



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

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Accounting and Information  
Management Division

B-249045

October 12, 1993

The Honorable William J. Perry  
Deputy Secretary of Defense

Dear Dr. Perry:

In April 1993, the Secretary of Defense directed a Department of Defense (DOD) wide review of the implementation and operation of the Defense Business Operations Fund. This letter provides our comments on the results of the DOD-wide review and suggestions for improving the implementation of the Fund.

The DOD-wide review endorsed the continuation of the Fund but, at the same time, confirmed the problems that we have identified with the Fund's implementation and operation.<sup>1</sup> To correct these known problems, DOD developed the Defense Business Operations Fund Improvement Plan. We have reviewed the Improvement Plan and have the following overall concerns: (1) exclusion of certain overhead support costs from the prices charged customers is contrary to the total cost concept of the Fund, (2) immediate actions are needed to correct the serious cash management problems, (3) short-term actions are needed to improve the accuracy and reliability of the financial reports, and (4) completion dates for correcting the Fund's implementation problems appear overly optimistic. In addition, although DOD has established a management approach for correcting the Fund's problems, we have concerns largely because that management structure lacks the overall authority for ensuring that the Fund's problems are corrected.

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. The benefits which can be derived from the

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<sup>1</sup>Appendix I lists the products we have issued on the Fund.

Fund will only be realized if it is implemented in a sound, logical manner.

ESTABLISHMENT OF THE  
DOD-WIDE REVIEW TEAM

Over the past 2 years, we have monitored the Fund's implementation and operation. We have reported that the

- policies critical to the Fund's operations either have not been developed or need to be revised;
- Fund's financial reports are inaccurate; and
- cost accounting systems are fragmented, costly to maintain, and do not provide the cost information necessary for managers to better control costs.

To address the Fund's problems, on April 20, 1993, the Secretary of Defense directed a detailed review of the implementation of the Fund. To accomplish this, DOD established a task force of 80 experts primarily from varying levels of DOD operations and management with financial and functional experience to review the Fund. They concentrated on eight areas: (1) organization, (2) education and training, (3) budget, (4) accounting policy, (5) centralized system development, (6) financial management systems, (7) cash management, and (8) financial reporting. The task force issued a report containing its recommendations on July 30, 1993.

A Steering Committee of top management officials in the Office of the Secretary of Defense, the Army, the Navy, the Air Force, and the Defense agencies (1) candidly discussed the problems hindering the Fund's implementation and operation and (2) identified the needed corrective actions. Based on the work of the task force and Steering Committee, on September 24, 1993, the Deputy Secretary of Defense and the secretaries of the Army, the Navy, and the Air Force approved the Fund's Improvement Plan.

DECISION TO ELIMINATE SUPPORT COSTS  
IS CONTRARY TO THE FUND'S TOTAL COST CONCEPT

The primary goal of the Fund is to focus the attention of all levels of management on the total cost of carrying out DOD's operations and the management of that cost. However, in developing the Improvement Plan, DOD decided to exclude the

Defense Finance and Accounting Service (DFAS) and the Joint Logistics Systems Center (JLSC) from the Fund starting in fiscal year 1995. This action is contrary to the total cost concept of the Fund and may decrease the incentive to reduce costs.

When the Deputy Secretary of Defense recommended the establishment of the Fund in February 1991, DOD officials believed that the Fund would foster an environment that encourages managers to reduce costs. Headquarters and field managers would oversee the cost of doing business, and DOD officials would establish goals, such as the cost per unit of output, for the individual services to meet. Further, DOD acknowledged that the Fund would enable it to accumulate the cost of services provided to the Fund's customers, including all support costs.

A basic concept underpinning the Fund's establishment was that managers who operate the Fund, and users who purchase goods and services from the Fund, would become more cost-conscious by knowing the full costs of operations, including the overhead costs. In turn, customers would be encouraged to (1) question the prices charged for goods and services received and (2) evaluate the actual need for the goods and services. Likewise, the customers' interest in reviewing the prices and their actual need for the goods and services would motivate the Fund to reduce its cost of operations, resulting in lower prices.

According to the Improvement Plan, DOD will exclude DFAS and JLSC from the Fund starting in fiscal year 1995. If this planned action is implemented, the cost of these two key support activities will not be included in the prices charged the customers. These costs are significant. According to the Fund's fiscal year 1994 budget estimate, the annual operating and capital budgets of DFAS and JLSC will be approximately \$2.3 billion and \$578 million, respectively.

DOD plans to suspend DFAS and JLSC from the Fund because these two activities did not meet all DOD's criteria for evaluating whether a business should be included into the

Fund.<sup>2</sup> With regard to DFAS, the July 30, 1993, task force report stated that DFAS met the three criteria in existence at that time. However, the Steering Committee believed it was unclear whether DFAS met the fourth criteria added by the Steering Committee. With regard to JLSC, the task force report noted and the Steering Committee agreed that JLSC did not meet most of the criteria.

We believe that DOD's interpretation of the criteria, as they relate to DFAS and JLSC, loses sight of the Fund's underlying principle of identifying and charging the total costs of providing goods and services to customers and reducing those costs. Not including DFAS and JLSC costs eliminates certain basic business costs from the Fund's operations. Such support costs include developing systems and performing accounting services that directly support Fund and other activities. Rather than eliminate these costs as factors in the prices charged the customers, DOD and the military services need to work together to find ways to lower the costs of providing these support services. Excluding these costs from the prices charged will not eliminate or lower them, but merely shift them from the Fund to other appropriation account(s). This, in turn, will relieve DFAS and JLSC of the customer pressure to reduce the costs of their services.

Since the idea of the Fund was put forth over 2 years ago, we have been convinced of the soundness of the underlying concept and principles and have been supportive of this initiative. Our testimonies have pointed out that if the Fund is properly implemented and well-managed, it can contribute to significant improvements in DOD operations. One of the benefits we pointed to was reducing operating cost by highlighting and charging the total cost of DOD's support operations. We suggest that DOD reconsider its planned action because the total cost of support operations should be identified and charged so that Fund customers and managers have incentives to reduce costs.

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<sup>2</sup>DOD established the following four criteria:

- (1) identification of outputs that relate to products or services required,
- (2) establishment of a cost accounting system to collect costs of producing outputs,
- (3) identification of customers so resources can be aligned in the account with the proper requirement, and
- (4) assessment of whether the customer can influence cost by changing demand.

DOD STILL HAS NOT RESOLVED THE  
FUND'S CASH MANAGEMENT PROBLEMS

Although we have testified and reported on many occasions that DOD needs to develop a cash management policy, DOD still has not done so. Without such a policy, DOD may continue to experience difficulty in managing the Fund's cash balance. In general, an effective cash management policy would (1) prescribe the minimum and maximum amounts of cash needed to support the Fund's operations, (2) address those functions that affect the Fund's cash balance, such as billing customers, collecting accounts receivables, and paying contractors for items procured, (3) provide for cash forecasting, and (4) hold military services and Defense agencies accountable for cash outlay targets.

Having a cash management policy is critical to the success of the Fund because of the billions of dollars involved in the Fund's collections, disbursements, and transfers each year. According to the Fund's fiscal year 1994 budget overview book dated April 1993, (1) DOD estimates that the Fund will collect and disburse about \$85.6 billion and \$83.1 billion, respectively, in fiscal year 1994 and (2) DOD plans to transfer about \$3.1 billion of cash in fiscal year 1994 to the Operation and Maintenance appropriation accounts.

DOD has recognized that the Fund's cash management practices are inadequate. DOD identified a cash shortage problem with the Fund in April 1993 and became concerned that it would not have sufficient funds to make the congressionally directed transfers totaling \$5.5 billion from the Fund primarily to the operations and maintenance accounts during fiscal year 1993. Because of the cash shortage, the Principal Deputy Comptroller of Defense, in June 1993, directed that all depot maintenance and selected research and development activities advance bill customers for the goods and services to be provided. At the end of August 1993, DOD reported that approximately \$5.7 billion had been advanced billed. In our view, advance billing is more of a stopgap measure than a normal business practice.

In addition, our analysis of the Fund's budget and accounting reports showed that DOD cash estimates have not been accurate. Specifically, the actual cash balance at the end of August 1993 resulting from normal operations was \$2.2 billion lower than the budgeted fiscal year-end 1993 cash balance. Part of the Fund's cash problem can be attributed to prices not being set to recover the full cost

incurred in providing goods and services. For example, our reports<sup>3</sup> on the Air Force and Navy depot maintenance operations noted that losses were incurred because prices were set too low to recover the full costs of operations.

The Fund's cash management problems could impede the military services' readiness. In response to our report,<sup>4</sup> the Principal Deputy Assistant Secretary of Defense for Production and Logistics noted that DOD was experiencing an inventory shortage for some items. Given the Fund's current cash crisis, DOD may not have sufficient funds to eliminate critical shortages.

According to the Fund's fiscal year 1992 financial statements, about \$79 billion of inventory is available for sale to the Fund's customers. The projected drawdown of inventory levels is anticipated to result in a cash infusion to the Fund. However, billions of dollars of DOD's inventory is in excess to its current needs. To the extent that the Fund has inventory for which there is limited current demand, the Fund will not realize an immediate cash infusion. There is a need to determine the utility of the existing inventory to meet current operational needs.

To help resolve the Fund's cash management problems, the Improvement Plan identifies the following actions to be completed by March 1994: (1) identify corrective actions for the current cash problems, (2) reevaluate the Fund's cash level requirement, and (3) establish and approve outlay plans for the Fund. Accurate cash forecasting is essential to ensure that the Fund has the appropriate level of cash needed to operate. To ensure accurate cash forecasting, the Fund activities would have to reliably estimate the amount of funds to be (1) collected from customers, including accurately setting prices to recover the full costs to the Fund, (2) disbursed in producing the goods and services, and (3) made available from the drawdown of inventory levels. Developing reliable estimates of the amount of funds to be

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<sup>3</sup>Financial Management: Navy Industrial Fund Has Not Recovered Costs (GAO/AFMD-93-18, March 23, 1993) and Air Force Depot Maintenance: Improved Pricing and Financial Management Practices Needed (GAO/AFMD-93-5, November 17, 1992).

<sup>4</sup>Defense Inventory: More Accurate Reporting Categories Are Needed (GAO/NSIAD-93-31, August 12, 1993).

collected and disbursed on a monthly basis is critical to developing an accurate cash outlay plan that can be used by DOD to manage the Fund's cash balance.

FINANCIAL REPORTS ARE  
NOT RELIABLE

Our March 1, 1993, letter to the congressional Defense committees (GAO/AFMD-93-52R) and our May and June 1993 testimonies (GAO/T-AFMD-93-4 and GAO/T-AFMD-93-6) noted that the Fund's financial reports contain billions of dollars of errors. The problems confronting the Fund in producing reliable and accurate financial information reflect similar DOD financial management reporting problems. For example, our financial audits<sup>5</sup> of the Air Force and the Army reported widespread failure of the systems to produce accurate information or to comply with established policies and procedures.

Meaningful and reliable financial reports are essential to the Congress and the Office of Management and Budget in exercising their oversight responsibilities. Likewise, DOD management needs accurate reports on the Fund's operations in order to properly analyze trends, make comparisons, evaluate the Fund's performance, formulate budget requests, and set prices to charge customers for the goods and services provided.

DOD has acknowledged that the Fund's financial reports are inaccurate and cannot be relied upon. For example, the July 30, 1993, task force report points out that the Fund's "reports are so inaccurate, untimely, incomplete, and inconsistent that the Department is unable to effectively manage the Fund." The task force report also notes that these problems are "due to the lack of standardized data elements and of systems to support DBOF requirements, policies, and procedures."

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<sup>5</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); Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82, August 7, 1992); and Financial Audit: Examination of the Army's Financial Statements for Fiscal Years 1992 and 1991 (GAO/AIMD-93-1, June 30, 1993).

The task force report and Improvement Plan identify actions aimed at improving the accuracy of the reports. These actions include the (1) overall system improvement efforts, (2) use of the DOD standard general ledger, and (3) development of the standard budget accounting classification code. However, these actions are, for the most part, long-term.

Further, DOD has cited the Corporate Information Management initiative (CIM) as the long-term solution to its system problems. CIM's objectives include (1) implementing new or improved business methods, (2) creating more uniform practices for common functions, and (3) improving the standardization, quality, and consistency of data from DOD's management information systems. CIM is intended to reduce or eliminate systems that perform the same function. While CIM initially appeared to be a promising undertaking, improvements in systems will not be implemented for years. For example, DOD has made little progress in improving the existing cost accounting systems used by the stock and industrial funds and is still determining the requirements for the Fund's cost accounting systems.

In light of DOD's long-established business practices, hundreds of existing information systems supporting these practices, and the problems DOD has encountered in developing or improving its systems, accomplishing CIM's objectives will be a long-term effort. Therefore, DOD will have to continue to rely on existing systems and reports produced from those systems for decision-making purposes. Thus, DOD needs to pursue short-term efforts to improve the quality of its financial reports. For example, the financial reports prepared during fiscal years 1992 and 1993 could have been improved if DOD had (1) followed and enforced existing accounting policies and procedures, (2) reviewed and analyzed its monthly reports to identify inaccuracies, and (3) taken the steps needed to correct the identified problems. We suggest that DOD undertake such short-term actions. Otherwise, reports on the Fund's results of operations in fiscal year 1994 may not be any more reliable than those issued for fiscal years 1992 and 1993.



SCHEDULED COMPLETION DATES IN THE  
IMPROVEMENT PLAN APPEAR OVERLY OPTIMISTIC

The Improvement Plan identifies the actions to be taken, the specific tasks to complete those actions, the office responsible for performing the tasks, and the scheduled task completion dates. Our analysis of the plan shows that DOD plans to complete 78 of the 185 tasks, or 42 percent, before December 31, 1993. However, we are concerned that DOD may not be able to meet the Improvement Plan milestones.

First, the Improvement Plan calls for the DOD Chief Financial Officer (CFO) to be responsible for the Fund's concepts, policies, and oversight. The CFO would be responsible for establishing the Fund's management structure, tracking progress against the Improvement Plan, and chairing the Fund's Corporate Board. However, as of October 8, 1993, DOD does not yet have a CFO. Until a CFO is designated, top leadership voids will continue to hamper the successful implementation of the Fund and the timely completion of the tasks for which the CFO is responsible.

Second, in the past, DOD has not been successful in completing actions related to implementing the Fund on schedule. For example, in May 1992, DOD issued the Defense Business Operations Fund Implementation Plan. This document indicated that all but one of the Fund's policies would be completed by September 1992. However, as discussed earlier, key policies such as cash management have yet to be finalized. Further, many of the schedule milestones relate to solving serious financial management problems, such as the lack of adequate systems and inaccurate financial reports, which the Fund inherited and which have existed for many years. While the Fund has served to highlight these long-standing financial management problems, correcting these problems will not be easy or occur overnight.

DOD'S MANAGEMENT APPROACH MAY NOT  
RESOLVE THE FUND'S PROBLEMS

Correcting the Fund's problems requires a well-focused, intensive, and high-level effort. To accomplish this, DOD has designated that the CFO provide Fund oversight and plans to establish a Fund Corporate Board. Through this management approach, DOD plans to ensure that the military services and Defense agencies are part of the decision-making process in resolving the Fund's problems. However, DOD's management approach does not provide an individual or an entity the

authority needed to ensure that the Fund's problems are corrected.

The task force report and the Improvement Plan acknowledge that the implementation of the Fund was impaired because the military services and the Defense agencies were not included in the decision-making process. The Improvement Plan further points out that a major recurring problem identified by the DOD-wide review was the lack of a designated focal point and clear lines of responsibility and authority within the DOD organizational structure for ensuring that the implementation of the Fund's concepts and policies were consistent with day-to-day operations. The problem was further compounded by the perception among Fund customers that the Fund's policymakers were not concerned about the problems being encountered in the implementation of the Fund.

The Improvement Plan further points out that a strong management team is needed to oversee the Fund's operation. To accomplish this, DOD plans to establish a Corporate Board. The Board will be responsible for ensuring that a collaborative process is followed in developing, reviewing, and coordinating the Fund's policies, procedures, operating and capital investment goals, rate setting, and business performance.

In addition, in July 1993, the Secretary of Defense announced the establishment of a Senior Financial Management Oversight Council to develop solutions to major DOD-wide financial problems. The Council is chaired by the Deputy Secretary of Defense and includes the service secretaries, the Vice Chairman of the Joint Chiefs of Staff, the Under Secretary of Defense for Acquisition, the Comptroller, the CFO, and the General Counsel. It is envisioned that the Council will scrutinize the Fund's policies before they are implemented. Through the committee approach, DOD hopes to ensure the military services and the DOD components "buy in" to the Fund's concepts and principles.

While DOD's approach should help provide a more cooperative environment to implement the Fund, it fails to appoint a single entity or individual that has the authority for ensuring that the Fund's implementation problems are corrected. To alleviate this situation, we suggest that DOD appoint a Fund director to be fully responsible for the day-to-day management of the Fund.

Further, because the Fund involves many functional areas, such as accounting and finance, logistics, and personnel, the Fund director should report directly to the Deputy Secretary of Defense and have the authority needed to make improvements to the Fund. For example, according to the task force report, approximately 90 percent of the financial data included in the reports originates outside the financial systems. Therefore, to correct the Fund's reporting problems requires not only changes to the financial systems, but also changes to the program systems that provide information related to areas such as inventory. However, the program systems are beyond the CFO's current oversight authority. Instituting changes needed in these systems requires someone who has the authority to direct that the needed changes be made.

#### CONCLUSIONS

While we continue to support the original concept underlying the Defense Business Operations Fund, we are concerned that the decision to exclude certain support costs is compromising the Fund's underlying principles. In correcting the Fund's operational problems, DOD should not lose sight of the Fund's original concept, which is to identify the total cost of operations, including overhead cost. By highlighting the cost implications of management decisions, DOD can take actions to reduce costs where appropriate. The Fund can make an important contribution to improving DOD's financial management and reducing DOD's overhead costs.

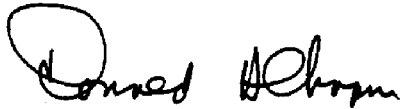
The successful implementation of the Fund also requires (1) a sound cash management policy and accurate cash forecasts, (2) accurate financial reports, and (3) the full commitment and support of the Office of the Secretary of Defense, the military services, and DOD components. Moreover, the Fund needs someone with top management authority to ensure effective and efficient implementation. Without such high-level commitment, we believe that DOD will not be able to successfully implement the Fund.

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We are sending copies of this letter to the Chairmen and Ranking Minority Members of the House and Senate Committees on Appropriations, the House and Senate Committees on Armed Services, the Senate Committee on Governmental Affairs, and the House Committee on Government Operations. We are also sending a copy to the Secretary of Defense.

We would appreciate receiving your comments on our suggested actions within 30 days of the date of this letter. If you have questions regarding this letter or wish additional information, please contact David O. Nellemann, Director, Information Resource Management/National Security and International Affairs, who may be reached at (202) 512-2666.

Sincerely yours,



Donald H. Chapin  
Assistant Comptroller General

GAO PRODUCTS RELATED TO THE  
DEFENSE BUSINESS OPERATIONS FUND

1. Defense's Planned Implementation of the \$77 Billion Defense Business Operations Fund (GAO/T-AFMD-91-5, April 30, 1991).
2. Financial Management: Defense Business Operations Fund Implementation Status (GAO/T-AFMD-92-8, April 30, 1992).
3. Financial Management: Status of the Defense Business Operations Fund (GAO/AFMD-92-79, June 15, 1992).
4. Letter to Congressional Committees (GAO/AFMD-93-52R, March 1, 1993).
5. Financial Management: Opportunities to Strengthen Management of the Defense Business Operations Fund (GAO/T-AFMD-93-4, May 13, 1993).
6. Financial Management: Opportunities to Strengthen Management of the Defense Business Operations Fund (GAO/T-AFMD-93-6, June 16, 1993).

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