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

June 2006

DEFENSE WORKING CAPITAL FUND

Military Services Did Not Calculate and Report Carryover Amounts Correctly

GAO-06-530

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Highlights

Highlights of GAO-06-530, a report to the Chairman, Subcommittee on Defense, Committee on Appropriations, House of Representatives

Why GAO Did This Study

According to the Department of Defense's (DOD) fiscal year 2006 budget estimates, working capital fund activity groups (depot maintenance, ordnance, and research and development) will have about $6.3 billion of funded work that will be carried over from fiscal year 2006 into fiscal year 2007. The congressional defense committees recognize that these activity groups need some carryover to ensure smooth work flow from one fiscal year to the next. However, the committees have previously raised concern that the amount of carryover may be more than is needed. GAO was asked to determine (1) if the military services' carryover calculations were in compliance with DOD's new carryover policy and (2) if customers were submitting orders to working capital fund activities late in the fiscal year and, if so, the effect this practice has had on carryover.

What GAO Recommends

GAO makes recommendations to DOD to (1) improve the military services' calculations of the allowable amount of carryover and actual carryover, (2) improve the reporting of carryover information to Congress and DOD decision makers, and (3) ensure that the military services follow the DOD regulation concerning the acceptance of orders placed with working capital fund activities. DOD concurred with all the recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-06-530.

To view the full product, including the scope and methodology, click on the link above. For more information, contact McCoy Williams at (202) 512-9095 or Williamsm1@gao.gov.

June 2006

DEFENSE WORKING CAPITAL FUND

Military Services Did Not Calculate and Report Carryover Amounts Correctly

What GAO Found

The military services have not consistently implemented DOD's revised policy in calculating carryover. Instead, the military services used different methodologies for calculating the reported actual amount of carryover and the allowable amount of carryover since DOD changed its carryover policy in December 2002.

- The military services did not consistently calculate the allowable amount of carryover that was reported in their fiscal year 2004, 2005, and 2006 budgets because they used different outlay rates for the same appropriation.
- The Air Force did not follow DOD's regulation on calculating carryover for its depot maintenance activity group, which affected the amount of allowable carryover and actual carryover by tens of millions of dollars and whether the actual carryover exceeded the allowable amount as reported in the fiscal year 2004, 2005, and 2006 budgets.
- The Army depot maintenance and ordnance activity groups' actual carryover was understated in fiscal years 2002 and 2003 because carryover associated with prior year orders was not included.
- While the Navy generally followed DOD's policy for calculating carryover, the Navy consolidated the reporting of carryover information for research and development activities. The Navy budgets no longer provide information to show if any of the five research and development subactivity groups individually exceeded the carryover ceiling as the Navy budgets did prior to the change in the carryover policy.

As a result, carryover data provided to decision makers who review and use the data for budgeting are erroneous and not comparable across the three military services. For example, the Air Force reported to Congress that the actual fiscal year 2002 carryover for depot maintenance was $87 million less than the ceiling. If the Air Force followed DOD's policy, GAO's calculations show its carryover would have exceeded the ceiling by $216 million.

Carryover is greatly affected by orders accepted by working capital fund activities late in the fiscal year that generally cannot be completed by fiscal year end, and in some cases cannot even be started prior to the end of the fiscal year. GAO's analysis of 68 fiscal year-end orders identified four key factors contributing to orders generally being issued by customers late in the fiscal year and being accepted by the working capital fund activities during the last month of the fiscal year. These reasons included (1) funds provided to the customer late in the fiscal year to finance existing requirements, (2) new work requirements identified at year end, (3) problems encountered in processing orders, and (4) work scheduled at year end. GAO's analysis showed that over half of the orders reviewed were not completed at the end of the next fiscal year, generating a second year of carryover on the same order. As a result, some orders may not have been the most effective use of DOD resources at that time and may not have complied with all of the order acceptance provisions cited in the DOD Financial Management Regulation.

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United States Government Accountability Office
Washington, D.C. 20548

June 27, 2006

The Honorable C. W. Bill Young
Chairman, Subcommittee on Defense
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

According to the Department of Defense's (DOD) fiscal year 2006 budget estimates, working capital fund activity groups (depot maintenance, ordnance, and research and development) will have about $6.3 billion of funded work that will be carried over from fiscal year 2006 into fiscal year 2007.[1] The congressional defense committees recognize that these activity groups need some carryover to ensure a smooth flow of work during the transition from one fiscal year to the next. However, past congressional defense committee reports raised concerns that the level of carryover may be more than is needed. Excessive amounts of carryover financed with customer appropriations are subject to reductions by DOD and the congressional defense committees during the budget review process. To the extent that carryover is too high, Congress may redirect the funds gained from such reductions to other priority initiatives. For example, Congress reduced the Army's fiscal year 2003 Operation and Maintenance appropriation by $48 million due to excessive carryover.

In May 2001, we reported[2] that DOD did not have a sound analytical basis for its 3-month carryover standard which it established in 1996. Based on our recommendation, in December 2002 DOD revised its carryover policy to eliminate the 3-month across-the-board standard for allowable carryover. Under the new policy, the allowable amount of carryover is to be

[1] The carryover amount includes work for which obligations have been made by requesting organizations but that has not yet started and the cost to complete work that has been started.

[2] GAO, *Defense Working Capital Fund: Improvements Needed for Managing the Backlog of Funded Work*, GAO-01-559 (Washington, D.C.: May 30, 2001).

based on the outlay rate[3] of the customers' appropriations financing the work. This means that in determining allowable carryover, the first year outlay rate is used for new orders received in the current year (first year of the work order). However, during our review of Army depot maintenance operations, we reported[4] in June 2005 that the Army encountered several problems implementing DOD's new policy on calculating actual carryover as well as the allowable amount of carryover. In that report, we also determined that activities exceeded the carryover ceiling because they received and accepted orders late in the fiscal year.

As requested and agreed to with your office, the objectives of this assignment were to determine (1) if the military services' carryover calculations were in compliance with DOD's new carryover policy and (2) if customers were submitting orders to working capital fund activities late in the fiscal year and, if so, the effect that this practice has had on carryover. Our review was performed from July 2005 through March 2006 in accordance with U.S. generally accepted government auditing standards. The carryover information in this report is budget data obtained from official Army, Navy, and Air Force budget documents. To assess the reliability of the data, we (1) reviewed and analyzed the factors used in calculating carryover and (2) interviewed officials knowledgeable about the data. We determined that the data were sufficiently reliable for the purposes in this report. Further details on our scope and methodology can be found in appendix I. We requested comments on a draft of this report from the Secretary of Defense or his designee. Written comments from the Under Secretary of Defense (Comptroller) are reprinted in appendix II.

Results in Brief

The military services have not consistently implemented DOD's revised policy in calculating carryover. Instead, the military services have used different methodologies for calculating the reported actual amount of carryover and the allowable amount of carryover since DOD changed its carryover policy in December 2002. Specifically, (1) the military services

[3] The amount of allowable carryover using the outlay rate follows. For example, customers order $100 of work, which is financed with a specific appropriation. If the outlay rate for this appropriation at the appropriation level is 60 percent, then this would result in the working capital fund activity group being allowed to carry over $40 ($100 – $60 [$100 x 60 percent] = $40).

[4] GAO, *Army Depot Maintenance: Ineffective Oversight of Depot Maintenance Operations and System Implementation Efforts*, GAO-05-441 (Washington, D.C.: June 30, 2005).

did not consistently calculate the allowable amount of carryover that was reported in their fiscal year 2004, 2005, and 2006 budgets because they used different tables (both provided by DOD) that contained different outlay rates for the same appropriation; (2) the Air Force did not follow DOD's regulation on calculating carryover for its depot maintenance activity group, which affected the amount of allowable carryover and actual carryover by tens of millions of dollars as well as whether the actual amount of carryover exceeded the allowable amount as reported in the fiscal year 2004, 2005, and 2006 budgets; and (3) the Army depot maintenance and ordnance activity groups' actual carryover was understated in fiscal years 2002 and 2003 because carryover associated with prior year orders was not included in the carryover calculation as required. Further, while the Navy generally followed DOD's policy for calculating carryover, the Navy consolidated the reporting of carryover information for research and development activities beginning with the fiscal year 2004 budget that included actual carryover information for fiscal year 2002. As a result, the Navy budgets no longer provide information to show if any of the five research and development subactivity groups individually exceeded the carryover ceiling as the Navy budgets did prior to the change in the carryover policy in December 2002. For example, Navy budget documents to Congress show that the Navy research and development activity group did not exceed the carryover ceiling for fiscal years 2003, 2004, and 2005. However, our analysis of Navy reports showed that the Naval Air Warfare Center—one of the subactivity groups—exceeded the carryover ceiling for these 3 fiscal years by $19 million, $57 million, and $52 million, respectively. The primary factor for these inconsistencies is that DOD's December 2002 guidance was verbal and DOD did not issue detailed written procedures for calculating carryover and the allowable amount of carryover until June 2004. As a result, year-end carryover data provided to decision makers who review and use the data for budgeting—Office of the Under Secretary of Defense (Comptroller) and congressional decision makers—are erroneous and not comparable across the three military services. For example, the Air Force reported to Congress that the actual fiscal year 2002 carryover for depot maintenance was $87 million less than the carryover ceiling. However, if the Air Force had followed DOD's policy, our calculations show that its carryover would have actually exceeded the ceiling by $216 million.

Carryover is greatly affected by orders accepted by working capital fund activities late in the fiscal year that generally cannot be completed by fiscal year end, and in some cases cannot even be started prior to the end of the fiscal year. As a result, almost all orders accepted late in the fiscal year increase the amount of carryover. We analyzed 68 orders accepted in September 2003 and September 2004 by certain activity groups for the three military services.[5] Our analysis identified four key factors contributing to orders generally being issued by customers late in the fiscal year and being accepted by the working capital fund activities during the last month of the fiscal year. These reasons included (1) funds provided to the customer late in the fiscal year to finance existing requirements, (2) new work requirements identified at year end, (3) problems encountered in processing orders, and (4) work scheduled at year end. Further, our analysis showed that 39 of the 68 orders—over half of the orders reviewed—were not completed at the end of the next fiscal year, generating a second year of carryover. For example, on September 29, 2004, an Army working capital fund activity accepted an order for about $2 million for 17,848 illumination candles with parachutes.[6] Due to the late acceptance of this order, about $2 million was carried over into fiscal year 2005. However, because another Army activity failed to supply enough component parachutes to meet the production schedule, about $1.9 million was carried over into fiscal year 2006. DOD Financial Management Regulation 7000.14-R, Volume 11A, identifies a number of requirements before a working capital fund activity accepts an order. For example, the work is expected to (1) begin without delay (usually within 90 days) and (2) be completed within the normal production period for the specific work ordered. However, our review of 68 orders accepted by the working capital fund activities at year end determined that work on some of these orders did not begin within 90 days or was not completed within the normal production period for the work being performed. As a result, these orders may not have been the most effective use of DOD resources at that time and may not have complied with all of the provisions cited in the above regulation.

We are making eight recommendations to DOD to (1) improve the military services' calculations of the allowable amount of carryover and actual carryover, (2) improve the reporting of carryover information to Congress and DOD decision makers, and (3) ensure that the military services follow

[5] As noted in our scope and methodology (app. I), the scope of our work for this review did not include determining whether there was a bona fide need for the work being ordered by the customers.

[6] Illumination candles are devices used by the military to provide light in the battlefield to see the enemy. The illumination candles are fired from a mortar and are held up in the sky with parachutes.

the DOD regulation concerning the acceptance of orders placed with working capital fund activities. DOD concurred with all the recommendations and identified corrective actions it is taking. It also commented that the inaccuracies we identified in reported carryover did not materially distort the evaluation of depot operations or projected workload levels. While we do not know how DOD defines materiality, the reporting inaccuracies we identified totaled hundreds of millions of dollars. DOD's comments are reprinted in appendix II.

Background

A working capital fund relies on sales revenue rather than direct appropriations to finance its continuing operations. A working capital fund is intended to (1) generate sufficient resources to cover the full costs of its operations and (2) operate on a break-even basis over time—that is, neither make a gain nor incur a loss. Customers use appropriated funds, primarily Operation and Maintenance appropriations, to finance orders placed with the working capital fund. DOD estimates that in fiscal year 2006, the Defense Working Capital Fund—which consists of the Army, Navy, Air Force, Defense-wide, and Defense Commissary Agency working capital funds—will have revenue of about $105 billion.

The Defense Working Capital Fund finances the operations of three fundamentally different types of support organizations: (1) stock fund activities, which provide spare parts and other items to military units and other customers; (2) industrial activities, which provide depot maintenance, research and development, ordnance, and other services to their customers; and (3) other service activities, which provide various services such as accounting (Defense Finance and Accounting Service) and computer services (Defense Information Systems Agency). Because carryover is primarily associated with industrial operations, this report discusses the results of our review of Defense Working Capital Fund industrial operations.

What Is Carryover and Why Is It Important?

Carryover is the dollar value of work that has been ordered and funded (obligated) by customers but not completed by working capital fund activities at the end of the fiscal year. Carryover consists of both the unfinished portion of work started but not completed, as well as requested work that has not yet commenced. Some carryover is necessary at fiscal year end if working capital funds are to operate efficiently and effectively. For example, if customers do not receive new appropriations at the beginning of the fiscal year, carryover is necessary to ensure that the working capital fund activities have enough work to ensure a smooth transition between fiscal years. Too little carryover could result in some personnel not having work to perform at the beginning of the fiscal year. On the other hand, too much carryover could result in an activity group receiving funds from customers in one fiscal year but not performing the work until well into the next fiscal year or subsequent years. By minimizing the amount of carryover, DOD can use its resources in the most effective manner and minimize the "banking" of funds for work and programs to be performed in subsequent years.

DOD Revised Its Carryover Policy

In 1996, DOD established a 3-month carryover standard for all working capital fund activities except for the contract portion of the Air Force depot maintenance activity group.[7] In May 2001, we reported[8] that DOD did not have a basis for its carryover standard and recommended that DOD determine the appropriate carryover standard for the depot maintenance, ordnance, and research and development activity groups. According to Office of the Under Secretary of Defense (Comptroller) officials, DOD provided verbal guidance concerning its new carryover policy for working capital fund activities in December 2002. Subsequently, DOD included its revised carryover policy in its DOD Financial Management Regulation 7000.14-R, Volume 2B, Chapter 9, dated June 2004, which eliminated the 3-month standard for allowable carryover. Under the new policy, the allowable amount of carryover is to be based on the outlay rate[9] of the customers' appropriations financing the work. This meant that in determining allowable carryover, the first year outlay rate would be used for new orders received in the current year (first year of the work order).

[7] The Air Force is the only military service that included its contract depot maintenance operation in its working capital fund. To reflect this difference, DOD established a 4.5-month carryover standard to account for the additional administrative functions associated with awarding contracts. The Air Force is currently taking its contract depot maintenance operation out of the working capital fund and plans to complete this action by the end of fiscal year 2006.

[8] GAO, *Defense Working Capital Fund: Improvements Needed for Managing the Backlog of Funded Work*, GAO-01-559 (Washington, D.C.: May 30, 2001).

[9] The amount of allowable carryover using the outlay rate follows. For example, customers order $100 of work, which is financed with a specific appropriation. If the outlay rate for this appropriation at the appropriation level is 60 percent, then this would result in the working capital fund activity group being allowed to carry over $40 ($100 – $60 [$100 x 60 percent] = $40).

According to the DOD regulation, this new metric allows for an analytical-based approach that holds working capital fund activities to the same standard as general fund execution and allows for more meaningful budget execution analysis.

Further, based on our work on Army depot maintenance operations, we recommended in our June 2005 report[10] that DOD clarify its written guidance for calculating the actual amount of carryover as well as the allowable amount of carryover. On June 29, 2005, DOD issued clarifying guidance on carryover.[11] The guidance specified that (1) the actual amount of carryover associated with current and prior year orders is required to be the amount reported to Congress and within DOD, (2) the allowable amount of carryover is to be calculated based on current year customer orders received and the first year outlay rate for the appropriations financing those orders for all activity groups except shipyards, and (3) shipyards are authorized to use 2 years of customer orders in the calculation of the allowable amount of carryover and to use the first and second year outlay rates for the appropriations financing those orders.

The Military Services Did Not Follow DOD Policy in Calculating Carryover

The military services have not consistently implemented DOD's 2002 revised policy in calculating carryover. Instead, the military services used different methodologies for calculating the reported actual and the allowable amount of carryover since DOD changed its carryover policy in December 2002. Specifically, (1) the military services did not consistently calculate the allowable amount of carryover that was reported in their fiscal year 2004, 2005, and 2006 budgets because they used different tables (both provided by DOD) that contained different outlay rates for the same appropriation; (2) the Air Force did not follow DOD's regulation on calculating carryover, which affected the amount of allowable carryover and actual carryover by tens of millions of dollars and whether the actual amount of carryover exceeded the allowable amount as reported in the fiscal year 2004, 2005, and 2006 budgets; and (3) the Army depot maintenance and ordnance activity groups' actual carryover was understated in fiscal years 2002 and 2003 because carryover associated

[10] GAO, *Army Depot Maintenance: Ineffective Oversight of Depot Maintenance Operations and System Implementation Efforts*, GAO-05-441 (Washington, D.C.: June 30, 2005).

[11] Office of the Under Secretary of Defense (Comptroller), Director of Revolving Funds, memorandum on clarifying guidance on carryover, June 29, 2005.

with prior year orders was not included in the carryover calculation as required. Further, while the Navy generally followed DOD's policy for calculating carryover, the Navy consolidated the reporting of carryover information for research and development activities. As a result, the Navy budgets no longer provide information to show if any of the five research and development subactivity groups individually exceed the carryover ceiling. This information had been provided in the Navy budgets prior to the change in the carryover policy in December 2002. The primary factor for these inconsistencies is that DOD's December 2002 guidance was verbal and DOD did not issue detailed written procedures for calculating carryover and the allowable amount of carryover until June 2004. Afterwards, DOD issued clarifying written guidance in June 2005, January 2006, and February 2006. As a result, year-end carryover data provided to decision makers who review and use these data for budgeting—Office of the Under Secretary of Defense (Comptroller) and congressional decision makers—are erroneous and not comparable across the three military services.

Military Services Used Different Outlay Rate Tables to Calculate the Allowable Amount of Carryover

The military services used different outlay rate tables that provided different outlay rates for the same appropriation when calculating the allowable amount of carryover. The outlay rate tables came from two sources—the Office of the Under Secretary of Defense (Comptroller), Revolving Funds Directorate,[12] and the Financial Summary Tables published by Office of the Under Secretary of Defense (Comptroller), Directorate for Program and Financial Control. Because the outlay rates in these documents sometimes differ, this could affect whether an activity group exceeded the carryover ceiling or not. Under the new carryover policy, the allowable amount of carryover is to be based on the outlay rates of the customers' appropriations financing the work. In implementing this policy, it is important for the services to use the same outlay rate tables so that their calculations on the allowable amount of carryover are consistent. However, when DOD changed the carryover policy in December 2002, DOD did not instruct the services, in writing, on which outlay rate tables should be used to calculate the allowable amount of carryover. Table 1 shows which outlay rate source each of the military services used.

[12] Unless otherwise noted in this report, the tables provided by the Office of the Under Secretary of Defense (Comptroller), Revolving Funds, will be referred to as the Office of the Under Secretary of Defense (Comptroller) tables.

Table 1: Schedule of the Source of Outlay Rates Used in Calculating the Allowable Amount of Carryover by Service

Service	Fiscal year 2004 budget	Fiscal year 2005 budget	Fiscal year 2006 budget
Army	Office of the Under Secretary of Defense (Comptroller) table	Office of the Under Secretary of Defense (Comptroller) table	DOD Financial Summary Tables
Navy	DOD Financial Summary Tables	DOD Financial Summary Tables	DOD Financial Summary Tables
Air Force	Office of the Under Secretary of Defense (Comptroller) table	Office of the Under Secretary of Defense (Comptroller) table	Office of the Under Secretary of Defense (Comptroller) table

Source: GAO analysis.

Table 2 shows the differences between the outlay rates for selected appropriations in the tables provided by the Office of the Under Secretary of Defense (Comptroller) and the DOD Financial Summary Tables that were used to calculate the allowable amount of carryover, which is included in the fiscal year 2005 budget. Some of the differences are large while others are small. These outlay rates, along with the amount of appropriations financing orders, are used to determine the allowable carryover (ceiling). Because the dollar amount of appropriations financing orders is sometimes in the hundreds of millions of dollars, even a small rate difference could result in significantly more or less allowable carryover. For example, the Navy estimated that the naval aviation depots would receive $694 million for new Operation and Maintenance, Navy orders in fiscal year 2005. Using the outlay rate provided in the DOD Financial Summary Tables, the Navy would be allowed to carry over about $146 million. In contrast, using the outlay rate table provided by the Office of the Under Secretary of Defense (Comptroller), the Navy would be allowed to carry over $180 million—about a $34 million difference for just this one appropriation financing orders received by the naval aviation depots.

Table 2: Schedule of Selected Appropriation Outlay Rates Used in Calculating the Allowable Amount of Carryover for the Fiscal Year 2005 Budget (in percent)

Appropriation	Outlay rates in the Office of the Under Secretary of Defense (Comptroller) table	Outlay rates in the DOD Financial Summary Tables
Operation and Maintenance, Army	78	68.8
Operation and Maintenance, Army Reserve	68	71.5
Research, Development, Test, and Evaluation, Army	53	51.5
Missile Procurement, Army	13	10.0
Operation and Maintenance, Navy	74	79.0
Operation and Maintenance, Navy Reserve	67	70.2
Other Procurement, Navy	39	36.5
Procurement, Marine Corps	26	30.0
Research, Development, Test, and Evaluation, Navy	59	56.0
Operation and Maintenance, Air Force	70	72.5
Operation and Maintenance, Air Force Reserve	70	80.8
Operation and Maintenance, Air National Guard	68	82.0
Research, Development, Test, and Evaluation, Air Force	57	61.58

Sources: Office of the Under Secretary of Defense (Comptroller) table and the DOD Financial Summary Tables.

In addition to using different outlay rate tables, there appeared to be uncertainties regarding which year's outlay rates to use. For the fiscal year 2006 budget, the Army and Navy used the DOD Financial Summary Tables to determine the appropriation outlay rates used in calculating the allowable amount of carryover. These tables contain different appropriation outlay rates for each fiscal year. Military service officials stated that DOD had not provided any written guidance on whether the services should use the fiscal year 2004 or 2005 outlay rates or both when determining the allowable amount of carryover in preparing the fiscal year 2006 budget. An excerpt of the outlay rates from the DOD Financial Summary Tables dated February 2004 follows.

Table 3: Schedule of Selected Outlay Rates Used to Calculate Allowable Carryover That Was Included in the Fiscal Year 2006 Budget (in percent)

Appropriation	Fiscal year 2004 outlay rates	Fiscal year 2005 outlay rates
Operation and Maintenance, Army	52.03	68.80
Operation and Maintenance, Navy	76.08	79.00
Operation and Maintenance, Air Force	66.59	73.50

Source: DOD Financial Summary Tables, dated February 2004.

The Navy used the fiscal year 2005 outlay rates for calculating the allowable amount of carryover for fiscal years 2004, 2005, 2006, and 2007—the fiscal years that are included in the fiscal year 2006 budget. The Army used the same document but instead used the fiscal year 2004 outlay rates for calculating the allowable carryover for fiscal year 2004. The Army used the fiscal year 2005 rates for calculating the allowable carryover for fiscal years 2005, 2006, and 2007. While this might appear to be a small matter because the rates are generally the same or almost the same from one fiscal year to the next, using the different rates (2004 versus 2005) for calculating the allowable carryover for the Army industrial operations activity group in fiscal year 2004 results in a different outcome. Based on its calculations, the Army reported that its actual carryover was $141 million below the ceiling for fiscal year 2004. However, using the fiscal year 2005 rates (the rates that the Navy used) would show the Army exceeded the ceiling by about $275 million—a swing of $416 million. This difference is attributable to the outlay rate for the Operation and Maintenance, Army appropriation being 52.03 percent for fiscal year 2004 but 68.8 percent for fiscal year 2005. According to Army officials, the outlay rate varied significantly for these 2 fiscal years because of the supplemental appropriations received during fiscal year 2004.

Based on our work involving the Army depot maintenance activity group, we recommended in our June 2005 report[13] that DOD clarify its written guidance for calculating the actual amount of carryover as well as the allowable amount of carryover. DOD concurred with our recommendations

[13] GAO, *Army Depot Maintenance: Ineffective Oversight of Depot Maintenance Operations and System Implementation Efforts*, GAO-05-441 (Washington, D.C.: June 30, 2005).

and on June 29, 2005, DOD issued clarifying guidance on carryover. Among other things, the guidance specified that (1) the allowable amount of carryover is to be calculated based on current year customer orders received and the first year outlay rates for the appropriations financing those orders for all activity groups except shipyards and (2) the outlay rates are to be based on historic outlay rates in the DOD Financial Summary Tables. DOD's guidance clarifies which source document should be used to identify the outlay rates. However, it does not address the question of which fiscal year or years that are contained in the DOD Financial Summary Tables are to be used.

During our current review, we informed Office of the Under Secretary of Defense (Comptroller) officials that the services did not always comply with DOD's policy on calculating the allowable amount of carryover. Specifically, the services (1) did not always use the correct outlay rate tables in determining the amount of allowable carryover and (2) used different outlay rates contained in the DOD Financial Summary Tables for calculating the allowable amount of carryover for specific fiscal years. In responding to our discussions, DOD took two actions. First, DOD included carryover guidance in its January 17, 2006, memorandum on the fiscal year 2007 budget justification book material for Congress. This guidance specifies that the services are to use the fiscal year 2006 DOD Financial Summary Tables to calculate carryover. The guidance further specifies that the services must use the rates in the DOD Financial Summary Tables unless a waiver is approved in writing by the Office of the Under Secretary of Defense (Comptroller), Director for Revolving Funds. Second, in February 2006, the Office of the Under Secretary of Defense (Comptroller) provided additional guidance to the services for the fiscal year 2007 budget specifying that the (1) fiscal year 2005 outlay rates in the DOD Financial Summary Tables will be used for calculating the allowable amount of carryover for fiscal year 2005 and (2) fiscal year 2006 outlay rates in the DOD Financial Summary Tables will be used for calculating the allowable amount of carryover for fiscal years 2006 and 2007.

Air Force Did Not Calculate Actual Carryover and Allowable Carryover Correctly

In reviewing the Air Force carryover figures shown in the fiscal year 2004, 2005, and 2006 budgets to Congress, we found a number of problems with how the Air Force calculated the reported actual as well as the allowable amount of carryover for the depot maintenance activity group. These problems significantly affected the determination of allowable carryover and whether the Air Force depot maintenance activity group exceeded that ceiling. With one exception, the Air Force took action and corrected the problems when preparing the fiscal year 2007 budget. These problems are discussed below.

- The Air Force used the fiscal year 2001 outlay rates provided by the Office of the Under Secretary of Defense (Comptroller) to determine the allowable amount of carryover in the fiscal year 2004 budget. This was the appropriate outlay rate table to use for that budget. However, even though the Office of the Under Secretary of Defense (Comptroller) provided updated outlay rates for the next fiscal year, the Air Force did not use the updated outlay rates when calculating its allowable carryover in the fiscal year 2005 budget. Instead, the Air Force continued to use the fiscal year 2001 outlay rates. Moreover, the Air Force continued to use the fiscal year 2001 outlay rates to calculate the allowable carryover in the fiscal year 2006 budget instead of using the updated outlay rates published by DOD.

- The Air Force used all orders received (both prior year and current year orders) in calculating the allowable amount of carryover in the fiscal year 2004, 2005, and 2006 budgets. For example, in calculating the allowable carryover for fiscal year 2004, the Air Force included about $1.8 billion of prior year orders in the calculation. DOD carryover policy states that only current year orders should be used in determining the allowable carryover. The Air Force method of including all orders allowed too much carryover.

- The Air Force excluded orders received from the U.S. Transportation Command when calculating the amount of actual carryover in the fiscal year 2004, 2005, and 2006 budgets. DOD Financial Management Regulation 7000.14-R, Volume 2B, Chapter 9, permits excluding some orders financed with non-DOD funds, such as orders received from foreign countries, but does not permit excluding U.S. Transportation Command orders. For example, because the Air Force excluded about $214 million of U.S. Transportation Command orders when calculating its actual carryover for fiscal year 2004, its carryover was understated.

- The Air Force's fiscal year 2006 budget to Congress expressed carryover in equivalent months of work (this is the old method of reporting carryover) rather than in terms of the allowable and actual carryover dollar amounts as required by DOD Financial Management Regulation 7000.14-R, Volume 2B, Chapter 9.

The problems cited above had a significant impact on the amount of allowable carryover and actual carryover and whether the actual carryover exceeded the allowable amount, as shown in table 4.

Table 4: Air Force's Reported Actual Carryover and GAO's Calculation of the Amount of Actual Carryover with Respect to the Ceiling

Fiscal year and Air Force activity group	Air Force reported actual carryover	GAO calculated actual carryover[a]	Difference
Fiscal year 2002 depot maintenance	$87 million under ceiling	$216 million over ceiling	$303 million
Fiscal year 2003 depot maintenance	$396 million under ceiling	$428 million under ceiling	($32 million)
Fiscal year 2004 depot maintenance	$722 million under ceiling	$598 million under ceiling	$124 million

Source: GAO analysis based on Air Force carryover data.

[a]We calculated the allowable amount of carryover and actual amount of carryover in accordance with DOD guidance in its regulation to determine the amount of actual carryover in relationship to the ceiling.

In discussing the carryover calculations with Air Force officials, they agreed that they were not calculating either the allowable amount of carryover or the actual amount of carryover correctly in the fiscal year 2004, 2005, and 2006 budgets. They informed us that in preparing the carryover information contained in the fiscal year 2004 budget, DOD budget analysts who review the budget information, including the carryover information, did not raise questions with the Air Force carryover calculations. Accordingly, they continued to use the same methodology for calculating the allowable carryover and actual carryover that was included in the fiscal year 2005 and 2006 budgets to Congress. Based on our discussions with them, these officials informed us that the Air Force would be developing the carryover figures that will be used in the fiscal year 2007 budget in accordance with DOD policy.

In reviewing the Air Force fiscal year 2005 carryover calculations included in the fiscal year 2007 budget, we determined that the Air Force was complying with DOD's carryover policy with one exception. For orders financed with the Air Force working capital fund supply account, the Air Force used a 61 percent outlay rate to calculate its allowable carryover instead of the 73.5 percent outlay rate for the Air Force operation and maintenance appropriation contained in the DOD Financial Summary Tables and required by the Office of the Under Secretary of Defense

(Comptroller), Revolving Fund Directorate. Using the 61 percent figure, the Air Force reported that its actual carryover for fiscal year 2005 was about $193 million under the carryover ceiling. However, if the Air Force used the 73.5 percent outlay rate, our analysis show that the fiscal year 2005 actual carryover would have exceeded the carryover ceiling by about $148 million. In discussing the outlay rate difference with the Air Force, officials stated that they used the 61 percent figure because the rate was more consistent with the actual outlay rate of the Air Force working capital fund supply account. However, the Air Force could not provide us with documentation supporting how they arrived at the 61 percent figure. On February 7, 2006, the Air Force requested from the Office of the Under Secretary of Defense (Comptroller) that it be allowed to use the 61 percent figure in developing the carryover ceilings contained in the fiscal year 2007 budget. The Office of the Under Secretary of Defense (Comptroller) approved the Air Force's request on March 6, 2006.

Army's Reported Actual Carryover Was Understated in Fiscal Years 2002 and 2003 because Prior Year Orders Were Not Included

In June 2005, we reported[14] that the Army understated the reported actual carryover for the depot maintenance activity group for fiscal years 2002 and 2003 because it interpreted DOD's 2002 carryover guidance as requiring only the inclusion of customer orders received in the current year when calculating actual carryover. During this review, we found this same problem affected the reported actual carryover for the ordnance activity group. Thus, the Army did not include customer orders received in prior years and the carryover related to those orders. The Army corrected this problem and included all carryover when it prepared its fiscal year 2006 budget. Table 5 provides information on the actual amount of carryover reported to Congress for fiscal years 2002 and 2003 and the amount of carryover not included.

[14] GAO, *Army Depot Maintenance: Ineffective Oversight of Depot Maintenance Operations and System Implementation Efforts*, GAO-05-441 (Washington, D.C.: June 30, 2005).

Table 5: Dollar Amount of Reported Actual Carryover that Exceeded the Ceiling and the Amount of Carryover Not Included (dollars in millions)

Fiscal year and Army activity group	Reported carryover that exceeded ceiling	Carryover not included	Total carryover exceeding ceiling
Fiscal year 2002 depot maintenance	$36. 1	$94.4	$130.5
Fiscal year 2003 depot maintenance	127.1	195.1	322.2
Fiscal year 2002 ordnance	3.9	98.0	101.9
Fiscal year 2003 ordnance	96.6	138.9	235.5

Source: GAO analysis of Army carryover data.

Army officials at headquarters acknowledged that the reported actual carryover did not include carryover related to prior year orders. Although DOD changed its carryover policy in December 2002, it did not issue detailed written procedures for calculating actual carryover until June 2004. Army headquarters officials stated that prior to the issuance of the written guidance in June 2004, the new carryover calculation was based on verbal instructions that the Army received from the Office of the Under Secretary of Defense (Comptroller). The Army said they interpreted the new guidance to include only actual carryover on orders received in the current year and instructed the Army Materiel Command to calculate carryover accordingly. When DOD issued the revised DOD regulation in June 2004, Army officials said they realized that they were not calculating reported actual carryover correctly and changed their methodology in developing the fiscal year 2006 budget so that the actual carryover calculation would include prior year orders and be in accordance with DOD's written guidance.

Navy Generally Followed DOD's Carryover Policy but Better Disclosure Is Needed for Reporting on Research and Development Activity Group's Carryover

In analyzing the Navy's actual carryover figures for the naval shipyards, aviation depots, and research and development activity groups shown in the fiscal year 2004, 2005, 2006, and 2007 budgets to Congress, we found that the Navy generally followed DOD's policy on calculating the actual amount of carryover as well as the allowable amount of carryover. Our analysis of the Navy budgets submitted to Congress shows that the naval aviation depots have consistently exceeded the carryover ceilings as shown in table 6. According to Navy budget documents and officials, the reasons why the actual reported carryover exceeded the ceiling for the aviation depots were (1) the lack of material to repair the components being fixed; (2) the increased deterioration of components, leading to longer repair cycles; and (3) the large dollar amount of orders financed with supplemental appropriations for fiscal year 2003.

Table 6: Navy's Reported Actual Carryover in Relationship to the Ceiling by Activity Group

Activity group	Fiscal year 2002	Fiscal year 2003	Fiscal year 2004	Fiscal year 2005
Aviation depots	**$113 million over ceiling**	**$205 million over ceiling**	**$5 million over ceiling**	**$0.2 million over ceiling**
Shipyards	$76 million under ceiling	**$195 million over ceiling**	$210 million under ceiling	$226 million under ceiling
Research and development	$442 million under ceiling	$435 million under ceiling	$439 million under ceiling	$310 million under ceiling

Source: Navy Working Capital Fund budgets.

Note: We highlighted the years when the activity group exceeded the carryover ceiling.

While the budgets show that the Navy research and development activity group did not exceed the ceiling for any of the 4 years, the budgets no longer provide information that shows if any of the five subactivity groups individually exceeded the carryover ceiling, as the Navy budgets did prior to the change in the carryover policy in December 2002. Prior to the Office of the Under Secretary of Defense (Comptroller) changing its carryover policy in December 2002, the Navy Working Capital Fund budget provided carryover information, such as the dollar amount of carryover and the number of months of carryover for each of the subactivity groups. An analysis of the budget documents would show if any of the subactivity groups exceeded the 3-month carryover standard. After DOD changed the carryover policy in December 2002, the Navy changed the level of reporting carryover information to be at the aggregate level and no longer provided carryover information at the subactivity group level. Our analysis of Navy reports showed that the Naval Air Warfare Center exceeded the ceiling for fiscal years 2003, 2004, and 2005, and the Naval Surface Warfare Center exceeded the ceiling for fiscal year 2002, as shown in table 7.

Table 7: Navy's Reported Actual Carryover in Relationship to the Ceiling for the Research and Development Subactivity Groups

Subactivity group	Fiscal year 2002	Fiscal year 2003	Fiscal year 2004	Fiscal year 2005
Naval Air Warfare Center	$201 million under ceiling	**$19 million over ceiling**	**$57 million over ceiling**	**$52 million over ceiling**
Naval Surface Warfare Center	**$95 million over ceiling**	$211 million under ceiling	$247 million under ceiling	$166 million under ceiling
Naval Undersea Warfare Center	$78 million under ceiling	$87 million under ceiling	$80 million under ceiling	$58 million under ceiling
Space and Naval Warfare Center	$148 million under ceiling	$76 million under ceiling	$81 million under ceiling	$51 million under ceiling
Naval Research Laboratory	$79 million under ceiling	$81 million under ceiling	$88 million under ceiling	$86 million under ceiling
Total	$411 million under ceiling[a]	$436 million under ceiling[b]	$439 million under ceiling	$309 million under ceiling[b]

Source: Navy reports on the research and development subactivity groups.

Note: We highlighted the years when the subactivity group exceeded the carryover ceiling.

[a]There is a $31 million difference between the amount shown here and the amount shown in table 6 for the research and development activity group. The Navy's report to Congress and its internal report on the subactivity groups contained different amounts.

[b] Due to rounding, there is a $1 million difference between the amount shown here and the amount shown on table 6 for the research and development activity group.

According to the Navy, there are two reasons why carryover should be reported at the activity group level and not at the subactivity group level. First, the Office of the Under Secretary of Defense (Comptroller) required the research and development activities to use a higher outlay rate for orders financed with procurement appropriations than the official published procurement outlay rates. Using a higher procurement outlay rate for calculating the carryover ceiling lowers the amount of allowable carryover. Because of this higher rate, a Navy official stated that the carryover should be reported at the aggregate level since subactivity groups reporting under the ceiling will offset those subactivity groups reporting over the ceiling. Second, the new methodology did not allow the exclusion of intrafund orders from the carryover calculation. These are orders placed by one research and development activity with another research and development activity. Since intrafund orders were no longer allowed to be excluded from the carryover calculation, this resulted in the double counting of actual carryover associated with these intrafund orders. Because the above two reasons reduce the carryover ceiling and increase the actual amount of carryover, the Navy reports the carryover information at the activity group level.

However, we believe that the carryover associated with the research and development activity group should be reported at the subactivity group level for several reasons. First, according to the fiscal year 2007 budget, the research and development activity group is the largest Navy activity group—it received about $10 billion of new orders and carried over about $3.5 billion for fiscal year 2005. By comparison, for fiscal year 2005, the Navy shipyards received about $1.8 billion of new orders and carried over about $636 million, and the aviation depots also received about $1.8 billion and carried over about $470 million. Further, the dollar amount of new orders received by three research and development subactivity groups (Naval Surface Warfare Center--$3.4 billion, Naval Air Warfare Center--$2.7 billion, and Space and Naval Warfare Systems Centers--$2.2 billion) exceeded the amount of new orders received by the shipyards and aviation depots for fiscal year 2005. Because of the dollar magnitude of research and development subactivity groups, we believe carryover reporting at the subactivity group level is needed for Congress and DOD to maintain oversight.

Second, concerning the Navy's comment on using a higher outlay rate for calculating the carryover ceiling, we agree with the Office of the Under Secretary of Defense (Comptroller) that the Navy should use a higher rate. We also believe that the Navy should report carryover information at the subactivity group level from a disclosure standpoint. Otherwise, subactivity groups reporting under the ceiling will offset those subactivity groups reporting over the ceiling and this information would not be available in the budgets to Congress. In the December 2002 management initiative decision, the Office of the Under Secretary of Defense (Comptroller) stated that research and development activities could achieve better results than the established outlay rates for orders financed with procurement appropriations because of the type of work performed by these activities. DOD further stated that 45 percent of the fiscal year 2002 carryover was linked to contractual efforts and 55 percent supported in-house requirements. DOD concluded that carryover linked to contractual obligations would disburse at the procurement appropriations rate. However, the amount supporting the in-house requirements would disburse at a higher rate because such requirements tend to be funded on an annualized basis. The Office of the Under Secretary of Defense (Comptroller) requested that the Navy examine the nature and scope of the procurement-funded work and report its recommendations by February 15, 2003, to the Comptroller. At the time DOD issued the management initiative decision in December 2002, the Navy reported carryover information to Congress at the subactivity group level. The Navy determined, based on work performed by one Warfare Center, that the outlay rate for Navy procurement appropriations should be 40 percent, which is higher than the actual outlay rate for these appropriations. However, the December 2002 management initiative decision did not discuss the Navy changing its level of reporting carryover information from the subactivity group level to the aggregate level.

Third, concerning the Navy's comments on intrafund orders, the Navy is correct in that the amount of actual carryover will be double counted. However, the effect of this is negated since the amount of allowable carryover is also double counted since both of these activities will include the intrafund order as a new order and include the new order in their calculations for determining the allowable amount of carryover. Furthermore, in May 2001 we reported[15] that the Navy was not following DOD's guidance on calculating carryover on intrafund orders. Specifically, Navy working capital fund activities reduced carryover for orders received from other working capital fund activities. However, Navy working capital fund activities categorized orders they sent to other working capital fund activities as contractual obligations and used these obligations to reduce reported year-end carryover. As a result, not only did the Navy eliminate the double counting of such orders, it eliminated all these orders from its calculations, thus understating the equivalent number of months of carryover work.

Carryover Increased Due to Military Services Placing Orders Late in the Fiscal Year

Carryover is greatly affected by orders accepted late in the fiscal year that generally cannot be completed, and in some cases cannot even be started, prior to the end of the fiscal year. As a result, almost all orders accepted late in the fiscal year increase the amount of carryover. We analyzed 68 orders accepted in September 2003 and September 2004 by certain activity groups for the three military services. Our analysis identified four key factors contributing to orders generally being issued by customers late in the fiscal year and being accepted by the working capital fund activities during the last month of the fiscal year. These reasons included (1) funds provided to customers late in the fiscal year to finance existing

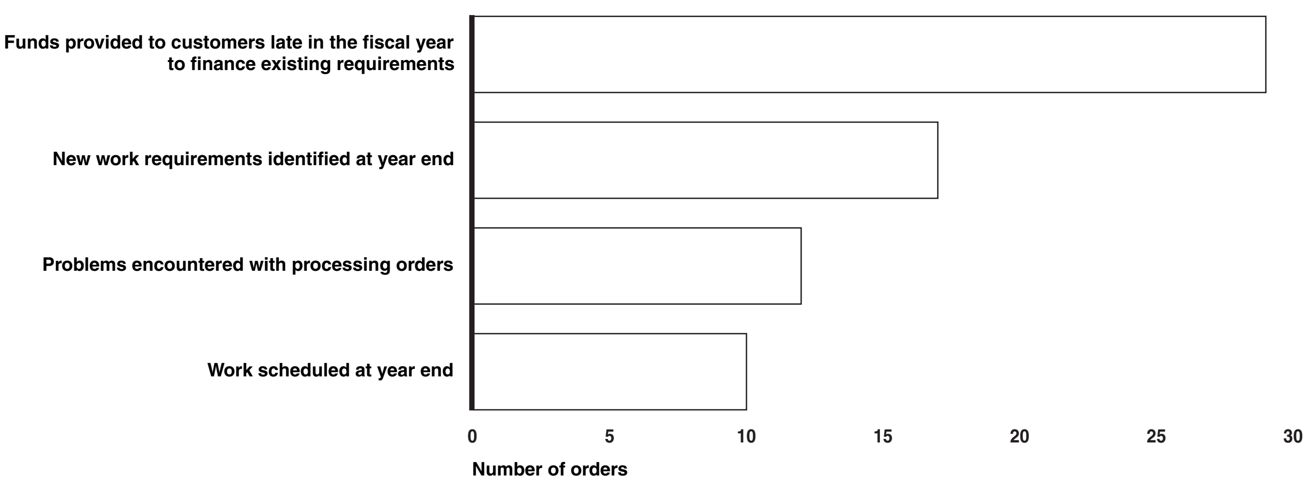
[15] GAO, *Defense Working Capital Fund: Improvements Needed for Managing the Backlog of Funded Work*, GAO-01-559 (Washington, D.C.: May 30, 2001).

requirements, (2) new work requirements identified at year end, (3) problems encountered in processing orders, and (4) work scheduled at year end. Further, our analysis showed that 39 of the 68 orders—over half of the orders reviewed—were not complete at the end of the next fiscal year, generating a second year of carryover. In addition to increasing carryover amounts, orders accepted by working capital fund activities late in the fiscal year, in which these activities do not perform the work until well into the next fiscal year or even subsequent years, may not (1) be the most effective use of DOD resources at that time and (2) have complied with all of the order acceptance provisions cited in the DOD Financial Management Regulation. As noted in our scope and methodology (app. I), the scope of our work for this review did not include determining whether there was a bona fide need for the work being ordered by customers.

Reasons Customer Orders Are Placed Late in the Fiscal Year

As shown in figure 1, our review of 68 fiscal year-end orders for 2003 and 2004 identified four key factors contributing to orders generally being issued by customers late in the fiscal year and being accepted by the working capital fund activities during the last month of the fiscal year.

Figure 1: Factors Contributing to Year-end Orders for 2003 and 2004



Source: GAO analysis of Working Capital Fund late year orders.

As depicted in figure 1, the factor contributing most frequently to orders being accepted by working capital fund activities late in the fiscal year—29 of the 68 orders (43 percent) we reviewed—is the late receipt of funds from customers to finance existing requirements. DOD customers stated that it is common for the military services to provide funds to them late in the fiscal year after the military services review their programs to identify funds that will not be obligated by year end. When these funds are identified, the military services realign the funds to programs that can use them. These funds are then used to finance orders placed with working capital fund activities at year end. Further, in fiscal years 2003 and 2004, the military services received supplemental appropriations from Congress to fund ongoing military operations. Some of these funds were distributed to DOD customers late in the fiscal year to finance repairs on DOD assets. The following examples illustrate situations when funds were provided to customers late in the fiscal year.

- On September 4, 2003, the Ogden Air Logistics Center accepted an order from the Air Force Ground Theater Air Control System program office totaling about $4.8 million financed with operation and maintenance funds that would have expired on September 30, 2003. This order provided for Ground Theater Air Control System hardware and software upgrades. According to program office officials, the Air Combat Command traditionally funds about 60 to 70 percent of its total software development requirements annually. However in August 2003, the Command provided the program office with funding to cover 100 percent of its fiscal year 2003 software requirements. Thus, the program office applied the funds to its next highest priority workload and issued the $4.8 million order.

- On September 27 and 29, 2003, the Space and Naval Warfare Systems Center in San Diego accepted two orders from the U.S. Pacific Fleet totaling approximately $4.15 million financed with operation and maintenance funds that would have expired on September 30, 2003. These two orders were to provide the technical and engineering support for the relocation of a Sea-Based Battle Laboratory from the USS Coronado to a new ashore headquarters activity. The Pacific Fleet identified this requirement in early fiscal year 2003; however, funds were not made available until the end of the fiscal year, when additional funds were identified from other programs.

- On September 26, 2003, the Red River Army Depot accepted an order from the Army Tank-automotive and Armaments Command totaling $17.9 million financed with operation and maintenance funds that would have expired on September 30, 2003. The order was for the repair and upgrade of 41 Bradley Fighting Vehicles needed to support the war effort in Iraq and Afghanistan. These vehicles were to be prepositioned in the theater of operation. According to a Tank-automotive and Armaments Command official, the order was issued late in fiscal year 2003 because the Army Materiel Command did not provide them with funding until September 2003. An Army Materiel Command official noted that the effort was funded by a supplemental appropriation used to support war operations.

The second most significant factor that contributed to the year-end orders we reviewed—17 of the 68 orders (25 percent)—was the identification of new requirements at year end. Some examples of DOD customers identifying requirements at year end include (1) a Navy aviation depot in performing scheduled maintenance identified damage to aircraft beyond what was originally included in its statement of work, (2) an Army depot identified inspection requirements at year end to keep ammunition storage inspections current and to satisfy requisitions to support the soldiers in the field, (3) Navy aircraft repair requirements were moved from fiscal year 2004 to fiscal year 2003 to meet an earlier deployment schedule, (4) the Army identified new requirements at year end for repair of Army assets necessary to support ongoing military operations, and (5) the Navy identified the need for additional capabilities for several aircraft and also needed to perform emergency repairs on one of its aircraft carriers. Two examples of some of the reasons for new requirements being identified at year end follow.

- On September 27 and 30, 2004, the Space and Naval Warfare Systems Center in Charleston accepted an order and an amendment from the Commander, Naval Air Force, U.S. Atlantic Fleet, totaling $425,000 financed with operation and maintenance funds that would have expired on September 30, 2004. A fleet official stated that it had received a casualty report from the USS Harry S. Truman on September 24, 2004, indicating repairs needed to be made to the ship's announcing system. An activity official stated that the order was accepted regardless of carryover concerns due to the urgency associated with a casualty report. Additionally, a fleet official noted that the time to complete the needed repairs was limited due to the ship's impending deployment.

- On September 8, 2004, the Army Rock Island Arsenal accepted an order from the Tank-automotive and Armaments Command totaling about $1.4 million financed with operation and maintenance funds that would have expired on September 30, 2004. The order was for the reconditioning of chemical biological protective shelters. The shelters mount on highmobility, multipurpose wheeled vehicles and provide an environmentally controlled work area that filters out nuclear, biological, and chemical agents. According to a logistics manager, in the fourth quarter of fiscal year 2004 the Tank-automotive and Armaments Command identified 11 shelters that needed reconditioning and issued an order to the Army Rock Island Arsenal for the work.

Further, we found 12 of the 68 orders (18 percent) were accepted by working capital fund activities in the last month of the fiscal year due to problems encountered with processing the orders. These problems included (1) delays in processing forms through different activities and multiple nonintegrated systems, (2) data input errors that were not corrected until September, and (3) difficulties encountered in processing documents and related funding from non-DOD customers to working capital fund activities. Two examples follow.

- In July 2003, the Air National Guard Headquarters prepared documentation that directed the Pennsylvania Air National Guard to send its ground mobile navigation radar to the Tobyhanna Army Depot to repair damage sustained by the radar system from multiple lightening strikes and power surges and to overhaul the system. The order was not accepted by the depot until September 26, 2003, about 3 months later. The delay in acceptance of the order was due to (1) the normal time required to process forms through six different activities using nonintegrated systems, (2) paperwork processing delays due to missing information, (3) confusion on how to process the workload in a new Army system implemented in July 2003, and (4) errors made in entering data into the Army system.

- Due to delays in correcting input errors on an order, the Warner Robins Air Logistics Center did not accept a $2.8 million order from the F-15 program office, financed with operation and maintenance funds, until September 17, 2004. The order was for the maintenance of an Air National Guard F-15 aircraft. When an order was generated by the F-15 program office on June 10, 2004, the office entered the program control and serial numbers into the project order system incorrectly. On September 17, 2004, the Center established a new order with the corrected information.

Finally, we found 10 of the 68 orders (15 percent) were accepted by working capital fund activities in the last month of the fiscal year when DOD assets were scheduled for maintenance. According to Air Force and

Navy officials, planning for the repair of major assets such as aircraft, ships, and engines begins several years prior to the date on which repairs will actually be performed. The assets are scheduled for maintenance based on routine cycles, such as numbers of years since the last depot maintenance was performed. The services include funding requirements for these repairs in their annual budget submissions. Generally, in the quarter the assets are scheduled for maintenance, the major commands distribute the repair funds to their customers and the customers, in turn, issue orders to fund the repair. Two examples follow.

- On September 16, 2003, the Oklahoma City Air Logistics Center accepted an order from the Air National Guard totaling about $7.2 million financed with operation and maintenance funds set to expire on September 30, 2003. The order was for the scheduled maintenance of the 39th Air National Guard KC-135E aircraft in fiscal year 2003. During fiscal year 2001, the Air National Guard determined that 39 KC-135E aircraft required maintenance in fiscal year 2003 in accordance with their 5-year maintenance schedule. In fiscal year 2001, the Air National Guard began planning and budgeting for the maintenance of these aircraft. The 39th aircraft arrived at the air logistics center in mid-September 2003 as planned. The Air National Guard issued the order in September 2003 once it determined that the work on this aircraft would be performed at the air logistics center instead of contracting out the workload.

- On September 29, 2003, the Naval Air Warfare Center-Aircraft Division accepted an order from the U.S. Atlantic Fleet in the amount of approximately $2.4 million financed with operation and maintenance funds set to expire the next day. The order required repairs and/or replacement of deteriorated and worn components to support flight deck operations on the USS Harry S. Truman. This work was scheduled for overhaul in fiscal year 2003. A fleet official stated that they did not perform an inspection of the ship to determine specific repair requirements until late in the fiscal year.

Impact of Late Orders on Carryover

Our further review of the 68 fiscal year-end orders for 2003 and 2004 disclosed that 39 of these orders—over half—were not completed within the next fiscal year, which resulted in carryover of 2 or more years. As we reported in June 2005,[16] two reasons generally caused work to carryover into a second fiscal year. First, the depots received orders late in the fiscal year and were unable to complete the effort by year end, as discussed in the previous section; and second, some depots were unable to obtain the materials/parts needed in a timely manner to complete the work. In addition to these reasons, we found that some working capital fund activities were unable to complete work within 1 year because of delays caused by backlogged or other higher priority work and broken or unsafe repair equipment. These factors have resulted in orders being carried over for more than 1 fiscal year and increased the carryover balances for subsequent years. As a result, these orders may not have been the most effective use of DOD resources at that time and may not have complied with all of the order acceptance provisions cited in the DOD Financial Management Regulation.

The DOD Financial Management Regulation 7000.14-R, Volume 11A, Chapters 2 and 3, prescribes regulations governing the use of orders placed with working capital fund activities. When a working capital fund activity accepts an order, the customer's funds financing the order are obligated. The DOD regulation identifies a number of requirements before a working capital fund activity accepts an order. For example, work to be performed under the order shall be expected to begin within a reasonable time after the order is accepted by the performing DOD activity. As a minimum requirement, it should be documented that when an order is accepted, the work is expected to (1) begin without delay (usually within 90 days) and (2) be completed within the normal production period for the specific work ordered. Further, the regulation states that no project order shall be issued if commencement of work is contingent upon the occurrence of a future event. Our review of 68 orders accepted by the working capital fund activities at year end determined that work on some of these orders did not begin within 90 days or was not completed within the normal production period for the work being performed. The following examples illustrate orders that were accepted by working capital fund activities at year end and (1) may not be the most effective use of DOD resources at that time and (2) may not have complied with all of the provisions contained in this regulation.

[16]GAO, *Army Depot Maintenance: Ineffective Oversight of Depot Maintenance Operations and System Implementation Efforts*, GAO-05-441 (Washington, D.C.: June 30, 2005).

- On September 25, 2003, the Crane Army Ammunition Activity accepted an order totaling $1,885,000 that was financed with operation and maintenance funds for X-ray work to determine the safety and usability of 200,000 rounds of 40-millimeter high-explosive ammunition. However, due to problems with the X-ray inspection machine, the activity had to suspend work on the ammunition until the inspection machine was qualified as safe to use. According to the program engineer, work was delayed because imaging panels in the inspection machine were burning up and had to be replaced. Compounding this problem was a delay in the approval process for the safe operation of the machine. As a result, very little work was completed on this order over 3 fiscal years. Specifically, $1,885,000 carried over into fiscal year 2004 and $1,881,105 carried over into fiscal year 2005 and again into fiscal year 2006.

- On September 14, 2004, the Ogden Air Logistics Center accepted an order totaling $3.4 million that was financed with operation and maintenance funds to build an F-16 radar test station on behalf of the Air National Guard. According to a center official, even though the depot did not have the material to build the station, it accepted the order late in the fiscal year. Thus, the entire $3.4 million order carried over into fiscal year 2005. The center official noted that during fiscal year 2005, the activity group ordered the material and began work assembling the station, but as of the end of fiscal year 2005 all the material had not yet been received from contractors. Therefore, $277,898 carried over into fiscal year 2006.

- On September 29, 2003, the Sierra Army Depot accepted an order totaling $11,680,175 that was financed with operation and maintenance funds for the receipt, inspection, storage, and re-containerizing of 203 containers of gas and oil pipeline equipment returned from Iraq and Afghanistan. Because this order was received so late in the fiscal year, the entire amount of the order—$11,680,175—was carried over into fiscal year 2004. According to the mission director, this order was delayed because (1) some containers were not returned from the war zones in a timely manner so the depot could refurbish them and (2) the depot received other, higher priority workloads, such as armored plating on wheeled vehicles. As a result, over half of the dollar amount of the order—$6,847,529—carried over into fiscal year 2005 and $2,643,093 carried over into fiscal year 2006.

- On September 16, 2003, the Space and Naval Warfare Systems Center in Charleston accepted an order for $232,200 that was financed with operation and maintenance funds. The U.S. Naval Forces Central Command identified and funded this emergent requirement in August 2003 in support of the Combat Terrorism Initiative during the Iraq war. More specifically, this order was for technical and installation services for a new communications link between Bahrain and Dubai. An activity official stated that minimal engineering services were initiated prior to the end of fiscal year 2003, so almost the entire dollar amount of the order—$230,000—carried over into fiscal year 2004. This official also stated the center encountered delays when the government of Dubai would not allow the leased line into the country from Bahrain. This resulted in $207,000 being carried over into fiscal year 2005, and $12,000 being carried over into fiscal year 2006.

- On September 11, 2003, the Oklahoma City Air Logistics Center accepted an order totaling about $1.8 million that was financed with operation and maintenance funds for the analytical condition inspection[17] of a F110-129 engine. According to an Oklahoma City Air Logistics Center official, the center brought the engine in for repair in September 2003 to ensure that the funds were obligated by fiscal year end. Otherwise, the funds would expire and be unavailable for new workload. However, the center did not begin work on the engine until March 2004 due to a backlog of engines waiting for repair. Since the engine was accepted for repair in the last month of the fiscal year, almost the entire $1.8 million was carried over into fiscal year 2004. Further, because of production delays and a failed serviceability test, the center carried funds into fiscal year 2005 and again into fiscal year 2006—more than 2 years after the order was accepted.

Conclusions

The military services have provided erroneous carryover information to Congress and DOD decision makers because the services have not consistently applied DOD's revised policy on carryover. Reliable and consistent carryover information is essential for Congress and DOD decision makers to perform their oversight, including reviewing DOD's budget to determine if an activity group has too much or not enough

[17]An analytical condition inspection is a systematic disassembly and inspection of a representative sample of end items to find hidden defects, deteriorating conditions, corrosion fatigue, overstress, or other deficiencies in an aircraft structure or systems. These inspections are normally over and above those inspections in normal program depot maintenance.

carryover. To provide greater assurance that the military services provide reliable and consistent carryover information, the military services must be held accountable for the accuracy of reported carryover information and ensure the timely identification of unneeded customer funds. While DOD's guidance on calculating carryover was not adequate when it revised its carryover policy in 2002, DOD began improving the guidance in 2004. However, DOD has not updated the Financial Management Regulation so that it includes comprehensive carryover guidance to the military services, and the services have not always complied with the carryover guidance in the past. Until this is done, Congress and DOD decision makers will be forced to make key budget decisions, such as whether to enhance or reduce customer budgets, based on unreliable information. In addition, DOD working capital fund activities' acceptance of year-end orders (1) increases the amount of carryover and (2) in some cases, contributes to DOD working capital fund activities' actual carryover amounts exceeding their allowable amounts by tens of millions of dollars. Excessive amounts of year-end carryover tie up customer funds that could be put to better near-term use and are subject to reductions by DOD and the congressional defense committees during the budget review process.

Recommendations for Executive Action

In order to improve the business operations of the Department of Defense Working Capital Fund, we are making the following eight recommendations to the Secretary of Defense.

We recommend that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to take the following actions:

- Issue written instructions in its DOD Financial Management Regulation 7000.14-R specifying the outlay rates to be used by DOD working capital fund activities for calculating the allowable amount of carryover and continue to issue carryover guidance to the military services in its annual guidance on preparing budget justification book material for Congress.

- Review the carryover information provided in the military services' annual budget submissions to help ensure the services are calculating their allowable and actual carryover amounts in accordance with DOD policy.

- Reiterate the requirements in the DOD Financial Management Regulation 7000.14-R to help ensure that working capital fund activities are in compliance with the regulations governing acceptance of orders, particularly at fiscal year end.

We recommend that the Secretary of Defense direct the Secretary of the Air Force to take the following actions:

- Use the current outlay rate tables that are included in the DOD Financial Summary Tables when calculating the allowable carryover amounts for the Air Force depot maintenance activity group, consistent with DOD policy.

- Use only current year orders for calculating the allowable carryover amounts for the Air Force depot maintenance activity group, as required by DOD carryover policy.

- Include all orders when calculating the amount of actual carryover for the Air Force depot maintenance activity group, except those orders that are specifically excluded in DOD Financial Management Regulation 7000.14-R or are excluded by the Under Secretary of Defense (Comptroller) in writing.

- Include the allowable and actual dollar amounts of carryover for the Air Force depot maintenance activity group in the Air Force's annual budget to Congress, as required by DOD Financial Management Regulation 7000.14-R.

We recommend that the Secretary of Defense direct the Secretary of the Navy to include the allowable and actual amounts of carryover for each of the five Navy research and development subactivity groups in the Navy's annual budget to Congress.

Agency Comments and Our Evaluation

DOD provided written comments on a draft of this report. DOD concurred with all eight of our recommendations. Regarding its plans for implementing the eight recommendations, DOD stated that it is in the process of updating its financial management regulations and issuing budget guidance for the fiscal year 2008/2009 President's Budget, which will address calculating the allowable amount of carryover. Further, DOD stated that it made a more rigorous review of the services' carryover information in the fiscal year 2007 President's Budget submission and that it will continue reviewing the services' budgets to ensure that the services are calculating allowable and actual amounts of carryover in accordance with DOD policy. DOD also stated that it will direct the Navy to report carryover information for each of the five Navy research and development subactivity groups in the Navy's annual budget to Congress. Finally, as preparation for the close out of fiscal year 2006, DOD will reiterate the guidance in its Financial Management Regulation governing the working capital fund acceptance of orders which obligates customers' funds, particularly at year end.

DOD also commented that the inaccuracies we identified in reported carryover did not materially distort the evaluation of depot operations or projected workload levels. While we do not know how DOD defines materiality, we believe that the reporting inaccuracies affect the evaluation of depot operations from a workload standpoint because the inaccuracies understated the carryover balances for some activity groups by hundreds of millions of dollars. For example, as stated in our report, the Air Force reported that its fiscal year 2002 depot maintenance carryover was $87 million under the ceiling but our calculation shows that the carryover exceeded the ceiling by $216 million, a difference of $303 million. In another case, the Army reported that its fiscal year 2003 depot maintenance carryover was $127 million over the ceiling but our calculations show that it was over the ceiling by $322 million, a difference of $195 million. As a result of these understatements, the amount of work carried over from one year to next was not reliable and could have affected DOD's and the congressional defense committees' review and evaluation of carryover during their annual budget review.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Armed Services; the Subcommittee on Readiness and Management Support, Senate Committee on Armed Services; the Subcommittee on Defense, Senate Committee on Appropriations; the House Committee on Armed Services; the Subcommittee on Readiness, House Committee on Armed Services; and the Ranking Minority Member, Subcommittee on Defense, House Committee on Appropriations. We are also sending copies to the Secretary of Defense, Secretaries of the Army, Navy, and Air Force, and other interested parties. Copies will be made available to others upon request. Should you or your staff have any questions concerning this report, please contact McCoy Williams, Director, at (202) 512-9095 or williamsm1@gao.gov, or William M. Solis, Director, at (202) 512-8365 or solisw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.

Sincerely yours,

McCoy Williams
Director, Financial Management and Assurance

William M. Solis
Director, Defense Capabilities and Management

Scope and Methodology

To determine if the military services' carryover calculations were in compliance with the Department of Defense's (DOD) new carryover policy, we obtained and analyzed the services' calculations for the (1) reported year-end actual carryover balances for fiscal years 2002 through 2005 and (2) allowable amount of carryover for fiscal years 2002 through 2005. We recomputed the services' calculations following DOD's regulation on carryover and compared our carryover calculations with the services' carryover calculations. We met with officials from the Army, Navy, and Air Force to discuss (1) the methodology the services used to calculate carryover and (2) any differences between our calculations and their calculations. We also met with officials from the Office of the Under Secretary of Defense (Comptroller) to discuss DOD's new carryover policy, including the proper calculation for actual carryover and the allowable amount of carryover. To assess the reliability of the carryover data, we (1) reviewed and analyzed the factors used in calculating carryover and (2) interviewed officials knowledgeable about the data. We determined that the data were sufficiently reliable for the purposes in this report.

To determine if customers were submitting orders to working capital fund activities late in the fiscal year and, if so, the effect that this practice has had on carryover, we obtained data on orders accepted by working capital fund activities in September 2003 and September 2004. Initially, we obtained information on the top 20 orders from a dollar standpoint that selected working capital fund activities accepted from customers in September 2003 and September 2004. We analyzed the information on the orders, which included the appropriation financing the order, the date the order was accepted by the working capital fund activity, and a description of the work to be performed. We then selected and analyzed 68 orders with large dollar amounts that working capital fund activities accepted in September. We also interviewed (1) working capital fund officials to determine the current status of performing the work on the orders and (2) customers to determine the reasons why they sent the orders to the working capital fund activities late in the fiscal year. In performing our work on these orders, we did not review these orders to determine if there was a bona fide need for the work being ordered by customers.

We performed our work at the headquarters offices of the Under Secretary of Defense (Comptroller), the Assistant Secretary of the Army (Financial Management and Comptroller), the Assistant Secretary of the Navy (Financial Management and Comptroller), and the Assistant Secretary of the Air Force (Financial Management and Comptroller), Washington, D.C. In performing our work on reviewing the services' carryover calculations, we obtained carryover information on the following Defense Working Capital Fund activity groups: (1) Army depot maintenance, (2) Army ordnance, (3) Army industrial operations, (4) Air Force depot maintenance, (5) Naval aviation depots, (6) Naval shipyards, and (7) Naval research and development. The Naval research and development activity group consists of the following five subgroups: Naval Air Warfare Center, Naval Surface Warfare Center, Naval Undersea Warfare Center, Naval Research Laboratory, and the Space and Naval Warfare Systems Command Center.

In performing our work on reviewing individual orders, we obtained information from the following working capital fund activities and their customers that submitted the orders.

Air Force

- Ogden Air Logistics Center, Hill Air Force Base, Utah
- Oklahoma City Air Logistics Center, Tinker Air Force Base, Oklahoma
- Warner Robins Air Logistics Center, Robins Air Force Base, Georgia

Navy

- Naval Air Systems Command, Patuxent River, Maryland
- Naval Air Warfare Center, Aircraft Division, Patuxent River, Maryland
- Naval Air Warfare Center, Weapons Division, China Lake, California
- Naval Aviation Depot, San Diego, California
- Space and Naval Warfare Systems Command, San Diego, California
- Space and Naval Warfare Systems Center, San Diego, California
- Space and Naval Warfare Systems Center, Charleston, South Carolina

Army

- Blue Grass Army Depot, Richmond, Kentucky
- Crane Army Ammunition Activity, Crane, Indiana
- Rock Island Arsenal, Rock Island, Illinois
- Sierra Army Depot, Herlong, California
- Red River Army Depot, Texarkana, Texas
- Tobyhanna Army Depot, Tobyhanna, Pennsylvania

The carryover information in this report is budget data obtained from official Army, Navy, and Air Force budget documents. We conducted our work from July 2005 through March 2006 in accordance with U.S. generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of Defense or his designee. The Under Secretary of Defense (Comptroller) provided written comments, and these comments are presented in the Agency Comments and Our Evaluation section of this report and are reprinted in appendix II.

Comments from the Department Of Defense

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

MAY 30 2006

Mr. McCoy Williams, Director, Financial Management and Assurance
Mr. William M. Solis, Director, Defense Capabilities and Management
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Williams and Mr. Solis:

This is the Department of Defense response to the Government Accountability Office (GAO) draft report, "DEFENSE WORKING CAPITAL FUND: Military Services Did Not Calculate and Report Carryover Amounts Correctly," dated April 20, 2006, (GAO Code 195066/GAO-06-530). We have received and reviewed the draft report. Specific comments on the draft report are attached.

The Department remains committed to providing accurate budget data. The Department believes that the reporting inaccuracies included in this draft report did not materially distort the evaluation of depot operations or projected workload levels. The Department will provide increased visibility of Navy Research and Development activity group carryover.

Sincerely,

for J. David Patterson
Tina W. Jonas

Attachment:
As stated

GAO DRAFT REPORT - DATED APRIL 20, 2006
GAO CODE 195066/GAO-06-530

"DEFENSE WORKING CAPITAL FUND: MILITARY SERVICES DID NOT CALCULATE AND REPORT CARRYOVER AMOUNTS CORRECTLY"

DEPARTMENT OF DEFENSE COMMENTS TO THE RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to issue written instructions in its DoD Financial Management Regulation 7000.14-R specifying the outlay rates to be used by DoD working capital fund activities for calculating the allowable amount of carryover and continue to issue carryover guidance to the military services in its annual guidance on preparing budget justification book material for Congress. (p. 39/GAO Draft Report)

DoD RESPONSE: Concur. The Department issued budget guidance for the FY 2007 President's Budget submission that specified the outlay rates to use for calculating the allowable amount of carryover. Additionally, the Department is in the process of updating the DoD Financial Management Regulations (FMR) and issuing budget guidance for the FY 2008/FY 2009 President's Budget. Both documents will include the recommended improvements.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to review the carryover information provided in the military services' annual budget submissions to help ensure the services are calculating their allowable and actual carryover amounts in accordance with DoD policy. (p. 39/GAO Draft Report).

DoD RESPONSE: Concur. A more rigorous review of the Services' carryover reporting was performed for the preparation of the FY 2007 President's Budget submission. For future budget submissions, the Under Secretary of Defense (Comptroller) will ensure that the Services' budget submission complies with the approved carryover policy.

RECOMMENDATION 3: The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to reiterate the requirements in the DoD Financial Management Regulation 7000.14-R to help ensure that working capital fund activities are in compliance with the regulations governing acceptance of orders, particularly at fiscal year end. (p. 39/GAO Draft Report)

DoD RESPONSE: Concur. As preparation for the close out of FY 2006, the Department will reiterate the requirements in the DoD FMR to help ensure that working capital fund activities comply with the regulations governing acceptance of orders, particularly at fiscal year end.

RECOMMENDATION 4: The GAO recommended that the Secretary of Defense direct the Secretary of the Air Force to use the current outlay rate tables that are included in the DoD Financial Summary Tables when calculating the allowable carryover amounts for the Air Force Depot Maintenance Activity Group, consistent with DoD policy. (p. 39/GAO Draft Report)

DoD RESPONSE: Concur. The Under Secretary of Defense (Comptroller) has already directed the Air Force to use approved outlay rates when calculating the allowable carryover amounts. For the FY 2008/FY 2009 budget submission, the Department will ensure that the Services' correctly follow outlay rate guidance.

RECOMMENDATION 5: The GAO recommended that the Secretary of Defense direct the Secretary of the Air Force to use only current year orders for calculating the allowable carryover amounts for the Air Force Depot Maintenance Activity Group, as required by DoD carryover policy. (p. 39/GAO Draft Report)

DoD RESPONSE: Concur. During the FY 2007 budget review, the Under Secretary of Defense (Comptroller) restated the requirements for calculating and reporting carryover. These restated requirements will be included in the next update of the DoD FMR. The Department will ensure that the Services' budget submissions comply with the revised carryover policy.

RECOMMENDATION 6: The GAO recommended that the Secretary of Defense direct the Secretary of the Air Force to include all orders when calculating the amount of actual carryover for the Air Force depot maintenance activity group, except those orders that are specifically excluded in DoD Financial Management Regulation 7000.14-R or are excluded by the Under Secretary of Defense (Comptroller) in writing. (p. 39/GAO Draft Report)

DoD RESPONSE: Concur. During the FY 2007 budget review, the Under Secretary of Defense (Comptroller) restated the requirements for calculating and reporting carryover. These restated requirements will be included in the next update of the DoD FMR. The Department will ensure that the Services' budget submissions comply with the revised carryover policy.

RECOMMENDATION 7: The GAO recommended that the Secretary of Defense direct the Secretary of the Air Force to include the allowable and actual dollar amounts of carryover for the Air Force depot maintenance activity group in the Air Force's annual budget to Congress, as required by DoD Financial Management Regulation 7000.14-R. (p. 40/GAO Draft Report)

DoD RESPONSE: Concur. During the FY 2007 budget review, the Under Secretary of Defense (Comptroller) restated the requirements for calculating and reporting carryover. These restated requirements will be included in the next update of the DoD FMR. The Department will ensure that the Services' budget submissions comply with the revised carryover policy.

RECOMMENDATION 8: The GAO recommended that the Secretary of Defense direct the Secretary of the Navy to include the allowable and actual amounts of carryover for each of the five Navy research and development sub-activity groups in the Navy's annual budget to Congress. (p. 40/GAO Draft Report)

Attachment

DoD RESPONSE: Concur. For the FY 2008 President's Budget the Department will direct the Navy to include the allowable and actual amounts of carryover for each of the five Navy Research and Development sub-activity groups in the Navy's annual budget submission to Congress.

Attachment

GAO Contacts and Staff Acknowledgments

GAO Contacts

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William M. Solis, (202) 512-8365

Acknowledgments

Staff who made key contributions to this report were Richard Cambosos, Francine DelVecchio, Keith McDaniel, Clara Mejstrik, Greg Pugnetti, Chris Rice, and Hal Santarelli.

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