OFFICE OF THE INSPECTOR GENERAL

CONGRESSIONALLY DIRECTED REBATES IN DEFENSE FINANCE AND ACCOUNTING SERVICE COST RECOVERY RATES

Report No. 96-040 December 11, 1995

Department of Defense

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Acronyms

DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
USD(C)	Under Secretary of Defense (Comptroller)

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

December 11, 1995

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Audit Report on Congressionally Directed Rebates in Defense Finance and Accounting Service Cost Recovery Rates (Report No. 96-040)

We are providing this audit report for your review and comments. Management comments on a draft of this report were considered in preparing the final report.

Based on comments received from the Under Secretary of Defense (Comptroller) and the Defense Finance and Accounting Service, we have revised the finding, recommendation, and potential benefits. DoD Directive 7650.3 requires that audit recommendations be resolved promptly. Therefore, we request that the Under Secretary of Defense (Comptroller) provide comments on this final report by February 9, 1996.

We appreciate the courtesies extended to the audit staff. Questions about this audit should be directed to Mr. James L. Kornides, Audit Program Director, or Mr. John K. Issel, Audit Project Manager, at (614) 751-1400. See Appendix E for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 96-040 **December 11, 1995**
(Project No. 5FJ-2010)

Congressionally Directed Rebates in Defense Finance and Accounting Service Cost Recovery Rates

Executive Summary

Introduction. This report was prepared as part of our "Audit of the Defense Finance and Accounting Service Administration of the FY 1995 and 1996 Unit Cost Rates." As part of the Defense Business Operations Fund, the Defense Finance and Accounting Service (DFAS) is required to recover all operating costs by charging fees or cost recovery rates to its customers for providing goods and services. On November 11, 1993, Congress directed that DFAS rebate $85.2 million of costs charged to its customers during FY 1994. This rebate was intended to encourage DFAS to cut overhead costs. Also, on April 10, 1995, Congress directed a rebate of $50 million in order to reduce expected FY 1995 operating gains.

Objective. The objective of this audit was to determine whether the Congressionally directed rebates were properly implemented and administered. We also evaluated efforts to resolve the problem of DFAS customers not providing sufficient funds to pay for services received.

Audit Results. DFAS complied with the direction of Congress and did not charge customers in FYs 1994 and 1995 for $135.2 million in services. However, in FY 1995, DFAS recouped the $85.2 million of rebates directed by Congress in FY 1994. DFAS took this action to comply with the Defense Business Operations Fund policy that allows the recovery of operating losses through increases to future year rates. As a result, the intent of the FY 1994 Congressional rebate, to reduce DFAS overhead costs passed along to customers, was partially thwarted (Part I).

Also, the Under Secretary of Defense (Comptroller) was implementing initiatives that should resolve the problem of customers not providing sufficient funds to pay for financial services received (Part II, Appendix B, "Other Matters of Interest").

Summary of Recommendations. The recommendations made in the draft report were revised to exclude any reference to reversing planned increases in future cost recovery rates to recoup the $85.2 million loss as a result of the FY 1994 Congressionally directed rebate. The loss was actually recovered in FY 1995 through increased cost recovery rates. However, to ensure that this condition does not recur, we recommend that the Under Secretary of Defense (Comptroller) revise the "DoD Financial Management Regulation," Volume 11B, to prohibit Defense Business Operations Fund activities from increasing rates to recover losses that are attributable to Congressional rebates. See Part II, Appendix C, for a summary of the potential benefits resulting from the audit.

Management Comments. We received comments on a draft of this report from the Office of the Under Secretary of Defense (Comptroller) and the DFAS. The Office of the Under Secretary of Defense (Comptroller) nonconcurred with the draft report. The Director for Accounting Policy stated that the report was factually incorrect, contained incorrect conclusions, and made inappropriate recommendations. The Deputy Director

for Resource Management, DFAS, agreed that the rebate caused an operating loss of $85.2 million and stated that, in accordance with Defense Business Operations Fund policy, Program Budget Decision 416 required DFAS to recover the $85.2 million loss along with other FY 1994 operating losses in its FY 1995 billing rates and revenue program. However, the Deputy Director for Resource Management disagreed with our statement that DFAS did not follow Congressional intent to cut costs, resulting in overcharges to its customers.

See Part I for a complete discussion of management comments and Part III for the complete text of those comments.

Audit Response. We revised our report based on management comments on the draft report. Specifically, we revised the portion of the finding that addressed administration of the $50 million rebate in FY 1995. Since the rebate reduced expected operating gains and did not increase operating losses, we agree that it was administered appropriately. However, we continue to believe that Defense Business Operations Fund policy on the recovery of operating losses through increases to future year rates should be revised to eliminate the carrying forward of losses caused by compliance with Congressional direction, such as the DFAS recovery of the $85.2 million loss that resulted from the Congressionally directed rebate in FY 1994. We request that the Under Secretary of Defense (Comptroller) provide comments on the revised final report, recommendation, and potential benefits by February 9, 1996.

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Part I - Audit Results

Audit Background

Reorganization of Finance and Accounting Activities. When Defense Management Review Decision 910 was implemented in January 1991, the finance and accounting activities of the Military Departments and Defense agencies were combined into the Defense Finance and Accounting Service (DFAS). The goals of that reorganization were to standardize, consolidate, and improve systems and operations, and to reduce the costs of providing finance and accounting support to the Services and DoD activities.

Financial Policy of the Defense Business Operations Fund. The Defense Business Operations Fund (DBOF) was established on October 1, 1991, and the DFAS was one of several activities that were consolidated into the DBOF. The intent of DBOF is to motivate providers of support services to reduce costs by forcing them to operate in a competitive, market type environment. The Under Secretary of Defense (Comptroller) (USD[C]) is responsible for developing financial policy for the DBOF and approving budget submissions. USD(C) policy requires DBOF activities such as DFAS to recover all operating costs, including prior year operating losses, by charging fees to their customers for providing goods and services. DFAS customers under DBOF include all DoD components that require finance and accounting support.

Congressionally Directed Rebates. In FY 1994, Congress reduced customer funding for DFAS services by 5 percent and directed that $85.2 million of costs charged to DFAS customers during the fiscal year be rebated to customers. The Senate Appropriations Committee directed the reduction in funding because it was disappointed with efforts to produce verifiable productivity savings that DFAS claimed could be achieved by eliminating accounting and administrative overhead. Also, in FY 1995, Congress directed an additional rebate of $50 million in order to reduce the DFAS projected operating gain for the year.

Audit Objective

The objective of this audit was to determine whether the Congressionally directed rebates were properly implemented and administered. See Part II, Appendix A, for a discussion of the scope, methodology, management controls, and prior audit coverage.

Additionally, we evaluated USD(C) and DFAS efforts to resolve the problem of DFAS customers not providing sufficient funds to pay for finance and accounting services received. See Appendix B, "Other Matters of Interest," for details.

Recovery of Congressional Rebates in Future Years

DFAS complied with the direction of Congress and did not charge customers in FYs 1994 and 1995 for $135.2 million in services. However, in FY 1995, DFAS recouped the $85.2 million of rebates directed by Congress in FY 1994 through increased cost recovery rates. DFAS took this action to comply with the Defense Business Operations Fund policy that allows the recovery of operating losses through increases to future year rates. As a result, the intent of the FY 1994 Congressional rebate, to reduce DFAS costs being passed along to customers, was partially thwarted by the DoD policy.

Congressionally Directed Rebates

Rebate Directed in FY 1994. Senate Report No. 103-153, which accompanied Public Law 103-139, "Department of Defense Appropriations Act, 1994" (the DoD Appropriations Act, 1994), November 11, 1993, stated:

> The Committee recommends reductions totaling $85,200,000 to the military departments' requests for purchasing accounting services from Defense Finance and Accounting Service (DFAS). Though touted as an effort to eliminate redundant accounting and administrative overhead in the Department, the establishment of DFAS has failed thus far to produce verifiable productivity savings. In fact, continuing conflicts between DFAS and the DoD Comptroller over accounting policy and other matters have led to unfortunate delays in implementing the defense business operations fund's accounting and information system. To encourage DFAS to cut overhead, this recommendation reduces funding for accounting purchases planned by the military services by 5 percent. The Committee directs the DFAS to rebate these reductions by reducing its rates charged to the military services.

Rebates Directed in FY 1995. Conference Report No. 104-889, which accompanied Public Law 104-6, "Emergency Supplemental Appropriations and Rescissions for the Department of Defense, Provision" (the Emergency Supplemental Appropriations Act), April 10, 1995, stated:

> The conferees agree to rescind $50,000,000 from the Operation and Maintenance, Defense-wide account, and direct the Defense Finance and Accounting Service (DFAS) to rebate prices charged to Defense Agencies and the Office

of the Secretary of Defense for accounting services provided in fiscal year 1995 in order to reduce expected operating gains by a like amount.

DFAS Actions to Accommodate the Congressional Rebates and Effect on Future Rates

DFAS took action to comply with the Congressionally directed rebates. However, in FY 1995, DFAS recouped the $85.2 million of rebates that were directed by Congress in FY 1994.

Actions to Accommodate Congressional Rebates. DFAS took appropriate action to reduce charges to its customers by $135.2 million during FYs 1994 and 1995. To comply with the DoD Appropriations Act, 1994, DFAS did not bill the Services for $85.2 million in finance and accounting services provided during FY 1994. Also, to comply with the Emergency Supplemental Appropriations Act, DFAS reduced Defense Logistics Agency charges by $50 million for financial services provided during FY 1995.

The FY 1995 Congressionally directed rebate of $50 million was a reduction in expected operating gains and did not increase operating losses. Consequently, future year rates were not increased to compensate for operating losses.

Increased Operating Losses and Effect on Future Rates. In response to the FY 1994 Congressionally directed rebate, DFAS showed a corresponding increase in accumulated operating losses in its budgetary projections for FY 1995. In accordance with DBOF policy, DFAS accumulated operating losses were required to be carried forward and recovered in future year rates. For example, Program Budget Decision 416, December 20, 1993, which established FY 1995 cost recovery rates for DFAS, showed the $85.2 million not billed to the Services in FY 1994 as a reduction in revenues, resulting in an equal increase to operating losses. Therefore, the FY 1995 cost recovery rates were increased to make up for the loss.

DBOF Policy on Recovery of Operating Losses

The "Department of Defense Financial Management Regulation," DoD Regulation 7000.14-R (the DoD Financial Management Regulation), Volume 11B, "Reimbursable Operations, Policy and Procedures -- Defense Business Operations Fund," December 1994, requires that prior year operating losses from underapplied cost recovery rates be carried forward for inclusion in future cost recovery rates.

Since establishment of the DBOF, the USD(C) has supported the carrying forward of operating losses in future cost recovery rates. In the DoD budget process, expected revenues and costs must be estimated up to 2 years in advance in a constantly changing environment. We understand that because of these uncertainties, the USD(C) supports the carrying forward of operating results (accumulated operating losses or gains) in future year rates. The DBOF was expected to operate as a private business, and businesses commonly base their adjustments to future year prices or rates partly on prior year operations. However, we disagree with the USD(C) approval of DFAS budgets containing increases in rates to recover operating losses caused by compliance with Congressional direction.

Summary

In ordering the FY 1994 rebate, the intent of Congress, as stated in the Senate Report accompanying the DoD Appropriations Act, FY 1994, was "to encourage DFAS to cut overhead." By approving DFAS budgets that contain increased cost recovery rates to compensate for losses caused by the directed rebates, the USD(C) is not promoting the reduction of DFAS operating costs. Instead of increasing future cost recovery rates and recovering funds rebated to its customers at Congressional direction, DFAS should be required to show the $85.2 million as a reduction in its equity and should try to achieve an equal reduction in operating costs.

Recommendation for Corrective Action

Deleted Recommendation. As a result of management comments, we deleted Recommendation 2 of the draft report, which recommended that the Under Secretary of Defense (Comptroller) (USD[C]) reverse planned increases in future cost recovery rates to recoup the $85.2 million loss as a result of the FY 1994 Congressionally directed rebate. The loss was recovered in FY 1995.

We recommend that the Under Secretary of Defense (Comptroller) revise the "DoD Financial Management Regulation," Volume 11B, "Reimbursable Operations, Policy and Procedures," December 1994, which requires Defense Business Operations Fund activities to recover accumulated operating losses in future year rates, to exclude Congressionally directed rebates. Rebates should be shown in financial records as a reduction in "Net Position" on the Statement of Financial Position.

Management Comments

We received comments on a draft of this report from the Office of the USD(C) and DFAS. Those comments are summarized below.

USD(C) Comments. The Office of the USD(C) nonconcurred with the conclusions in the draft report. The USD(C), Office of the Deputy Chief Financial Officer, Director for Accounting Policy (the Director), stated that the report was factually incorrect, drew incorrect conclusions, and made inappropriate recommendations. The Director also stated that, when measured against the baseline that Congress reviewed, DFAS reduced its costs by substantially more than Congress anticipated. For example, the DFAS budgeted costs for FY 1994, as shown in the FY 1995 President's Budget, were $432 million below those in the baseline from which Congress made its adjustment. Also, the actual costs for FY 1994 were an additional $90 million below the revised FY 1994 baseline included in the FY 1995 President's Budget. The Director believed that such reductions indicate that DFAS satisfied the Congressional intent to reduce its costs.

DFAS Comments. The Deputy Director for Resource Management, DFAS (the Deputy Director), agreed that the rebate caused an operating loss of $85.2 million and stated that, in accordance with DBOF policy, Program Budget Decision 416 required DFAS to recover the $85.2 million loss along with other FY 1994 operating losses in its FY 1995 billing rates and revenue program. However, the Deputy Director disagreed with our statement that DFAS did not follow Congressional intent to cut costs, resulting in overcharges to its customers. The Deputy Director stated that since the DFAS actual costs for FY 1994 were more than $85.2 million below that agency's approved budget and because the FY 1994 loss recovery was included in the FY 1995 budget approved by Congress, DFAS had fully complied with Congressional direction. The Deputy Director also stated that the FY 1995 Emergency Supplemental Appropriations Act directed the $50 million rebate to reduce projected FY 1995 operating gains and did not direct a commensurate cost reduction. Therefore, by rebating the $50 million, DFAS complied with the intent of Congress.

For the complete text of management's comments, see Part III.

Audit Response

We revised the finding in our draft report that addressed administration of the $50 million rebate in FY 1995. Since the rebate reduced expected operating gains and did not increase operating losses, we agree that it was administered properly.

However, we continue to believe that by carrying forward the $85.2 million loss resulting from compliance with the FY 1994 Congressionally directed rebate, and recovering the loss through increased charges in FY 1995, DFAS did not satisfy Congressional intent. Congress reached similar conclusions. The Senate Committee on Appropriations, Report No. 103-321, July 29, 1994, stated:

> DFAS failed to abide by Congressional intent in its execution of the 1994 program. The Committee learned that DFAS

simply increased prices charged to its customers for fiscal year 1995 to make up the reductions approved by Congress for fiscal year 1994.

Concerning the DFAS cost savings discussed by the USD(C), Director of Accounting Policy, and DFAS, we believe that comparing actual costs incurred to expected costs presented to Congress during the budget process does not necessarily represent savings. DFAS is an evolving organization, and many events on which its expected costs were based have not occurred. For example, most of the $432 million difference in costs incurred in FY 1994 (costs that differed from expected or budgeted costs) did not result from cost savings. Rather, the costs were not incurred because planned consolidations of finance and accounting activities under DFAS, such as consolidations of Nonappropriated Fund accounting activities and overseas finance offices, did not occur.

At the request of the Director, DFAS, and the USD(C), we have met with DFAS resource management personnel on several occasions, but as of this date, we have not been able to verify the cost savings achieved by DFAS in FY 1994 as a result of the Congressional rebate. During FY 1994, DFAS was still consolidating the DoD finance and accounting work load, and therefore showed an overall increase in costs.

The USD(C) also asked us to review the manner in which Congressionally directed rebates were handled by other DBOF activities. The other Congressionally directed rebates were properly administered and involved reductions in expected operating gains, as in the FY 1995 DFAS Congressionally directed rebate. Since the rebates did not increase operating losses, future year rates were not increased to recoup losses, as DBOF policy would have required.

We request that the Under Secretary of Defense (Comptroller) provide comments on the revised finding, recommendation, and potential benefits by February 9, 1996.

Part II - Additional Information

Appendix A. Scope and Methodology

Scope and Methodology

We reviewed USD(C) policies on DBOF financial operations issued from September 1991 through June 1995. We also reviewed reports from the House and Senate Armed Services Committees on the establishment of DBOF cost recovery rates for FYs 1993 through 1995, as well as applicable public laws.

Our audit was limited to the effect of the USD(C) policy on the DFAS, although the policy was applicable to all DBOF business areas. We examined the DBOF program budget decision documents used to establish the cost recovery rates for DFAS for FYs 1993 through 1997. We met with senior managers in the Office of the USD(C) and DFAS to discuss the appropriateness of reflecting Congressional rebates as operating losses and including those rebates in future cost recovery rates set by DFAS.

This financial-related audit was conducted from April through July 1995 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. We did not use computer-processed data or statistical sampling procedures. Appendix C lists organizations visited or contacted during the audit.

Management Controls

A review of management controls was not an objective of this audit because the principal focus was on a DBOF policy, not on management practices or control issues.

Prior Audit Coverage

Since establishment of the DFAS, there have been no previous audits relating to the objectives of our audit of DFAS unit costs. However, the General Accounting Office (GAO) has issued several reports, and GAO officials have testified before Congress on several occasions, regarding DBOF policy on the recovery of operating losses in future year prices. All of the reports and testimony expressed the same opinion. The principal report and opinion are summarized in General Accounting Office Report No. GAO/AIMD-94-132 (OSD Case No. 9339-F), "Defense Business Operations Fund: Improved Pricing Practices and Financial Reports Are Needed to Set Accurate Prices," June 1994. The report stated that the DBOF policy of recovering past operating

losses by increasing future year prices distorts the actual results of DBOF operations in a given year, diminishes the incentive for the DBOF to operate efficiently, and makes evaluation and monitoring of the DBOF difficult. The report contained no recommendations, but the GAO repeated its opinion that the DBOF should be required to justify recovering prior year losses as part of the appropriation process, rather than increasing future year prices.

Appendix B. Other Matters of Interest

During the initial phase of the audit, we became aware of an existing problem. Specifically, DFAS customers had failed to provide sufficient funds to pay for services received. For example, the Army and the Navy had not paid for $74 million in services received during FYs 1993 and 1994. Also, as of March 30, 1995, the Services and the Defense Logistics Agency had not provided sufficient funding to pay for $89 million in financial services provided by DFAS during FY 1995.

The DBOF operates under the concept that its business areas will provide goods and services to customers and will charge fees sufficient to recover costs incurred in providing the goods or services, and that DBOF customers receiving goods or services will promptly pay the costs incurred. The DBOF cannot operate unless customers promptly pay for the goods and services received.

We are reporting this issue because at the time of our audit, the past due amounts had not been paid to DFAS. However, the USD(C) and DFAS have initiated action to collect past due amounts and to ensure that the situation does not recur. For example, the USD(C) has begun to restrict (referred to as "fencing" by Comptroller personnel) DFAS customer appropriations provided for payment of financial services. Fencing appropriations will ensure that funds provided to DFAS customers for the payment of DFAS services can be used only for that purpose.

Further, USD(C) senior managers stated that, beginning in FY 1996, the USD(C) will require DFAS customers to provide reimbursable funding orders to DFAS within 10 working days after the start of the fiscal year for the entire amount of funds provided for payment of financial services. Implementation of these actions should correct the problem of DFAS customers not paying for services received. Therefore, we are not making additional recommendations at this time.

Appendix C. Summary of Potential Benefits Resulting From Audit

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
1.	Compliance with laws and regulations. Eliminating the carrying forward of losses caused by Congressional rebates would reduce the costs passed on to customers of the DBOF, and would ensure that DBOF activities are in compliance with the intent of Congress.	Undeterminable.

Appendix D. Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller), Washington, DC
  Office of the Deputy Chief Financial Officer, Director of Accounting Policy
  Office of the Deputy Comptroller (Program/Budget), Director of Revolving Funds, Washington, DC

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller), Washington, DC

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller), Washington, DC

Defense Agencies

Defense Finance and Accounting Service, Washington, DC
  Defense Finance and Accounting Service Center, Columbus, OH

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
  Office of the Deputy Chief Financial Officer, Director of Accounting Policy
  Office of the Deputy Comptroller (Program/Budget), Director of Revolving Funds

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Defense Agencies

Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency

Non-Defense Federal Organizations

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division, General Accounting Office

Appendix E. Report Distribution

Chairman and ranking minority member of each of the following Congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs and Criminal Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Under Secretary of Defense (Comptroller) Comments

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

COMPTROLLER

AUG 25 1995

MEMORANDUM FOR DIRECTOR FOR FINANCIAL MANAGEMENT DIRECTORATE, DODIG

SUBJECT: Draft Audit Report on Congressionally Directed Rebates in Defense Finance and Accounting Service Cost Recovery Rates (Project No. 5FJ-2010)

In a recent meeting between our two offices, we advised that this office would provide comments on the subject audit report. Subsequent to that meeting this office was advised that the USD(Comptroller) and the Deputy Inspector General, DoD, plan to meet on Monday, August 28, 1995, to discuss the subject audit report. As a result, you asked that we provide comments as soon as possible. Accordingly, the following comments are provided for your consideration.

As you know, the Office of the Under Secretary of Defense (Comptroller), as well as the Defense Finance and Accounting Service, adamantly disagrees with the subject draft report. We believe that the report is factually incorrect, and provides incorrect conclusions and, therefore, inappropriate recommendations. In addition, this report could be read as depicting the Defense Finance and Accounting Service as an organization, with little management vision for containing cost and improving customer service. Further, the report implies that the Defense Finance and Accounting Service may have ignored, or worse manipulated, the intent of congressional action to DFAS' advantage, at the expense of its customers. However, neither of these perceptions are correct. Attached are additional detailed comments on the subject draft audit report. This office anticipates that additional more detailed comments may be provided to your office in the next week or so.

As indicated in the recent meeting, we believe that the subject draft audit report should not be published into a final report. Should you wish to discuss this matter further, please contact me on 695-7000.

Nelson Toye
Director for Accounting Policy

Attachment

Final Report Reference

INSPECTOR GENERAL, DEPARTMENT OF DEFENSE,
DRAFT REPORT
"AUDIT REPORT ON CONGRESSIONALLY DIRECTED REBATES IN DEFENSE FINANCE AND ACCOUNTING SERVICE COST RECOVERY RATES"
(PROJECT NO. 5FJ-2010)

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER) COMMENTS

DoDIG Finding: DFAS inappropriately planned to recover $135.2 million not charged to its customers at the direction of Congress. Revised Page 3

OUSD(C) Response: Nonconcur. The DFAS did not classify the rebates as operating losses (as stated on page 3 and elsewhere in the draft report). The DFAS did not record or make an entry in its financial records classifying the rebates as operating losses. At the direction of the Congress, the DFAS reduced the amount billed to its customers. Prior year amounts (gains or losses) recovered in the DFAS rate are similar to amounts recovered in rates for any other DBOF business area--they are the result of comparing revenue and costs for the applicable years involved. The factors that contribute to the net difference between revenue and cost amounts are various. In the absence of a detailed analysis of all such factors it is difficult for this office to understand how the DoDIG can attribute the planned recovery to specific causes.

This office believes that the actions taken by the DFAS comply with the stated intent of the Congress. When measured against the baseline costs that the Congress reviewed, the DFAS reduced its costs by substantially more than the Congress anticipated. The following table shows costs projected in the President's budget, and those costs ultimately incurred by the DFAS.

	($ in Millions)	
	FY 1994	FY 1995
FY 1994 President's Budget	2,085	-
FY 1995 President's Budget	1,653	1,807
FY 1994 Actual Cost	1,543	
FY 1996/97 President's Budget		1,669

As indicated in the above table, DFAS' budgeted costs, for FY 1994, in the FY 1995 President's budget, were $432 million below those in the baseline from which the Congress made its adjustment. Additionally, the actual costs for FY 1994 were an additional $90 million below the revised FY 1994 cost baseline included in the FY 1995 President's budget. Further, the FY 1995 actual costs are estimated to be over $100 million below the costs estimated in the FY 1995 President's budget. These reductions in costs are considerably more than the congressionally directed rebates of $85.2 million for FY 1994 and $50 million for FY 1995. This office believes that such reductions indicate that the DFAS satisfied the congressional intent to reduce costs.

The FY 1995 congressionally directed rebate in the amount of $50 million directed rebates to Defense Agencies to reduce the projected FY 1995 DFAS operating gain and does not direct a Revised Page 4

Final Report Reference

commensurate cost reduction. In fact, such rebates could contribute to increased operating losses and Defense Business Operations Fund policy requires that such losses be recovered through increases in subsequent year billing rates.

DoDIG Recommendation: Revise the DoD Financial Management Regulation, Volume 11B, which requires Defense Business Operations Fund activities to recover accumulated operating losses in subsequent year rates, to exclude Congressionally directed rebates. Rebates should be reflected as a separate contra-account to the "Net Position" on the Statement of Financial Position. The rebate contra-account should be maintained until it is eliminated through reductions in operating costs. The objective of this treatment is to avoid double crediting of the rebate to DFAS customers, which could occur if operating cost reductions are reflected in reductions to subsequent year rates.

OUSD(C) Response: If this is the desired outcome of the report, recommend that the DoDIG request such a policy change separate from the audit report. This could be accomplished via a memorandum asking the USD(C) to modify Volume 11B "Reimbursable Operations, Policy and Procedures -- Defense Business Operations Fund," of the DoD Financial Management Regulation or by submitting a proposal to the DoD Defense Business Operations Fund Corporate Board for its consideration.

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DoDIG Recommendation: Initiate action to reverse increases planned by the Defense Finance and Accounting Service in future cost recovery rates resulting from Congressionally directed rebates to customer, and make corresponding reductions in customer funding allocations for financial services or otherwise return inappropriate collections to customers.

DoD Response: Nonconcur. This office believes that the DFAS properly processed the congressionally directed rebates and achieved reductions in costs that met or exceeded the intent of the Congress. Additionally, the mechanics of the proposed approach are such that, to accomplish the desired goal, the DFAS would have to retain (rather pass along to its customers in lower future rates) $135 million in future gains (if any).

Defense Finance and Accounting Service Comments

DEFENSE FINANCE AND ACCOUNTING SERVICE
1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291

AUG 11 1995

MEMORANDUM FOR DOD INSPECTOR GENERAL, DIRECTOR,
FINANCE AND ACCOUNTING DIRECTORATE

SUBJECT: Draft Audit Report on Congressionally Directed Rebates

I have reviewed the working draft audit report, Project Number 5FJ-2010, dated August 9, 1995, and titled Congressionally Directed Rebates in Defense Finance and Accounting Service (DFAS) Cost Recovery Rates. I take strong exception to the assertion that DFAS did not follow Congressional intent. Congress instructed us to rebate funds to our customers, and so we did.

In FY 1994 and FY 1995 Congress directed that DFAS rebate $85.2 million and $50.0 million, respectively, to designated customers. As noted in the draft finding, we did this in FY 1994 and have done so in FY 1995. As a result of these rebates, we incurred an $85.2 million operating loss in FY 1994 and are reducing our operating gain by $50.0 million in FY 1995. In accordance with Defense Business Operations Fund (DBOF) policy, the Under Secretary of Defense (Comptroller) directed in Program Budget Decision 416 dated December 20, 1993, the recovery of the FY 1994 loss along with other FY 1994 operating losses in our FY 1995 billing rates and revenue program.

The report recommends that DBOF policy be changed to exclude losses caused by Congressionally directed rebates from recovery in DBOF billing rates. Additionally, it states that DFAS should not be allowed to recover any losses in its FY 1996 and FY 1997 billing rates resulting from the FY 1994 and 1995 Congressionally directed rebates totalling $135.2 million.

I would note that the report incorrectly states that DFAS purposively did not follow the intent of Congress to cut costs and that our actions resulted in our customers being overcharged. This is not correct. DFAS built in an $84.4 million cost reduction into its FY 1994 program. However, Program Budget Decision 416 reduced FY 1994 revenues to reflect the Congressional reduction but not costs. Additionally, our FY 1994 actual costs were more than $85.2 million below our approved program. As directed by Congress, we did rebate to the designated customers the FY 1994 Congressionally directed funds. Both our FY 1994 cost reduction and FY 1995 loss recovery were contained in the FY 1995 Department of Defense (DOD) DBOF budget forwarded to Congress. And, we have budgeted for productivity savings in each succeeding year at a level greater than that which the Congress identified.

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Additionally, the Congressional language in the FY 1995 Emergency Supplemental Appropriations Act directs the rebate of $50 million to Defense Agencies to reduce the projected FY 1995 DFAS operating gain and does not direct a commensurate cost reduction. As a result, by rebating the $50 million to Defense Agencies, we are in compliance with stated Congressional intent. Finally, I would also note that some of the figures the report cites are in error. For example, the amount of DFAS' prior year losses budgeted for recovery in FY 1995, not FY 1996, were $200.5 million, not $240.3 million.

I support your efforts to revise DoD regulations in order to improve management of the DBOF. However, changes to the existing policy on recovering prior year losses should be addressed directly to the Under Secretary of Defense (Comptroller). I am concerned that, based the current report language, the use of DFAS as a test case creates the misleading impression that we are not in compliance with Congressional intent and are purposively overcharging our customers. Neither is the case. I request that you revise the draft accordingly.

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