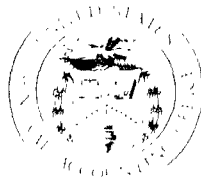


June 1990

INDUSTRIAL FUNDS

The Department of Defense's Management of ACP Funds



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**National Security and
International Affairs Division**

B-239648

June 28, 1990

The Honorable Daniel Inouye
Chairman, Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable Ted Stevens
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

This report responds to your October 16, 1989, request that we obtain information on several aspects of the Department of Defense's (DOD) management of Asset Capitalization Program (ACP) funds. You expressed particular concern about DOD's policy of allowing the industrial fund activities to obligate ACP funds without reserving the assets necessary to pay these contracts as they came due. In your initial request and during subsequent discussions with your staff, you specifically asked us to determine (1) ACP obligations and disbursements for fiscal years 1983 through 1989, (2) the balance of unliquidated ACP obligations as of September 1989 for which cash reserves have not been retained, (3) whether DOD's policies and guidance permit the obligation of ACP funds without retaining the unexpended balance to meet such obligations, and (4) whether DOD had used current year appropriated funds to meet prior year obligations.

Answers to questions regarding DOD's management of ACP funds are discussed below, and in greater detail in appendix I. In a subsequent report, we will address (1) your concerns on the legality of DOD's practice of using future year budget authority to fund prior year obligations, (2) potential legislative guidance to improve DOD's management of the industrial funds, and (3) DOD's execution of the fiscal year 1990 program.

Background

DOD has five industrial funds (one each for the Army, Navy, Air Force, Marine Corps, and defense agencies) to finance such activities as aircraft depots, shipyards, and public work centers that perform work of an industrial or commercial nature. Effective in fiscal year 1983, the Congress approved DOD's request to establish the ACP as a source of

funds for modernizing industrial fund equipment and as a means of providing industrial fund activity managers greater authority for purchasing equipment. For each fiscal year 1983 through 1989, the Congress established ACP obligation authority in DOD's appropriation accounts, which allowed DOD's industrial fund activity managers to obligate ACP funds within the general constraints of the program.

Effective in fiscal year 1990, the Congress transferred ACP funding from the operation and maintenance accounts to the procurement accounts. According to the House and Senate Committees on Appropriations conference report, this transfer was intended to be permanent and was based, in part, on our August 1989 report¹ and other GAO reviews, which documented misuse of ACP funding to procure low-priority assets, such as furniture and other items, that have little relevance to industrial modernization and productivity. In conjunction with this funding transfer, the conference report effectively precludes the use of fiscal year 1990 ACP funds to pay prior year ACP obligations. In addition, DOD is required to retain any unexpended ACP funds in the procurement accounts.

Results in Brief

Data provided by the Office of the Secretary of Defense and the military services indicates that during fiscal years 1983 through 1989 DOD's industrial fund activities disbursed about \$4 billion for ACP contracts. An additional \$1 billion had been obligated but remained unliquidated² as of September 30, 1989.

DOD's policies and procedures did not require the industrial fund activities to retain the unexpended ACP funds or to establish cash reserves to pay the unliquidated obligations. Consequently, DOD officials told us that the industrial fund activities commingled the unexpended ACP funds with other industrial fund assets, and spent these funds on other industrial operations. DOD officials also acknowledged that because cash reserves were not established to pay the unliquidated ACP obligations, prior year obligations were being funded with current year assets.

¹Plant Modernization: DOD's Management of the Asset Capitalization Program Needs Improvement (GAO/NSIAD-89-147, Aug. 4, 1989).

²Unliquidated obligations include obligations based on signed contracts that have not yet been fully paid.

Scope and Methodology

We obtained information about the management of ACP funds from the Office of the Secretary of Defense; the Departments of the Army, Navy, and Air Force; the Defense Logistics Agency; and the Defense Communications Agency. We interviewed officials responsible for managing ACP budget and accounting data, and reviewed applicable policies, procedures, and related documents. The ACP budget and accounting data presented in this report were provided to us by officials from the Office of the Secretary of Defense and the services. As agreed with members of your staff, we did not independently verify the data provided by DOD. We did, however, discuss with DOD officials the procedures they use to collect and report this data, and the extent to which they verify the data reported by each of the industrial fund activities. According to these officials, they rely on each activity to verify its own data, and do not independently verify the data provided by the activities and subordinate commands.

As you requested, we did not obtain official agency comments on this fact sheet, but we discussed its contents with cognizant DOD and military service officials and incorporated their comments where appropriate.

We conducted our work from November 1989 to April 1990 in accordance with generally accepted government auditing standards.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this fact sheet until 15 days from its issue date. At that time, we will send copies to the Chairmen, Senate Committee on Governmental Affairs, House Committee on Government Operations, House Committee on Appropriations, and Senate and House Committees on Armed Services; the Director, Office of Management and Budget; and the Secretaries of Defense and the Army, Navy, and Air Force. We will also make copies available to others on request.

If you have any additional questions, please contact me on (202) 275-8412. Major contributors to this report are listed in appendix II.



Donna M. Heivilin
Director, Logistics Issues

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Abbreviations

ACP	Asset Capitalization Program
DOD	Department of Defense
OSD	Office of the Secretary of Defense

Answers to Questions Regarding DOD's Management of Asset Capitalization Program Funds

1. What is the total value of ACP obligations and disbursements for each fiscal year from 1983 through 1989?

DOD was given total ACP obligation authority of about \$5 billion for fiscal years 1983 through 1989 for its five industrial funds. Data provided to us by the Office of the Secretary of Defense (OSD) and the services indicates that DOD's industrial fund activities had obligated approximately \$5 billion by September 30, 1989. According to DOD officials, these funds were obligated for ACP projects that were designed to improve the equipment at the activities, modernize operations, and enhance productivity.¹ Although the activities had obligated \$5 billion for ACP contracts, they had disbursed only about \$4 billion for these contracts. As a result, ACP obligations of about \$1 billion incurred from fiscal years 1983 through 1989 remained unliquidated as of September 30, 1989 (see table I.1).

Table I.1: Unliquidated ACP Obligations as of September 30, 1989

Dollars in millions			
Fiscal year	Obligations ^a	Disbursements	Unliquidated obligations
1983	\$367.9	\$361.8	\$6.1
1984	592.2	559.1	33.1
1985	912.1	905.3	6.8
1986	974.2	941.1	33.1
1987	954.7	850.1	104.6
1988	754.6	223.9	530.7
1989	475.2	153.2	322.0
Total	\$5,030.9	\$3,994.5	\$1,036.4

Source: Compiled from data provided by OSD, Army, Navy, and Air Force.

^aThe ACP obligations shown for each fiscal year are based on data provided by OSD and each of the services. The total ACP obligations exceeded the obligation authority we reported in August 1989 by about \$27.1 million. OSD officials were unable to explain these discrepancies.

For fiscal year 1983, the Congress appropriated \$306.1 million to DOD's operations and maintenance accounts to provide initial funding for the ACP. Subsequently, for fiscal years 1984 through 1989, DOD's industrial fund activities generated revenues to fund the ACP by increasing the rates they charged their customers (generally the military services and defense agencies) for costs they incurred in producing or contracting for goods and services. This increase consisted of a factor for depreciation

¹In our August 1989 report we identified that some ACP projects had not achieved expected benefits because of unclear program guidance, inadequate compliance with existing guidance, and inadequate implementation of elements of a sound capital investment management program. We also reported that the ACP was lacking management support, well-defined program criteria, and post-investment analyses.

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expenses and, in some years, an ACP surcharge. Under the ACP, therefore, the funding for modernization was shifted to the appropriations of each activity's customers. The cost of capital improvements became a part of each activity's operating cost and, therefore, was recovered from its customers through depreciation charges over the useful life of the assets. In approving the ACP, however, the Congress and DOD recognized that depreciation expense alone might not provide the financial resources for capital investment at a level comparable to the private sector. As a result, the Congress allowed the industrial activities to charge their customers a surcharge to cover the difference between the ACP obligation authority and the depreciation expense.

Because actual depreciation charges varied somewhat from estimates, ACP revenues for fiscal years 1983 through 1989 totaled about \$4.8 billion, which was about \$200 million less than the total ACP obligation authority. Of the total \$4.8 billion in ACP revenues that DOD's industrial activities had collected, about \$830 million had not been disbursed for ACP contracts as of September 30, 1989 (see table I.2).

Table I.2: Comparison of ACP Revenues and Disbursements for Fiscal Years 1983 Through 1989

Dollars in millions			
Fiscal year	Revenues collected	Disbursements	Difference
1983	\$396.6	\$361.8	\$34.8
1984	406.5	559.1	(152.6)
1985	952.3	905.3	47.0
1986	889.5	941.1	(51.6)
1987	925.8	850.1	75.7
1988	705.9	223.9	482.0
1989	547.9	153.2	394.7
Total	\$4,824.5	\$3,994.5	\$830.0

Source: Compiled from data provided by OSD, Army, Navy, and Air Force.

2. What is the balance of unliquidated ACP obligations as of September 1989 for which cash reserves have not been retained?

OSD Comptroller officials stated that during fiscal years 1983 through 1989, the industrial fund activities commingled ACP revenues with their overall cash balances, and did not establish cash reserves to fund ACP obligations. According to these officials, the \$830 million in ACP revenues that had not been disbursed for ACP contracts as of September 1989 were spent on other industrial operations. Consequently, DOD's industrial fund activities do not have any assets specifically reserved to fund the \$1

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billion in unliquidated ACP obligations. The unliquidated ACP obligations for each industrial fund and the fiscal years in which those obligations were incurred are shown in table I.3.

Table I.3: Unliquidated Obligations by Industrial Fund for Each Fiscal Year From 1983 Through 1989.

Dollars in millions

Fiscal year	Navy	Air Force	Army	Defense	Marine Corps	Total
1983	\$0.0	\$5.2	\$0.0	\$0.0	\$0.9	\$6.1
1984	0.0	31.8	0.0	0.0	1.3	33.1
1985	0.0	5.6	0.0	0.0	1.2	6.8
1986	0.0	27.0	6.0	0.0	0.1	33.1
1987	56.5	21.9	25.2	0.0	1.0	104.6
1988	418.5	41.0	59.7	10.1	1.4	530.7
1989	206.8	64.3	49.3	0.0	1.6	322.0
Total	\$681.8	\$196.8	\$140.2	\$10.1	\$7.5	\$1,036.4

Source: Compiled from data provided by OSD, Army, Navy, and Air Force.

According to OSD officials, DOD does not have a comprehensive plan for funding the \$1 billion in unliquidated ACP obligations. Effective in fiscal year 1990, the House and Senate Committees on Appropriations conference report effectively precludes the use of fiscal year 1990 ACP funds to pay prior year ACP obligations. Therefore, these officials said that the industrial fund activities will continue to fund these obligations with current resources and anticipated revenues generated from their industrial operations. Of the total \$1 billion, DOD estimates that \$542 million will have to be paid in fiscal year 1990, \$273 million in 1991, and the remainder in 1992 and beyond.

To supplement the industrial funds in fiscal years 1990 and 1991, DOD notified Congress as required by statutory authority that it plans to retain about \$134.8 million in the industrial funds that was originally approved for transfer to the military services' operations and maintenance accounts in fiscal year 1990, and has requested an additional appropriation to the industrial funds in fiscal year 1991 of \$393.8 million.

3. Does DOD guidance and policy permit the obligation of funds without retaining the unexpended balance to meet such obligations?

DOD's guidance and policies governing the industrial funds and the ACP do not require the industrial fund activities to establish cash reserves to

meet unliquidated obligations. DOD officials stated that, for fiscal years 1983 through 1989, ACP funds were commingled with other industrial fund assets and were managed in accordance with their policies governing the industrial funds. We found, however, that these policies do not specifically address the commingling of funds.

Under the industrial fund concept, DOD's industrial fund activities are reimbursed by their customers for the goods and services they provide. The industrial funds operate on a break-even basis over the long term, and customer billing rates are established at levels intended to recover costs plus applicable surcharges, if any, necessary to ensure continued operation. Under this concept, all revenues are commingled and are available to fund the industrial fund activities' operating expenses.

In May 1986, we reported² that DOD's industrial fund activities had not established separate subaccounts for ACP revenues and were using these revenues as a source of additional working capital. In that report, we recommended that DOD consider establishing separate cash accounts (or subaccounts) for ACP revenues in the industrial fund accounting system. DOD did not agree with our recommendation and stated that establishing separate cash accounts would unnecessarily limit the use of available resources to meet valid industrial fund requirements and thus would appear contrary to the principles under which industrial funds had operated for over 35 years. Consequently, DOD did not establish separate cash accounts for ACP revenues.

4. Were current year appropriated funds passed through another DOD account to meet prior year obligations?

For each fiscal year 1984 through 1989, the Army, Navy, Air Force, and Marine Corps industrial fund activities were using current year funds to meet prior year ACP obligations. According to OSD officials, however, the current year funds were not appropriated funds and were not being passed through other DOD accounts. According to these officials, as the ACP obligations came due, the industrial funds were paying them out of their cash balances and current year revenues.

According to DOD officials, the industrial fund activities generally obligated most of their ACP funds in the year authorized but spread disbursements for those obligations over several years, creating

²Industrial Funds: DOD Should Improve Its Accounting for Asset Capitalization Program Funds (GAO/NSIAD-86-112, May 23, 1986).

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unliquidated obligations at the end of each fiscal year. Because the industrial fund activities commingled ACP revenues with other funds and did not set aside monies to pay unliquidated ACP obligations, prior year obligations were being funded with current year assets. For example, in fiscal year 1989, the total ACP disbursements were about \$745.7 million, of which \$592.5 million (about 80 percent) were for prior year obligations (see table I.4).

Table I.4: Extent to Which Fiscal Year 1989 ACP Disbursements Were Associated With Prior Year Obligations

Dollars in millions			
Industrial fund	Total ACP disbursements	Fiscal year 1989 obligations	Prior year obligations
Army	\$97.0	\$7.5	\$89.5
Navy	532.8	139.5	393.3
Air Force	95.6	4.9	90.7
Marine Corps	4.8	0.8	4.0
Defense	15.5	0.5	15.0
Total	\$745.7	\$153.2	\$592.5

Source: Compiled from data provided by OSD, Army, Navy, and Air Force.

Effective in fiscal year 1990, the Congress transferred ACP funding from the Operations and Maintenance Accounts to the Procurement Accounts, and the House and Senate Committees on Appropriations conference report effectively precludes DOD from using part of the \$519.3 million appropriated for ACP in fiscal year 1990 to pay prior year ACP obligations. OSD officials stated that the industrial fund activities have not used fiscal year 1990 ACP funds to pay prior year obligations. These officials told us that the industrial fund activities are paying these obligations from their cash balances and current year revenues. We plan to address DOD's execution of the fiscal year 1990 program in a subsequent report.

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