Report No. DODIG-2012-131 September 19, 2012

Inspector General

United States
Department of Defense

Improvements Needed in How the Defense Finance and Accounting Service Adjusts and Supports Billing Rates

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Acronyms and Abbreviations

AOR	Accumulated Operating Results
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
DoD FMR	DoD Financial Management Regulation
DPBS	DFAS Program and Budget System
FBWT	Fund Balance with Treasury
NARA	National Archives and Records Administration
NOR	Net Operating Results
QMD	Quantitative Methods Division
RMD	Resource Management Decision
U.S.C.	United States Code
USD(C)/CFO	Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

September 19, 2012

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/CHIEF FINANCIAL OFFICER, DOD
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE
DIRECTOR, DEFENSE LOGISTICS AGENCY
NAVAL INSPECTOR GENERAL
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Improvements Needed in How the Defense Finance and Accounting Service Adjusts and Supports Billing Rates (Report No. DODIG-2012-131)

We are providing this report for review and comment. The Defense Finance and Accounting Service (DFAS) did not comply with DoD requirements when it returned $35.5 million to customers in FY 2011. Additionally, DFAS only adjusted one billing rate in returning an additional $128.7 million in FY 2012, and it did not maintain sufficient support for billing rates. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that recommendations be resolved promptly. Comments from the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, were generally responsive, and we do not require additional comments. The DFAS Chief Financial Officer also provided comments that were generally responsive; however, comments on Recommendation B.2 were only partially responsive. Therefore, we request additional comments on this recommendation by October 19, 2012.

Please provide comments that conform to the requirements of DoD Directive 7650.3. If possible, send a portable document file (.pdf) file containing your comments to audfmr@dodig.mil. Copies of management comments must contain the actual signature of the authorizing official. We are unable to accept the /Signed/ symbol in place of the actual signature. If you arrange to send classified comments electronically, you must send them over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 604-8938.

Richard B. Vasquez

Richard B. Vasquez, CPA
Acting Assistant Inspector General
Financial Management and Reporting

Report No. DODIG-2012-131 (Project No. D2011-D000FI-0001.000) September 19, 2012

Results in Brief: Improvements Needed in How the Defense Finance and Accounting Service Adjusts and Supports Billing Rates

What We Did

We determined whether the methodology the Defense Finance and Accounting Service (DFAS) used to estimate the workcounts and direct costs for Retired Military Pay Accounts and Accounting Services for the FY 2011 stabilized billing rates complied with applicable laws and regulations. We also determined whether DFAS had taken action to reduce rates through greater efficiencies.

What We Found

DFAS did not comply with DoD Financial Management Regulation (DoD FMR) requirements when returning $35.5 million to DoD customers in FY 2011. This occurred because a DFAS Resource Management representative misinterpreted guidance from the Revolving Funds Directorate, Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD (USD[C]/CFO). As a result, DFAS did not properly align costs with outputs, potentially causing Accumulated Operating Results to increase. On August 31, 2011, we issued a memorandum to USD(C)/CFO requesting that his office determine an appropriate course of action. On November 8, 2011, he responded but did not take corrective action.

DFAS also did not adjust the FY 2012 billing rates for all services in returning $128.7 million to DoD customers. This occurred because DFAS had not developed procedures to routinely compare costs and revenues at the output levels. As a result, DFAS distorted the FY 2012 billing rates.

In addition, DFAS personnel did not maintain sufficient documentation to demonstrate full compliance with DoD guidance for rate development. This occurred because DFAS did not establish a policy to maintain budgetary documentation. As a result, DFAS could not demonstrate that FY 2011 workcounts or $52.9 million of direct cost for Retired Military Pay Accounts and $254.1 million of direct cost for Accounting Services were based on historical results.

Additionally, we determined that DFAS took action to reduce rates through efficiencies, but we were unable to determine any effect on customer billing rates.

What We Recommend

The USD(C)/CFO should enforce policies for returning Accumulated Operating Results through rate adjustments unless he can support using billing credits.

The DFAS Director of Resource Management should:

- establish procedures to routinely identify the outputs responsible for significant changes in Net Operating Results and reconciling Accounting Services workload,
- provide customers with additional information on accounting services and a monthly comparative analysis of actual and anticipated workcounts, and
- develop policy to identify and maintain budgetary documentation.

Management Comments and Our Response

USD(C)/CFO's comments met the intent of the recommendations. The DFAS Chief Financial Officer's comments on Recommendation B.2 were partially responsive. We request additional comments as specified in the recommendations table on the back of this page.

Recommendations Table

Management	Recommendations Requiring Comment	No Additional Comments Required
Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD		A
Director of Resource Management, Defense Finance and Accounting Service	B.2	B.1, B.3, B.4, C

Please provide comments by October 19, 2012.

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Introduction

Audit Objectives

The objective was to determine whether the methodology the Defense Finance and Accounting Service (DFAS) used to estimate the units of production (workcounts) and direct costs for FY 2011 stabilized billing rates complied with applicable laws and regulations. Specifically, we determined whether DFAS estimated workcounts and direct costs for two outputs, Retired Military Pay Accounts (Output 4) and Accounting Services (Output 11), in accordance with applicable laws and regulations. We also determined whether DFAS had taken action to reduce rates through greater efficiencies. See Appendix A for a discussion of the scope and methodology.

Background on DFAS Services, Costs, and Systems

DFAS personnel pay all DoD military and civilian personnel, retirees, and annuitants, as well as major DoD contractors and vendors. According to DFAS officials, DFAS is the world's largest finance and accounting operation. DFAS consists of nine sites in seven states and two cities overseas, with its headquarters in Indianapolis, Indiana.

DFAS is financed as a working capital fund, obtaining revenue by charging customers for services provided rather than being funded through direct appropriations from Congress. As a working capital fund, DFAS must recoup the costs it incurs for performing services. The goal of all DoD working capital funds is to achieve an Accumulated Operating Result (AOR)[1] of zero. Because DFAS sets rates for its services based on estimated levels of work and costs, DFAS may have either a positive or negative Net Operating Result (NOR) at the end of each fiscal year. DoD Regulation 7000.14-R, "DoD Financial Management Regulation (DoD FMR)," volume 2A, chapter 1, "General Information," October 2008, states that rates charged to customers are to be set to either make up actual or projected losses or give back actual or projected gains in the budget years.

DFAS Services

DFAS classifies its services into specific outputs, which represent its functions, such as military and civilian pay, retired military pay, vendor pay, travel pay, accounting services, and Foreign Military Sales. The November 2010 version of "Doing Business with DFAS: Catalog of Services" (DFAS Catalog of Services), identifies 31 DFAS outputs.[2] See Appendix B, Table B, for a list of DFAS outputs.

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[1] The AOR represents the cumulative impact of gains and losses on total operations of the activity group since the inception of the fund. In the report, we refer to an excessive positive amount of an AOR as an AOR surplus.

[2] DFAS has 29 rate-based outputs. In addition to the rate-based outputs, DFAS provides two services billed at actual cost: Support to Others (Output 18), which is reimbursable work performed by DFAS that is not within the established DFAS rate structure, and Direct System Reimbursement (Output 61), which relates to actual systems and systems support not aligned with a specific output.

We selected two rate-based outputs to examine: Output 4, "Retired Military Pay Accounts," and Output 11, "Accounting Services." The November 2010 DFAS Catalog of Services defined Output 4 (Retired Military Pay Accounts) as:

> all accounts maintained for retirees, annuitants, former spouses, Voluntary Separation Incentive (VSI), Reservist Special Separation Program (RSSP), Victims of Dependent Abuse (VOA), and Combat Related Special Compensation (CRSC) at the end of the processing month. Counts include pay, non-pay, suspended, un-established, and terminated waiting settlement status accounts. Excluded are terminated Retiree and Annuitant accounts which are dropped from the work count total on the first of the month, following the completed processing of the account.

DFAS personnel determine the quantity of workcounts from the number of accounts serviced by the Defense Retiree and Annuitant Pay System. DFAS only provides Output 4 services to the Army, Navy, Air Force, and Marine Corps. In FY 2011, Output 4 comprised approximately 5 percent of the total DFAS estimated revenue, but it had the largest number of estimated workcounts (33.2 million).[3] (Appendix A shows how the workload and direct costs for Outputs 4 and 11 compare to all other outputs.)

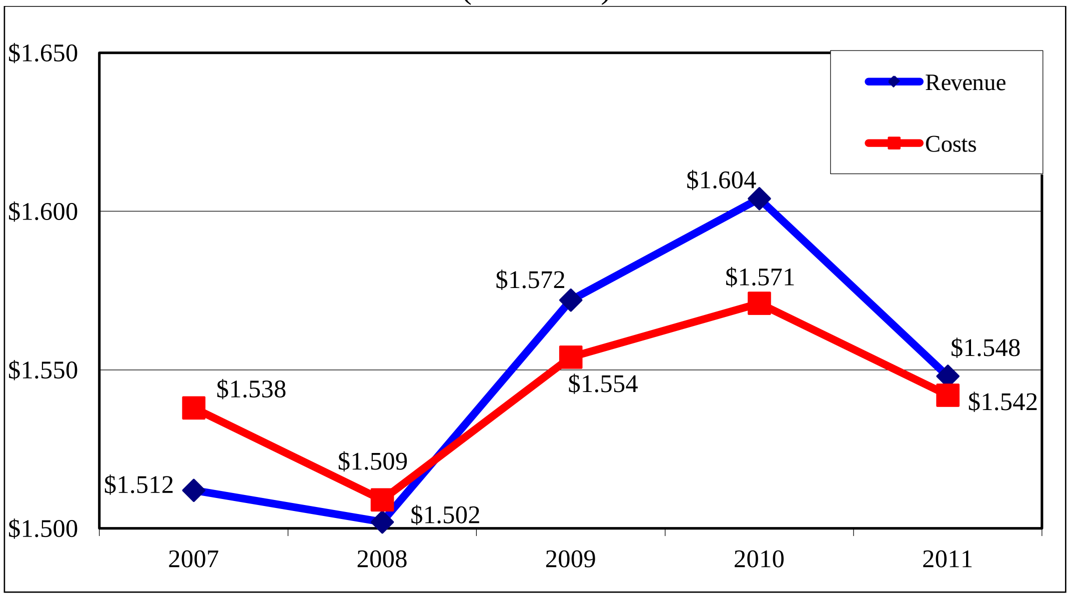
The November 2010 DFAS Catalog of Services defined Output 11 (Accounting Services) as "direct productive civilian, military, contractor, and foreign national labor hours associated with employees performing accounting services." In addition, the DFAS Catalog of Services states that Output 11 workcounts are determined by those labor hours directly reported by employees in the e-Biz system and certified as correct by their supervisors. Output 11 estimated revenues were $467 million, or about 30 percent of the total DFAS FY 2011 estimated revenue. DFAS's estimated revenues for Output 11 totaled $413.7 million from the Army, Navy, Air Force, Marine Corps, and Defense Logistics Agency (DLA).

DFAS Costs

Statement of Federal Financial Accounting Standards No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," July 31, 1995, states that managerial cost accounting should be a fundamental part of the financial management system. Direct costs, indirect costs, and general and administrative costs comprise the basic classification of costs within the financial data used by DFAS to develop output rates. Of DFAS's $1.5 billion in costs incurred during FY 2011, direct costs were $0.9 billion, indirect costs were $0.4 billion, and general and administrative costs were $0.2 billion. The Figure shows the DFAS revenues and costs for FYs 2007 through 2011.

[3] We excluded Outputs 18 and 61 when comparing the estimated number of workcounts because they were cost-reimbursable services, not rate-based outputs. As such, they did not have estimated workcounts, only estimated costs.

Figure. DFAS Revenues and Costs
(in billions)



Note: Amounts obtained from the Accounting Reports 1307.

In FY 2011, DFAS provided services to 43 customers. The Army, Navy, Air Force, Marine Corps, and DLA were DFAS's five largest customers by revenue. Cumulatively, they provided 86 percent of the FY 2011 DFAS revenues.

DFAS Systems

DFAS uses the DFAS Program and Budget System (DPBS) for resource programming and budget planning of full-time equivalents, capital investments, expenses, and workcounts. There are two separate modules of databases in the system: Formulation and Distribution. DFAS uses the Formulation module for budgeting and programming resources. DFAS uses the Distribution module for current-year execution data associated with establishing the agency's annual operating budget.

DFAS uses the e-Biz system as its cost accounting system. The e-Biz Workcount/ Performance Measurement Indicator module allows DFAS to measure the work it performs in order to bill its customers. DFAS defines workcounts for each of the functions it performs for customers. There are three processes to accumulate workcounts: one is internal (data within e-Biz based on labor transactions), another is external (data generated outside e-Biz), and the last is manual (data manually input into the transaction notebook). The e-Biz Timekeeping module feeds the Defense Civilian Personnel System and the Non-Civilian Labor Batch process, which update the general ledger. The internal accumulation process updates the Performance Measurement Indicator module.

Stabilized Rates

DoD FMR, volume 2B, chapter 9, "Defense Working Capital Funds Activity Group Analysis," September 2008, defines a stabilized rate as the cost per direct labor hour (or other output measure) customers are charged for the products and services provided by the activity. The stabilized rate is determined by taking an approved cost per output measure for the budget year and adjusting it for inter-Fund transactions and the impact of prior-year gains or losses as reflected by the AOR. Chapter 9 also states that rates charged to customers are to be developed by working capital fund activities in their budget estimates to recoup all costs associated with the operating and capital budgets, including all labor and non-labor, direct, indirect, and general and administrative costs.

A stabilized billing rate policy serves to protect customers of a working capital fund from unexpected inflationary increases and better assures customers that they will not need to reduce programs to pay for higher-than-anticipated prices. Once established, billing rates are stabilized for the budget year and will not change during the execution year, except in unusual circumstances. Additionally, a stabilized billing rate allows activities to fully execute the budgeted program level and permits more effective planning and use of financial resources. DFAS calculates billing rates 2 fiscal years in advance of the year of execution. DFAS personnel finalized the DFAS FY 2011 billing rates in early January 2010. Appendix B describes the DFAS rate development process.

Review of Internal Controls Over the Development of Billing Rates

DoD Instruction 5010.40, "Managers' Internal Control Program (MICP) Procedures," July 29, 2010, requires DoD organizations to implement a comprehensive system of internal controls that provides reasonable assurance that programs are operating as intended and to evaluate the effectiveness of the controls. We identified internal control weaknesses. DFAS did not comply with the DoD FMR guidance when it returned $35.5 million to its customers in FY 2011 because DFAS Resource Management personnel misinterpreted the Under Secretary of Defense (Comptroller)/Chief Financal Officer, DoD (USD[C]/CFO), President's Budget 2011 Resource Management Decision (RMD) 700, Issue No. RF-D002-DFAS, believing that a specific amount should be returned to each customer. In addition, DFAS personnel did not adjust billing rates for all services for prior gains when it adjusted the FY 2012 billing rates for Output 11 to return $128.7 million in positive AOR to its customers because DFAS had not developed procedures to routinely compare costs and revenues at the output level so that it could identify the causes for the increasing AOR. Finally, DFAS personnel did not establish a policy to maintain sufficient documentation for billing rates. We will provide a copy of the report to the senior official responsible for internal controls in DFAS.

Finding A. Improper Method Used to Return AOR to Customers in FY 2011

DFAS Resource Management personnel chose an improper method for returning $35.5 million of AOR to customers in FY 2011. Specifically, DFAS personnel failed to follow a directive from the USD(C)/CFO, Revolving Funds Directorate, not to use a billing credit methodology, but to adjust the billing rates to comply with the DoD FMR. This occurred because the DFAS Resource Management personnel misinterpreted the President's Budget 2011 RMD 700, Issue No. RF-D002-DFAS, believing that a specific amount should be returned to each customer, which could be done only by billing credits to DFAS customers. As a result, DFAS did not properly align its costs with its outputs, potentially causing AOR to increase.

On August 31, 2011, we issued a memorandum to USD(C)/CFO, requesting his office to determine whether the DFAS billing credit methodology improperly augmented customers' appropriations and to direct an appropriate course of corrective action. He responded on November 8, 2011, concluding that the billing credit methodology did not improperly augment customer appropriations. Therefore, he did not direct DFAS to take any additional action. However, USD(C)/CFO personnel did not perform a documented analysis to support this position. Without this information, the question remains whether the use of billing credits had the equivalent impact on customer accounts as lowering customer rates, which may have led DFAS to augment customer appropriations in FY 2011.

AOR Increased From FY 2008 to FY 2010

According to fiscal year-end Accounting Reports 1307,[4] the DFAS recoverable AOR[5] increased from $101.8 million in FY 2008 to $161.1 million in FY 2010. Additionally, the reports showed that DFAS's FY 2010 Fund Balance with Treasury (FBWT)[6] increased to approximately $132 million, more than five times the FY 2008 ending balance of $24.2 million. Table 1 shows the increases in DFAS's AOR and FBWT from FY 2008 through FY 2010.

[4] Accounting Report 1307 is the main source and official document for budget execution for working capital funds.
[5] Recoverable AOR is the sum of the unadjusted AOR at the beginning of the year, prior-period adjustments, and the NOR. Recoverable NOR is intended to disclose differences, if any, between NOR reported on the Statement of Operations and the operating results used in the budget formulation of stabilized billing rates. As a matter of policy, any amounts that a DoD Component requests be excluded from its Defense Working Capital Fund rates, whether identified in the USD(C)/CFO guidance as permissible or requested by the DoD Component, must be adequately documented and quantified. When discussing AOR throughout the report, recoverable AOR is the amount discussed.
[6] FBWT is an entity asset account that reflects the available funds in the entity's accounts with Treasury.

Table 1. DFAS AOR and Cash Accumulation (in millions)

Fiscal Year Ending	AOR Amount	FBWT
2008	$101.8	$24.2
2009	117.2	72.1
2010	161.1	132.0

The increase in AOR indicates that DFAS charged its customers more than the costs it incurred to provide them with billed services.

The President's Budget 2011 RMD 700, Issue No. RF-D002-DFAS, directed DFAS to adjust FY 2011 customer rates to return $35.5 million of the positive AOR. Revolving Funds Directorate personnel stated that they intended for the rate changes to lessen the amount of revenue DFAS would collect from its customers during FY 2011, thereby decreasing the DFAS AOR. Within RMD 700, Revolving Funds Directorate personnel identified the following factors as justification for the DFAS rate reduction.

- DFAS had positive AOR and a cash gain of approximately $72.1 million in FY 2009.
- Actual 2009 workcount volume exceeded budgeted amounts and was expected to continue in FY 2010.
- The FY 2010 cash balance would continue to grow, so a rate decrease was required in FY 2011 to stabilize the rate structure and cash growth.

Within RMD 700, Revolving Funds Directorate personnel identified projected amounts to be returned to specific customers.

DFAS Personnel Did Not Follow Guidance in Returning AOR

Contrary to guidance from the Revolving Funds Directorate, DFAS personnel returned $35.5 million of AOR surplus as billing credits in FY 2011. From January 2011 through August 2011, DFAS returned the AOR to DoD customers by crediting the customer's Military Interdepartmental Purchase Request applicable at the time of the return. DFAS credited $32.8 million to its five major customers.[7] Table 2 provides a breakdown of the billing credit amounts issued by DFAS.

[7] DFAS returned the remaining $2.7 million to 24 other Defense organizations. The DoD Office of Inspector General was one of the 24 other organizations.

Table 2. Billing Credits Issued by DFAS (in millions)

DFAS Customer	Amount DFAS Credited to Customers on Bills
Army	$15.6
Navy	7.2
Air Force	8.0
Marine Corps	1.7
DLA	0.3
Other DFAS Customers	2.7
Total	**$35.5**

By providing billing credits to its customers, rather than adjusting rates to prevent AOR growth, DFAS failed to comply with DoD FMR, volume 2A, chapter 1.

DFAS Personnel Misinterpreted Guidance

DFAS Resource Management personnel stated that when reviewing RMD 700, they believed the amounts listed were exact amounts that USD(C)/CFO wanted each customer to receive. However, in correspondence with DFAS personnel in December 2010, Revolving Funds Directorate personnel stated that DFAS was not responsible for ensuring that customer bills were decreased by the exact amount listed in RMD 700. On December 30, 2010, Revolving Funds Directorate personnel informed DFAS that returning the positive AOR using billing credits was not approved because doing so did not adhere to DoD FMR guidance. Revolving Funds Directorate personnel provided DFAS the following reasons for denying the proposed billing credit methodology.

Revolving Funds Directorate personnel informed DFAS that returning the positive AOR using billing credits was not approved because doing so did not adhere to DoD FMR guidance.

- The RMD directed a total AOR amount to return to customers through the rates. However, DFAS was not responsible for ensuring that bills to individual customers decrease exactly as shown in the RMD.

- Rebating customers for the AOR surplus, rather than adjusting rates to prevent the growth of AOR, was not in compliance with the DoD FMR.

- The use of a rebate to customers implies customer rates were higher than actual costs on a recurring basis, which defeats the stabilized rate concept. Further, it can be viewed as extending the life of an appropriation – higher rates paid by customers in one year are returned in a rebate the following year for future use.

DFAS returned the positive AOR in the form of a credit on the customer bills to prevent the bias of too little or too much being returned to a specific customer, which could happen if the AOR adjustment was built into the rates and DFAS did more or less work for customers than was expected. DFAS Resource Management personnel stated that if they adjusted the customer billing rates, they could not ensure that the customers received the exact AOR return amounts identified in RMD 700. DFAS Resource Management personnel concluded that the only way to ensure an exact refund of AOR listed on RMD 700 was to provide a credit to each customer's bill.

DFAS personnel acknowledged that the alternate methodology violated the DoD FMR, but stated that revising billing rates within a budget execution year would have defeated the purpose of setting and stabilizing rates 2 years in advance. According to DFAS Resource Management personnel, reversing and correcting the bills would have required a significant amount of rework and caused additional costs to be billed to their customers; therefore, DFAS choose to issue billing credits.

Costs Were Not Properly Aligned With Outputs

By providing billing credits, DFAS personel did not properly align its costs with its outputs. By not aligning the costs with outputs, DFAS could cause the AOR to increase further, which would eventually lead to future billing rate adjustments. In addition, providing billing credits to organizations whose annual funds were overcharged in a prior fiscal year could result in an augmentation of those appropriations.

The term "augmentation" refers to an action taken by an agency which increases the effective amount of funds available in that agency's appropriation. This generally results in obligations and expenditures by that agency in excess of the amount originally appropriated by Congress. Augmentation is considered a violation of law because Congress appropriates a specific amount of funding to agencies for specific purposes during a specific period of time. If an agency obtains additional funding from another source, unless provided for by another law, it has more budget authority than Congress provided.

The basis for the prohibition against augmentation is that the action would normally result in a violation of one or more of the following legal provisions:

- Article I, Section 9, Clause 7 of the Constitution, which states, "No money shall be drawn from the Treasury, but in Consequence of Appropriations made by law."

- Title 31, United States Code (U.S.C.), Section 1301 (a) – the "Purpose Statute," which states, "Appropriations shall be applied only to the objects for which the appropriations were made, except as otherwise provided by law.

- Title 31, U.S.C., Section 3302 (b) – the "Miscellaneous Receipts Statute," which states, "Except as [otherwise provided] an official or agent of the Government receiving money for the Government from any source shall deposit the money in the Treasury as soon as practicable without deduction for any charge or claim."

By returning the positive AOR using billing credits, DFAS may have extended the life of an annual appropriation beyond the lawful period for new obligations. This situation could give the appearance of improperly augmenting appropriated funds by the amount of the billing credit.

USD(C)/CFO Was Notified and Responded

On August 31, 2011, we issued a memorandum to USD(C)/CFO that requested his office direct an appropriate course of action, such as directing DFAS to reverse the billing credits applied to its customers for the return of the excess AOR and either adjust future rates accordingly or grant an exception to the DoD FMR (see Appendix C). On November 8, 2011, in response to the memorandum, the USD(C)/CFO stated that he concluded, after legal and comptroller review, that the DFAS billing credit methodology did not augment customer appropriations for FY 2011 by enabling customers to operate above those levels that would have existed had DFAS lowered its rates for FY 2011 (see Appendix D). He also stated that it was not necessary to waive any provisions in the DoD FMR or require adjustment to FY 2011 rates or billings. The USD(C)/CFO's position was that the issuance of billing credits had an equivalent impact on customer accounts as would the lowering of customer rates. However, he did not explain how the issuance of billing credits had the equivalent impact on customer accounts.

Documentation provided by Revolving Funds Directorate personnel indicated that the DoD General Counsel advised that no augmentation of customer appropriations had occurred and the billing credit methodology had an equivalent impact on customer accounts as lowering customer rates. However, Revolving Funds Directorate personnel could not provide support to show that General Counsel had done any analysis to support these assertions.

The position that billing credits had an equivalent impact on customer accounts as lowering customer rates contradicted earlier communication between Revolving Funds Directorate personnel and DFAS personnel. Without support to demonstrate that individual credits for past purchases would equal reduced rates in a future year, we maintain that the use of billing credits could have augmented customer appropriations and was a violation of the DoD FMR.

USD(C)/CFO personnel should document the analysis supporting the decision to allow billing credits as an alternate methodology to adjusting rates as well as the determination that using billing credits did not extend the life of customer funds. If USD(C)/CFO personnel can provide a business case that supports the position that returning positive AOR through billing credits is an acceptable course of action that does not result in augmenting customer appropriations and has an equivalent impact on customer accounts, then it should change the DoD FMR. If this is not his position, then the USD(C)/CFO should ensure that DFAS adheres to the DoD FMR requirements in returning AOR surpluses through customer rates.

Conclusion

The DoD FMR defines how a Defense Working Capital Fund entity, such as DFAS, should return an AOR surplus. In returning $35.5 million to DoD customers through billing credits from January 2011 through August 2011, DFAS did not comply with the DoD FMR and explicit guidance from the Revolving Funds Directorate. In response to our memorandum dated August 31, 2011, USD(C)/CFO stated that the DFAS billing credit methodology did not augment customer appropriations for FY 2011 and had an equivalent impact on customer accounts as would the lowering of customer rates. Although he stated that it was not necessary to grant an exception to the DoD FMR or adjust FY 2011 rates or billings, he did not dispute that DFAS did not follow the DoD FMR.

Additionally, Revolving Funds Directorate personnel could not provide documentation to support that the DFAS billing credit methodology had an equivalent impact on customer accounts as would lowering customer rates and did not extend the life of customer funds. By not adjusting billing rates for the positive AOR, DFAS did not properly align its costs with its outputs and increased its risk of having to return additional AOR in the future.

Management Comments on the Finding and Our Response

USD(C)/CFO Comments on the Augmentation of FY 2011 Funding Levels Caused by DFAS Issuing Billing Credits

USD(C)/CFO provided comments on the finding discussion. He stated that he did not agree with the conclusion that FY 2011 appropriation accounts of DFAS customers might have been augmented by DFAS's issuance of billing credits in lieu of downwardly adjusting FY 2011 customer rates. Further, he stated that RMD 700, Issue No. RF-D002-DFAS, instructed DFAS to adjust rates to return approximately $35.5 million of AOR to its customers and decremented each customer's funding request by an amount commensurate with that reduction. Customer requirements were not reduced, but their budget requests were reduced in anticipation of a lower bill from DFAS.

USD(C)/CFO also stated that in the year of execution, without action by DFAS, customer Operation and Maintenance appropriations available for non-DFAS requirements would, in effect, have been reduced by approximately $35.5 million below amounts budgeted. Therefore, he concluded that the impact on the FY 2011 customer appropriation accounts by DFAS's issuing the billing credits was equivalent to the effect on such appropriations had DFAS decreased FY 2011 customer rates.

Our Response

We acknowledge that RMD 700, Issue No. RF-D002-DFAS, instructed DFAS to return approximately $35.5 million of AOR to its customers and decremented each customer's funding request by an amount commensurate with that reduction. However, the return of an AOR surplus to customers indicates that the rates charged by DFAS exceeded DFAS costs in previous years. By returning the AOR surplus using billing credits in subsequent years, DFAS may have extended the life of an annual appropriation, such as Operation and Maintenance funds. In addition, depending on how the estimated workcounts compared to actual workcounts, the amounts billed to DFAS customers may have been more or less than the billing credits. For example, as stated in Finding C, DFAS significantly underestimated Air Force workcounts and overestimated Marine Corps workcounts for Output 11 at the major customer level in FYs 2008, 2009, and 2010.

Recommendation, Management Comments, and Our Response

A. We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, document the analysis supporting the decision to allow billing credits as an alternate methodology to adjusting rates and the determination that using billing credits did not extend the life of customer funds. If he can provide a business case that supports this position, he should change DoD policy and allow this as an alternate approach for returning positive Accumulated Operating Results. Otherwise, he should enforce compliance with approved policies for returning Accumulated Operating Results through rate adjustments.

USD(C)/CFO Comments

USD(C)/CFO partially agreed with the recommendation. He stated that his office decided not to issue policy to allow working capital fund activities to issue billing credits as a means of reducing AOR because the adjustment of rates charged to working capital fund customers remains the authorized method for reducing AOR. Therefore, he stated, DoD would not undertake a business case analysis to compare the effects of reducing customer rates with the effects of issuing billing credits. However, he stated that the DoD FMR, volume 2B, chapter 9, would be updated to clarify and strengthen guidance on management-directed AOR reductions.

Our Response

Comments from USD(C)/CFO were generally responsive. Without a business case analysis, we agree that the USD(C)/CFO should not change DoD policy to allow working capital fund activities to issue billing credits as an alternate methodology to adjusting rates. The use of billing credits implies that customers rates were higher than actual costs on a recurring basis, which defeats the stabilized rates concept and should be avoided. Clarifying and strengthening guidance in the DoD FMR on management-directed AOR reductions will be helpful, but ineffective if DoD policy is not enforced. The USD(C)/CFO comments met the intent of the recommendation, and no additional comments are necessary.

Finding B. Return of AOR Distorted FY 2012 Billing Rates

DFAS Resource Management personnel did not adjust the FY 2012 billing rates for the 29 rate-based outputs[8] for prior gains to ensure reimbursable costs would be recovered on a break-even basis. Instead, DFAS returned $128.7 million to DoD customers by reducing the FY 2012 billing rates for Output 11 (Accounting Services). This occurred because DFAS had not developed procedures to routinely compare costs and revenues at the output level so that it could identify the causes for the increasing AOR. As a result, DFAS distorted FY 2012 billing rates for Output 11, and DFAS customers had more concerns over the development of the Output 11 billing rates. DFAS's efforts to improve the cost allocation process should lead to more accurate billing rates and better information for customers to develop realistic plans and budgets.

DoD Had Guidance for Adjusting Customer Rates

DoD FMR, volume 11B, chapter 1, "Defense Working Capital Funds General Policies and Requirements," October 2002, states that Defense Working Capital Fund activities operate on a break-even basis and that customer rates are to be established on an end-product basis to recover, over the long term, the cost of products or services to be provided. It further states that the budget process is the mechanism used to ensure that adequate resources are budgeted in the customer's appropriated fund accounts to pay the established rates.

DoD FMR, volume 2B, chapter 9, states that, except in unusual circumstances, prices for the budget year are to be set to break even over the long run. Customer rates are set to achieve a zero AOR over time. The AOR and the NOR are the primary financial management targets of a Defense Working Capital Fund entity and they are used in conjunction with other performance metrics to assess overall operational effectiveness. The Revolving Funds Directorate established an AOR goal for DFAS of $80.4 million in FY 2011. In the President's Budget submission in February 2011, DFAS included an FY 2012 AOR estimate of $55.5 million. However, in October 2011, the Revolving Funds Directorate established an AOR goal of zero for DFAS in FY 2012.

The Revolving Funds Directorate and DFAS planned additional actions to reduce the AOR that had increased to $177.7 million at the end of FY 2011. In the FY 2012 President's Budget Request submission to the USD(C)/CFO, dated August 2010, DFAS identified $50 million that it could return to customers during FY 2012. During the review of the FY 2012 DFAS President's Budget Request submission, the Revolving Funds Directorate determined that DFAS could return an additional $20 million of AOR during FY 2012. In December 2010, the Revolving Funds Directorate formally directed

[8] DFAS has 29 rate-based outputs. In addition to the rate-based outputs, DFAS provided two services billed at actual cost: Support to Others and Direct System Reimbursement.

DFAS to return the $20 million in the President's Budget 2012 RMD 700, Section 700A2, Issue No. RF-005. Further, after approving the FY 2011 operating costs in October 2010, the Revolving Funds Directorate reduced the FY 2011 DFAS annual operating budget by $58.7 million in the President's Budget 2012 RMDs 702 and 703A2. However, because the FY 2011 rates had already been established, DFAS reduced the FY 2012 rates by an additional $58.7 million. In total, DFAS had $128.7 million to return to its customers in FY 2012. Table 3 summarizes the sources of the FY 2012 AOR return.

Table 3. FY 2012 AOR Return (in millions)

Source of AOR Return	AOR Return
DFAS FY 2012 President's Budget Request Submission	$50.0
USD(C)/CFO President's Budget 2012 RMD 700	20.0
USD(C)/CFO FY 2011 Budget Reduction	58.7
Total	**$128.7**

DFAS Could Not Identify the Outputs That Caused AOR to Increase

DFAS personnel did not adjust FY 2012 billing rates for all services for prior gains to ensure that reimbursable costs would be recovered on a break-even basis, which was not consistent with guidance in the DoD FMR. Rather than adjusting all billing rates to return the AOR surplus, DFAS only reduced the rate for Output 11 (Accounting Services) by $128.7 million. According to volume 11B, chapter 1, a Defense Working Capital Fund should establish, whenever feasible, standard prices or stabilized rates and unit prices for goods and services, thus enabling ordering agencies to more confidently plan and budget.

According to a DFAS Resource Management representative, the decision to reduce only the Output 11 rate was made by managers in DFAS Resource Management. DFAS Resource Management personnel provided senior DFAS officials with two options: either apply the positive AOR return across multiple outputs or to Output 11. DFAS Resource Management managers, after conferring with Revolving Funds Directorate personnel, chose to apply the positive AOR to Output 11. The Revolving Funds Directorate personnel approved the DFAS methodology for returning the entire AOR amount via a single output. DFAS personnel stated that the most equitable manner to return the funds was to factor the entire $128.7 million into the Output 11 billing rates for the following reasons:

- DFAS performed accounting services for each of its customers.
- Output 11 had a large enough cost base to absorb the amount of the adjustment.
- DFAS could better track the amount being returned by adjusting only one output.

However, by reducing the reimbursable costs of only one output, DFAS did not take into account the revenues and costs of the other outputs that contributed to the growth in NOR, which increases or decreases the AOR annually. A more equitable manner and an approach more consistent with the DoD FMR would have been for DFAS to apply the positive AOR to the outputs that caused the AOR. DFAS Resource Management personnel could not take this approach because they could not identify which outputs caused the positive AOR.

DFAS personnel had not developed procedures to routinely compare costs and revenue at the output level so that they could identify the specific reasons for the increasing AOR. As a result, DFAS could not ensure that the AOR would be returned to those customers who use the services which contributed to the increased AOR. Although each customer would receive some benefit by DFAS's returning the $128.7 million in AOR surplus through Output 11, the amount being returned would vary based on the amount of work DFAS executed for each customer in FY 2012, which might not accurately reflect the true cost of DFAS services. To ensure an equitable return of AOR and avoid artificial fluctuations in customer rates and budget estimates, DFAS should establish procedures to routinely identify which outputs are responsible for significant increases and decreases in the NOR. By identifying the outputs responsible for significant increases and decreases in NOR, DFAS could charge customers more reliable rates for services provided.

DFAS personnel had not developed procedures to routinely compare costs and revenue at the output level so that they could identify the specific reasons for the increasing AOR.

AOR Return Distorted Billing Rates and Increased Customer Concerns

Applying the entire $128.7 million to Output 11 distorted the FY 2012 Output 11 billing rates charged to DoD customers.[9] For its five major customers, DFAS significantly reduced the billing rates for Output 11 in FY 2012 by 29 percent to 39 percent. Table 4 shows the reduction in Output 11 rates from FY 2011 to FY 2012.

Table 4. Output 11 Rates for FYs 2011 and 2012

DoD Component	FY 2011	FY 2012	Percent Decrease
Army	$71.21	$45.90	35.5
Navy	73.73	46.79	36.5
Air Force	72.55	44.04	39.3
Marine Corps	74.01	49.21	33.5
DLA	70.43	49.43	29.8

[9] Output 11 (Accounting Services) is a customer-unique rate; therefore, it has a different rate for each customer.

For example, DFAS charged Army customers $45.90 per direct billable hour for accounting services starting October 1, 2011, $25.31 less per direct billable hour than in FY 2011. (See Appendix E for further details regarding the reductions in rates.)

Customers Were Concerned About the Lack of Information on the Rate Development Process

Some DFAS customers expressed concerns about the reliability of DFAS rates and the workcounts used to estimate rates, especially Output 11. DFAS client executive liaisons coordinated the FY 2011 estimated workcounts for Output 4 (Retired Military Pay Accounts) and Output 11 with their customers to obtain concurrence on the projections. The Military Services agreed to the Output 4 estimates,[10] and each of the Military Services, along with DLA, agreed verbally or in writing to the estimated Output 11 workcounts.

However, Army, Navy, and DLA personnel expressed concerns about the process. Specifically, they stated that the time DFAS allowed them to coordinate the workcounts was not sufficient to adequately respond to the workcount estimates. In addition, Army personnel stated that they did not have sufficient information on the FY 2011 workcounts and costs and lacked the information necessary to reduce their costs. Army personnel also expressed concerns that additional funding would be needed to cover the artificially low FY 2012 Output 11 funding requirement. Output 11 rates were expected to increase significantly in FY 2013 if the Revolving Funds Directorate personnel did not direct any additional AOR return. DFAS should provide sufficient information to its customers so that they can better understand the accounting services provided and take appropriate action to reduce their costs.

Inability to Reconcile Output 11 Workcounts

DFAS was unable to identify anyone who routinely reconciled the direct productive labor hours in the e-Biz system to the Output 11 workcounts on the customer bills. DFAS personnel stated that they could trace a customer's bill back to the timekeeping data, but the reconciliation would be very difficult. They also stated that they did not believe that customer bills were intended to be able to reconcile to the DFAS timekeeping data. However, according to DFAS's workcount measure definition, Output 11 is billed as direct productive civilian, contractor, military, and foreign national hours associated with employees performing accounting services. Although no additional hours were to be distributed to customers above those directly reported by employees in e-Biz and certified as correct by supervisors, DFAS had limited assurance that this occurred. DFAS should develop procedures for reconciling the Output 11 workcounts billed to customers to the direct, productive labor hours in the timekeeping system.

[10] DFAS only provides Output 4 (Retired Military Pay Accounts) to Army, Navy, Air Force, and Marine Corps customers.

Unit Cost Effort Should Improve the Cost Allocation Process

In FY 2010, DFAS initiated an effort to improve its cost allocation in an attempt to identify unassigned costs, which should help identify the AOR growth as well as better align costs with specific outputs. Revolving Funds Directorate personnel recognized in the President's Budget 2011 RMD 700 that DFAS faced challenges evaluating prior-year execution data and reconciling actual cost data against budgetary rates. In the RMD, Revolving Fund Directorate personnel directed DFAS to report on its efforts to improve its rate development process by comparing actual costs from previous years to the amounts that were built into the rate structure.

DFAS personnel stated that the DFAS unit cost effort was an endeavor to reinstitute a process that was in place before the implementation of the e-Biz timekeeping module in October 2002. Further, they stated that the FY 2010 focus was on internal efforts to improve the DFAS cost allocation methodology. During FY 2010, DFAS defined a new cost allocation process and designed a structure for Agency Unit Cost, Agency Revenue/ Cost, and Strategic Unit Cost reporting. Beginning in FY 2011, the focus was on reporting metrics. Planned reporting requirements include the following items.

- **Agency Unit Cost.** A monthly measure with an official report to the DFAS Director, which provides both the budgeted and executed unit cost data by DFAS cost indicator for various output and product levels.

- **Agency Revenue/Cost.** A quarterly measure to provide year-to-date revenue and execution cost performance at the agency and primary client levels.

- **Strategic Unit Cost.** A quarterly measure that provides Price/Usage variance data.

In May 2011, DFAS began unit cost reporting to the DFAS Director for specific DFAS outputs. In July 2011, DFAS began using an Off-Line Cost Allocation database to allocate cost to both the output and client levels in preparation of the rates for the President's Budget Review 2013. DFAS also combined the unit cost reporting with some productivity reporting to provide a summary of unit cost reporting budget variances by output. According to a DFAS Resource Management personnel, DFAS has been able to nearly reach a sustainment phase of monthly unit cost reviews after working with the DFAS sites and organizations to fine-tune its unit cost reports. Beginning in FY 2012, DFAS unit cost reporting is to use both budget and execution data from the Off-Line Cost Allocation database.

According to the DFAS Resource Management personnel, DFAS was already seeing the benefits of the unit cost analysis as it allowed DFAS to more properly align costs and properly resource activities. DFAS also anticipated realizing efficiencies, identifying areas where cost allocation corrections needed to be made in the billing rates, and identifying trends by reporting both the unit cost and productivity together. The DFAS

Resource Management representative stated the goal was to have better cost allocations within the organization, which would allow it to better identify its cost-reimbursable requirements. Although we did not analyze the unit cost effort, these efforts demonstrate the DFAS commitment to properly identifying and allocating costs to provide accurate billing rates to its customers. As part of reviewing and improving upon its cost allocation methodology, DFAS should provide its customers with a monthly comparative analysis of actual and anticipated workcounts so customers could take action and have better visibility and understanding of execution issues.

Conclusion

DFAS Resource Management personnel did not comply with DoD FMR requirements when it adjusted the FY 2012 billing rate for Output 11 in order to return $128.7 million in AOR surplus to its customers. Adjusting the billing rate for only 1 of the 29 direct billable outputs DFAS regularly provides its customers did not meet the goal of stabilized rates and prices.

Rates are required to be established during the budget process at levels estimated to recover the budgeted costs of goods and services to be provided, including prior-period gains and losses. Because DFAS personnel did not have procedures to identify the specific cause of AOR increases, they were returning the positive AOR through a reduction of a single output billing rate during FY 2012. In doing so, DFAS management could not ensure that AOR would be returned to those customers who used the services that caused the positive AOR.

In addition, DFAS personnel should evaluate the accuracy of budgeted rates through a comparison with actual execution data in response to the President's Budget 2011 RMD 700, Issue No. RF-D002-DFAS, and they should provide customers with the information they need to better understand accounting services DFAS personnel performed and the variance between anticipated levels of service and actual execution data. This is especially important for Output 11 because accounting services are vaguely defined and billed as direct, productive labor hours.

Recommendations, Management Comments, and Our Response

B. We recommend that the Defense Finance and Accounting Service, Director of Resource Management:

1. Establish procedures to routinely identify which outputs are responsible for significant increases and decreases in Net Operating Results.

Defense Finance and Accounting Service Comments

The DFAS Chief Financial Officer (also serving as the DFAS Director of Resource Management) agreed and stated that DFAS has developed and implemented a Unit Cost analysis capability that allows for the identification of output execution revenue and cost variances from the budgeted plan and identifies the impact each output has on increases and decreases to the DFAS NOR.

Our Response

Comments from the DFAS Chief Financial Officer were responsive, and the actions met the intent of the recommendation.

2. Develop procedures for reconciling the Output 11 workcounts billed to customers to the direct, productive labor hours in the timekeeping system.

Defense Finance and Accounting Service Comments

The DFAS Chief Financial Officer agreed and stated that the DFAS timekeeping system does not have the capability to link individual employee records to customer bills, but does provide detailed organizational information allowing DFAS to reconcile timekeeping data between the revenue reflected on its financial statements and the customer bills.

Our Response

The DFAS comments were partially responsive. DFAS should be able to reconcile timekeeping data between the revenue reflected on its financial statements and customer bills. However, DFAS did not state how it would use the detailed organizational information in its timekeeping system to reconcile the Output 11 workcounts billed to customers to the direct, productive labor hours in the timekeeping system.

DFAS should also be able to reconcile Output 11 workcounts to the direct, productive labor hours in the timekeeping system. DFAS customers should have assurance that only hours worked by DFAS personnel while performing accounting services are being billed to them.

We request that the DFAS Chief Financial Officer reconsider her response to the recommendation and provide additional comments on the final report addressing DFAS's plans for reconciling Output 11 workcounts to the direct labor hours in the timekeeping system.

3. Provide customers with a monthly comparative analysis of actual and anticipated workcounts so customers can take actions and have better visibility and understanding of execution issues.

Defense Finance and Accounting Service Comments

The DFAS Chief Financial Officer agreed and stated that the DFAS Client Executive staff provides customers with a monthly breakout of billing, including workload/ workcount execution year-to-date by output and an adjusted estimate of anticipated workload/workcounts for the remainder of the year.

4. Provide sufficient information to customers so that they can understand the accounting services performed and how they contribute to increased Defense Finance and Accounting Service costs and workload.

Defense Finance and Accounting Service Comments

The DFAS Chief Financial Officer agreed and stated that DFAS has initiated a product that provides further transparency of direct billable hours, identifying the specific type of accounting services being performed. This product would be coupled with monthly workload updates to the customers, providing a forum for DFAS and its customers to discuss costs and future estimates.

Our Response

Comments from the DFAS Chief Financial Officer were responsive, and the actions met the intent of the recommendation.

Finding C. DFAS Needs to Maintain Supporting Documentation for Workcounts and Costs

DFAS Resource Management personnel complied with certain provisions of the rate development requirements in section 2208, title 10, U.S.C. (10 U.S.C. § 2208 [2004]), and the DoD FMR for submitting budget estimates in support of billing rates. They also took specific actions to reduce DFAS billing rates through greater efficiencies. However, DFAS personnel did not maintain sufficient support for the workcounts and direct costs they estimated for Outputs 4 and 11. This occurred because DFAS did not establish a policy to maintain budgetary documentation in accordance with the National Archives and Records Administration (NARA) General Records Schedule No. 5. As a result, DFAS personnel could not demonstrate that customers were not overbilled or underbilled for services rendered. DFAS also could not demonstrate how actions taken to achieve greater efficiencies resulted in lower rates.

DFAS Complied With Some Rate Development Guidance

DFAS personnel complied with certain provisions of 10 U.S.C. § 2208 (2004) and the DoD FMR. Specifically, they charged amounts necessary to recover the full costs of goods and services provided for Outputs 4 and 11, including amounts for depreciation of capital assets in compliance with 10 U.S.C. § 2208 (2004). According to 10 U.S.C. § 2208 (2004), charges for goods and services provided by an activity through a working capital fund must include the following:

- amounts necessary to recover the full costs of goods and services provided for that activity; and
- amounts for depreciation of capital assets, set in accordance with generally accepted accounting principles.[11]

However, DFAS personnel made a minor error in computing depreciation costs included in Output 4. DFAS incorrectly double-counted $278,703 in estimated depreciation in computing the FY 2011 billing rate for Output 4. Although $278,703 of estimated depreciation costs should not have been included in the rates, it only translated to a $.01 rate increase for DFAS customers, which we considered to be insignificant.

DFAS personnel also complied with DoD FMR requirements by:

- projecting and separately identifying customer requirements,
- establishing customer rates on an end-product basis,

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[11] We did not verify whether depreciation was computed in accordance with generally accepted accounting principles.

- establishing unit cost rates, and
- including the costs of management improvement initiatives in the rates.

The DoD FMR also requires that prices remain fixed during the year of execution. DFAS charged stabilized rates to the Army, Navy, Air Force, Marine Corps, and DLA for Outputs 4 and 11 during FY 2011 in compliance with the DoD FMR. However, DFAS did not adjust its billing rates as required by DoD FMR, volume 2A, chapter 1, when it returned a $35.5 million AOR surplus to its customers in FY 2011. Finding A discusses our concerns with how DFAS returned the AOR surplus to DoD customers.

DFAS Did Not Maintain Documentation on Workcounts and Direct Costs for Outputs 4 and 11

DFAS did not maintain the necessary detailed documentation to support the estimated workcounts or direct costs used to calculate the FY 2011 rates for Outputs 4 and 11, finalized in January 2010. DFAS calculated the FY 2011 rates for Outputs 4 and 11 based upon the estimated workcounts and costs within DPBS. For a statistical sample of workcounts and direct costs supporting Outputs 4 and 11 in DPBS, we requested the supporting documentation for the estimates that DFAS functional offices had submitted to the DFAS Resource Management Office for entry into DPBS. (The DFAS rate development process is described in Appendix B. Appendix F discusses the universe and the sample selection.) The DFAS Resource Management Office provided some documentation, but it could not provide detailed information to support the workcounts and direct costs.

The DFAS Resource Management Office provided some documentation, but it could not provide detailed information to support the workcounts and direct costs.

DFAS Did Not Maintain Sufficient Support for Estimated Workcounts

DFAS personnel did not maintain the necessary detailed documentation to support the FY 2011 estimated workcounts. Specifically, DFAS personnel did not support the methodology they used to establish their estimates for the Army, Navy, Air Force, Marine Corps, and DLA. DFAS estimated that workcounts for Output 4 totaled 33.2 million retired military pay accounts. For its five major customers, DFAS estimated that workcounts for Output 11 totaled 5.7 million direct billable hours.

DFAS personnel provided the workcounts executed for prior fiscal years, the FY 2011 workcount baselines, and adjustments as well as general reasons for the adjustments. However, they did not demonstrate how historical data were used to make the projections, and they did not include enough detail in their rationale to validate their methodology. Therefore, in order to determine whether the workcount estimates were reasonable projections, we compared the estimated workcounts for Outputs 4 and 11 to the workcounts executed (billed amounts) for the Army, Navy, Air Force, Marine Corps, and DLA in FYs 2008 through 2010.

- **Output 4.** In March 2009, DFAS established the FY 2011 estimated workcounts for Output 4 based on the projection that retired military pay accounts would grow at an annual rate of approximately 1.2 percent for all customers from FY 2009 through FY 2011, using the FY 2008 (DPBS President's Budget 2008) workcounts as a baseline. We compared the Output 4 workcount estimates with the executed workcounts for FYs 2008, 2009, and 2010 and determined that the executed workcounts were within 3 percent of the estimates. Based on our analysis, the Output 4 workcount estimates appeared to be reasonable projections.

- **Output 11.** DFAS workcount estimates for FY 2011 were less than during FYs 2008, 2009, and 2010, but not by a wide margin. However, we found significant variances when comparing estimated to executed workcounts at the major customer level. For example, DFAS significantly underestimated Air Force workcounts in FYs 2008, 2009, and 2010. Conversely, DFAS significantly overestimated the Marine Corps workcounts in FYs 2008, 2009, and 2010. The FY 2011 executed workcounts, at the output level, were within 1 percent of the workcount estimates. However, DFAS's major customers still had concerns with the reliability of the FY 2011 workcount estimates for Output 11. (See Finding B for more discussion of customer concerns and Appendix E for additional analysis on the changes in rates and workload for Outputs 4 and 11 from FYs 2008 through 2011.)

DFAS Did Not Maintain Sufficient Support for Estimated Direct Costs

DFAS personnel did not maintain sufficient documentation to support cost estimates for direct costs for Outputs 4 and 11. For five major customers, DFAS personnel did not maintain sufficient information to support the FY 2011 direct costs for Outputs 4 and 11, estimated at $52.9 million and $254.1 million, respectively. In response to our request for support, DFAS personnel stated that supporting documentation was not available for direct costs of estimated labor, overtime, voluntary separation incentive program, awards, travel, locally procured supplies and materials, commercial purchases of equipment, Defense Printing Services, Defense Information Systems Agency support and communication services, depreciation for software development, foreign national indirect hire, equipment maintenance by contract, training, base operations support, and other contracts and contractor workyears. Further, they stated that they did not have supporting documentation for the FY 2011 baselines, productivity factors, average salaries, and the training and travel factors that DFAS personnel used to estimate employee travel and training.

For five major customers, DFAS personnel did not maintain sufficient information to support the FY 2011 direct costs for Outputs 4 and 11, estimated at $52.9 million and $254.1 million, respectively.

DFAS Did Not Retain Supporting Documentation

DFAS Resource Management personnel did not have sufficient detailed data to support the estimated workcounts and direct costs for Outputs 4 and 11 in its FY 2011 budget because they did not have a policy for the retention of supporting documentation used to develop the DFAS budget and rates charged to customers. The NARA General Records Schedule No. 5 states that cost statements, rough data, and similar materials accumulated in the preparation of annual budget estimates, including duplicates of budget estimates and justifications and related appropriation language sheets, narrative statements, and related schedules can be destroyed 1 year after the close of the fiscal year covered by the budget. This would include copies of reports the originating offices submitted to budget offices.

Although DFAS personnel provided a significant amount of information and documents, the data provided were insufficient to document the extent to which DFAS complied with the FY 2011 – 2015 Integrated Program and Budget Submission Guidance issued by USD(C)/CFO. This guidance required that estimates for costs of operations reflect the best estimate of FY 2009 actual results. DFAS personnel could not prove that the amounts used to calculate the rates were based on FY 2009 actual results or other source documents. For example, DFAS personnel stated that actual salary and benefits data were taken from the e-Biz Cost Accumulation module as of February 2009. However, DFAS personnel could not demonstrate that the estimated labor or overtime costs in our sample were based upon historical results. Consequently, DFAS could not demonstrate that the estimated workcounts and direct costs were based upon historical data. To comply with NARA General Records Schedule No. 5 and help DFAS better defend the rate development process to DoD customers, the DFAS Director of Resource Management should develop a policy for maintaining documentation in support of the DFAS budget and rates.

Cost-Saving Initiatives

DFAS had taken actions to reduce rates through greater efficiencies. For example, DFAS coordinated efforts with its major customers on the implementation of many different Enterprise Resource Planning solutions and initiated numerous Lean6 projects within the organization. However, because of the lack of detail in the documentation maintained, DFAS could not show how those initiatives specifically impacted the workcount or cost estimates and resulted in lower billing rates. For further information regarding DFAS cost-saving initiatives, see Appendix G.

Conclusion

DFAS complied with certain provisions of the rate development requirements in 10 U.S.C. § 2208 (2004) and the DoD FMR. However, DFAS did not maintain budgetary materials in conformance with NARA General Records Schedule No. 5. Specifically, DFAS did not maintain sufficient support for the estimated workcounts and direct costs used to compute the FY 2011 billing rates for Outputs 4 and 11. This occurred because DFAS did not have an established policy to maintain budgetary documentation. As a result, DFAS could not support whether the FY 2011 workcounts and direct costs for Outputs 4 and 11 that DFAS estimated for its five primary customers complied with the FY 2011 - 2015 Integrated Program and Budget Submission Guidance issued by USD(C)/CFO. DFAS should establish a policy to maintain sufficient, detailed budgetary documentation in support of workcounts and costs used to establish customer billing rates that could be used to demonstrated compliance with rate development guidance, support and defend the rates and increasing AOR, and show how cost-savings initiatives resulted in lower costs.

Recommendation, Management Comments, and Our Response

C. We recommend that the Defense Finance and Accounting Service, Director of Resource Management, develop policy to identify and retain budgetary documentation in support of billing rate development.

Defense Finance and Accounting Service Comments

The DFAS Chief Financial Officer (also serving as the DFAS Director of Resource Management) agreed and stated that DFAS developed a policy requiring specific supporting documentation for all decisions regarding workcount and cost estimates and the corresponding development of rates to be recorded and maintained for 2 years after the year of execution.

Our Response

Comments from the DFAS Chief Financial Officer were responsive, and the actions met the intent of the recommendation.

Appendix A. Scope and Methodology

We conducted this performance audit from November 2010 through June 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We focused our review on FY 2011 estimated direct costs[*] for 2 of the 29 rate-based DFAS outputs: Output 4 – Retired Military Pay Accounts and Output 11 – Accounting Services. We selected Output 4 because it had the largest number of estimated workcounts to be performed during FY 2011. We selected Output 11 because it was estimated to be DFAS's largest reimbursable dollar value output for FY 2011 based on direct costs. Table A compares the total estimated workcounts and direct costs for Outputs 4 and 11 to all other outputs in FY 2011.

Table A. Comparison of Estimated Workcounts and Direct Costs for Outputs 4 and 11 to All Outputs**

Output	Workcounts	Direct Costs
4	33,157,447	$52,868,082
11	6,501,864	286,339,879
All Others**	96,024,306	760,424,103
Total	**135,683,617**	**$1,099,632,064**

** Support to Others (Output 18) and Direct Systems Reimbursement (Output 61) were excluded from the count of workcounts (Output Category "All Others"). Outputs 18 and 61 are reimbursed on a cost-incurred basis. As such, there are no estimated workcounts, only estimated costs.

We reviewed the United States Code, USD(C)/CFO guidance, DoD FMR, and DFAS policy and procedures regarding budgeting and output rate-setting; identified guidance for computing stabilized billing rates; and identified NARA requirements for budgetary data retention. We identified how DFAS estimated FY 2011 workcounts and direct costs and how DFAS allocated system costs between Outputs 4 and 11. The scope of our review encompassed the five major DFAS customers: the Army, Navy, Air Force, Marine Corps, and DLA.

We obtained the DPBS data relevant to the President's Budget 2011 from DFAS and requested that the data include the FY 2011 cost, workyear, and workcount estimates. Using DPBS system codes and field definitions, the DoD Office of Inspector General, Quantitative Methods Division (QMD), selected a random sample of the estimated workcounts and direct costs contained in DPBS for FY 2011. We reconciled the

[*] Although the largest, direct costs are only one element of costs DFAS must recover through its billing rates. The other elements of cost are indirect costs and general and administrative costs.

FY 2011 cost estimates contained within DPBS to the DFAS Schedule 2 and to the Annual Operating Budget approved by the USD(C)/CFO, Director of the Revolving Funds Directorate.

We verified the accuracy of the computation of the FY 2011 billing rates for Outputs 4 and 11, analyzed the first quarter of FY 2011 actual versus estimated workcounts for Outputs 4 and 11, and evaluated the value and form of the AOR returns in FY 2011 and FY 2012. We identified and evaluated relevant internal controls over the rate-setting process. We also attempted to reconcile timekeeping data in the e-Biz Momentum Timekeeping module to the December 2010 billing statements created by e-Biz. Finally, we identified and assessed efficiency actions taken by DFAS to lower its operating costs and customer bills.

We also examined the DFAS procedures for returning $35.5 million of the AOR surplus in FY 2011 and $128.7 million of the AOR surplus in FY 2012, including the coordination between DFAS and representatives of the Revolving Funds Directorate.

Use of Computer-Processed Data

To perform this audit, we obtained FY 2011 budgetary data in DPBS for Outputs 4 and 11. We evaluated application controls over the data in the system. We determined that there were adequate controls over the estimated workcount and cost data within DPBS. However, we did not identify sufficient controls over the formulation of the baseline data for which the workcount and cost estimates were derived. Therefore, we were unable to test the reliability of the cost and workcount data entered into DPBS. The lack of sufficient documentation to support the estimated workcount and cost data in DPBS effectively prevented us from being able to assess the reliability of the computer-processed data needed to perform a significant aspect of the audit. However, we reached conclusions based on other data available to us that we determined to be sufficiently reliable.

Use of Technical Assistance

QMD provided technical assistance through the development of a statistical sample of data contained within DPBS for Outputs 4 and 11. Specifically, QMD analysts selected a random sample of the estimated workcounts and direct costs contained in DPBS for FY 2011. See Appendix F for detailed information concerning the work performed by the QMD analysts.

Prior Coverage

No prior coverage has been conducted on the subject during the last 5 years.

Appendix B. DFAS Development of Workcounts and Costs

The DFAS rate development process begins with the President's Budget from the prior year. The workcounts, workyears, and cost baselines from the prior year's President's Budget serve as the Program Budget Review baseline for the budget year under development. Adjustments to the baselines, including those that result from the USD(C)/CFO RMDs, produce the final estimates used to formulate the President's Budget submission for the budget year.

Development of Estimated Workcounts

DFAS personnel used workcounts to forecast the resources needed to operate in the future and to determine future billing rates for each output they perform. DFAS client executives were responsible for establishing the FY 2011 workcount estimates and coordinating the estimates with the DFAS customers. DFAS Resource Management personnel encouraged the client executive liaisons to use actual monthly and annual historical workcount data to help make their projections. DFAS Resource Management further directed the client executives to consider current and future DoD strategic initiatives and to provide the estimates to their respective customers for feedback. Even though the client executive liaisons initiated the workcount discussion, DFAS considered the workcount estimates to be the desired output and requirements of the customer.

Development of Estimated Costs

The DFAS rate development manual states that after the estimated customer workcounts are entered into DPBS, productivity factors are to be applied to determine the direct workyears. Workyears are a derivate of the workcounts and are used in computing the estimated costs to fill customer requirements. Added to the direct workyears are any additional indirect and general and administrative workyears as approved by the DFAS Requirements Assessment Conference.[*] DFAS components, such as Corporate Organizations, Operations, and Strategic Business Management, are required to identify their workyear and cost requirements for entry into DPBS.

The cost development process used by DFAS results in three categories of costs: direct, indirect, and general and administrative costs. Along with detailed workcount estimates, direct costs are driven by the following elements.

- **Productivity Factors.** Productivity factors for labor include historical, output-specific, full-time-equivalent productivity estimates. DFAS personnel adjust the factors for planned process changes and productivity improvements. In addition

[*] The Requirements Assessment Conference provides a DFAS forum to apply feasible and realistic quality control to DFAS program planning, allowing the Agency to efficiently allocate resources tied to its strategic goals. The Requirements Assessment Conference Board, selected by Deputy Directors from each DFAS component, evaluates and substantiates funding and execution rationale as it relates to DFAS strategic goals.

to the labor productivity factors, DFAS personnel incorporate a hiring lag when calculating the estimated labor. Productivity factors also apply a standard per capita factor to estimate the costs for awards, travel, supply, and training.

- **Programmatic Initiatives.** Programmatic initiatives include project-specific direct cost requirements, such as the Military Services's Enterprise Resource Programs.

- **Systems Support.** Systems support includes support provided for finance systems and associated disbursing systems aligned with outputs and customers.

Upon completion of the DFAS budget and the population of DPBS with the workcounts, workyears, and costs, the rate computation process can begin. DFAS personnel calculate the rates for each rate-based output from the estimated workcounts and costs. Rates are calculated based upon the quantity of workcounts and the relationship of the costs to the customers. DFAS personnel calculate both composite and customer-unique rates. A composite rate is calculated for those outputs where the costs associated with the support do not vary between customers. Composite rates apply to all customers. A customer-unique rate is calculated for outputs in which the costs are unique to one or more customers. DFAS personnel calculated a composite rate for Output 4 and customer-unique rates for Output 11.

Resource Management Decision

A RMD reflects the decisions of the Secretary of Defense as to appropriate programs, funding and broad strategic trade-offs related to programs, and resource levels identified in the program objectives memorandum that is included in the annual defense budget request. The defense budget request is included in the President's Budget. The RMD budget decision documents are issued during the joint review of DoD components' budget submissions by analysts of the Office of the Secretary of Defense and the Office of Management and Budget.

DFAS Outputs

In FY 2011, DFAS provided its customers with services that it categorized into 31 different outputs. Table B identifies the 31 outputs, along with the total estimated costs for each output, according to the President's Budget 2011.

Table B. FY 2011 DFAS Outputs and Estimated Costs (in millions)

Output	Title	FY 2011 Estimated Cost
1	Civilian Pay – DoD – Manual Leave and Earnings Statement (LES)	$32.69
3	Active Military Pay Accounts	154.25
4	Retired Military Retired Pay Accounts	74.83
5	Reserve Military Pay Accounts	49.80
6	Contract Payments – Mechanization of Contract Administration Services (MOCAS) Composite	37.46
7	Travel Vouchers Computed and Paid	33.17
9	Commercial Invoices Paid	101.34
10	Out of Service Debt Cases – Persons	21.09
11	Accounting Services – Direct Billable Hours	467.00
12	Accounting and Finance Support – Commissaries	4.87
14	Foreign Military Sales – Direct Billable Hours	25.72
16	Direct Billable Hours MOCAS Reconciliation	19.26
18	Support to Others	192.79
19	DLA Enterprise Business System – Manual	7.21
20	Commercial / Vendor Debt Cases	1.09
21	Civilian Pay – DoD – Electronic LES	51.06
24	Technology Services – Direct Billable Hours	22.01
26	Contract Payments MOCAS (Electronic Commerce Composite)	11.82
27	Travel Vouchers Paid – Disbursement Only	9.88
29	Commercial Payments – Electronic Commerce	23.06
30	DLA Enterprise Business System – Electronic Commerce	11.31
31	Contract Payments – Defense Commissary Agency	5.39
32	Contract Payments – Defense Information Technology Contracting Office (DITCO) Manual	3.96
36	Contract Payments MOCAS – Automatic Paid Invoice	1.31
39	Commercial Payments – Government Purchase Card	6.52
40	Garnishments	12.99
41	Civilian Pay – Non-DoD – Manual LES	0.14
42	Contract Payments – DITCO Electronic Commerce	0.01
49	Commercial Payments – Fully Electronic Commerce	12.40
51	Civilian Pay – Non-DoD – LES	41.39
61	Direct Systems Reimbursement	168.00
	Total	**$1,603.82**

Appendix C. Memorandum for USD(C)/CFO

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

August 31, 2011

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/
CHIEF FINANCIAL OFFICER

SUBJECT: Audit of Defense Finance and Accounting Service Billing Rates for Services Provided to DoD Customers (Project No. D2011-D000FI-0001.000)

During the subject audit, we identified a matter that warrants your attention. In FY 2011, Defense Finance and Accounting Service (DFAS) reduced its customers' bills by $35.5 million to return a portion of its Accumulated Operating Result (AOR) as directed by a Resource Management Decision (RMD). However, DFAS personnel did not return the $35.5 million in accordance with the DoD Financial Management Regulation (FMR) or guidance they received from the Office of the Under Secretary of Defense (Comptroller) (OUSD[C]), Revolving Funds Directorate. Instead of reducing customer bills by adjusting the billing rates, DFAS issued billing credits to its customers from January 2011 through August 2011. By providing billing credits, DFAS may have augmented the appropriations of its DoD customers, a potential violation of the Antideficiency Act.

Our overall audit objective was to determine whether the methodology DFAS used to estimate the workcounts and costs for FY 2011 stabilized billing rates complied with applicable laws and regulations. Specifically, we wanted to determine whether DFAS estimated workcounts and direct costs for two outputs, Retired Military Pay and Accounting Services, were in accordance with DoD regulations and established policies and procedures. Our objective was also to determine whether DFAS has taken action to reduce rates through greater efficiencies. This memo only identifies a potential augmentation of appropriations due to the DFAS noncompliance with the DoD FMR so management may take corrective action.

Resource Management Decision Directive

Resource Management Decision 700 issued by OUSD(C) on December 23, 2009, directed DFAS to adjust FY 2011 customer rates in order to return $35.5 million of excess AOR expected to accumulate through FY 2010. OUSD(C) personnel stated that they intended for the rate changes to reduce the amount of revenue that DFAS would collect from its customers during FY 2011, thereby decreasing the DFAS AOR. In RMD 700, OUSD(C) personnel identified the following factors as justification for the DFAS rate reduction.

- DFAS had positive AOR and a cash gain of approximately $72.1 million in FY 2009.
- Actual 2009 workcount volume exceeded budgeted amounts and was expected to continue in FY 2010.
- The FY 2010 cash balance would continue to grow, so a rate decrease was required in FY 2011 to stabilize the rate structure and cash growth.

RMD 700 identified projected amounts to be returned to specific customers.

OUSD(C) Disapproval of the DFAS AOR Return Methodology

On December 30, 2010, the Director of the OUSD(C), Revolving Funds Directorate, informed DFAS that returning the AOR amount through the use of billing credits was not appropriate. OUSD(C) personnel provided DFAS the following reasons for disapproving the proposed billing credit methodology.

- The RMD directed a total AOR amount to return to customers through the rates. However, DFAS was not responsible for ensuring bills to individual customers decrease exactly as shown in the RMD.

- Rebating customers for the AOR surplus, rather than adjusting rates to prevent the growth of AOR, was not in compliance with the DoD FMR.

- The use of a rebate to customers implies customer rates were higher than actual costs on a recurring basis, which defeats the stabilized rate concept. Further, it can be viewed as extending the life of an appropriation – higher rates paid by customers in one year are returned in a rebate the following year for future use.

Contrary to this guidance, from January through August 2011, DFAS returned the $35.5 million AOR surplus to the DoD customers listed in the RMD 700 by crediting the exact amounts from RMD 700 against each customer's Military Interdepartmental Purchase Request for DFAS services. The table identifies the dollar amount credited to each DoD customer.

Table. Billing Credit Amount Issued by DFAS

Customer	Amount Credited
Army	$15,600,000
Air Force	8,000,000
Navy	7,200,000
Marine Corps	1,700,000
Defense Health Program – Army	547,279
Defense Health Program – Navy	398,675
Defense Logistics Agency	310,000
Office of the Secretary of Defense *(Note: Air Force received this billing credit)*	247,000
Defense Information Systems Agency	244,000
Defense Contract Management Agency	202,000
Department of Defense Education Activity	191,000
Washington Headquarters Service	164,000
Customer	**Amount Credited**
Defense Contract Audit Agency	139,000

Business Transformation Agency	114,000
National Geospatial Agency	100,000
Defense Threat Reduction Agency	75,000
Defense Health Program – Financial Management Office	73,252
Department of Defense, Office of Inspector General	53,000
Department of Defense, Human Resources Activity	39,000
National Security Agency	33,000
Defense Intelligence Agency	19,000
National Defense University	18,000
Defense Security Service	18,000
Defense Acquisition University	14,000
Defense Health Program – Air Force	11,794
Defense Legal Services Agency	8,000
Defense Technology Security Administration	6,000
Defense Prisoner of War/Missing Personnel Office	6,000
Office of Economic Adjustment	6,000
TOTAL	**$35,537,000**

DFAS Resource Management personnel stated that when reviewing RMD 700, they believed the amounts listed were exact amounts that OUSD(C) wanted each customer to receive. DFAS Resource Management personnel stated that if they adjusted the customer billing rates, they could not ensure that the customers received the exact AOR return identified in the RMD 700. DFAS Resource Management personnel concluded that the only way to ensure an exact refund of AOR listed on the RMD was to provide a credit to each customer's bill.

Billing Credits and Augmenting Appropriation

By providing billing credits to customers rather than adjusting rates to prevent AOR growth, DFAS failed to comply with the DoD FMR and guidance from the OUSD(C), Revolving Funds Directorate. DoD FMR, volume 2B, chapter 9, "Defense Working Capital Funds Activity Group Analysis," June 2010, states that the stabilized rates are to be adjusted for the impact of prior year gains or losses as reflected by the AOR. The practice of providing credits in the current or future fiscal years to organizations whose annual funds were overcharged in a prior fiscal year, results in a potential augmentation of those appropriations and violation of law. This generally results in obligations and expenditures by that agency in excess of the amount originally appropriated by Congress. Augmentation is considered a violation of law because Congress appropriates a specific amount of funding to agencies for specific purposes during a specific period of time. If an agency obtains additional funding from another source, unless provided for by another law, it has more budget authority than Congress said it could have for those purposes during that time. The basis for the prohibition against augmentation is that the action would normally result in a violation of one or more of the following legal provisions:

- Article I, Section 9, Clause 7, of the Constitution, which states, "no money shall be drawn from the Treasury but in consequence of appropriations made by law."
- Title 31, U.S. Code, Section 1301 (a) - the "Purpose Statute", which states "appropriations shall be applied only to the objects for which the appropriations were made except as otherwise provided by law."
- Title 31, U.S. Code, Section 3302 (b) - the "Miscellaneous Receipts Statute", which states "Except as...[otherwise provided]...an official or agent of the government receiving money for the government from any source shall deposit the money in the Treasury as soon as practical without any deduction for any charge or claim."

DFAS applied the billing credits against each customer's accepted customer order that had been funded by Operation and Maintenance appropriations. By returning the AOR surplus using billing credits, DFAS may have extended the life of an annual appropriation beyond the lawful period for new obligations and essentially allowed its customers to have funds "parked" at DFAS. This situation could be viewed as a means by which the currently appropriated funds have been improperly augmented by the amount of the billing credit provided.

Actions Needed to Address Situation

By not adjusting billing rates for the AOR surplus return, DFAS may have augmented the appropriations customers used to pay DFAS. We suggest that your office determine the appropriate course of action, such as ensuring that DFAS reverses the billing credits applied to its customers for the return of the AOR surplus and either adjust rates accordingly or grant an exception to the DoD FMR before September 30, 2011. A determination should also be made as to whether DFAS extended the life of customer funds when it issued billing credits.

We are performing this audit in accordance with generally accepted government auditing standards and are providing you these interim results so that you may start taking appropriate corrective actions before the end of the fiscal year. We will include the above issues and any corrective actions taken as a result of this memo in a draft report. Therefore, we request that you apprise us of all corrective actions you take or have taken to address the issue by September 20, 2011. If you have questions regarding this matter, please contact me at (703) 601-5868 or [redacted]

Patricia A. Marsh

Patricia A. Marsh, CPA
Assistant Inspector General
Financial Management and Reporting

Appendix D. USD(C)/CFO Response

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

COMPTROLLER

NOV 8 2011

Ms. Patricia A. Marsh
Assistant Inspector General
Financial Management and Reporting
Inspector General, Department of Defense
400 Army Navy Drive
Arlington, Virginia 22202

Dear Ms. Marsh:

This is the Department of Defense's (DoD's) response to the DoD Inspector General's statement of preliminary findings in Project No. D2011-D000FI-0001.000, "Audit of Defense Finance and Accounting Service (DFAS) Billing Rates for Services Provided to DoD Customers." Thank you for bringing to our attention this matter of actions taken in response to Resource Management Decision (RMD) 700, issued on December 23, 2009, which provided that rates charged by DFAS for Fiscal Year (FY) 2011 should be downwardly adjusted by \$35.5 million. As you may be aware, the DFAS Working Capital Fund rate structure developed for FY 2011 was one of the myriad of planning factors taken into account in preparing the January 2010 annual budget submission to the Office of Management and Budget for inclusion in the President's budget submission to Congress the following month. The DFAS responded to the RF-D002-DFAS directive in RMD 700 by developing a process to prorate billing credits to lower the FY 2011 rates or charges for its customers by the exact \$35.5 million prescribed in the RMD.

After legal and Comptroller review, we have concluded that this action did not augment customer appropriations for FY 2011 by enabling those customers to operate at levels above those levels that would have existed had DFAS lowered its rates for FY 2011. Primarily for that reason, it is not necessary to waive any provision in the DoD Financial Management Regulation or to require adjustment to FY 2011 rates or billings. The issuance of billing credits had an equivalent impact on customer accounts, as would have the lowering customer rates. If you require additional information, my point of contact is [redacted].

Sincerely,

Robert F. Hale

Appendix E. DFAS Rate Fluctuations

Output 4 Rates Increased Due to Contract Costs

From FY 2007 through FY 2010, the estimated workcounts* for Output 4 (Retired Military Pay Accounts) remained relatively stable, increasing by no more than 1.3 percent annually. During that time, the stabilized billing rates increased from $1.55 to $2.38. DFAS personnel attributed the increase in the billing rates to increased contract costs for performing the Retired Pay function. In February 2010, DFAS management recapitalized the Retired Pay function. DFAS personnel stated that performing the function in-house resulted in rate reductions in FY 2012. Table E-1 identifies the Output 4 estimated workcounts, budgeted contract costs, and composite rates for FYs 2007 through 2012.

Table E-1. Output 4 Information for FYs 2007 Through 2012

Fiscal Year	**Estimated Workcounts** (in millions)	**Budgeted Contract Cost** (in millions)	**Stabilized Billing Rate**
2007	31.8	$25.8	$1.55
2008	32.0	25.5	1.80
2009	32.4	32.8	2.15
2010	32.8	37.4	2.38
2011	33.2	0	2.26
2012	33.7	0	1.90

Output 11 Rates Decreased Due to a Return of Accumulated Operating Results

The stabilized rates for Output 11 (Accounting Services) remained relatively constant from FY 2007 through FY 2011. However, Output 11 rates drastically dropped in FY 2012. The Director, DFAS Corporate Budget Office stated that the FY 2012 rate reduction for Output 11 was due to a decision to use Output 11 exclusively to return the AOR surplus to its customers (see Finding A). According to a DFAS Resource Management representative, the rates for Output 11 were expected to increase in FY 2013 if no additional AOR return is directed by USD(C)/CFO. Table E-2 identifies the rates DFAS charged its five major customers from FYs 2007 through 2011 and plans to charge in FY 2012.

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* Workcount estimations for each DFAS customer are those output-based totals negotiated between the individual customers and their respective DFAS Client Executive Liaison. The initial estimates are prepared about 2 fiscal years before the year of execution, with updates to the estimates on an as-needed basis.

Table E-2. Output 11 Rates for FYs 2007 Through 2012

DFAS Customer	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Army	$68.25	$70.94	$74.60	$68.86	$71.21	$45.90
Navy	72.24	75.68	79.12	75.13	73.73	46.79
Air Force	69.11	74.74	74.56	76.22	72.55	44.04
Marine Corps	81.13	72.08	79.17	75.90	74.01	49.21
DLA	75.77	75.44	76.88	76.22	70.43	49.43

Table E-3 summarizes the differences between the estimates and actual workcounts for FY 2008 through FY 2011.

Table E-3. FY 2008 – FY 2011 Output 11 Estimated vs. Actual Workcounts
(in millions)

Fiscal Year	Estimate/Actual/ Percentage	Army	Air Force	Navy	Marine Corps	DLA	Other	Total
2008	Estimate	2.45	1.23	1.12	0.28	0.50	0.83	6.41
	Actual	2.42	1.46	1.08	0.25	0.45	0.77	6.43
	Percent Over (Under) Estimate	1%	(19%)	4%	12%	10%	7%	0
2009	Estimate	2.42	1.12	1.12	0.27	0.50	0.73	6.15
	Actual	2.35	1.52	1.12	0.20	0.44	0.75	6.37
	Percent Over (Under) Estimate	3%	(36%)	0	24%	12%	(1%)	(4%)
2010	Estimate	2.31	1.37	1.10	0.26	0.48	0.75	6.25
	Actual	2.63	1.56	1.13	0.22	0.42	0.78	6.74
	Percent Over (Under) Estimate	(14%)	(14%)	(3%)	16%	11%	(4%)	(8%)
2011	Estimate	2.36	1.55	1.03	0.24	0.57	0.76	6.50
	Actual	2.38	1.55	1.04	0.26	0.44	0.77	6.44
	Percent Over (Under) Estimate	(1%)	0	(1%)	(8%)	22%	(1%)	1%

Appendix F. Statistical Sample

Population

The population consisted of two Excel files, the DPBS President's Budget 2011 Workload file, which consisted of 5,310 records, with a total of 496.8 million workcounts, and the DPBS President's Budget 2011 Dollar file, which consisted of 32,552 records, with a total value of $1.6 billion. We used the column labeled "FY2011" to tally our counts for number of records and the values for workcounts and dollars.

For the DPBS President's Budget 2011 Workload file, we selected the workload estimates for Outputs 4 and 11 that pertained to the five major DFAS customers. The five major DFAS customers in FY 2011 were the Army, Navy, Air Force, Marine Corps, and DLA. This reduced our population to 928 records, with a total of 38.9 million workcounts. Once we removed the records that contained zero workcounts, the number of records in our population was reduced to 521.

For the DPBS President's Budget 2011 Dollar file, we selected the direct cost records for Outputs 4 and 11. This reduced our population to 511 records, with a total value of $339.2 million. Once we removed the records that contained zero dollars, the number of records in our population was reduced to 338.

Measures

The primary objective of the sampling plan was to randomly select estimated workcounts and direct costs for two outputs, Retired Military Pay Accounts (Output 4) and Accounting Services (Output 11), to determine whether workcounts and direct costs were calculated in accordance with applicable laws and regulations.

Parameters

We used a 90-percent confidence interval with a coefficient of variation three times the mean to determine the sample size.

Sample Plan

QMD used a stratified sampling design for this project, stratifying each of the subpopulations into three strata, based on workcounts and dollar values, respectively. Using the random function in Excel, we selected a random sample of 67 workcount records and 77 dollar value records.

Analysis and Interpretation

The QMD analysts did not project the results of our testing because we determined that DFAS did not maintain sufficient documentation for us to determine whether or not the workcounts and direct costs were calculated in accordance with applicable laws and regulations.

Our sample of $305.2 million in estimated direct costs included two items for depreciation expense totaling $2.3 million. DFAS personnel stated that the estimated depreciation expense for the two sample items was extracted from the Defense Property and Accountability System. However, the estimated $2.3 million in Defense Retiree and Annuitant Pay System depreciation expense from our sample incorrectly double-counted $278,703 in estimated depreciation expense. Although we informed DFAS of what we found, DFAS did not adjust the Output 11 billing rates because of the immateriality of the amount.

Appendix G. DFAS Efficiency Actions

Secretary of Defense Efficiency Initiatives

In a speech on August 9, 2010, former Secretary of Defense Robert Gates provided his rationale for mandating efficiencies across DoD as well as a broad overview of what he intended to accomplish with these actions. Rather than reduce the Department's top-line budget, the efficiencies were intended to significantly reduce excess overhead costs within DoD in order to apply the savings to force structure and modernization.

In his followup memorandum to the DoD community, dated August 16, 2010, Secretary Gates provided further details regarding initiatives to reduce excess and duplication throughout DoD. Specifically, the former Secretary identified 20 actions designed to reduce duplication, overhead, and excess within the Department and instill a culture of savings and restraint across DoD.

DFAS-Initiated Efficiency Actions

DFAS initiated efficiency actions in response to the former Secretary's efficiency initiative. Specifically, DFAS initiated the following actions.

- Ensure all contract-writing systems electronically interface with both entitlement and accounting systems and fully implement Wide Area Workflow and the Government Purchase Card program. This recommendation has an estimated personnel savings of 203 civilian billets and estimated FY 2012 savings of $10 million.

- Eliminate paper leave and earnings statements and use electronic leave and earnings statements for the remaining 271,000 DoD employees that receive them on paper. DoD employees would still be able to get their statements online. Savings realized are from postage and printing. This recommendation has no estimated personnel and an estimated FY 2012 savings of $3.1 million.

- Eliminate one Civilian Senior Executive billet, 227 contractor positions, and five civilian billets in enterprise and administrative support staff to reduce personnel and budget costs without impacting the underlying mission. This recommendation has an estimated FY 2012 savings of $27.8 million.

In addition, DFAS identified numerous other initiatives aimed at improving operational efficiencies, achieving some level of cost avoidance, or assisting in complying with applicable laws and regulations. Many of these initiatives were in existence before the efficiency efforts mandated by Secretary Gates were made known. Many DFAS initiatives involved significant coordination with specific DFAS customers. Much of the cost-savings will primarily benefit the customers. For example, when Enterprise Resource Planning systems have been fully implemented, DFAS's workload should decrease and result in a reduction in operational costs billed to the customers. DFAS is also expected to achieve cost-savings through the following initiatives and projects.

- **Lean6 Projects.** Lean6 projects provide a fact-based approach for improving business processes in an attempt to deliver the best value to the customer. For FY 2010, DFAS claimed to have completed 119 Lean6 projects resulting in $21.3 million in cost-savings.

- **MYMETRICS.** The MYMETRICS initiative is an application that will track DFAS metrics in a single integrated source, which will allow DFAS executives to monitor the performance of the organization. DFAS did not reference any potential cost-savings or process improvements in the MYMETRICS factsheet.

- **Base Realignment and Closure.** Base Realignment and Closure is an ongoing DoD initiative. The Base Realignment and Closure 2005 legislation closed 20 sites, realigned the headquarters, and established the primary footprint for DFAS at five locations. DFAS estimated that the Base Realignment and Closure consolidation will yield a net savings of $450 million by the end of FY 2011.

- **Accounting High-Performance Organization.** The Accounting High-Performance Organization is an internal initiative to merge accounting and commercial pay into a standard structure across DFAS sites. DFAS anticipated savings for this initiative of $122.7 million and 1,827 full-time-equivalent positions by the end of FY 2011.

- **Business Activity Monitoring.** Business Activity Monitoring provides DFAS with greater assurance that potential weaknesses are detected and properly mitigated in a timely manner. The DFAS factsheet for this initiative made no reference to any potential cost savings or specific process improvements.

- **Enterprise Local Area Network Reengineering.** DFAS hopes that the reengineering of the Enterprise Local Area Network will provide improved services, greater reliability, and reduced total cost of ownership for the agency.

- **Centralized Electronic Document Management System.** The Centralized Electronic Document Management System is an internal DFAS initiative that provides DFAS with the ability to remotely scan all types of documents, transmit them to a central repository, and retrieve the imaged documents. DFAS projects that the Centralized Electronic Document Management System will save approximately $37 million beginning in FY 2012.

Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, Comments

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

COMPTROLLER

JUL 6 2012

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL (DoD IG), FINANCIAL MANAGEMENT AND REPORTING

SUBJECT: DoD Inspector General's draft report (Project no. D2011-D000FI-0001.000) "Improvements Needed in How the Defense Finance and Accounting Service Adjusts and Supports Billing Rates."

The Department of Defense (DoD) is providing the attached response to Finding A, "Improper Method Used to Return Accumulated Operating Results to Customers in Fiscal Year 2011," to the DoD IG draft report dated June 5, 2012. My point of contact is [redacted]

Robert F. Hale

Attachment:
As Stated

DoD Comments
DoD IG Draft Report
Project No. D2011-D000FI-0001.000

Recommendation:

A: We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, document the analysis supporting the decision to allow billing credits as an alternate methodology to adjusting rates and the determination that using billing credits did not extend the life of customer funds. If he can provide a business case that supports this position, he should change DoD policy and allow this as an alternate approach for returning positive Accumulated Operating Results. Otherwise, he should enforce compliance with approved policies for returning Accumulated Operating Results through rate adjustments.

DoD Comment:

We partially concur with the recommendation. We decided not to issue policy to allow working capital fund (WCF) activities to issue billing credits to customers as a means of reducing Accumulated Operating Results (AOR). Adjustment of rates charged to WCF customers remains the authorized method for reducing AOR. The Department, therefore, will not undertake a business case analysis to compare the effects of reducing customer rates with the effects of issuing of billing credits. The DoD Financial Management Regulation (DoD FMR), Volume 2B, Chapter 9, will be updated to clarify and strengthen the guidance on management-directed AOR reductions.

We non-concur that FY 2011 appropriation accounts of Defense Finance & Accounting Service (DFAS) customers might have been augmented by the DFAS's issuance of billing credits in lieu of downwardly adjusting FY 2011 customer rates. A signed Resource Management Decision (RMD) adjusts appropriation accounts (e.g. Operation and Maintenance) to reflect decisions made in the RMD. Specifically, in RMD 700, December 23, 2009, issue no. RF D002-DFAS, the Secretary of Defense instructed the DFAS to adjust rates to return approximately $35.5 million of AOR to its customers and decremented each customer's funding request by an amount commensurate with that reduction. Customer requirements were not reduced, but their budget requests were reduced in anticipation of a lower bill from the DFAS. The effective amount of funds available to customers of the DFAS was not increased by actions taken by the DFAS.

In the year of execution, without action by the DFAS, (e.g. a downward rate adjustment called for by established policy or the issuance of billing credits), customer O&M appropriations available for non-DFAS requirements would, in effect, have been reduced by approximately $35.5 million below amounts budgeted. The impact on the FY 2011 customer appropriation accounts by the DFAS issuance of $35.5 million of billing credits is equivalent to the effect on such appropriations had the DFAS decreased FY 2011 customer rates. The DFAS actions did not augment customer appropriations for FY 2011 by enabling customers to operate above levels that would have existed had the DFAS decreased its rates for FY 2011.

This response has been coordinated with OSD Fiscal lawyers.

Defense Finance and Accounting Service Comments

DEFENSE FINANCE AND ACCOUNTING SERVICE
8899 EAST 56TH STREET
INDIANAPOLIS, INDIANA 46249

DFAS-ZR/IN

JUN 2 8 2012

MEMORANDUM FOR DEPARTMENT OF DEFENSE OFFICE OF INSPECTOR GENERAL (DoD IG)

SUBJECT: Improvements Needed in How the Defense Finance and Accounting Service Adjusts and Supports Billing Rates (Project No. D2011-D000FI-0001.000)

The Defense Finance and Accounting Service (DFAS) is providing the attached comments and actions taken in response to the DoD IG draft report, dated June 5, 2012.

My POC for questions or concerns is [redacted]

Laura N. Jankovich
Chief Financial Officer

Attachment:
As stated

www.dfas.mil
Your Financial Partner @ Work

DFAS Comments
DoDIG Draft Audit Report
Project no. D2011-D000FI-0001.000

General

The chart on page 3, highlighting DFAS costs and revenue, reflects figures over a relatively short period. DFAS suggests including 2006 expenses of $1.813B and revenue of $1.803B as data points to highlight the significant expense fluctuations and cyclical nature of Working Capital Fund cost recovery.

The internal control weaknesses summarized in the report section titled, "Review of Internal Controls over the Development of Billing Rates" are explicitly addressed in the subsequent DFAS responses.

FINDING B. Return of AOR Distorted FY2012 Billing Rates:

DFAS RM Response

- Recommendation B1 – Concur. DFAS developed and implemented a Unit Cost analysis capability, which allows for the identification of output execution revenue and cost variances from the budgeted plan. This tool specifically identifies the impact each output has on increases and decreases to the Net Operating Results (NOR) of DFAS.

- Recommendation B2 – Concur with comment. The DFAS timekeeping system does not provide the capability to specifically link individual employee records to customer bills. However, the system does provide detailed organizational information allowing DFAS to reconcile timekeeping data between the revenue reflected on its financial statements and the customer bills, ensuring customers are properly and accurately billed.

- Recommendation B3 – Concur. The DFAS Client Executive staff provides customers with a monthly breakout of billing which includes workload/workcount execution year-to-date, by output, and an adjusted estimate of anticipated workload/workcounts for the remainder of the year.

- Recommendation B4 – Concur. DFAS has initiated an effort to develop a product that provides further transparency of Direct Billable Hours, identifying the specific type of accounting services being performed. This product will be coupled with the monthly workload updates to the customers, discussed above, providing a forum for DFAS and its customers to discuss costs and future estimates.

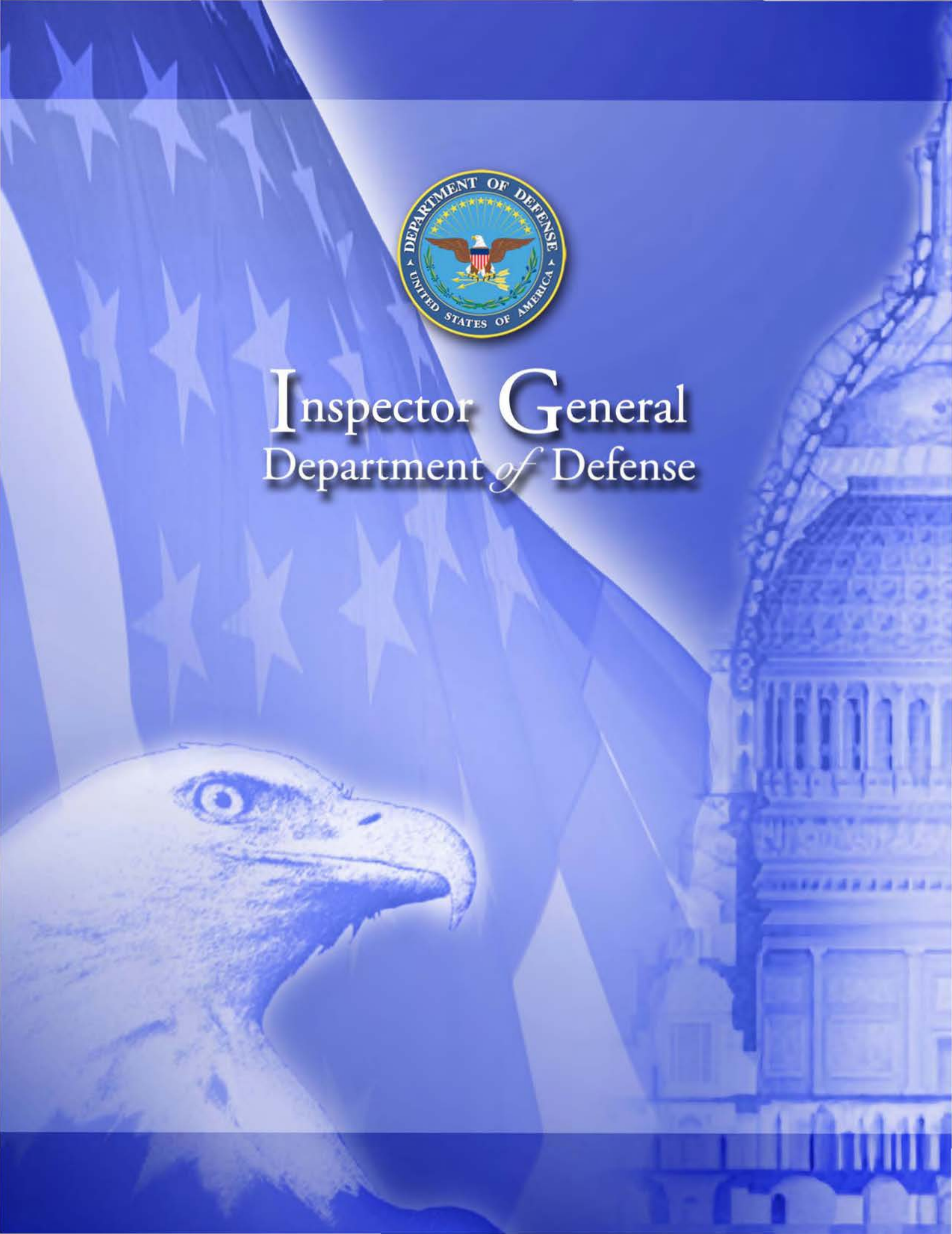
- DFAS considers this finding closed.

FINDING C. DFAS Needs to Maintain Supporting Documentation for Workcounts and Costs

DFAS RM Response

- Recommendation C – Concur. The DFAS Director of Resource Management has developed a policy requiring specific supporting documentation for all decisions regarding workcount and cost estimates and the corresponding development of rates be recorded and maintained for two years after the year of execution.

- DFAS considers this finding closed.



Inspector General
Department of Defense