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FINANCIAL  
MANAGEMENT

Opportunities to Strengthen  
Management of the Defense  
Business Operations Fund

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Mr. Chairman and Members of the Subcommittee:

We are here today to present our views on the Department of Defense's progress in implementing and operating the Defense Business Operations Fund. Last month we presented our views on Defense's management of the Fund before the Subcommittee on Readiness, House Committee on Armed Services.

In October 1991, Defense implemented the Fund, which consolidated the nine existing industrial and stock funds operated by the military services and Defense, 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. To put the size of the Fund in perspective, its fiscal year 1993 estimated sales of \$81 billion are larger than the amounts requested in the President's fiscal year 1993 budget for any federal agency, except the Departments of Defense, Health and Human Services, and Treasury. The Fund has assets reportedly valued at \$126 billion, and employs 360,000 personnel.

In our prior testimonies,<sup>1</sup> we have supported the Fund's concepts. We are convinced that the Fund can contribute to a significant improvement in Defense's operations. The short-term potential benefits of the Fund--if it is properly implemented and well managed--include (1) reducing the amount of cash needed to support Fund operations, (2) permitting better management of the investment in the Fund, and (3) reducing operating costs by highlighting the total costs of Defense's support operations. Important initiatives are under way to accumulate and report costs of various activities in the Fund's business areas. Longer term, the potential benefits of the Fund include eliminating redundant operations in the various stock and industrial funds.

However, Defense continues to have difficulties in effectively implementing and operating the Fund. Two years ago, we pointed out that Defense did not have the policies, procedures, and systems in place to operate the Fund. Today, many of the same problems still exist. Many important policies and procedures have not been developed for the Fund. Other serious problems have not been dealt with such as the accuracy of the Fund's financial and unit cost reports. Basic system problems remain, such as those affecting the Fund's cost accounting systems. We believe that delays in appointing experienced individuals to many key leadership positions have contributed to the continuing problems in implementing the Fund.

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<sup>1</sup>Defense's Planned Implementation of the \$77 Billion Defense Business Operations Fund (GAO/T-AFMD-91-5, April 30, 1991) and Financial Management: Defense Business Operations Fund Implementation Status (GAO/T-AFMD-92-8, April 30, 1992).

Further, according to the Defense Business Operations Fund fiscal year 1994 budget document, Defense plans to add the Defense Contract Management Command and the Defense Contract Audit Agency to the Fund in fiscal year 1994. The two activities will add about 24,000 personnel and generate about \$1.7 billion in revenue. Based upon the problems we have identified and those reported by Defense in its February 2, 1993, report to the Defense congressional committees, Defense should not be permitted to add any new activities to the Fund in fiscal year 1994.

We are encouraged by the Secretary of Defense's decision to review the Fund's operation. The Fund's Implementation Review Group has been tasked to review, analyze, and report on the (1) policies and procedures already promulgated for the Fund, (2) information available to business managers within the Fund, and (3) methodologies used to budget and execute the Fund's financial plan. To date, about 70 individuals have been assigned to the Review Group and they have been divided into the following eight functional 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 Review Group is to present a final report on its review of the Fund by July 30, 1993. To support the review effort, a team of financial management experts from the Army, Navy, Air Force, DFAS, and the Defense Logistics Center was established. The team is chaired by a representative of the Office of the Secretary of Defense and reports to the Office of the Secretary of Defense Financial Management Executive Steering Group.

Once the review has been completed, the Secretary will be faced with a critical decision--whether to proceed with or terminate the Fund. Terminating the Fund, however, will not resolve the serious financial management problems embedded in the Fund's component activities. Many of these problems existed before the creation of the Fund and will continue to exist even if the Fund is terminated. The Fund has served to highlight the long-standing financial management and other problems that have plagued the business operations of Defense for years. These basic problems must be solved.

If the Secretary decides to continue with the Fund, he and his deputies, along with their counterparts in the military services and Defense components, will need to be satisfied with the principles and objectives of the Fund and be fully committed to supporting the Fund. We believe they will need to develop an implementation strategy which (1) deals with personnel needs, (2) provides a focused and intensive effort, and (3) sets up an organizational framework to deal with the divided responsibilities for the Fund.

Strengthening the management of the Fund is essential to improving its implementation and operations. Top leadership voids are exacerbating Defense's problems. For the last several months, and in some cases since last summer, a number of key positions needed to provide the leadership and ongoing consensus-building necessary to implement the Fund have either been vacant or filled by individuals on an interim or "acting" basis. To help fill this void, the Secretary of Defense announced that he will select a separate CFO and Comptroller for the Department. Further, we believe that Defense needs to appoint a top-level Defense official as the director of the Fund. This individual should be fully responsible for the day-to-day management of the Fund and must have sufficient authority in order to be effective.

#### BACKGROUND

The National Defense Authorization Act for Fiscal Year 1993 established three milestone dates for implementation of the Fund. The act also requires us to report to the congressional Defense committees by February 15, 1994, on Defense's efforts to implement and operate the Fund.

The act directed Defense to complete the first phase (Milestone I) of the Fund's implementation by November 22, 1992. For Milestone I, the act required Defense to (1) substantially complete the development of the policies governing the operation of the Fund, (2) identify the Fund's interim system requirements, and (3) report on the adequacy of the skills and resources devoted to the Fund and its related systems.

For phase two (Milestone II), by March 1, 1993, Defense was required to (1) develop performance measures and corresponding goals for each of the Fund's business areas and (2) prepare a report on

- the status of the interim systems efforts,
- the status of Defense's efforts to select a standard cost accounting system, and
- specific tangible benefits resulting from Fund operations.

Further, the act provided that not later than September 30, 1993, (Milestone III) the Secretary of Defense is to conduct a field test of the standard cost accounting system selected to support the Fund. Finally, and most importantly, the act established a sunset date of April 15, 1994, by which the Congress' approval is needed if the Fund is to continue. In March 1993, we reported (GAO/AFMD-93-52R) that Defense had not fully complied with the Milestone I requirements. Our comments regarding Defense compliance with Milestone II are discussed later in our testimony.

DEFENSE'S ADMINISTRATIVE  
ENVIRONMENT IS CHANGING

In response to the President's February 1989 address to the Congress calling for improved Defense management, Defense initiated a number of comprehensive, long-term projects in July 1989 to streamline its administrative operations. Many of the changes that affect the Fund's activities began before it was created in October 1991 and would have occurred even without the Fund being implemented. Several of these changes which affect the Fund follow.

First, the Corporate Information Management (CIM) project, initiated in October 1989, represents Defense's long-term strategy to improve its systems. An objective of the CIM effort is to provide standardization, improve the quality and consistency of data in Defense's various information systems, and reduce the number of redundant systems. In December 1992, Defense reported that it was operating 83 separate systems to account for the Fund's resources. However, Defense has also reported that these systems do not produce reliable and accurate information to support the Fund. Defense officials stated that designing, developing, and implementing new systems could take years.

Second, in January 1991, Defense 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 Defense 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. DFAS develops accounting guidance for the Fund as well as produces the Fund's financial reports.

Third, Defense Management Report Decision (DMRD) 908 on consolidating depot maintenance operations and DMRD 904 on financing the purchase and repair of repairable items through the stock funds were started prior to the Fund's implementation. These initiatives affect two of the largest Fund business areas. To implement these two initiatives, Defense must issue policies and procedures and, in some cases, modify its accounting systems.

While these changes have caused some disruption in the Fund's implementation, their ultimate success will favorably affect the operation of the Fund. As for the Fund itself, Defense has made some progress in installing a unit cost and budgeting system to support the fee-for-service requirement of the Fund. But the problems with the system and other aspects of the Fund's operation still remain.

AN EFFECTIVE FUND COULD SIGNIFICANTLY  
IMPROVE DEFENSE'S OPERATIONS

There are several potential benefits to a well-operated and managed Fund. First, it would provide more relevant information for budgeting and oversight. In implementing the Fund, Defense issued operating and capital budgets for each business area beginning in fiscal year 1992. The operating budgets provide the total cost authority required to support a Fund activity's operations, based on the actual work to be performed. The capital budgets reflect the Fund's obligational authority for the acquisition of capital assets. Each military service and Defense activity is expected to allocate the annual cost authority to the activities within a business area. For example, the Naval Air Systems Command is responsible for allocating the budget to each aviation depot. The individual activities are to (1) compare the actual results of operation to the estimated cost and determine the reasons for the variances and (2) develop means for reducing the cost for performing various functions such as issuing and receiving inventory items.

Second, two of the Fund's objectives are to establish transfer prices based on full costs and to identify the activities that cause or drive the level of cost. Knowing the full costs of operations should make managers who operate the Fund and users who purchase goods and services from the Fund more cost-conscious. Identifying the full costs of the goods and services produced should facilitate the benchmarking and process reengineering necessary to reduce the costs of operations. For example, the financing of repairable inventory items through the stock fund should help reduce the demand for repairable items because customers would have to pay for the items instead of receiving them free. Thus, they would be encouraged to repair items rather than simply replacing them with new ones.

Third, by consolidating cash balances of the old stock and industrial funds, Defense can reduce the amount of cash needed to support the Fund's operations by several billion dollars. Since the cash control has been consolidated in Defense, the cash balance has been reduced from approximately \$6.6 billion in October 1991 to \$1.7 billion at the end of April 1993.

Fourth, a Fund that is operated with sound policies and systems and reports accurate costs can provide better financial information for Defense-wide management. Without accurate and timely information, operating problems will continue to go unidentified, making corrective management action difficult, if not impossible. Cost comparisons need to be made and cost variations need to be known. Accurate profit and loss information needs to be available.

Finally, a full-scale effort to make the Fund successful could prove to be the catalyst needed for effective action to correct Defense's long-standing financial and information management problems. The Fund, the DFAS organization, the CIM process, and the logistics operations of the services, among others, are all connected and their success is mutually dependent. Successfully dealing with the Fund's problems will require a coordinated effort in those other areas as well. It is possible that focusing management attention on the Fund could bring collateral cost savings and benefits to other areas of Defense's operations.

DEFENSE'S FINANCIAL MANAGEMENT  
WEAKNESSES ARE LONG-STANDING

In its February 2, 1993, Milestone I letter to the congressional Defense committees, Defense acknowledged that the Fund's systems were inadequate. The fundamental problems have been discussed in numerous audit reports by us and by other organizations, as well as in our testimonies and a June 1992 report focusing on the Fund's implementation. Most recently, our April 27, 1993, letter to the Secretary of Defense (GAO/AFMD-93-61R) took exception to Defense's fiscal year 1992 Federal Managers' Financial Integrity Act report and pointed out Defense's pervasive system and control problems.

Attachment I provides examples of Defense's financial management weaknesses. We have provided these examples since many of the activities with inadequate financial management systems are part of the Fund. With that in mind, I would like to discuss Defense's progress and problems over the last year in managing and operating the Fund.

FUND'S CASH MANAGEMENT  
PRACTICES NEED IMPROVEMENT

In establishing the Fund, Defense stated that consolidating cash control should permit the reduction of the total amount of cash needed to support the Fund. While the cash balance has been reduced, Defense has not developed a comprehensive cash management policy for the Fund. This policy should (1) prescribe the minimum and maximum amounts of cash needed to support the Fund's operations, (2) provide for cash forecasting so that Defense and the Congress can carry out more precise fiscal planning by considering such things as the Fund's cash balance increasing as the Fund's total investment in inventory is reduced, and (3) address those functions that affect the Fund's cash balance, such as billing customers, collecting accounts receivable, and paying contractors for items procured. To make a cash management policy effective, some basic problems must be addressed, such as the Fund not billing customers for services in a timely manner and not charging customers the correct price for inventory items.



Fund's Cash Management Policy  
Is Partially Developed

In February 1993, Defense established a goal of maintaining a working capital level of 5 days of cash--about \$1 billion. Managing at this level of cash will not be an easy task. Since the beginning of fiscal year 1993, Defense has reported that the Fund's cash balance has declined from \$4.1 billion to \$1.7 billion at the end of April 1993. The April 1993 balance is significantly lower than the Fund's fiscal year 1992 cash balance, which ranged from \$3.8 billion to \$7.8 billion.

Accurate cash forecasting is critical to ensure that the Fund has the appropriate level of cash needed to operate. In finalizing its policy, Defense needs to specify the actions it will take if the balance goes below the \$1 billion needed to operate the Fund. Defense must also ensure that the Fund's cash balance remains positive. If the cash balance becomes negative, Defense would be in violation of the Antideficiency Act (31 U.S.C. 1341). Defense also needs to consider, with the appropriate congressional committees, how to use excess funds, both temporary amounts and those which should be generated as the investment in inventory comes down over the long term. Developing a cash management policy is an important step in establishing the discipline needed to manage the Fund and its business activities and to properly control the flow of funds.

To improve cash management of the Fund, the National Defense Authorization Act for Fiscal Year 1993 authorized the Fund to award contracts for capital assets before it has cash available to cover the obligations, to the extent provided in the appropriations acts. This concept was not new to Defense since, for many years, stock funds have operated under contract authority to maintain stock levels. A Defense budget official stated that if the Fund had used the contract authority for capital projects, the Fund would need \$1.3 billion, which is \$400 million less than the projected cash balance at the end of fiscal year 1994 to cover the disbursements for capital projects to be made early in fiscal year 1995.

The National Defense Appropriations Act for Fiscal Year 1993 also directed Defense to transfer \$5.5 billion from the Fund to the military services and Defense agencies. Through April 1993, Defense reported that it had transferred about \$2.2 billion to the military services. Defense also informed us that it transferred an additional \$900 million in May 1993. As noted previously, at the end of April 1993, the Fund's cash balance was only \$1.7 billion. Our analysis of Defense April reports show that about \$829 million should be reserved to pay outstanding obligations for purchases of capital assets. It is not known when the cash balance will increase; and, therefore, Defense may not have sufficient funds available to transfer the remaining

\$2.4 billion in this fiscal year. This shortfall could diminish the readiness of the services. The Acting Secretary of the Navy made this point in a February 1993 memorandum to the Secretary of Defense.

Fund Activities Are Not Billing  
for Services Promptly

Billings to customers for services provided by the Fund activities have not been timely. Major private sector organizations with similar operations bill their customers promptly for the services provided. The "old" industrial and stock funds were required to bill customers on a monthly basis. The Fund's billing process should be no exception because billings provide the Fund with the working capital that it needs to continue its operations. Specific examples of weaknesses in the Fund's billing process follow.

During the first 3 months of fiscal year 1993 (October through December 1992), DFAS incurred costs totaling \$156 million, but billed and was reimbursed only \$3 million for the services provided. DFAS officials stated that DFAS customers were not billed for all the costs incurred because DFAS had not reached agreement with the military services and Defense agencies on the amount to charge for the services to be provided. According to DFAS, a formal contractual agreement is needed before it can bill its customers. Defense is currently working to resolve this issue and, as of March 1993, DFAS had billed about \$129 million of the \$248 million of services provided between October 1992 and January 1993.

Further, during fiscal year 1992, the Air Force Supply Management business area did not promptly bill its customers for repairable inventory items. Although this business area was to begin charging customers for repairable items in April 1992, it did not bill customers for inventory items issued to them until July 1992. At that time, they billed the customers \$308 million. An Air Force Material Command official informed us that they did not bill the customers because they had not received sufficient guidance from Air Force headquarters.

Army Supply Management  
Is Undercharging Customers

As part of our Army financial statement audit, we identified 11,019 inventory items with understated prices for fiscal year 1992. Based on the average demand for these items, the lost revenue to the Fund from understated prices is estimated at \$227 million in fiscal year 1992. In addition, we identified 6,054 items with understated prices for fiscal year 1993, which, if left uncorrected, would result in an estimated loss of

\$111 million. Undercharging customers for inventory items has an adverse effect on the Fund's cash balance, as well as a detrimental effect on cost control.

These understated prices and resulting losses occurred because the Army failed to follow its own regulation, as well as Defense guidance, in determining the inventory prices to charge customers. The inventory prices should be based on the latest representative acquisition cost plus appropriate surcharges. However, we found that the Army (1) calculated the standard price of inventory items using the weighted average of representative acquisition costs over the last 2 years, (2) inappropriately factored in maintenance and overhaul costs in the standard price, and (3) made input errors to its system, which resulted in representative procurements being excluded from the price calculation.

For example, using the weighted average method, the Army calculated an inventory price of \$258,999 for the transmission used on the Black Hawk helicopter. However, if the Army had followed its own and Defense pricing guidance, it would have charged the customers \$276,159 for each item. By not following the appropriate pricing guidance, the Fund is undercharging \$17,160 for this item.

#### FUND'S FINANCIAL REPORTS ARE INACCURATE

As discussed in our March 1, 1993, letter to the congressional Defense committees (GAO/AFMD-93-52R), the Fund's financial reports contain billions of dollars of errors. The reports do not accurately reflect the Fund's financial condition or provide reliable information to management. Based on our analysis, these inaccurate financial reports occurred because (1) the financial systems, as they are now being operated, cannot produce the required data, (2) little guidance has been provided to the field activities on how to prepare the reports, (3) personnel were not analyzing the data in the financial reports, and (4) confusion existed as to which Defense organization was responsible for the accuracy of the data in the reports. The lack of adherence to existing policies and procedures for data handling, review, and verification continues to be a major problem. Absent this basic discipline, continuing problems will exist with the reports and undermine Defense's ability to manage and evaluate the Fund's operations and to maintain oversight of taxpayer funds.

Accurate and reliable financial reports are necessary in order to properly analyze trends, make comparisons, evaluate the Fund's performance, and formulate budget requests. However, the Army, the Air Force, and the Defense Commissary Agency issued erroneous fiscal year 1992 year-end monthly reports which had to be revised

several months after the end of the fiscal year. In the Air Force's case, DFAS-Denver originally reported a loss of \$8.6 billion for the supply management business area. However, after DFAS-Denver and the Air Force analyzed the report, DFAS-Denver revised the report to show a profit of \$1.1 billion. The \$9.7 billion difference is more than the total revenue reported by the business area for fiscal year 1992.

Defense has initiated efforts to improve the accuracy and reliability of the Fund's financial reports. Defense formed a task force to review the Fund's reporting requirements. The task force consists of representatives of various offices within the Office of the Secretary of Defense (Comptroller) and DFAS. Only through the use of a common accounting approach can Defense assure that the Fund's various business areas are reporting in a consistent manner. Attachment II provides additional details on the inaccurate reports and Defense's efforts to correct the problem.

#### UNIT COST ACCOUNTING REPORTING IS NOT RELIABLE

Reliable cost information is critical for managing costs. Beginning in fiscal year 1992, Defense began issuing activity based unit cost budgets to the Fund's business areas. While the reports represent an important step in raising cost visibility, they are not yet reliable enough to achieve their intended objective. It is critical that these problems be overcome quickly because unit cost budgets will enable managers to seek ways to become more efficient and effective by reducing the costs of operations. In addition to providing a means to consider cost as part of day-to-day decision-making, unit cost provides visibility of cost drivers. Cost drivers are those actions that contribute to the accomplishment of an output or a product at a significant cost and should be evaluated for value added.

However, we found that many of the Fund's activity managers are not using the unit cost reports in assessing their operations. Seven of the 12 activities we visited were not receiving the reports because responsibility for controlling and managing the costs remained at a higher management level. Furthermore, at the five activities receiving the reports, managers often did not use them because (1) the accuracy of the reports was questionable or (2) the reports did not contain sufficient detail to satisfy their day-to-day management needs. For example, at one activity, officials told us that the unit cost reports have been inaccurate since July 1992 because the systems used to accumulate the cost information by each performing activity were not updated to reflect organization changes made since June 1992. At another activity, officials told us that the cost reports could not be used because they were inaccurate.

FUND ACCOUNTING SYSTEM SELECTED  
PRIOR TO IDENTIFICATION OF REQUIREMENTS

In August 1992, the Acting Department of Defense Comptroller selected the Defense Business Management System (DBMS)<sup>2</sup> as the primary system to support the Fund's implementation. In December 1992, he expanded the scope of this decision by designating DBMS as the Defense-wide standard financial management system.

As discussed in our March 1, 1993, letter to the congressional Defense committees, DBMS was selected without evaluating the system's costs/benefits and technical risks or defining all of the features needed. It is essential that Defense follow its information management policy before proceeding further with DBMS. We are concerned that Defense plans to spend about \$40 million in fiscal year 1993 to modify the system, even though the Fund's functional requirements have not been finalized. On March 31, 1993, the military services' Assistant Secretary for Financial Management expressed concern about the selection of this system in a joint memorandum to the Comptroller of Defense.

Further, the cost accounting systems used by the industrial and stock funds need to be reevaluated to gain the full range of benefits available through an integrated standard cost system using replacement costs. Replacement cost is fully consistent with the revolving fund concept. A standard replacement cost system provides a number of significant benefits such as (1) assisting managers in formulating their budget requests for inventory purchases, (2) establishing cost for determining realistic transfer prices, (3) identifying cost variances, when and where they occur, to evaluate performance, and (4) developing a more streamlined, integrated approach to cost accounting.

Defense objects to using a standard cost system based on replacement cost and instead prefers to continue the current policy of using the latest acquisition cost. Defense's current practice may be acceptable as an interim step, but not as a long-term solution.

Current cost accounting systems are fragmented, costly to maintain, and not effectively utilized by management. In addition, we have previously recommended that the data in the existing systems be cleaned up, and existing policies and procedures be followed. Since this has yet to occur, the existing systems cannot be depended upon to establish accurate prices to charge customers, nor provide cost information to

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<sup>2</sup>Previously, DBMS was called the Automated Payroll, Cost, and Personnel System (APCAPS).

managers and customers to better control costs. These problems have existed for years and are by no means the consequences of implementing the Fund. Cleaning up the data in the existing systems should be a priority which is not neglected. A new system will not fix the problems. No new system, by itself, will ensure good information unless there is adherence to fundamental discipline in the processing of the data.

It is essential to develop the functional requirements for a standard cost accounting system and go through proper systems planning and evaluation before proceeding with the implementation of a new system for the Fund. It is also critical that the existing systems, which are to be replaced by a new system, be brought under reasonable control and that proper discipline be established. As discussed in further detail in attachment III, we believe the selection of DBMS needs to be revisited.

#### BASIC GOVERNING POLICIES FOR THE FUND NEED TO BE DEVELOPED AND IMPLEMENTED

Two years after Defense first presented the idea of the Fund to the Congress, several key policies still need to be developed and some of the policies already issued are inappropriate. Defense Comptroller officials stated that the Fund's policies related to intrafund transactions, common cost, and military personnel will not be finalized until September 1993. We believe that four of the policies Defense has already finalized are inappropriate, two of which will improperly increase the prices customers will be charged in fiscal year 1994.

As discussed in last year's testimony, Defense should not be permitted to increase prices charged customers to recover (1) prior year losses and (2) depreciation expense of facilities that are separately financed by military construction appropriations. Further, the Fund's major real property maintenance and repair projects policy is inappropriate because it is based on averaging rather than actual expenses. This results in actual expenses not being recorded in the period in which they are incurred. The Fund's capital asset policy is also inappropriate because it provides for the capitalization and amortization of intangibles such as training and management initiatives. Many of these costs are recurring costs, and the future periods for which benefits would be received are uncertain.

The development and issuance of appropriate policies is only a first step. Once a policy is issued, Fund managers need to (1) develop detailed procedures for the various field activities to implement the policies and (2) determine if modifications need to be made to the existing accounting systems. These essential steps to provide for consistent implementation have not been taken. To correct the problem, Defense must develop a new plan

and related timetable for completing the policies as well as the detailed procedures and system modifications. Further discussion of the policies are presented in attachment IV.

TANGIBLE BENEFITS OF THE FUND  
NEED TO BE DEMONSTRATED

The Milestone II reporting requirements called for in the National Defense Authorization Act for Fiscal Year 1993 directed Defense to (1) develop performance measures and corresponding goals for each of the Fund's business areas and (2) prepare a report on

- the status of the interim systems efforts,
- the status of Defense's efforts to select a standard cost accounting system, and
- specific tangible benefits resulting from Fund operations.

While Defense provided a statement on performance measures, information on the status of the interim system efforts and planning for the development and implementation of a standard cost accounting system were limited. The Milestone II requirements also required Defense to identify specific tangible benefits from the operations of the Fund, including any reduction in the costs of providing goods and services and improvements in the efficiency of Fund operations. In its Milestone II report, the only benefits Defense reported were the development and issuance of some of the Fund's policies. Defense did not identify how the Fund resulted in improved operations or reduced costs.

In March 1991, before the Fund was established, Defense estimated that the Fund would result in a \$500 million savings in fiscal year 1993. However, according to Defense documents on the Defense Management Review initiatives, the Fund initiative has not resulted in any documented savings. If properly implemented, the Fund has the potential to reduce the costs of Defense's operations by identifying the total cost of providing goods and services to the customers and management taking actions to reduce those costs.

STRONG MANAGEMENT TEAM NEEDED  
TO IMPLEMENT THE FUND

The slower-than-expected progress and other problems to date have occurred primarily because (1) management positions that are needed to support successful Fund implementation have been vacant or are filled by "acting" managers, (2) key management personnel have underestimated the magnitude, complexity, and difficulty of implementing and operating the Fund, and (3) severe systems,

controls, and other financial and information management problems throughout Defense have not been addressed.

Key Executives Need  
to Be Appointed

Top leadership voids are exacerbating Defense problems. For the last several months and, in some cases, since last summer, a number of key positions needed to provide the leadership and ongoing consensus-building necessary to implement the Fund have either been vacant or filled by individuals on an interim or "acting" basis. These positions include the Comptroller of Defense, the secretaries of the military services, and the Army and Navy Assistant Secretaries for Financial Management. Further, we believe that Defense needs to appoint a top-level Defense official as the director of the Fund. This individual should be fully responsible for day-to-day management of the Fund and have sufficient authority in order to be effective. Once top management is appointed, the adequacy of the staffing for the Fund will need to be reassessed. Top management will need to identify staff with talent, experience, and a desire to deal with and correct the severe problems inhibiting successful Fund implementation.

In selecting individuals for top financial management positions, the criteria set forth in the CFO Act should be considered. The act requires that a CFO "possess demonstrated ability in general management of, and knowledge of and extensive practical experience in financial management practices in large governmental or business entities." Deputy CFOs should possess "demonstrated ability and experience in accounting, budget execution, financial and management analysis, and systems development, and not less than 6 years practical experience in financial management at large governmental entities." In the past, almost total emphasis was placed on individuals having a budgetary background. Although budgetary knowledge is important and should be well represented in the group of top people responsible for financial operations, financial and information management expertise is perhaps even more important.

Information resource management is integral to the success of the Fund; therefore, it is critical that the CIM initiative also be successful. If Defense does not give priority to selecting appropriate information resource managers, as well as financial management and Fund personnel, then the Fund will continue to experience the problems Defense acknowledged in its February 2, 1993, and March 1, 1993, letters to the congressional Defense committees.



### Steering Committee Could Provide Overall Guidance and Support

The successful implementation of the Fund requires the full commitment and support of the Office of the Secretary of Defense, the military services, and Defense components. One way to facilitate this support would be to establish a Defense Business Operations Fund Steering Committee under the direction of the Deputy Secretary of Defense. The Committee should comprise top-level managers such as the secretaries of the military services and the Fund Director. The Secretary of Defense may wish to broaden the Steering Committee's scope of oversight responsibility to other areas, such as logistics and acquisition, once the basic Fund management organization is established and functioning.

This Steering Committee could serve as the overall Fund program sponsor and ensure that it is supported by the military services. The Steering Committee should direct its attention to (1) evaluating the Fund's objectives and identifying any changes that are required, (2) developing an implementation strategy, (3) ensuring adequate leadership resources are assigned to guide the Fund's implementation, (4) overseeing the development of a realistic implementation plan, and (5) resolving problems involving the development or implementation of policies, procedures, and systems needed to support the Fund.

### Steering Committee Could Be Supported by Task Forces

The Steering Committee could be supported by a project manager who directs a number of task forces covering the various implementation requirements. The project manager should report to the Fund's director for day-to-day supervision. Monthly, the project manager would present to the Steering Committee the progress and problems encountered in the implementation and operation of the Fund.

The task forces should consist of military service and Defense component staff who are knowledgeable, skilled, and experienced in financial and information management. Since Defense has operated revolving funds for many years, it should draw from staff experienced with the operation of those funds. Some outside consultants are likely to be needed temporarily to complement existing personnel.

In our view, some of the more important tasks that need to be undertaken include

- developing the Fund's policies and procedures and providing implementation guidance and direction to ensure that the policies and procedures are in place;

- directing efforts to improve the accuracy of the data in the Fund's existing financial systems and the Fund's financial reports;
- evaluating the recently announced performance measures and performance targets for the Fund;
- reevaluating the selection of the Defense Business Management System as the standard system for the Fund;
- identifying critical personnel and consulting needs and taking steps to satisfy those needs;
- resolving coordination problems between the major components-- the Office of the Secretary of Defense, the Defense Finance and Accounting Service, and the military services; and
- providing training for both Fund operating personnel and Fund users.

Attachment V illustrates the responsibilities of the project manager and a logical grouping of task force implementation activities.

It is time to proceed with a well focused, intensive, and high-level effort to implement the Fund. To succeed, this effort must become a top priority for senior Defense officials. Unless the right executive leadership is put in place at the top and is backed up by personnel with the requisite knowledge, skills, and systems experience, Defense will be unable to effectively implement the Fund.

### CONCLUSIONS

We continue to support the concept underlying the Defense Business Operations Fund. We believe that the Fund represents a comprehensive management tool for the services and components to plan and control their operations. The Fund could make an important contribution to reducing Defense's costs. For this reason, Defense needs to minimize risks that might cause the Fund to fall short of its objectives.

However, Defense underestimated the tasks of implementing the Fund, in both scope and complexity. As a result, organizational resources have been spread much too thin to handle the planning and development of the policies and procedures, to identify functional requirements, and to provide needed direction.

We are encouraged by the Secretary's decision to undertake the review of the Fund and raise this issue to a top priority of Defense management. This review should be comprehensive. In our judgment, if Defense decides to proceed with the Fund, early on

it needs to identify, organize, and assign the management personnel and staffing required to successfully implement the Fund. Unless the right executive leadership and process is put into place at the top, the Fund's financial management operations will continue to be inadequate.

Simply put, Defense must demonstrate both its commitment and ability to implement the Fund and it should not be permitted to add any new activities or functions to the Fund until it does so. In our view, Defense, at a minimum, should have an organizational structure in place along the lines previously discussed and should tangibly demonstrate its commitment to the Fund before the Congress considers any requests to extend the April 1994 sunset date. Given our understanding of the legislative calendar, if Defense decides to proceed with the Fund, the management structure and a plan for operating the Fund should be in place by September 1993.

We will continue to monitor the Fund's implementation. We plan to report to the Congress by February 15, 1994, as required by the National Defense Authorization Act for Fiscal Year 1993, on the overall status of the Fund and its viability.

Mr. Chairman, this concludes my statement. I will be pleased to answer any questions you or other Members of the Subcommittee may have at this time.

DEFENSE'S FINANCIAL MANAGEMENT  
WEAKNESSES ARE PERVASIVE

Defense does not accurately account for the hundreds of billions of dollars of resources it is entrusted with. Defense's February 2, 1993, Milestone I report, required by the National Defense Authorization Act for Fiscal Year 1993, suggests that its current efforts to implement the Fund have only recently uncovered financial and accounting system problems which are hindering the Fund's progress. However, the lack of adequate financial management systems and internal controls are long-standing problems that have not been resolved. We have been pointing out these problems for years. Only in the case of the Army have we seen a concerted and organized effort started to correct them. To illustrate the comprehensiveness and serious nature of the problems, we offer these illustrations.

First, our financial audits of the Air Force and Army disclosed that the information provided by their financial systems cannot be relied upon to conduct financial analysis and to manage and evaluate operations.<sup>3</sup> Specifically, we found billions of dollars of errors in Air Force's accounting records and in its annual Treasury reports. After we informed Air Force of the magnitude of the errors in these reports, officials recalled the reports, made approximately \$62 billion of corrections, and submitted the revised reports to the Department of the Treasury.

Our financial audit of the Army found that because DFAS could not rely on data provided by Army accounting activities, it initiated and processed about \$250 billion in adjustments to the data before preparing the Army's fiscal year 1991 financial statements. These adjustments were generally made without adequate documentation or supervisory review. In addition, our review also disclosed serious weaknesses in the internal controls over inventories valued at \$17 billion. These weaknesses have contributed to the inefficient use of material and potential for undetected losses and theft. As a result of these and other uncertainties regarding account balances, we were unable to

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<sup>3</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, 1990); and Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82, August 7, 1992).

express an overall opinion on the Army's fiscal year 1991 financial statements<sup>4</sup> and cautioned users that these statements have limited reliability.

Second, we found that because of years of neglect, inadequate systems, and poor management, Defense could not properly implement provisions of the "M" account legislation (Public Law 101-510).<sup>5</sup> The legislation required Defense to conduct a one-time audit of its "M" account balances by December 31, 1991, to (1) establish the amounts supported by valid obligations and (2) identify and cancel amounts found to be invalid. However, because of the large amount of funds and Defense's poor controls over these funds, the Defense Inspector General (IG), who was tasked to complete the audit, only reviewed a sample of \$5.2 billion (or 27 percent) of Defense's \$18.8 billion recorded "M" account balances. Of the balances reviewed, only \$2.9 billion were supported by valid obligations. In projecting the results of the sample, the IG estimated that invalid obligations could total as much as \$10.2 billion (or over 54 percent) of the total \$18.8 billion of "M" account balances. The IG concluded that Defense's "M" account balances were materially misstated, inadequately managed, and vulnerable to abuse.

We also found that Defense's implementation of Public Law 101-510 resulted in Defense having more budget authority than the Congress intended when it passed the act. For example, because its accounting records were so poor, the Air Force did not discover a \$649 million difference between its control accounts and supporting records until it started to review its account balances. According to Air Force Comptroller officials, this difference was the cumulative result of over 30 years of accounting errors. Although the Air Force could not provide adequate documentation to show that it needed the additional \$649 million, the Defense Deputy Comptroller permitted the Air Force to restore the funds--budget authority both we and the Defense IG said was not justified.

Third, our High-Risk report on Defense inventory management (GAO/HR-93-12, December 1992) pointed out that for decades

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<sup>4</sup>Financial Audit: Examination of the Army's Financial Statements for Fiscal Year 1991 (GAO/AFMD-92-83, August 7, 1992).

<sup>5</sup>Financial Management: Agencies' Actions to Eliminate "M" Accounts and Merged Surplus Authority (GAO/AFMD-93-7, April 2, 1993).

Defense has not effectively managed its inventory, valued at about \$100 billion in fiscal year 1991. Most of the inventory is now owned by the Defense Business Operations Fund. According to its own estimates, Defense is maintaining unrequired inventory valued at over \$40 billion.

We also reported in August 1992<sup>6</sup> that the Air Force's key financial management systems did not generate reliable inventory balances needed to make sound budget estimates and purchase decisions for repairable inventory items. The Air Force maintains duplicate automated and manual worldwide inventory records that are inaccurate and unreliable. Discrepancies between the two sets of records occurred because (1) the Air Force automated systems lacked adequate internal controls over the transmission of inventory data from bases, depots, and contractors and (2) item managers made errors and unsupported adjustments in the manual records. The item managers could not explain \$182 million in differences between the automated and manual records. Because of these errors and adjustments, the budget estimate for repairable inventory items lacked credibility and purchase decisions were made using unreliable data.

Finally, our reports<sup>7</sup> on the Air Force and Navy industrial funds identified serious financial management weaknesses. Over the last several years, the Air Force and Navy depot maintenance industrial funds incurred losses totalling \$250 million and \$794 million, respectively, because they did not recover the cost incurred in providing goods and services to customers. These losses clearly suggest that the Air Force and Navy industrial funds have not achieved the objectives Defense intended when they were established. These losses should have served as an indicator to management that the industrial funds were not operating as intended and corrective actions were needed. Since the Air Force and Navy industrial funds are now part of the Defense Business Operations Fund, continued losses of this magnitude could impair the Fund's financial integrity.

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<sup>6</sup>Financial Management: Internal Control Weaknesses Impede Air Force's Budgeting for Repairable Items (GAO/AFMD-92-47, August 26, 1992).

<sup>7</sup>Air Force Depot Maintenance: Improved Pricing and Financial Management Practices Needed (GAO/AFMD-93-5, November 17, 1992) and Financial Management: Navy Industrial Fund Has Not Recovered Costs (GAO/AFMD-93-18, March 23, 1993).

ACCURATE AND RELIABLE REPORTS ARE ESSENTIAL

Meaningful and reliable financial reports, including the Fund's budget presentations, are essential to the Congress' exercising oversight responsibilities and allowing Defense management to monitor the Fund's operations. Our analysis of the fiscal year 1992 financial reports disclosed numerous instances in which the reports were inaccurate and therefore of questionable value. To its credit, Defense is acting upon the information we provided to improve the accuracy of the data reported on the Fund's operations.

FUND'S FISCAL YEAR 1992 REPORTS  
ARE OF QUESTIONABLE VALUE

The Fund's financial management systems cannot provide complete and reliable financial data nor can they be depended upon to report accurately on the resources entrusted to its managers. These conditions adversely affect financial reporting and management at all levels. Financial information requires constant analysis to ensure its validity. However, in many instances, Defense has allowed obvious erroneous data to remain in the accounting records, and these data are ultimately included in the Fund's financial reports.

Fund's Financial Reports Contain  
Billions of Dollars of Errors

In January 1993, we informed DFAS Headquarters and the Office of the Secretary of Defense-Comptroller officials that our analysis of the 1992 fiscal year-end financial reports disclosed numerous instances in which the reports were inaccurate and, therefore, of questionable value. Using the information we provided, the Acting Director-DFAS, in a January 13, 1993, memorandum to all DFAS Centers stated, "We have a serious problem with accuracy, consistency, completeness, timeliness, and usefulness of Defense Business Operations Fund financial reports." Also, in February 1993, the Deputy Comptroller (Program/Budget) requested that the military services and Defense agencies identify errors in the 1992 fiscal year-end reports and reflect validated corrections in the fiscal year 1992 financial statements. In response to the request, the military services and Defense agencies identified numerous errors with the year-end reports. Examples include the following.

- The Defense Logistics Agency (DLA) Comptroller did not have an opportunity to review the year-end reports prior to their being finalized by DFAS. The Comptroller stated that adjustments made by DFAS, without DLA's knowledge, created differences between the summary data and detailed data. Our analysis supports the Comptroller's view. For example, DFAS was directed by Defense officials to increase reported collections on the September 1992 Report on Budget Execution for DLA's supply management business area by \$799 million. This adjustment was made to compensate for the reductions Defense officials made to the Air Force's reported collections for its supply management business area. Since the Report on Budget Execution had already been submitted to the Office of Management and Budget and Defense could not change the overall totals on the report, the above adjustment was made. The adjustment was made without supporting documentation.
- Because the Air Force's 1992 fiscal year-end report on supply management operations contained invalid data, the report was significantly revised by DFAS-Denver in February 1993-- 5 months after the end of the fiscal year. The original report showed that the Air Force supply management operations had a loss of \$8.6 billion. However, the revised report showed that the Air Force had a profit of \$1.1 billion--a difference of \$9.7 billion. This difference is more than the total revenue reported by this business area for the fiscal year.
- The Army's 1992 fiscal year-end report on operations of the Fund's business areas was inaccurate. For the depot maintenance business area, the Army acknowledged that surcharges were distributed incorrectly, depreciation was erroneously recorded as funded rather than unfunded, and funds were not placed in an account established for the capital surcharge. The original year-end report on operations for all of the Army's business areas showed a net operating profit of \$1.2 billion. However, a revised year-end report dated March 1, 1993, showed a net operating profit of \$57 million--a difference of over \$1.1 billion.

Defense Has Initiated Actions to  
Improve Accuracy of Fund's Reports

Defense has taken action to improve the accuracy of the Fund's financial reports. For example, starting in fiscal year 1993, DFAS headquarters began analyzing the Fund's monthly reports. In addition, on March 12, 1993, the Acting Director of DFAS provided guidance to all DFAS Centers on preparing the Fund's reports. The Acting Director's memorandum stated that reconciliations must



be conducted each month for each business area and descriptive footnotes should highlight and explain each unusual circumstance. The memorandum further pointed out that "the reconciliation is not limited to merely verifying the numerical accuracy of the reports, but must present a professional analysis."

Further, Defense formed a task force to review the Fund's reporting requirements. The task force consists of representatives of various offices within the Office of the Secretary of Defense (Comptroller) and DFAS. Their objectives are to (1) eliminate useless reports, (2) eliminate redundant data on the reports, and (3) make the reports more businesslike. For example, the proposed Monthly Report on Operations would provide more detailed information on the results of operations, which would more closely resemble the information presented in the Fund's Overview Book, which contains budgetary information. Further, obligations and disbursements for capital assets will now be tracked by fiscal year. This will enable Defense and the Congress to track the execution of the capital asset program to the fiscal year in which Defense received authorization and funds for the specific capital asset project. In the past, obligations and disbursements were reported in a lump sum amount which prevented the monitoring of the program by fiscal year.

Defense's efforts should help provide a standard methodology to be followed in preparing the Fund's financial reports. The lack of a standard methodology and limited guidance provided to the DFAS Centers on how to prepare the financial reports are the primary reasons the Air Force and Army needed to significantly revise their fiscal year-end financial reports. Only through the use of a common approach and detailed procedures can there be assurance that the Fund's various business areas are reporting in a consistent manner. In addition, Defense's efforts should help them to meet the requirements of the Chief Financial Officers Act, which requires the preparation of financial statements for all business-type entities.

SELECTION OF FUND ACCOUNTING  
SYSTEM WAS PREMATURE

In August 1992, the former Acting Comptroller of Defense selected the Defense Business Management System<sup>8</sup> (DBMS) as the primary system to support Fund implementation. DBMS was designed to provide information to managers in various functional areas, such as civilian personnel, civilian payroll, manpower, cost accounting, and appropriation accounting. The former Acting Comptroller selected DBMS because he believed it would provide the discipline Defense was lacking in developing the requirements to implement both the Chief Financial Officers (CFO) Act and the Corporate Information Management (CIM) initiative.

DBMS IS A HIGH-RISK INVESTMENT

During fiscal year 1993, Defense plans to spend about \$40 million to modify DBMS prior to finalizing the Fund's functional requirements. However, implementing a system prior to defining the functional requirements can result in costly system changes later. Further, the military services have raised concerns about the selection of DBMS as the Fund's standard system.

Military Services' Concerns About DBMS

In a March 31, 1993, joint memorandum to the Comptroller of Defense, the military services' Acting Assistant Secretaries for Financial Management expressed concern that "there was risk of making a serious mistake," because the selection of DBMS was made without adequate evaluation. The Assistant Secretaries also stated that Defense, working collectively, could determine the requirements for and select an accounting system that fully supports not only the Fund but all of Defense's financial management needs.

Further, in a March 25, 1993, memorandum, the Director of the Navy Office of Civilian Personnel Management prohibited offices from entering into any agreement utilizing the DBMS Civilian Personnel Module without the Director's approval. According to the memorandum, DBMS does not meet the Navy functional requirements and will require costly system changes. The Director also pointed out that using DBMS would result in operating two automated systems and create problems in reconciling data. In an April 5, 1993, memorandum to the

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<sup>8</sup>Previously, DBMS was called the Automated Payroll Cost and Personnel System (APCAPS)

Comptroller of Defense and the Assistant Secretary of Defense for Force Management and Personnel, the Acting Assistant Secretary of the Navy (Manpower and Reserve Affairs) stated, "Navy would like to go on record as taking strong exception to the designation of DBMS as the standard system for Personnel, Payroll, and Accounting." The Acting Assistant Secretary further pointed out that the systems being used--Defense Civilian Personnel Data System and Defense Civilian Pay System--singularly and in combination are more functional than DBMS.

Fund's Functional  
Requirements Not Finalized

As we discussed in our March 1, 1993, letter, we are concerned over the process used to select DBMS. Currently, we are even more concerned that Defense plans to spend about \$40 million during fiscal year 1993 to modify DBMS without finalizing the Fund's functional requirements. The functional requirements document serves as the blueprint for the later phases of a system project and describes the tasks that the system must be capable of performing in order to provide management the information it needs. This document must be carefully developed, reviewed, and approved before starting the detailed design. Otherwise, expensive system changes may occur.

Since Defense selected DBMS without finalizing the Fund's functional requirements, we believe this makes the DBMS development effort a \$40 million high-risk investment. In effect, Defense selected DBMS before business processes were identified and changed, data accuracy problems addressed, and technical issues analyzed. As we previously reported,<sup>9</sup> the process used to select DBMS represents a business-as-usual approach in Defense's departmentwide implementation of CIM. By using this approach, Defense is increasing the risk that it will not achieve the goals of the Fund and that it may be wasting millions of dollars.

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<sup>9</sup>Defense ADP: Corporate Information Management Must Overcome Major Problems (GAO/IMTEC-92-77, Sept. 14, 1992).

SOME FUND POLICIES NEED TO BE REVISED

We disagree with Defense policies to increase prices charged to customers for (1) prior year losses and (2) depreciation expense for military construction facilities. These policies will result in the customers needing additional funds in fiscal year 1994 to cover the higher prices. We also disagree with the expense portions of the Fund policy related to major real property maintenance and repair projects and the capitalization and amortization of intangible capital assets. Our specific concerns regarding these policies are discussed below.

RECOVERY OF PRIOR YEAR LOSSES IS  
INCONSISTENT WITH FUND PRICING CONCEPT

Defense has estimated that the Fund will have a \$645.4 million accumulated operating loss at the end of fiscal year 1993. Accumulated operating results are the sum of all annual results of operations since the inception of the activity.

According to Defense's pricing policy, prices for fiscal year 1994 will be increased to recover these prior year losses. This policy is inconsistent with a basic tenet of the Fund--that prices should reflect the actual cost incurred in providing goods and services. Increasing prices to cover past losses diminishes the incentive for the Fund to operate efficiently and makes it difficult to evaluate and monitor the Fund's status. Charging prices that reflect only the cost expected to be incurred for that period will enable Defense and the Congress to determine the cost of each year's operations and measure the performance of the Fund's activities for that period. Defense should be required to justify recovering prior year losses as part of the appropriation process. The justification should identify the specific reasons why a business area, such as depot maintenance, incurred a loss. For example, losses could occur because anticipated savings from (1) the Defense Management Review initiatives did not materialize or (2) productivity increases were not achieved.

DUPLICATE CHARGING FOR MILITARY  
CONSTRUCTION FACILITIES

Defense's pricing guidance states that the prices charged customers will include depreciation expense for military construction facilities. However, the Congress has directed that military construction facilities be financed by military construction appropriations. As long as the Congress continues to treat these expenditures as non-Fund expenditures, including depreciation expense in the prices charged customers is inappropriate since military construction facilities costs are

borne, not by the Fund, but by the military construction appropriation.

However, in developing the fiscal year 1994 prices, Defense included \$376 million of Fund-related military construction depreciation expenses as part of the total price to be charged customers for goods and services. According to a Defense official, the depreciation expense will not generate additional cash for the Fund because the \$376 million was excluded from the customers appropriations request for fiscal year 1994. However, to cover this \$376 million shortfall, Defense plans to transfer \$376 million from the Fund to the customers during fiscal year 1994.

POLICY ON MAINTENANCE AND REPAIR  
PROJECTS DOES NOT CONFORM TO STANDARDS

Defense implemented a policy that uses a predetermined amount for the monthly estimated expenses for major real property maintenance and repair projects to minimize fluctuations in the amount charged customers. The amount charged customers each month is computed annually based on the average cost incurred over a 10-year period. For example, if Defense estimated that its annual expenses would total \$600 million for fiscal year 1994, \$50 million would be recorded as an expense each month. However, no year-end adjustments would be made if the actual expenses incurred were more or less than \$600 million. This policy is not in accordance with generally accepted accounting principles, but may nevertheless have merit in a well controlled and well managed government revolving fund. This accounting issue should be referred to the Federal Accounting Standards Advisory Board for resolution. But, for the present time, it is not appropriate for the Fund to follow this policy, because the actual expenses will not be recorded in the period in which they are incurred. This could impair the integrity of the Fund by (1) providing misleading financial reports and (2) increasing the risk of manipulating the Fund's financial resources. Moreover, the National Defense Authorization Act for Fiscal Year 1993 requires Defense to develop its policies for the Fund consistent with generally accepted accounting principles and accounting standards generally applicable to federal agencies.

CAPITALIZATION OF INTANGIBLES  
IS INAPPROPRIATE

Finally, Defense's capital asset policy provides for the capitalization and amortization of intangible capital assets, such as training and management initiatives. Some capitalization could be permitted of some special kinds of intangibles, such as

those which are extraordinary in size and which might distort period operations, if expressed. However, in general, the costs associated with these types of activities should not be considered intangible assets since many of these costs are recurring and the period for which benefits would be received is uncertain. These costs should be considered a normal operating expense and, therefore, should be recognized in the period in which they occur.

CASH MANAGEMENT PRACTICES FOR  
CAPITAL PROJECTS COULD BE IMPROVED

The Fund's capital budget for fiscal year 1994 is estimated to be about \$2.1 billion. The capital budget includes investment in equipment, minor construction, and management information systems costing more than \$15,000. Capital budget investments are funded through either surcharges or an amount for depreciation added to the prices charged customers.

Funds for capital projects are to be set aside in reserve. According to Defense policy, the cash balance in reserve will be sufficient at all times to cover unliquidated obligations. However, the cash will remain essentially idle while the Fund awaits delivery of capital items, which could take several years. For example, at the end of fiscal year 1994, Defense estimates the cash reserve will have a balance of \$1.7 billion to cover unliquidated obligations for capital projects.

To improve cash management of the Fund, the National Defense Authorization Act for Fiscal Year 1993 authorized the Fund to award contracts for capital assets before it has cash available to cover the obligations, to the extent provided in the appropriations acts. The fiscal year 1993 appropriation acts, however, did not provide an amount in order for the Fund to exercise this contract authority.

Contract authority would allow the Fund to award contracts for capital projects without having to maintain the full amount of cash for capital projects in the Fund. By using contract authority, the Fund would only need to have cash available to pay the required outlays for capital projects. A Defense budget official stated that the Fund would need \$1.3 billion in cash at the end of fiscal year 1994 to cover outlays to be made early in fiscal year 1995.

The use of contract authority does not alleviate Defense's responsibility to maintain cash in reserve for the capital projects. Further, in preparing the budget for capital projects, Defense should display information in the Defense Business

Operations Fund overview book on the (1) total amount to be obligated for the capital projects and (2) estimated amount to be disbursed against those capital projects by fiscal year. In addition, the budget should explain how the capital projects will improve the Fund's operation and thereby reduced its overall costs.

POSSIBLE FUND IMPLEMENTATION TEAM

The implementation team will (1) keep the steering committee informed, (2) develop program plans and schedules, (3) oversee work plan development, (4) manage programs on a daily basis, and (5) coordinate among the various groups. Objectives will be carried out through task forces whose responsibilities are outlined below.

<u>Task Forces</u>	<u>Duties/Responsibilities</u>
Functional Requirements	--Accounting policies & procedures --Performance measures --Unit cost operating budgets --Management financial reports --Cost accounting --Fund accounting
Systems Integration	--Business process reengineering --Functional requirements --Management reporting --Data requirements --Short- and long-term projects --Functional economic analysis --Training --Design reconciliation --Interfaces --Hardware and system software --Capacity management --Response time
Implementation	--Conversion --Documentation --Training --Testing and acceptance
Data Management	--Physical data design --Data definition --Data administration
Critical Short-Term Improvements	--Design --Development --Testing --Training --Documentation --Implementation --Management reporting --Data integrity

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