the refunds. Our reports on the Navy and the Defense Logistics Agency's stock funds will be issued separately.

Results in Brief

We found that from 1987 through 1989, the stock fund's average month-end operating cash balances have ranged from 1.3 to 9 days of cash. We believe, similar to our earlier position regarding the Air Force, that the Army stock fund has shown it can operate with less than 11 days of cash. The Department of Defense, considering what it believes to be normal fluctuations in income received from customers and payments made to suppliers, established an 11-day requirement to ensure that a sufficient amount of cash was available to pay bills from suppliers. However, our analysis of the Army's operating cash balances from fiscal years 1986 through 1989 showed that the average fluctuation in the cash balances from one month to the next was only 1.8 days.

In addition, for the past 5 years, the stock fund has refunded \$736 million to selected customers. By making these refunds, the Army reduced the operating cash level below 11 days. We were unable, just as the

¹Financial Management: Operating Cash Requirement for Air Force Stock Fund Can Be Reduced (GAO/AFMD-89-60, April 7, 1989).

Army was unable, to determine the ultimate disposition of over \$600 million of these refunds because they were merged into other accounts. Of the remaining refunds, officials told us that about \$88 million were used to improve readiness, support training, and purchase supplies in two of the Army's nine retail divisions. In addition, an Army National Guard official responsible for operations and maintenance activities told us that \$28 million of the refunds were used for clothing, repair parts, and equipment purchases.

Background

The Department of the Army stock fund provides for the financial management, inventory control, and distribution of consumable supply items to support Army peacetime and wartime operations. At the end of fiscal year 1989, the stock fund had a total reported inventory value of \$8.9 billion and annual sales of \$7.3 billion. The total assets held by the stock fund, consisting of inventory and cash, are referred to as the stock fund corpus.

The stock fund operates under a revolving fund concept, whereby it buys and holds inventory for sale to authorized customers, such as activities funded by the Army's Operation and Maintenance appropriation. Sales of stock fund inventory generate cash that is used to replenish inventory levels.

To ensure that sufficient cash is available to pay incoming bills from suppliers, Department of Defense Regulation 7420.13-R requires that the stock fund maintain a certain level of funds with Treasury. Until November 1989, when the House and Senate Appropriations Committees recommended that this balance be reduced to 5 days, Defense had used 11 days of operating cash to accommodate fluctuations in revenue received from customers and payments made to vendors. Such a cash level is achieved by adding a surcharge to the acquisition cost of inventory items when setting prices charged customers. For the Army stock fund, the disbursements for 1 day are currently worth about \$18.4 million, for an 11-day total of \$202.4 million.

While the stock fund obtains most of its funds by selling inventory items to its customers, it also receives appropriations from the Congress. The congressional committees indicated that these funds are intended to purchase war reserve material and inventory items to support weapon system modernization and modification. By designating funds for these items, the congressional committees attempted to gain a degree of

budget visibility over certain stock fund purchases. These appropriations increase the corpus of the stock fund and are available to cover stock fund cash needs. For fiscal year 1989, the Army stock fund received \$292 million in appropriated funds.

The stock fund has only a single cash balance consisting of both the operating and appropriated cash amounts. Therefore, when calculating the fund balance that is available to cover stock fund cash needs, Department of Defense officials can use the appropriated funds, to the extent they are available, to cover temporary cash shortages in the operating portion of the stock fund.

Objectives, Scope, and Methodology

Based on our April 1989 report on the Air Force stock fund, which discusses the budgetary impact of reducing the operating cash balance of the stock fund, you requested that we review certain Army, Navy, and Defense Logistics Agency stock fund pricing and refund practices. In responding to your request, we reviewed the operating cash balances of these stock funds and briefed your staff on the status of our work. The objectives of this review were to determine (1) whether the Army stock fund can operate at less than an 11-day operating cash balance, (2) how refunds made to stock fund customers affected the 11-day cash balance, and (3) how stock fund customers used the refunds. Our reports on the Navy and the Defense Logistics Agency's stock funds will be issued to you separately.

You also asked us to provide certain information regarding the use of refunds. In this report, the term "refund" describes two kinds of payments: (1) payments made under various statutory transfer authorities and (2) payments made to adjust the original price charged stock fund users. Although different legal authorities govern these two types of payments, we have used the same term to cover both.

To accomplish these objectives, we discussed with the Office of the Secretary of Defense and Army officials how stock fund (1) inventory prices and surcharges are determined, (2) operating cash balances are calculated, and (3) cash is returned to customers. We examined Army stock fund budget documents and related accounting records. We reviewed congressional reports and legislation as well as Department of Defense and Army regulations concerning stock fund cash balances and refund policies. In addition, to determine if any material weaknesses had

previously been reported on Army stock fund pricing and refund practices, we reviewed the Army's Federal Managers' Financial Integrity Act reports.

Army officials could only provide us with year-end data on appropriated and operating cash balances for fiscal years 1984 and 1985 and monthly data for fiscal years 1986 through 1989. We did not verify the accuracy of the budgetary data, but we did analyze the monthly Army stock fund cash balances. We performed our work at the Office of the Secretary of Defense; Headquarters, U.S. Army; the Army Materiel Command; and the Army Accounting and Finance Center. We conducted our work from June 1989 to March 1990 in accordance with generally accepted government auditing standards.

Stock Fund Operated at Less Than an 11-Day Operating Cash Balance

The Army stock fund has functioned with less than an 11-day operating cash balance. Army information shows that since 1987, stock fund fiscal year-end operating balances have been equivalent to or less than 8.4 days of cash. Furthermore, our analysis of the operating cash balances from fiscal year 1986 through fiscal year 1989 showed that the average month-end fluctuation was only 1.8 days. In essence, the cash balances changed, on average, no more than 2 days from one month to the next, which was less than the 5-day cash target recommended by the House and Senate Appropriations Committees.

Four-Year Analysis of the Stock Fund Operating Cash Balance

From our analysis of Army stock fund cash, we determined that the Army's fiscal year-end operating cash balances have been less than 11 days since 1986. Table 1 displays the fiscal year-end balances, the average month-end balances, and the range of the operating month-end cash balances from 1986 through 1989.

Table 1: Stock Fund Operating Cash Balances for Fiscal Years 1986 Through 1989

Fiscal year	Fiscal year-end balance	Average month-end balance	Range of month-end balances	
			High	Low
1986	\$110.3	\$304.8	\$659.8	\$78.1
1987	102.0	108.1	151.0	57.1
1988	13.1	24.6	92.1	(38.0)
1989	153.9	164.6	274.4	22.4

Table 1 shows that from 1986 through 1988, the fiscal year-end and average month-end cash balances decreased while the balances increased in 1989. To relate this information to the 11-day requirement, table 2 provides the same data as shown in table 1, but converts the dollar information to equivalent days. To determine the equivalent days of cash for each fiscal year, we used the Department of Defense formula of total stock fund operating expenditures divided by 360 days. The 1-day disbursement rate for fiscal years 1986 through 1989 was \$18.2 million, \$18.9 million, \$18.4 million, and \$18.4 million, respectively.

Table 2: Stock Fund Operating Cash Balances for Fiscal Years 1986 Through 1989 Converted to Equivalent Days

Fiscal year	Fiscal year-end balance	Average month-end balance	Range of month-end balances	
			High	Low
1986	6.1	16.8	36.3	4.3
1987	5.4	5.7	8.0	3.0
1988	0.7	1.3	5.0	(2.1)
1989	8.4	9.0	14.9	1.2

Table 2 shows that in 1986, the average month-end operating cash balance exceeded the 11-day operating cash target. However, since 1986, the average month-end and fiscal year-end operating cash balances have both been less than 11 days of cash.

In our April 1989 report, we stated that the Air Force stock fund operating cash balance could be substantially reduced. By reducing the cash target below 11 days, the surcharge added to the selling price of inventory items could be reduced, thus lowering the prices the stock fund charges its customers by a corresponding amount. This, in turn, could result in a reduction to Defense budget authority.

Acting on our recommendation, in November 1989, the House and Senate Appropriations Committees recommended lowering the stock fund operating cash requirement from 11 days to 5 days which resulted in the Congress reducing the fiscal year 1990 Department of Defense budget by \$707.2 million. Further, because stock fund customers should theoretically be able to purchase the same quantity of items at reduced prices, the customers' ability to perform their missions should not be adversely affected.

Changes in Stock Fund Month-end Cash Balances Have Been Less Than 5 Days

The fluctuation in the monthly cash balances is a key measure in analyzing the needed level of the stock fund cash balance. In analyzing the monthly fluctuations in the operating cash balances, we adjusted the operating cash balances for refunds. As agreed with the Office of the Secretary of Defense and Army officials, refunds need to be added back to the operating cash balances because they are not part of the normal stock fund process of income received from customers and payments made to vendors.

Our analysis showed that for the 4-year period there were minor fluctuations or changes in operating cash balances. For example, of the 47 months of data available, the average operating cash fluctuation was 1.8 days. In addition, of the 47 months of data, there were 24 months in which cash increased and 23 months in which cash decreased, with only 1 of these fluctuations exceeding 5 days. Neither we nor Army headquarters officials were able to determine the reason for this fluctuation.

Refunds Total \$736 Million in Last 5 Years

The Army has made substantial amounts of refunds from the stock fund operating cash to its customers—\$736 million since fiscal year 1985. Table 3 shows the refunds made during the year as well as the fiscal year-end operating cash balances after refunds, in dollars and equivalent days.

Table 3: Stock Fund Refunds and Year-end Operating Cash Balances for Fiscal Years 1985 Through 1989

Dollars in millions

Fiscal year	Refunds		Operating cash after refunds	
	Amount	Equivalent days	Amount	Equivalent days
1985	\$102.3	5.7	\$596.1	33.5
1986	389.5	21.4	110.3	6.1
1987	28.9	1.5	102.0	5.4
1988	70.0	3.8	13.1	0.7
1989	145.4	7.9	153.9	8.4
Total	\$736.1			

As table 3 shows, in 1985, after the refunds were made, the stock fund maintained 33.5 days of cash. However, in fiscal years 1986 through 1989, after the refunds were made, the level of cash was reduced below 11 days. In July 1989, the Office of the Secretary of Defense notified the House and Senate Committees on Armed Services and on Appropriations that it intended to transfer \$195 million from stock fund operating cash

to the Army appropriation for Operations and Maintenance activities. On April 30, 1989, the stock fund balance was \$228.6 million, or 12 days of cash. This transfer would have left the stock fund with 5 days of cash at the end of fiscal year 1989. However, the House Appropriations Committee, Subcommittee on Defense, opposed portions of the transfer. Consequently, the Army transferred a total of only \$145.4 million. As a result, at the end of fiscal year 1989, the stock fund operated at about 8 days of cash.

The \$736 million in refunds were made with various levels of congressional involvement and approval. These refunds were generally intended to offset budget reductions in the customers' accounts, which allowed Army units to have more money to spend for general operating and maintenance purposes. When we attempted to determine how the \$736 million in refunds were used by customers, we found that over \$600 million had been merged with customers' appropriations and, therefore, could not be traced. As a result, neither we nor the Army could determine how these refunds were ultimately used other than for the general purposes of the appropriation which received the refund.

Based on what Army customers told us, of the remaining refunds, about \$88 million were used to improve readiness, support training, and purchase supplies in two of the Army's nine retail divisions. In addition, an Army National Guard official responsible for operation and maintenance activities told us that \$28 million of the refunds were used for clothing, repair parts, and equipment purchases.

While we were not able to determine the use of all refunds, table 4 shows the amount of refunds major Army stock fund customers received by fiscal year from 1985 to 1989.

Table 4: Amount of Refunds Stock Fund Customers Received From Operating Funds for Fiscal Years 1985 Through 1989

Customers	Fiscal year				
	1985	1986	1987	1988	1989
Operation and Maintenance, Army	\$102.3	\$343.3	\$28.9	\$70.0	\$145.4
Operation and Maintenance, Army Reserve	0	18.2	0	0	0
Operation and Maintenance, Army National Guard	0	28.0	0	0	0

Over the last 5 years, the majority of Army stock fund refunds have been received by Operations and Maintenance, Army, with a very small portion distributed to other stock fund customers. Specifically, Army operations and maintenance activities have received about \$690 million or 94 percent of the \$736 million in refunds from operating cash in the last 5 years.

Conclusions

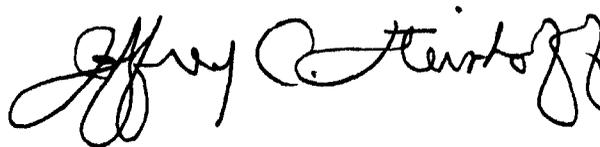
Since 1987, the Army stock fund operating cash balance has been less than 11 days. During 1989, the House and Senate Appropriations Committees recommended that Defense change its policy and lower the stock fund operating cash requirement from 11 days to 5 days. Our analysis shows that a 5-day cash supply is adequate and, as a result, we are not making any recommendations at this time.

As requested by your Office, we did not obtain written comments on a draft of this report. We did, however, discuss its contents with pertinent Defense and Army officials and have incorporated their views where appropriate.

Unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from its date. At that time we will send copies to the Secretary of Defense, the Secretary of the Army, the Director of the Office of Management and Budget, and other interested parties. We will also make copies available to others upon request.

Please contact me at 275-9507, if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix I.

Sincerely yours,



Jeffrey C. Steinhoff
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