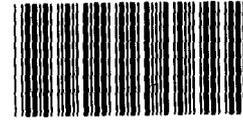




Accounting and Financial  
Management Division



148597

B-249045

March 1, 1993

Congressional Committees

The National Defense Authorization Act for Fiscal Year 1993 (Public Law 102-484, October 23, 1992) directed the Department of Defense (DOD) to complete the first phase (Milestone I) of its implementation of the Defense Business Operations Fund by November 22, 1992. Specifically, the act required that for this milestone, the Secretary of Defense was to (1) substantially complete the development of the policies governing the Fund's operations, (2) identify the Fund's interim systems requirements, and (3) prepare an evaluation report on the adequacy of the skills and resources devoted to the Fund and its related systems. The act also required GAO to monitor and evaluate DOD's progress in implementing the Fund and established a sunset date of April 15, 1994, by which the Congress must approve its continued existence. This letter provides our comments on DOD's progress in implementing the Fund and our suggestions for improvement.

We are convinced of the soundness of the Fund's concept and principles and have been supportive of this initiative. Clearly, a properly functioning Fund is essential to DOD achieving the cost efficiencies the new administration has set as a goal. At the same time, we recognize that the benefits which can be derived from the Fund will only be realized if it is implemented in a sound, logical manner. Thus far, we do not believe DOD's progress has met these criteria. Accordingly, we will only be able to continue our support of the Fund if DOD significantly strengthens the management of its implementation.

RESULTS IN BRIEF

On February 2, 1993, DOD reported to the Defense congressional committees that it had achieved the Milestone I requirements established by the act. DOD also reported that its efforts to implement the Fund had uncovered serious financial system deficiencies which hampered the Fund's operations.

We take exception to DOD's report. Overall, the Milestone I requirements have not been met, and DOD is behind schedule by about a year in developing the Fund's policies. Moreover, the financial system problems to which DOD refers have been known for many years. DOD's failure to correct these problems in the past is now jeopardizing the successful implementation of the Fund.

DOD's lack of progress is particularly disappointing because a properly implemented and efficiently operating Fund has much to offer in helping DOD reach its goal of greater efficiency and economy in its operations. Achieving this goal will be essential if DOD is to maintain the highest possible military readiness within the constraints of the vastly reduced budgets and force structure it now faces.

DOD needs to demonstrate measurable progress and show that it can operate Fund activities more efficiently than in the past. The Fund's success or failure will inevitably influence the outcomes of DOD's other major reform efforts under the Defense Management Reviews, including the Corporate Information Management initiative. While the Fund is only one of several major DOD initiatives, it is one of the most visible to date. The degree to which DOD's leadership successfully implements the Fund will have a direct bearing upon DOD's credibility as it pursues other reform and management initiatives. A high degree of credibility will be required to successfully complete the initiatives.

BACKGROUND

In October 1991, DOD implemented the Fund, which consolidated the nine existing industrial and stock funds operated by the military services and DOD, as well as the Defense Finance and Accounting Service (DFAS), the Defense Industrial Plant Equipment Services, the Defense Commissary Agency, the Defense Reutilization and Marketing Service, and the Defense Technical Information Service. For fiscal year 1993, DOD estimates that the Fund will have sales of

goods and services of about \$81 billion and assets valued at \$126 billion. It will employ 360,000 civilian and military personnel.

Potential Benefits of the Fund Recognized

The primary goal of the Fund is to focus the attention of all levels of management on the cost of carrying out DOD's operations and the management of those costs. We have previously testified before the Subcommittee on Readiness, House Committee on Armed Services, that the potential benefits of the Fund are enormous.<sup>1</sup> The potential benefits of the Fund--if it is well implemented and managed--include the following.

- Setting rates to recover the full costs of services and goods provided by the Fund could make DOD managers more aware of, and help reduce, those costs.
- Identifying the full costs of providing the Fund's goods and services and measuring performance on the basis of cost goals would help reduce the Fund's operating costs.
- Consolidating cash control in DOD should help reduce the amount of cash needed to operate the Fund.
- Providing better information on business operations would allow for more informed policy decisions by DOD management and the Congress as DOD adapts to the new world environment.

Achieving these benefits would mark a fundamental improvement in the manner in which DOD conducts business.

GAO Previously Identified  
Improvements Needed Within the Fund

Over the past 2 years, we have monitored the Fund's planning, implementation, and operation. In our April 1991 testimony,<sup>2</sup> we pointed out that DOD needed to (1) develop comprehensive policies and procedures to govern the Fund's operations, (2) develop accurate and reliable cost

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<sup>1</sup>Financial Management: Defense Business Operations Fund Implementation Status (GAO/T-AFMD-92-8, April 30, 1992).

<sup>2</sup>Defense's Planned Implementation of the \$77 Billion Defense Business Operations Fund (GAO/T-AFMD-91-5, April 30, 1991).

accounting systems to capture and report the full cost of operations, and (3) describe to the Congress, the Fund's managers, and the Fund's customers precisely how the Fund would operate and how it would be controlled.

In follow-up testimony<sup>3</sup> 1 year later, we suggested that DOD periodically report to the Congress on its progress in implementing the Fund. At that hearing, the DOD Comptroller agreed to identify key milestones and to report on DOD's progress in achieving those milestones. Subsequently, we discussed the key implementation tasks and milestones with DOD Comptroller officials and reached agreement on what needed to be completed by certain milestone dates.

POLICIES CRITICAL TO THE FUND'S  
OPERATIONS HAVE NOT BEEN COMPLETED

Milestone I's first requirement is to substantially complete the policies to govern the Fund's operations. Given the immense size, complexity, and scope of the Fund's \$81 billion in operations, the need for such policies is particularly acute. Unfortunately, DOD has still not completed all the policies which it agreed were needed about a year ago. DOD must adopt workable policies that are consistent with businesslike practices.

In response to the act's requirement, DOD committed to completing policies in the following areas by November 22, 1992:

- capital asset accounting,
- intrafund transactions,
- common costs,
- cash management,
- revenue recognition, and
- major real property maintenance and repair.

However, according to DOD's February 1993 report, it has only completed policies on capital asset accounting, revenue recognition, and major real property maintenance and repair. For the three uncompleted policies, as well as a policy on military personnel which DOD did not originally plan to complete by the Milestone I date, the DOD report shows completion dates of early 1993 to mid-1993. However, DOD Comptroller officials said that these dates are now

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<sup>3</sup>See footnote 1.

expected to slip at least several months. These officials do not anticipate completing all of the policies until September 1993, nearly a year after the Milestone I date.

Detailed Procedures and System  
Changes Needed to Accommodate Policies

Issuance of the policies is only the first step in putting them into effect. Subsequently, the Fund's various field activities will need detailed procedures to implement these policies. Implementing some policy changes will also require significant revisions to the accounting systems. For example, documents used to monitor the Fund's implementation at one DFAS Center show that accommodating the policies issued to date for one service would require changes to eight financial systems. Officials at the major command responsible for making the changes to seven of the systems stated that they plan to complete changes to the depot maintenance system by the end of fiscal year 1993. However, they did not have a timetable for completing changes to the supply management system. Until procedures are developed and changes are made to the systems, the benefits of the new policies, once developed, will not be realized.

The problems confronting DOD in operating the Fund in an efficient and effective manner are symptomatic of DOD's financial management environment. These are similar to the problems we identified in our financial audits<sup>4</sup> of the Air Force and the Army, which reported widespread failure of the systems to produce accurate information or to comply with established policies and procedures.

ACCOUNTING SYSTEM SELECTED PRIOR TO  
IDENTIFICATION OF SYSTEM REQUIREMENTS

Milestone I's second requirement was for DOD to determine the specific interim systems requirements for the Fund. Identifying such requirements represents a critical first step in any disciplined approach to either developing a

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<sup>4</sup>Financial Audit: Air Force Does Not Effectively Account for Billions of Dollars of Resources (GAO/AFMD-90-23, February 23, 1990); Financial Audit: Aggressive Actions Needed for Air Force to Meet Objectives of the CFO Act (GAO/AFMD-92-12, February 19, 1992); and Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82, August 7, 1992).

system or selecting an existing system for implementation. Although DOD has not determined its complete system requirements, it has selected and begun implementation of a new departmentwide accounting system, which is to include the Fund's operations. Its approach in selecting and implementing the system was not in accordance with DOD's own policy and procedures governing system selection and development.

#### Acting Comptroller Selected New Accounting System

In August 1992, the Acting DOD Comptroller selected the Defense Business Management System (DBMS)<sup>5</sup> as the primary system to support the Fund's implementation. In December 1992, he expanded the scope of this decision by designating DBMS and all of its subsystems as the DOD-wide standard business/financial management system. Originally, the system was designed and used primarily by the Defense Logistics Agency. The system was designed to provide information to managers in various functional areas such as civilian personnel, civilian payroll, manpower, cost accounting, and appropriation accounting.

In DOD's February 1993 report, the DOD Acting Comptroller stated that he selected DBMS because (1) it was the most integrated financial management system in operation at the time and (2) it allows DOD to focus its resources on improving a single system. In making the decision, he acknowledged that other more technically or functionally advanced systems were available, but they were less integrated than DBMS.

#### Selection of DBMS Was Not Made in Accordance With DOD Policy

Currently, DOD operates 82 other financial management systems for the various Fund business areas, such as depot maintenance and supply management. In selecting DBMS as DOD's financial management system, the Acting DOD Comptroller recognized that the system does not perform all of the functions found in the other systems. Therefore, he decided that until DBMS is modified to perform these functions, the other systems will continue to operate.

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<sup>5</sup>Previously, DBMS was called the Automated Payroll, Cost, and Personnel System (APCAPS).

However, DOD has yet to determine the priority of the changes that must be made to DBMS in order to assimilate functions now performed by the 82 systems or the cost and complexity of implementing these changes.

Further, DBMS was selected without evaluating the system's costs/benefits and technical risks or establishing performance measures that can be used to evaluate its implementation progress. As discussed in our September 1992 report,<sup>6</sup> each of these tasks is critical to the long-term success of any system development effort. To illustrate, DBMS runs on a proprietary system architecture, and DOD has yet to determine the costs associated with converting DBMS to an "open" architecture compatible with existing departmentwide standards. Further, DOD has yet to define how other functional areas, such as procurement, material management, and contract information, will be integrated into DBMS, even though it acknowledges that this information is necessary to manage the business areas within the Fund.

We believe it is essential that DOD follow its information management policy before proceeding further with DBMS. By following this policy, DOD may determine that there are other more appropriate alternatives than unilaterally selecting DBMS.

SKILL AND RESOURCE NEEDS  
WERE NOT ADDRESSED

Milestone I's third requirement was for DOD to prepare a report evaluating the adequacy of the skills and resources devoted to the Fund and its related systems. In our view, DOD has not conducted the type of comprehensive assessment needed to comply with the objectives of this requirement. Rather, as conveyed in its February 1993 report, DOD has asserted that by refocusing and reorganizing its existing personnel and resources, it will be able to meet the very ambitious objectives laid out for the Fund and related major initiatives. DOD did not explain or provide a basis for this assertion.

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<sup>6</sup>Defense ADP: Corporate Information Management Must Overcome Major Problems (GAO/IMTEC-92-77, September 14, 1992).

Understandably, this has been a sensitive issue. However, the facts need to be faced; namely, DOD has not been able to achieve effective financial management and control with its present mix of knowledge, expertise, and skills. With the downsizing of DOD, its personnel base will likely be significantly reduced. It is simply not logical to assume that by using fewer of the same personnel, DOD somehow will be able to successfully accomplish the fundamental changes in direction it envisions.

Instead, DOD should conduct the kind of detailed assessment that is absolutely essential for an undertaking of the Fund's magnitude, which includes

- determining what resources (funding, management and personnel expertise, and skills) are needed to accomplish the Fund's objectives;
- assessing its current situation in light of those resource requirements; and
- notifying the Congress of the difference between the personnel and resources needed and those that are currently available.

Accordingly, we believe that it is clearly essential to the Fund's ultimate success that DOD fulfill this Milestone I requirement as soon as possible.

FUND'S OPERATIONS SIGNIFICANTLY  
HAMPERED BY DOD'S PAST FAILURES TO  
REMEDY FINANCIAL DEFICIENCIES

DOD's report suggested that its current efforts to implement the Fund have only recently uncovered financial and accounting system deficiencies which are hampering the Fund's progress. The report is misleading in this respect--the kinds of problems DOD refers to have been discussed in numerous financial audit reports by us and by other organizations, as well as in our testimonies and a report focusing on the Fund's implementation. For example, our financial audits of the Air Force and the Army found the financial statements and reports of these services to be virtually unauditible due to profound deficiencies in the underlying financial systems, practices, and controls. Similarly, the Naval Audit Service declined to express an opinion on the aircraft inventory portion of the Navy Stock Fund for essentially the same reasons. This inventory represents about 35 percent of the \$23 billion in total assets of the Navy Stock Fund.

DOD has, until now, consistently taken the position that its stock and industrial fund accounting systems well served their managers' needs and would provide an adequate foundation for launching the Fund. While DOD's decision to acknowledge long-standing problems can be viewed as somewhat encouraging, that view needs to be balanced by the fact that DOD must still take fundamental and substantial actions to correct these problems.

DOD's report pointed out that (1) managers and decision-makers at all levels, including the Congress, have received inaccurate and inconsistent information and (2) these deficiencies are no longer hidden. DOD's report further acknowledged that as a result of the deficiencies, the Fund's financial reports are inaccurate. Therefore, the reports cannot be relied upon to conduct financial analysis or to manage and evaluate the Fund's operations. Based upon our analysis of the financial reports, these inaccurate reports occurred because (1) the financial systems as they are now being operated cannot produce the required data and (2) little guidance has been provided to the field activities on how to prepare the reports. DOD officials agreed with our analysis.

#### Financial Reports Cannot Be Relied Upon

Meaningful and reliable financial reports, including the Fund's budget presentations, are essential to enable the Congress to exercise its oversight responsibilities and to allow DOD management to monitor the Fund's operation and measure its performance. However, in a January 13, 1993, memorandum to all DFAS Centers, the Acting Director-DFAS acknowledged "a serious problem with the accuracy, consistency, completeness, timeliness, and usefulness of Defense Business Operations Fund financial reports."

Our brief and limited analysis of the fiscal year 1992 financial reports disclosed numerous instances in which the reports were inaccurate and, therefore, of questionable use. As discussed in our Financial Management Issues Transition Report (GAO/OGC-93-4TR, December 1992), the government has not achieved a rudimentary degree of accounting for its resources. The examples below illustrate this point with respect to the Fund.

- Significantly different amounts were reported for the Fund's fiscal year 1992 net operating results in its financial and budget reports. The net difference for all the Fund's business activities between the two reports was \$2.5 billion. However, if the individual

business areas' gains and losses are not netted against each other, the gross difference is over \$14 billion. Net operating results are a factor considered in setting the prices the Fund will charge its customers. These prices will be used as a basis for establishing the customers' fiscal year 1994 budget requests. The fact that the two sets of reports show vastly different amounts for the same item is clearly not logical; the financial reports should provide the information for the budget reports and should provide the basis for establishing prices.

- The DFAS-Denver Center and the Air Force disagree on the fiscal year 1992 net operating results for the Air Force's supply management business area. Although the Denver Center reported a loss of \$8.6 billion, an Air Force analysis disclosed a profit of \$800 million. The \$9.4 billion difference is more than the total revenue reported by this business area for the year, suggesting a financial and accounting process that is seriously deficient. The Center and the Air Force are currently attempting to resolve this difference.
- Significant differences exist between the Fund's disbursements reported by DOD and those reported by Treasury. These differences represent disbursements which DOD cannot allocate to specific business areas or military services. As of September 30, 1992, the difference between the two sets of records was approximately \$558 million. For fiscal year 1992, the monthly difference ranged from \$83 million to \$1.6 billion, with the average monthly difference being about \$900 million. Acting upon our suggestion, DOD started in October 1992 to disclose the difference on its monthly financial reports. Prior to this, the difference was not separately identified but was included in the Defense supply management business area.

Managers and personnel within the military services and DOD components informed us that the lack of guidance is one reason the Fund's financial reports are not accurate. For example, the Fund's 1992 fiscal year-end management reports did not show activity in many accounts, even though DOD officials acknowledged that results should have been reported. They specifically identified two areas where additional guidance and/or training would be beneficial: (1) accounting for funds under the revolving fund concept and (2) report preparation and analysis to improve report accuracy. Until specific guidance and procedures are developed and adhered to for preparing Fund reports, the

reliability of these reports for decision-making purposes will remain questionable. Even more important than the lack of guidance, in our view, is the lack of discipline in following procedures. Steps will be needed to introduce the discipline necessary to ensure that both existing and new policies and procedures are in fact followed. Our financial audits of the military services have shown noncompliance with established policies and procedures to be a pervasive condition.

Actions to Determine the Extent  
of Accuracy Problems in Reports

In the past 6 months, the Office of the Secretary of Defense (Comptroller) and DFAS headquarters have issued several memoranda to the military services and DFAS Centers concerning the accuracy of the Fund's financial reports. Issues raised include (1) inaccurate financial information in the reports, (2) no information on reports where financial information might be expected, (3) inconsistent financial information, (4) late reporting, and (5) little or no analysis of the reports. The memoranda are aimed at trying to help management identify the problems causing the inaccurate reports and determine potential solutions.

In responding to the January 13, 1993, DFAS memorandum discussed earlier, the individual Centers also raised concerns with the accuracy of the reports. The Centers identified a variety of causes leading to the inaccurate reports, including those listed below.

- Specific guidance and procedures are needed for preparing all Fund reports. The guidance and procedures must be agreed to by both the preparers and users of those reports.
- The accounting systems do not provide all information necessary to produce the financial reports. For example, data needed to prepare the reports are received from a variety of sources, such as logistical systems. Further, since the services and DOD agencies do not have compatible general ledgers in their accounting systems, manual intervention is sometimes necessary to transfer data from one system to another. Such intervention exacerbates problems encountered in trying to reconcile the reports and increases the likelihood of errors.
- Inadequate staffing in the field, accounting personnel turnover at the Centers, and limited experience and

education in preparing business-type financial statements have contributed to inaccurate reports.

Clearly, DOD has been overly optimistic with respect to both its assessments of current system capabilities and its capacity to make the needed changes. We believe that the efforts required to successfully implement the Fund will vastly exceed DOD's original estimates and that without a more intensive effort, there will be lengthy delays in achieving benefits.

As we pointed out in our April 1992 testimony, the Fund's success is dependent upon systems, processes, and procedures that produce credible cost information. Accurate cost data are critical for budgeting purposes since these data should form the basis for the customers' budget requests. Now that DOD has acknowledged that deficiencies exist, it must make a concerted effort to improve the Fund's overall financial management environment.

STRONGER TOP MANAGEMENT COMMITMENT  
NEEDED TO IMPLEMENT THE FUND

The slower-than-expected progress and other problems encountered by DOD in implementing the Fund suggest that management seriously underestimated the magnitude, complexity, and difficulty of the endeavor it was undertaking in initiating the Fund. Moreover, it should be recognized that the Fund's ultimate success is in part dependent upon how well two of DOD's other major management initiatives achieve the goals intended for them.

The two initiatives which directly affect the Fund are the Corporate Information Management (CIM) initiative and DFAS. DOD implemented CIM, in part, to improve business operations and data accuracy in functional areas under the Fund, such as finance and logistics.

In January 1991, DOD made a major change in departmental accounting and finance responsibilities. The overall responsibility for these functions was shifted from each military service to a new DOD organization--DFAS. DFAS is intended to provide uniform accounting policy guidance, establish requirements for financial systems, provide finance and accounting services, and prepare financial statements. These three initiatives--the Fund, CIM, and DFAS--are interrelated. The Fund's successful operation will require effective and coordinated financial systems (CIM) and accurate financial reporting (DFAS).

DOD has stated that it intends to rely on CIM, DFAS, and the Fund to help satisfy the requirements of the Chief Financial Officers Act of 1990. DOD's success in meeting the act's requirements to (1) develop reliable cost accounting systems and reports and (2) develop and report on performance measurements is closely linked to the Fund's successful implementation. Further, since the Fund is a revolving fund, it is required under the act to prepare financial statements annually and have them audited.

Clearly, DOD has a great deal at stake in the outcome of these initiatives. The Fund's disappointing progress to date is a clear indication that DOD's top management needs to take a closer personal interest in the effort and demonstrate a very visible commitment to the Fund and related initiatives. Resolving the problems discussed above and in DOD's February 1993 report will not be an easy task; solutions will be difficult and will not occur overnight.

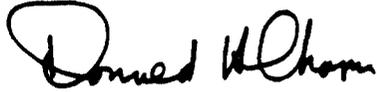
#### CONCLUSIONS

We continue to support the overall objective and concept underlying the Defense Business Operations Fund and believe it has the potential to bring about substantial cost savings. However, DOD continues to face many challenges in implementing the Fund--a truly formidable task considering that the Fund encompasses \$81 billion in revenue, \$126 billion in assets, and 360,000 employees. The potential for increased efficiencies and cost saving will be forgone should the Fund fail in implementation or should a decision be made to terminate it. For this reason, DOD needs to minimize any risk that would cause the Fund to fall short of its objectives.

Successful implementation of the Fund will require substantial and continuing commitment from DOD's top management to (1) place a high priority on financial management, including developing performance indicators, (2) enhance existing financial systems in the short term to improve the accuracy of financial data and develop and implement new systems that are capable of meeting the Fund's needs, and (3) make a realistic evaluation of management and personnel resources required to accomplish the Fund's objectives.

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We are sending copies of this letter to the Secretary of Defense and the Acting Comptroller of Defense. If you have questions regarding this letter or wish additional information, please contact David O. Nellesmann, Director, Defense Financial Systems Audits, who may be reached at (202) 512-9095.



Donald H. Chapin  
Assistant Comptroller General

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**B-249045**

**List of Commitees**

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Chairman**

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Committee on Appropriations  
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**The Honorable Sam Nunn  
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