Audit Report

OFFICE OF THE INSPECTOR GENERAL

ARMED FORCES RECREATION CENTER-ORLANDO

Report No. 95-087 January 27, 1995

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Acronyms

AFRC	Armed Forces Recreation Center
CFSC	Army Community and Family Support Center
*	*
MWR	Morale, Welfare, and Recreation
NAF	Nonappropriated Funds

*Proprietary data deleted.

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

January 27, 1995

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR PERSONNEL AND READINESS
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Audit Report on Armed Forces Recreation Center-Orlando (Report No. 95-087)

We are providing this report for review and comments. The audit reviewed the financial operations, the room-rate structure, and the terms of lease for the newly established Armed Forces Recreation Center in Orlando, Florida. Comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all audit recommendations be resolved promptly. Based on management comments, we added one recommendation and revised two recommendations. The Army comments were not fully responsive. Therefore, the Army is requested to provide final comments on the unresolved recommendations and monetary benefits by March 27, 1995. See the chart at the end of each finding for the unresolved recommendations and the specific requirements for the comments.

We appreciate the cooperation extended to the audit staff. If you have questions on this audit, please contact Mr. Joseph P. Doyle, Audit Program Director, at (703) 604-9348 (DSN 664-9348) or Ms. Deborah L. Culp, Audit Project Manager, at (703) 604-9335 (DSN 664-9335). Appendix E lists the distribution of this report. The audit team members are listed inside the back cover.

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Assistant Inspector General
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Office of the Inspector General, DoD

Report No. 95-087 **January 27, 1995**
(Project No. 4CK-5012)

ARMED FORCES RECREATION CENTER-ORLANDO

EXECUTIVE SUMMARY

Introduction. The Army Community and Family Support Center manages the morale, welfare, and recreation program for the Army. The Army Community and Family Support Center established the Armed Forces Recreation Center in Orlando, Florida (AFRC-Orlando), by leasing a 288-room hotel for 100 years from a subsidiary of Walt Disney, Incorporated. AFRC-Orlando began operations on February 1, 1994. The Army morale, welfare, and recreation standards state that for Category C activities, such as AFRC-Orlando, net income before depreciation should be break-even or positive. During the approval process, the Acting Secretary of the Army approval was predicated upon the ability of AFRC-Orlando to be completely self-sustaining.

Objectives. The audit objectives were to evaluate AFRC-Orlando actual and forecasted financial statements, hotel room-rate structure, and internal controls applicable to the audit objectives. The objectives also included a determination of whether the lease was properly approved and whether the terms of the lease were fair and reasonable.

Audit Results. AFRC-Orlando operations for the first 4 months did not meet the morale, welfare, and recreation standards of being break-even or positive. Although AFRC-Orlando was 92 percent occupied, the first 4 months of operations (February through May 1994) had an actual net loss of about $535,000 after depreciation and about $397,000 before depreciation on revenues of about $5 million. For the first 12 months of operations, we estimate a net loss of about $1.6 million. In addition, AFRC-Orlando operations were insolvent (liabilities exceed assets) by about $2.4 million and will not be able to be self-sustaining in the next 2 years (Finding A).

The Army cannot afford to continue to operate AFRC-Orlando under the existing lease terms. The Army will pay about $ * in land rents and about $ * in building rents if the existing lease terms continue until the lease expires in 100 years. The options in the lease do not provide a viable solution to reduce expenses and lower the risk to the Army Morale, Welfare, and Recreation Fund, commonly referred to as the soldiers' money. The Army can purchase the building or prepay the building rents for about $ * to $ * . The estimated cost to prepay the land rent, if negotiated, is about $ * to $ * (Finding B).

Internal Controls. The audit identified control weaknesses, but they were not material. See Part I for internal controls reviewed and Finding A in Part II for details on internal control weaknesses.

Potential Benefits of Audit. Potential monetary benefits can be realized by taking appropriate actions before any lease options are exercised. If the building lease options are not exercised and the lease is terminated before termination costs apply, funds to cover an estimated $ * to $ * in option costs and about $ * to $ * in termination costs will be available for other use. If the purchase option

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*Proprietary data deleted.

is exercised versus the prepayment option before year 4, $ * to $ * will be available for other use. See Appendix C for summary of the potential benefits resulting from the audit.

Summary of Recommendations. We recommend that the Army evaluate the existing room-rate structure and take the actions necessary to make the operations self-sustaining to include increasing existing and future room rates in the reservation system. We further recommend that the Army correct internal control weaknesses related to the accounting and attraction ticket departments. We also recommend that the Army establish a plan that evaluates the future of AFRC-Orlando. Additionally, we recommend termination of the lease if AFRC-Orlando cannot be self-sustaining and if sufficient funds are not available for the lease options. Finally, we recommend that DoD officials review the plan and disapprove the purchase and prepayment options if operations are not self-sustaining and if lease terms are not renegotiated.

Management Comments. The Army stated that the audit report was overly pessimistic and nonconcurred with increasing room rates, asserting that long-term financial self-sufficiency is virtually assured if the building and land rents are eliminated. The Army is willing to underwrite the cash losses until the rents are eliminated, positive cash flow is achieved, or the lease is terminated. The Army plans to adopt a new room-rate structure by July 1995, but no reservation system limitations will be made relative to grade. The Army agreed to correct the internal control weaknesses in the accounting and attraction ticket departments. Accounting corrections were resolved except for telephone expenses of $119,941, which AFRC-Orlando categorized as preopening expenses.

The Army agreed to meet Army Morale, Welfare, and Recreation Category C financial standards and obtain approval from Army leadership, Army Morale, Welfare, and Recreation Board of Directors, DoD officials, and Congressional oversight committees to purchase the building and to prepay land rents. If the standards are not met or the purchase and prepayment are not approved, the lease will terminate by *. The Army comments also stated that a reasonable land prepayment price will be the only lease term negotiated.

The Under Secretary of Defense for Personnel and Readiness concurred with the recommendations and requested an additional review after May 1995. A discussion of the responsiveness of management comments is in Part II of this report. The complete text of management comments is in Part IV.

Audit Response. We disagree with the Army's refusal to consider the increase to room rates. The Army obtained approval to establish AFRC-Orlando based on a plan to increase room rates annually and not to use other sources to subsidize AFRC-Orlando operations. The $119,941 in telephone services and equipment were incurred, billed, and paid after the lease was signed on January 15, 1994, and should be reflected in the FY 1994 income statement, not as preopening expenses. We also disagree with the Army position that the lease terms are acceptable and should not be renegotiated. Comments on the unresolved recommendation's and clarification of the Army plan to attain self sustainability are requested from the Army by March 27, 1995.

After May 1995, we will conduct a financial status review requested by the Assistant Secretary of Defense (Force Management Policy).

*Proprietary data deleted.

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This report was prepared by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD.

*Proprietary data deleted.

Part I - Introduction

Background

The Army Community and Family Support Center (CFSC) manages the morale, welfare, and recreation (MWR) program for the Army. CFSC established the Armed Forces Recreation Center (AFRC) in Orlando, Florida, to provide accommodations, food, beverages, and recreation to authorized patrons at affordable prices while generating sufficient net income to be self-sustaining. The 20-acre property (formerly the Disney Inn) is located on the Walt Disney World Resort and consists of a hotel with 288 guest rooms, 2 restaurants with lounges, 2 swimming pools, a ticket office for local attractions, and a fitness room. The hotel, officially named Shades of Green on Walt Disney World Resort, opened on February 1, 1994.

CFSC Process for Source Selection. In 1991, CFSC hired consultants to survey whether active Army and retired military personnel would support an AFRC in Orlando (AFRC-Orlando). Based on the favorable results of the study, CFSC personnel placed an advertisement in an Orlando newspaper requesting information on hotels for lease near Walt Disney World Resort. CFSC personnel evaluated 39 responses before they decided in 1992 to sole-source the Disney Inn using nonappropriated funds (NAF). NAF, commonly referred to as the soldiers' money, are cash and assets received from sources other than funds appropriated from Congress. NAF receives cash from activities such as exchanges, slot machines, and officers' and enlisted clubs.

Management of the Hotel. The initial CFSC plan included a Disney-managed hotel with a 1-year lease term, renewable for 5 years. However, the Army decided to have the CFSC Hospitality Directorate manage the hotel for a 100-year lease term. CFSC personnel stated that Disney declined to manage the hotel and the 100-year lease term was negotiated to qualify for a property tax exemption. CFSC personnel believed that the operations would be less expensive and assets would be better controlled if the CFSC Hospitality Directorate managed the hotel.

Approval to Lease the Hotel. CFSC obtained approval from Army and DoD officials to establish AFRC-Orlando and to lease the Disney Inn. Throughout 1992 and 1993, CFSC personnel provided briefings about AFRC-Orlando to the House Armed Services Committee MWR Panel, to DoD and Army officials, and to the MWR Board of Directors. CFSC stated in the briefings that AFRC-Orlando would have a first-year profit of about $1.1 million. During the approval process, the Acting Secretary of the Army approval was predicated upon the ability of AFRC-Orlando to be completely self-sustaining. In August 1993, the Acting Secretary of the Army approved the establishment of AFRC-Orlando and the contract to lease the Disney Inn. In October 1993, the Deputy Secretary of Defense permitted the Army to proceed with the contract to lease with an option to purchase. CFSC personnel signed the lease on November 3, 1993.

Hotel Lease Terms. The lessor is the Palm Hospitality Company, a subsidiary of Buena Vista Pictures Distribution, Incorporated, which is an affiliate of Walt Disney Company. The tenant is the Army MWR Fund (MWR Fund).

The MWR Fund provides funds for NAF major construction projects, large purchases, and other Army items including CFSC policy and overhead expenses.

The term of the lease is for 100 years and began on January 15, 1994. The lease year generally follows the Government's fiscal years (lease year). However, lease year 1 is only 8.5 months, beginning on January 15, 1994, and ending on September 30, 1994. The lease states that appropriated funds will not be held liable for any costs associated with the lease. The lease contains provisions over room rates, building and land rents, purchase option, prepayment option, termination costs, operating standards, and liabilities.

Objectives

The audit objectives were to evaluate AFRC-Orlando actual and forecasted financial statements, hotel room-rate structure, and internal controls applicable to the audit objectives. The objectives also included a determination of whether the lease was properly approved and whether the terms of the lease were fair and reasonable.

Scope and Methodology

Audit Scope and Methodology. We reviewed the establishment process for AFRC-Orlando, which included the market study and the selection and approval processes. We evaluated the lease terms and the future costs of the lease. Appendix A lists lease costs based on various * .
We also reviewed the preopening expenses that CFSC funded and accounted for and the February through May 1994 financial statements at AFRC-Orlando. The financial statements are required to follow MWR standards and generally accepted accounting principles. We did not perform a financial statement audit but used the financial statements to evaluate the financial condition of AFRC-Orlando.

We used computer-processed data from the attraction ticket and reservation systems. Portions of the attraction ticket data were not reliable; however, the unreliable data will not effect the results of the audit. The data were used to evaluate the understatement of expenses in the financial statements. The reservation data were reliable and were used to determine the current and future occupancy and average daily room rates.

Audit Period, Standards, and Location. This economy and efficiency audit was made from January through September 1994. The audit was performed in accordance with auditing standards issued by the Comptroller General of the

*Proprietary data deleted.

United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of internal controls that were considered necessary. The organizations visited or contacted are listed in Appendix D.

Internal Controls

Internal Controls Reviewed. We evaluated AFRC-Orlando's internal controls for financial reporting and implementation of the DoD Internal Management Control Program.

Adequacy of Internal Controls. The audit did not identify material internal control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987, but there were weaknesses that need to be corrected. In addition, AFRC-Orlando management did not fully implement the DoD Internal Management Control Program during the first 4 months of operations. The AFRC-Orlando attraction ticket and accounting departments did not properly record transactions and report expenses. In addition, the AFRC-Orlando internal control coordinator did not complete and review the internal control checklists for all AFRC-Orlando departments during the first quarter. However, updated checklists and internal control training for executive personnel were completed in July 1994. The implementation of the DoD Internal Management Control Program should enhance controls over future financial reporting. See Finding A in Part II for further details.

Corrective Actions Recommended. Implementation of Recommendations A.1.d., A.1.e. and A.1.f. will correct the internal control weaknesses. The potential monetary benefits are indeterminable. A copy of the final report will be provided to the senior official responsible for internal controls in the Department of the Army.

Prior Audits and Other Reviews

We obtained prior audits and other reviews of the NAF cash balances and operations of other AFRCs. The General Accounting Office and the Army Audit Agency recently reviewed the cash balances in NAF accounts. The General Accounting Office report stated that the Army goal is to close Category C activities that do not report a profit by 1995. The report also recommended the delay of capital improvement and NAF construction projects until such projects are shown to be sound investments. The Inspector General, DoD, issued a report concerning the ability of the AFRC in Europe to be self-sustaining. The report also questioned the use of appropriated funds and identified contract and work management internal control weaknesses. The Army Audit Agency also issued a report on the AFRC in Europe that addressed weaknesses in the NAF contracting operations. Additional details on the reports are shown in Appendix B.

Other Matters of Interest

We received an informal request to review the funding and propriety of the grand opening of AFRC-Orlando. In February 1994, CFSC spent about $665,000 of NAF on a 4-day grand opening ceremony at AFRC-Orlando. The costs included transportation, rooms, food, and attraction tickets for the hotel guests. AFRC-Orlando billed CFSC for the services and items provided to the attendees. The hotel guests during the grand opening included 271 Army enlisted soldiers, 17 special guests, and about 400 of their dependents and friends. Other attendees at the ceremonies included Army and CFSC personnel and two Members of Congress. We found no evidence of impropriety. The soldiers received permissive leave to attend the grand opening. The other attendees were either granted permissive leave or were on temporary duty. The audit did not identify any appropriated funds directly used at AFRC-Orlando for the grand opening or for the hotel operations.

Press coverage and correspondence regarding AFRC-Orlando indicated concern among some hoteliers and travel industry firms about an Army venture that entails direct competition with the private sector. We did not review or make any value judgements concerning that issue, since the Army followed the prescribed procedures for obtaining approval of AFRC-Orlando.

Part II - Findings and Recommendations

Finding A. Hotel Financial Performance

AFRC-Orlando did not comply with the Army MWR standards to be self-sustaining and financially sound. AFRC-Orlando was not self-sustaining and financially sound because management underestimated total expenses and did not establish rates for services to cover the actual expenses. Further, AFRC-Orlando operations have limited profit potential in the future. In addition, the lack of internal controls contributed to inaccurate financial statements. As a result, AFRC-Orlando had a net loss of about $535,000 during the first 4 months of operations and will have an estimated first-year net loss of about $1.6 million. We also estimate that AFRC-Orlando will not be able to become self-sustaining in the next 2 years unless the charges for services are increased or subsidies are received.

Background

The MWR Board of Directors adopted revised MWR standards for Category C activities on March 3, 1994. Category C activities, such as AFRC-Orlando, are considered business activities and have the greatest capability to generate revenue. The revised MWR standards state that net income before depreciation, including allocated overhead, should be break-even or positive. The standards also state that net income should be within 15 percent of the budget.

Self-Sustaining and Financially Sound Operations

AFRC-Orlando was not self-sustaining and was in an unsound financial position after 4 months of operation (February through May 1994). The first 4 months of AFRC-Orlando operations did not meet the MWR standards for Category C activities or the condition of approval. The May 1994 income statement reported a net loss, and the balance sheet reported a negative equity balance (liabilities exceeded assets). Furthermore, we do not anticipate that AFRC-Orlando will be self-sustaining in the next 2 years.

Income Statement Actual Net Loss. The actual net loss for the first 4 months of AFRC-Orlando operations was about $535,000 (after depreciation and amortization). AFRC-Orlando, however, reported an understated net loss of about $395,000 because about $140,000 of expenses were omitted. Using either the Inspector General, DoD, or the AFRC-Orlando reported net loss, in the first 4 months of operations AFRC-Orlando did not meet the MWR standards or the condition of approval to be self-sustaining.

Evaluation of Net Loss After Depreciation and Amortization. The MWR activities are normally evaluated on net income (loss) before depreciation and amortization because capital improvements and purchases are generally

purchased with other NAF accounts. This MWR evaluation method (before depreciation and amortization) excludes the costs of subsidized (from other NAF accounts) projects and purchases. However, the evaluation method also excludes the costs of any depreciable item purchased with the activity's own funds.

In our opinion, the MWR evaluation method does not accurately show the financial position of AFRC-Orlando. AFRC-Orlando is responsible for funding all the items (vehicles, equipment, preopening expenses, etc.) that are being depreciated and amortized. Therefore, when the AFRC-Orlando operations are evaluated, more accurate financial procedures are to use net loss after depreciation and amortization of about $535,000, which includes about $138,000 of depreciation and amortization.

Solvency Ratios of AFRC-Orlando Operations. The AFRC-Orlando operations are insolvent by about $2.4 million if intangible assets are excluded and by about $0.4 million if intangible assets are included. AFRC-Orlando solvency ratios are below the solvency ratio standards used for evaluating the financial soundness of NAF activities. While NAF activities are required to maintain a positive financial position, the AFRC-Orlando unaudited balance sheet as of May 31, 1994, reported negative equity (liabilities exceeded assets) of about $0.4 million. Furthermore, about $2 million of the assets are intangible assets (preopening expenses that will be amortized) that are not available to pay debts. A review of two key ratios, current and cash-to-debt, showed that AFRC-Orlando was not financially sound.

Current Ratio. The AFRC-Orlando current ratio is significantly below the levels considered financially sound for NAF activities. The AFRC-Orlando balance sheet as of May 31, 1994, shows an unacceptable current ratio of only 0.79 to 1. The current ratio measures the ability to pay for liabilities that are due within 1 year. Army Regulation 215-5, update 16, "Nonappropriated Funds Accounting Policy and Reporting Procedures," October 10, 1990, shows that a current ratio of at least 1.5 to 1 (current assets to current liabilities) is generally acceptable and states that, if current assets are less than current liabilities, the financial position may not be sound. Therefore, the AFRC-Orlando current ratio of 0.79 to 1 shows that the financial position is unsound.

Cash-to-Debt Ratio. The AFRC-Orlando cash-to-debt ratio is also below a financially sound level for NAF activities. The AFRC-Orlando balance sheet as of May 31, 1994, shows a cash-to-debt ratio of only 0.17 to 1. NAF management policy states that NAF activities should maintain a positive financial position. A positive financial position is defined as maintaining a cash-to-debt (total liabilities) ratio of at least 0.75 to 1. Therefore, AFRC-Orlando may not have sufficient cash to meet short- and long-term requirements.

Self-Sustaining and Financially Sound Operations Summary. Our analysis of the financial statements shows that AFRC-Orlando has not been a profitable venture. In the first 4 months of operations, AFRC-Orlando has not met the

conditions upon which the Acting Secretary of the Army approval was predicated. In addition, AFRC-Orlando has not met the Army MWR standards to have at least break-even operations or a positive financial position.

Budgeted Versus Actual Income and Expenses

Budgeted Income Versus Actual Income. The Army overstated first-year net income by about $2.7 million, and losses occurred sooner than anticipated. Based on the first 4 months of operations, we estimate that AFRC-Orlando will lose about $1.6 million in the first 12 months of operations. AFRC-Orlando also spent about $2 million during the preopening that will be expensed in future periods. Also, the Army budgets did not include the amortization of the preopening expenses or depreciation of purchased fixed assets. The Army stated during the approval process that AFRC-Orlando operations would generate profits of about $1.1 million for the first 12 months, about $2.6 million by the end of the third year, and more than $5.8 million by the end of the seventh year. The Army management forecasted that the increase in building and land rents would not cause a net loss until the ninth year.

Table 1 shows that AFRC-Orlando actual net income after depreciation and amortization for the first 4 months (February through May 1994) was 246 percent below the budgeted net income. The table compares the actual amounts with the budgeted amounts used in the briefing charts for the approval of AFRC-Orlando. The variance is the percent difference between the actual and budgeted amounts. MWR standards state that the actual versus budget variance should be within 15 percent.

Table 1. Actual Versus Budgeted Income Statement
(February through May 1994)

	Actual Amount	Budgeted Amount	Variance (percent)
Revenues	$5,143,773	$4,386,333	17
Less Expenses	5,541,133	4,020,669	38
Income (Loss) Before Depreciation	($ 397,360)	$ 365,664	(209)
Less Depreciation	137,560	0	-
Net Income (Loss)	($ 534,920)	$ 365,664	(246)

Budgeted Expenses Versus Actual Expenses. AFRC-Orlando actual expenses before depreciation and amortization for the first 4 months exceeded the budgeted expenses by 38 percent. The Army budgeted expenses about 15 percent below the Disney Inn expenses. The Army budget reflected anticipated reductions in labor, corporate management, food and beverage, and other operating expenses. However, the Disney Inn received centralized operational support from the Walt Disney World Resort, while AFRC-Orlando is a stand-alone facility that requires additional administration space and independent hotel functions (such as accounting, purchasing, reservations, and engineering). As a result, the actual AFRC-Orlando expenses exceeded both the amount the Army budgeted and the Disney Inn expenses.

Room-Rate Structure

The room rates, which the Army set based on the understated budget expenses, were not sufficient to generate the revenues needed to cover the budgeted expenses or to ensure that AFRC-Orlando operations would be self-sustaining. Also, Army personnel did not accurately estimate the percent of customers in each rate category and made a decision not to control the number of rooms available in each rate category within the reservation system. Even though actual occupancy rates exceeded 92 percent, the actual room revenue for February through May 1994 was about $317,000 less than budgeted. Based on the confirmed average daily room rate, we estimated that the room revenue for June 1994 to June 1995 will be about $1.7 million below the budgeted amount.

Room Rates for Lower-Ranking Enlisted Personnel. Army management emphasized that an inexpensive room rate for lower-ranking enlisted personnel was the main priority when they established the room-rate structure. CFSC used a contracted market analysis that showed that respondents expected room rates to range between $30 and $70 per night. Subsequently, CFSC established a $49 rate for lower-ranking enlisted personnel. Table 2 shows the room rates and the rank or grade of the authorized guests by category as of May 31, 1994. Table 2 shows that the lower-ranking enlisted personnel room rates were at least $24 lower than the room rates for authorized guests in other categories.

Table 2. Authorized Guests by Category, Room Rate, and Rank or Grade as of May 31, 1994

Category	Rate	Military Rank	Civilian Grade
I	$49	E-1 - E-5	GS-1 - GS-7
II	73	E-6, E-7, O-1, O-2, W-1	GS-8 - GS-12
III	85	E-8, E-9, O-3 - O-5, W-2 - W-5	GS-13 - GS-15
IV	92	O-6 - O-10	GS-16 and above

Budgeted Average Daily Room Rates. The average daily room rates were not budgeted to cover the actual expenses or the annual building and land rental increases. The average daily room rates were based on the budgeted expenses, which were 38 percent below the actual expenses for the first 4 months of operations. The annual building and land rental will increase about $ * in FY 1995 and about an additional $ * in FY 1996. However, Army personnel only budgeted the average daily room rates at $78, $82, and $84.36 for FYs 1994, 1995, and 1996, respectively. Therefore, the budgeted average daily room rates did not consider the actual expenses, and the increase in rates of $4 and $2.36 are not proportional to the annual building and land rental increases.

Actual Room Revenue Less Than Budgeted. Army management established a reservation system that did not ensure that the budgeted average daily room rates would be achieved. The Army did not achieve the budgeted average daily room rate because Army personnel did not install controls in the reservation system to limit the number of guests in each category. Therefore, the February through May 1994 actual average daily room rate was only $73, which resulted in about $317,000 less revenue than budgeted.

Guaranteed Rates Limit Generation of Additional Revenue. The confirmed reservations have guaranteed rates that severely limit AFRC-Orlando from generating additional revenue because only 27 percent of the rooms for June 1994 to June 1995 (1 year out) can have rates increased. The confirmed reservations for the 12-month period show an average room rate of $69 for 73 percent of all rooms. Using the $69 confirmed room rate and the actual 92 percent occupancy, we calculate that the room revenue for the period of June 1994 to June 1995 will be about $1.7 million less than budgeted.

Occupancy Rate Estimates. Army personnel did not accurately estimate the occupancy rates for the first 4 months of operations. Army personnel estimated an average occupancy rate of 97 percent for FY 1994 and 99 percent for FY 1995 and beyond. The actual occupancy for February through May 1994 was 92 percent. CFSC personnel stated that occupancy rates were lower for FY 1994 because the first month occupancy rate was only about 75 percent. CFSC personnel further stated that FY 1995 occupancy rates should reach the estimated occupancy rates based on the rooms already reserved.

Occupancy Rates by Category. AFRC-Orlando did not achieve the budgeted average daily room rate because the occupancy rate of lower category guests was higher than anticipated. Further, AFRC-Orlando budgeted all civilians at the highest category; however, AFRC-Orlando charged civilians based on their equivalent military rank. Figure 1 compares the budgeted, actual, and reserved occupancy by category for February 1 through May 31, 1994. Figure 1 shows that the actual and reserved occupancy rates for the lower rate categories ($49 and $73) exceeded the budgeted rate, while occupancy rates for the higher rate categories ($85 and $92) were lower than the budgeted rate.

*Proprietary data deleted.

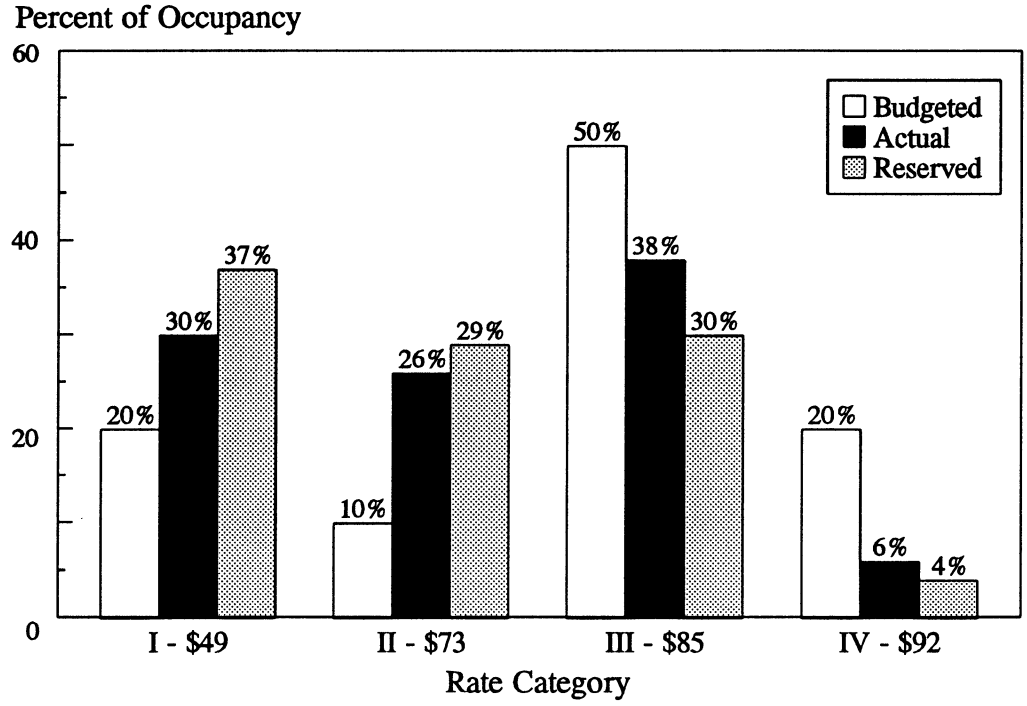

Figure 1. Comparison of Budgeted, Actual, and Reserved Occupancy by Rate Category for February 1 Through May 31, 1994

Room-Rate Summary. AFRC-Orlando will not achieve the average daily room rate needed to be self-sustaining for FYs 1994 and 1995. AFRC-Orlando did not obtain the needed average room rate for FY 1994 because the Army management based room rates on underestimated budgeted expenses and inaccurately estimated the percentage of military guests for each room-rate category. Also, AFRC-Orlando charged DoD civilians based on their equivalent military ranks instead of the budgeted $92 room rate for all civilians. As a result, Army management met their goal to provide an affordable hotel to lower-ranking enlisted personnel but did not meet their financial goals. In addition, AFRC-Orlando will not obtain the needed average daily room rate for FY 1995, because the room rates in the reservation system were not increased to affect the FY 1995 average daily room rate. We believe that losses will continue unless the Army increases room rates, restructures the guest rate categories, and limits the number of rooms in each room-rate category to achieve the actual daily rate needed to be self-sustaining.

Analysis of Profit Potential

AFRC-Orlando did not generate the revenue needed to break even, and the profit potential is limited for the revenue departments. The revenue departments are separated into rooms, attraction tickets, food and beverage, and other sources (telephones, amusement games, vending machines, interest earned, and commissions from room referrals). A break-even analysis showed that AFRC-Orlando operations would require an additional $17 per occupied room each day to be self-sustaining. However, the two largest revenue departments, rooms and attraction tickets, are limited by the competitive market in Orlando and by the lease terms.

Break-Even Analysis of the Revenue Departments. The AFRC-Orlando revenue departments did not generate the revenue needed to break even. For February 1 through May 31, 1994, the revenue departments generated about $161 each day, with an average occupancy rate of 92 percent. However, AFRC-Orlando needed about $178 of revenue per occupied room each day to break even. Therefore, AFRC-Orlando would need about an additional $17 in revenue per occupied room each day to break even if expenses and occupancy remained the same. Figure 2 shows the average daily revenue by department per occupied room and the amount needed to break even as of May 31, 1994.

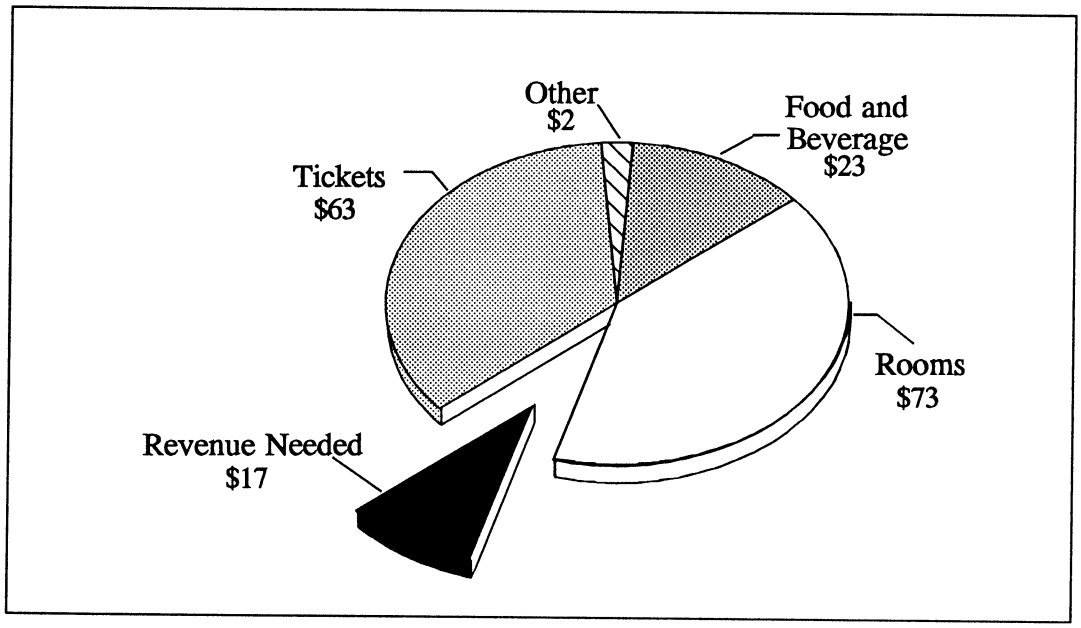

Figure 2. Average Daily Revenue Per Occupied Room Needed to Break Even

In addition to the $17 needed to break even as of May 1994, we estimate that AFRC-Orlando will need to generate about $4 more per occupied room in FY 1995 and an additional $7 in FY 1996 to cover the increase in the land and building rents. Therefore, AFRC-Orlando will need to generate about $28 more per occupied room in FY 1996 if other expenses and occupancy remained the same.

Room-Rate Competition. Although the current AFRC-Orlando room rates of $49 to $92 are more affordable than the average Walt Disney World Resort room rate, cheaper rates are available outside of Walt Disney World Resort. In fact, more than 75,000 hotel rooms are available in the Orlando area with varying room rates.

Table 3 shows Orlando area hotels, their estimated distance from Walt Disney World, and the estimated average room rates, including a 10 percent tax. The Walt Disney World Resort average room rate does not include the new Disney All-Star Resorts with a room rate of $87 per night.

Table 3. Orlando Area Hotel Distances From Walt Disney World and Average Room Rates

Hotel/Area	Distance	Rate
Kissimmee West Area	4 to 8 Miles	$ 49
Kissimmee East Area	4 to 16 Miles	57
International Drive	9 to 8 Miles	64
AFRC-Orlando	On Site	73
Disney All-Star Resorts	On Site	87
Lake Buena Vista	2 to 5 Miles	104
Other Disney Hotels	On Site	173

Competition within the Walt Disney World Resort will increase in the future. Disney plans to expand the approximate 800-room Disney All-Star Resorts to more than 5,000 rooms. The Disney All-Star Resorts offer an economical alternative with smaller rooms. Disney is also planning to build other hotels on site that, in combination with the Disney All-Star Resorts, will increase the available rooms on Walt Disney World Resort by about 8,500 rooms.

Army Room Rates Limited by Lease. The 100-year lease that the Army signed with the Palm Hospitality Company, the affiliate of Walt Disney Company, limits the amount of revenue that AFRC-Orlando can obtain from rooms for each room-rate category. (See Table 2 for each room-rate category.) When room rates exceed the rental contingency limits for a category,

AFRC-Orlando must pay the Palm Hospitality Company * * . The lease establishes rental contingency rates for each room-rate category; however, AFRC-Orlando may transfer military ranks and civilian grades to another room-rate category at any time during the lease term. CFSC personnel stated that under no circumstances will the condition that triggers the rental contingency revenue sharing ever occur.

Figure 3 shows the room rates and rental contingency limits based on the room-rate categories as of June 1994. The rental contingency limits * * depending on the room-rate category. For example, AFRC-Orlando cannot charge more than $ * for a category IV room without sharing the excess revenue with the Palm Hospitality Company. As a comparison, when Walt Disney, Incorporated, operated the hotel as the Disney Inn, the 1993 average daily room rate was $146. Therefore, the lease controls AFRC-Orlando's ability to obtain the fair market value for the rooms. We believe that the rental contingency clause is not fair and reasonable to the Army.

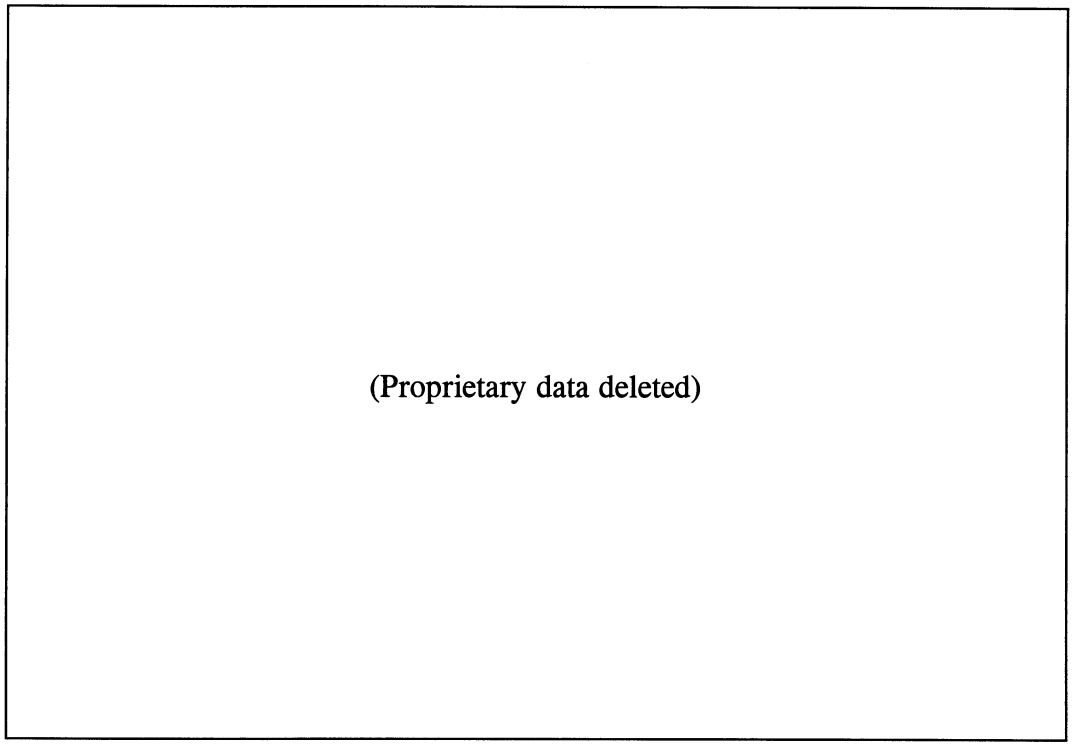

Figure 3. Room-Rate Limits for Each Category as of June 1994

Ticket Agreements and Competition Limit Revenue. Additional profits from attraction tickets are limited because of the AFRC-Orlando negotiated attraction ticket agreements and the highly competitive market.

*Proprietary data deleted.

Agreements Limit Revenue. AFRC-Orlando negotiated multiple attraction ticket agreements with Magic Kingdom, Incorporated (Disney), Universal Studios, and Busch Attractions. However, AFRC-Orlando management personnel did not negotiate a guaranteed price or discount percentage for tickets. Therefore, AFRC-Orlando could not prevent price increases for attraction tickets within the first 3 months of operations. Disney tickets increased an average of about 4 percent, Universal Studios tickets increased about 3 percent, and Busch Attractions tickets increased about 13 percent.

The Disney ticket agreement offered additional discounts if AFRC-Orlando met a specified sales goal for the length-of-stay tickets (for example, 3-day tickets). We reviewed the ticket agreement and determined that the goal was unreasonable. We advised AFRC-Orlando to negotiate guaranteed length-of-stay ticket prices or discount percentages and to change the sales formula so that the additional discount could be achieved. AFRC-Orlando contracting personnel stated that they will try to renegotiate the ticket agreement.

Competition From Other Sources Limits Revenue. AFRC-Orlando's profit potential on attraction tickets is limited because of the competitiveness from other discount sources. Table 4 shows examples of retail ticket prices (prices at the gate), AFRC-Orlando, and other discount sources. The table shows that the attraction ticket prices at AFRC-Orlando are less expensive than retail ticket prices and other discount sources. However, for some types of attraction tickets, AFRC-Orlando and other sources differ by as little as $*.

Table 4. Comparison of Attraction Ticket Prices

Attraction	Retail	AFRC	Other Sources
1-Day Disney Pass	$ 38	$ *	$38
5-Day Disney Pass	180	*	not available
Universal Studios	38	*	34
Sea World	35	*	31

Internal Controls

CFSC and AFRC-Orlando management did not fully implement the DoD Internal Management Control Program in the first 4 months of operations. Management partially implemented administrative aspects of internal controls during the first quarter of operations. Although departmental managers had checklists to ensure that internal controls were in place, the checklists were not completed within the first quarter. CFSC allowed AFRC-Orlando personnel

*Proprietary data deleted.

only 15 days to prepare the hotel before the first guests arrived. Therefore, the accounting and attraction ticketing departments were not fully functional when operations began.

Accounting Department. Even though CFSC personnel began the AFRC-Orlando establishment process in 1992 and is the agency responsible for four other AFRC sites, an adequate accounting system was not in place when the hotel opened for business. The following accounting problems existed during the first quarter of operations:

- o Expenses were incorrectly posted.
- o Items paid by CFSC from other NAF accounts were not verified.
- o Accounting methodology for fixed assets, preopening and telephone expenses, and lease payments was not determined.

Inaccurate Income Statement. Even though AFRC-Orlando accounting personnel made about $300,000 in corrections to the May 1994 year-to-date unaudited income statement, expenses of about $140,000 were omitted. The unreported expenses included telephone, transportation, and insurance expenses.

Telephone Expense. AFRC-Orlando accounting personnel planned to expense telephone services of $119,941 over a 5-year period as preopening costs even though the telephone services occurred after the hotel opened. AFRC-Orlando accounting personnel expensed telephone equipment for April and May 1994 but failed to expense the February and March 1994 costs. The accounting personnel also excluded telephone operator services for February, March, and April 1994. The costs should be expensed in the months that the services were received to ensure that expenses are matched with revenues.

Transportation and Insurance Expenses. AFRC-Orlando accounting personnel also did not include about $6,667 of transportation and $13,162 of insurance costs. The costs were incorrectly excluded from February and March 1994 income statements. AFRC-Orlando plans to expense the transportation and insurance costs in FY 1994.

Corrections to Income Statements. AFRC-Orlando accounting personnel did not correct all errors in accordance with the Army Regulation 215-5. AFRC-Orlando accounting personnel made corrections to the financial statements during audit site visits. For example, $300,000 of adjustments were made to the May 1994 income statement. However, each of four monthly income statements contained material errors including the $140,000 of omitted expenses in the May 1994 income statement.

Attraction Ticket Department. The attraction ticket department was not prepared to operate effectively when AFRC-Orlando opened. AFRC-Orlando did not install or maintain an adequate inventory system for attraction tickets during the first quarter of operations. Management could not properly maintain inventory data because of the unexpected volume of attraction ticket sales and the lack of an adequate inventory system. In addition, the attraction ticket department incorrectly voided an attraction ticket invoice that resulted in an understatement of cost of goods sold. As a result, attraction ticket inventories were inaccurate and the accounting department overstated attraction ticket profits by about $127,000 until a correction was made in the May 1994 income statement.

Management Actions. AFRC-Orlando management corrected the internal control deficiencies in the attraction ticket department. Specifically, management installed a new point of sale (perpetual) inventory system that improves the accountability and reporting of the attraction tickets. CFSC should review the new system to ensure that it provides adequate accountability for inventory. Management also dismissed the inventory specialist. AFRC-Orlando personnel identified the understatement of cost of goods sold and adjusted the May 1994 income statement. The corrected actions and future attention to the attraction ticket department should reduce the inaccuracy in inventories and should reduce further reporting errors.

Conclusion

AFRC-Orlando has not satisfied the conditions stipulated by the Acting Secretary of the Army during the approval process for the establishment of AFRC-Orlando. The approval was contingent on the ability of AFRC-Orlando operations to be self-sustaining. The first 4 months of AFRC-Orlando operations did not meet the MWR standards for Category C activities because the operations had a net loss of about $535,000 and a negative net income variance of 246 percent compared with the budget. In addition, the balance sheet as of May 31, 1994, showed that the operations were insolvent.

Army management met their goal to provide affordable hotel accommodations to lower-ranking personnel, but did not meet their financial goals. Losses will continue unless the Army increases room rates, restructures the guest-rate categories, and limits the number of rooms per room-rate category. However, the potential to generate additional room and attraction ticket revenue is limited because of the confirmed room reservations, the restrictions imposed by the lease, and the competitive market. We believe that the Army's estimated profit of about $2.6 million by the end of the third year and more than $5.8 million by the end of the seventh year is drastically overstated.

Recommendations, Management Comments, and Audit Response

Added Recommendation. As a result of the comments received from the Army, we added Recommendation A.2. to the Commander, Army Community and Family Support Center, to brief appropriate parties on the Army's subsidy plans for AFRC-Orlando.

1. We recommend that the General Manager, Armed Forces Recreation Center in Orlando:

a. Evaluate existing room-rate structure and take the actions necessary to make the operations self-sustaining. The actions should include:

(1) Increasing room rates immediately to the levels required to be self-sustaining without subsidies from Army Community and Family Support Center.

(2) Increasing room rates for reservations made for future periods to reflect changes in budgeted expenses. The adjustments should consider the level required to be self-sustaining without subsidies from Army Community and Family Support Center.

Management Comments. The Army nonconcurred. The Army stated that increasing room rates may be unnecessary until the effects of implemented revenue enhancements and cost avoidances are evaluated. The Army also stated that long-term financial self-sufficiency is virtually assured if the building and land rents are eliminated. The Army is willing to underwrite the modest cash losses until the rents are eliminated, positive cash flow is achieved, or the lease is terminated.

Audit Response. The Army comments are not responsive. We disagree with the Army position not to increase room rates until the effects of implemented revenue enhancements and cost avoidances are evaluated. Even though Army management already initiated limited revenue enhancements and cost avoidances, our audit and the Army provided no evidence that losses can be avoided without an increase to room rates. The disparity between the budgeted average daily room rate and actual average daily room rate will continue to increase each lease year if the Army does not take recommended actions. We believe that the revenue enhancement and cost avoidance actions will not put AFRC-Orlando in the self-sustaining position required by the MWR standards.

The approval of the establishment of AFRC-Orlando was based on budgets that showed profits the first 8 lease years. The Army stated during the approval process that AFRC-Orlando operations would generate profits of about $1.1 million for the first 12 months, about $2.6 million by the end of the third year, and more than $5.8 million by the end of the seventh year. Management forecasted that the increase in building and land rents would not cause a net loss until the ninth year. The budgets showed an increase in the

average daily room rates for each lease year beginning on October 1, 1994. According to the Army comments, the Army has abandoned the plan to increase room rates as expenses increase. Instead, the Army will use other sources to subsidize AFRC-Orlando until the rents are eliminated, positive cash flow is achieved, or the lease is terminated.

The Army and CFSC officials did not inform the approval officials that AFRC-Orlando operations would be subsidized. In fact, the Army and CFSC officials projected 7-year profits of $5.8 million when they showed briefing charts to Congress, the Office of Secretary of Defense, and the Inspector General, DoD. We request the Army to reconsider its position on this recommendation and provide additional comments when responding to the final report. Additionally, as a result of the Army comments, we have added Recommendation A.2.

(3) Reevaluating the current rate category structure and transferring military ranks and civilian grades to a higher-level room-rate category to meet the average daily rate needed to be self-sustaining.

Management Comments. The Army concurred in principle by planning to adopt a three-tier room-rate structure by July 1995.

Audit Response. The Army comments were partially responsive. The Army response did not address how or whether the proposed revision to the room-rate structure would increase the average daily rate needed to be self-sustaining. We request the Army to provide further details on the new rate structure and to explain whether this rate structure will increase revenues enough for AFRC-Orlando to be self-sustaining.

(4) Establishing controls in the reservation system to limit the number of rooms available in each room-rate category to obtain the average daily rate needed to be self-sustaining.

Management Comments. The Army nonconcurred because AFRCs, like all other MWR facilities, are operated for the benefit of all authorized patrons without limitations relative to grade.

Audit Response. The Army comments are not responsive. We believe that the Army cannot attain the average daily rate needed to break even without establishing controls in the reservation system. The controls would not restrict soldiers from using the facility, but rather would limit the number of rooms at each rate category. We request the Army to reconsider its position on this recommendation and provide additional comments when responding to the final report.

b. Negotiate with the attraction ticket vendors a guaranteed price or discount percentage for tickets.

c. Negotiate with Magic Kingdom, Incorporated, a change in the length-of-stay ticket sales formula to achieve additional discounts.

d. Review the new point of sale inventory system for attraction ticket sales to determine whether the system provides adequate accountability for inventory.

e. Review the adequacy and implementation of the internal controls over the attraction ticket department. Change the internal controls over the attraction ticket department as necessary.

f. Direct the Comptroller, Armed Forces Recreation Center in Orlando, to:

(1) Use the accrual method of accounting, and record all expenses incurred in the period incurred.

Management Comments. The Army agreed to those recommendations.

(2) Adjust the FY 1994 financial statements to include telephone expense for $119,941, transportation expense for $6,667, and insurance expense for $13,162.

Management Comments. The Army partially concurred. The transportation and insurance expenses were adjusted in the June 1994 accounting period. However, the Army stated that the telephone expense of $119,941 should remain as a preopening expense because it was incurred before commencement of lease.

Audit Response. The Army comments are partially responsive. The Army could provide no documentation to support its position that the $119,941 in telephone expense was incurred before commencement of the lease. The $119,941 in telephone expense for services incurred during February, March, and April of 1994 is not a preopening expense and must be reflected in the FY 1994 income statement. We request the Army to reconsider its position on the telephone expense and provide additional comments when responding to the final report.

2. We recommend that the Commander, Army Community and Family Support Center, take immediate action to brief the Under Secretary of Defense for Personnel and Readiness; the Morale, Welfare, and Recreation Board of Directors; the House National Security Committee Morale, Welfare, and Recreation Panel; and the Senate Committee on Armed Services and inform them that the Army plans to subsidize the Armed Forces Recreation Center in Orlando until the rents are eliminated, positive cash flow is achieved, or the lease is terminated.

Response Requirements Per Recommendation

Responses to the final report are required from the addressees shown for the items indicated with an "X" in the chart below.

		Response Should Cover:		
Number	Addressee	Concur/ Nonconcur	Proposed Action	Completion Date
1.a.	Army	X	X	X
1.f.(2)	Army	X	X	X
2.	Army	X	X	X

Finding B. Affordability of Armed Forces Recreation Center-Orlando

The Army cannot afford to continue to operate AFRC-Orlando under the existing lease terms. Further, the options in the lease to purchase the building or prepay the building rents are not economically viable. AFRC-Orlando is not affordable because the lease terms place significant financial burdens on the operation's ability to be self-sustaining. The termination and amortization lease terms prevent the Army from obtaining a monetary benefit from purchasing the building. The MWR Fund also does not have sufficient NAF available to exercise either option before termination costs apply. CFSC will be risking an estimated $ * to $ * of the soldiers' money to provide a recreational facility that will be popular, but will serve only about 1 percent of the active-duty military.

Existing Lease Terms

The Army cannot afford to rent and maintain AFRC-Orlando under the existing lease terms. The Army cannot reduce the annual increases in land rent unless the Army renegotiates new lease terms. The Army can control the increase in building rents only if the Army exercises the lease option to purchase the building. However, even if the building is purchased, AFRC-Orlando will continue to be responsible for the maintenance, repair, replacement, and liability of the land and building.

Land Rent. The annual increase in land rent will cause a financial burden that the Army cannot control or afford. The lease specifies that land rent payments will continue to increase annually until lease termination or expiration. The Army continues to pay the land rent regardless of any options exercised to purchase the building or prepay the building rents. The lease specifies the amount of the land rent for lease years 1 and 2 and then increases the land rent

*

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*

CFSC personnel have agreed that the land rents should be renegotiated before any building purchase or prepayment decisions are made. The lease specifies that the land cannot be purchased or the rents prepaid. However, CFSC personnel believe that the Palm Hospitality Company may negotiate a land rent prepayment. We believe that if CFSC negotiates a prepayment of the land rent, it will cost between the present value of the land rental payments (about $ *) and the appraised value of the land (about $ *). However,

*Proprietary data deleted.

if the Army cannot renegotiate the land rent, the MWR Fund may pay more than $ * in land rent payments before the lease expires.

Building Rent. Because of the substantial financial burden of the building rent, CFSC expects to purchase the building, prepay the building rent, or terminate the lease within the first 7 years. The building rent is specified for lease years 1 through 6 and then increases * . However, a portion of the rent is deferred in lease years 4 through 6. CFSC personnel stated they have no intention to rent the building past lease year 7, because the rents become cost prohibitive. However, CFSC did not provide any written plans or milestones detailing the decision process. CFSC should prepare a detailed plan with milestones to budget for the cost of the lease options or to end the lease before the end of the third year of operations to avoid termination costs. Table 5 shows the amount of annual land and building rents and the cumulative total for various lease years.

Table 5. Annual Land and Building Rents and the Cumulative Total

Lease Year	Land Rent	Building Rent	Cumulative Rent
1	$ *	$ *	$ *
2	*	*	*
3	*	*	*
7	*	*	*
15	*	*	*
25	*	*	*
50	*	*	*
99	*	*	4,057,061,875

*

We believe that the Army cannot afford to pay the $ * cumulative land and building rents and be self-sustaining. The $ * cumulative land and building rents by the end of lease year 7 would also be a large investment without a favorable return. We believe that the Army cannot raise prices enough to cover the increased rental costs and remain competitive with the surrounding market. Therefore, the continuation to rent the land and building is not prudent or affordable in the long term. In addition, the Army estimated a 4-percent * even though the * increased an average of * * . See Appendix A for the cumulative land and building rents using a 4-percent, 5-percent, and 6-percent * .

*Proprietary data deleted.

Army Liability for Land and Building. The Army is liable for the land and building during the lease term except for previous environmental dangers. The Army is required to maintain and operate the hotel according to first-class hotel standards. The Palm Hospitality Company enforces the hotel standards through daily in-house inspections. The lease also requires the Army to purchase insurance that protects the Palm Hospitality Company from liability claims. The total annual premiums for the first year are about $136,000 for the Palm Hospitality Company liability coverage. The Palm Hospitality Company liability insurance is in addition to the property and operational insurance required by the lease. The property and operational insurance cost about $107,000.

Building Purchase and Prepayment Options

The options to purchase the building or to prepay the building rents do not provide the Army a viable solution to AFRC-Orlando's negative financial position. The prepayment option does not provide any additional benefits compared with the purchase option and is generally more costly. However, if CFSC decides to exercise either option, the Army must obtain additional approval from DoD officials and Congress.

Purchase of the Building. The Army will not gain the exclusive rights of ownership if the building purchase option is exercised. The lease terms, including operating standards, land rent, and termination costs, will continue to be in effect if the building is purchased. Even if the building is purchased, the Army must return the building upon termination or lease expiration to the Palm Hospitality Company. The building must be returned in at least the same condition as existed when the Army began to lease the hotel. In addition, if the Army exercises the purchase option, the Army still may not sell, assign, sublease, or transfer the building without the prior written approval of the Palm Hospitality Company.

Prepayment of Building Rent Versus Purchase of Building. The prepayment of rent is more costly than the purchase of the building except in lease year 7 and provides fewer advantages. The lease includes an option to prepay the building rent that can be exercised for $ * within 7 years after the lease began. The Army can purchase the building for about $ * to $ * before the end of lease year 7. The prepayment option does not allow AFRC-Orlando to keep replaced furniture and gives AFRC-Orlando less support if the tax exemption was questioned. Table 6 shows the purchase and prepayment costs during the 7 years that the options can be exercised and shows that the Army can exercise the purchase option for less than the prepayment option through lease year 6. The legal costs to exercise the purchase and prepayment options are not included in the table.

*Proprietary data deleted.

Table 6. Costs of Building Purchase and Prepayment Options

Lease Year	Purchase	Prepayment
1	$ *	$ *
2	*	*
3	*	*
4	*	*
5	*	*
6	*	*
7	*	*

Purchase and Prepayment Approval. The Deputy Secretary of Defense approval stated that the purchase option would require advance approval from the Under Secretary of Defense for Personnel and Readiness. CFSC personnel stated that further approval is not technically required if the option to prepay the building rent is exercised. However, we believe that the decision to prepay the building rent without further Army and Under Secretary of Defense for Personnel and Readiness approval would circumvent the intent of the approval officials to reevaluate any long-term decisions.

The Army must also obtain a waiver of DoD Instruction 1015.6, "Funding of Morale, Welfare, and Recreation Programs," to purchase the building. The regulation states that NAF are not authorized for the purchase of commercial real property unless located on Government property. Because AFRC-Orlando is located on Walt Disney World Resort, the waiver must be obtained before the purchase option can be exercised.

Termination and Amortization Lease Terms

The termination and amortization lease terms do not allow the Army to receive the monetary benefits that result from the appreciation of real property. In addition, the termination terms are not equitable to the Army because the termination costs are higher than the Palm Hospitality Company's costs and increase annually, while the residual value of the building decreases as the lease ages. The Army is also prevented from obtaining the fair market value of the building because the lease limits the sale of the building.

*Proprietary data deleted.

Termination Terms. The Army termination costs are higher than the Palm Hospitality Company's termination costs and are not reasonably proportionate to the value of the property.

*

; however, the costs are not equitable because the Palm Hospitality Company termination costs start at only $ * . Both parties' termination costs increase * and both pay an additional penalty of $ * for lease default. If the Army purchases the building, the termination costs still remain in effect. We believe the termination costs, which are about * percent of the purchase price, are not reasonably proportionate to the value of the property.

Amortization Terms. The amortization terms of the lease are not equitable to the Army because the terms do not allow the Army to recover the purchase price. The lease contains a fixed amortization schedule that decreases the residual amount of the building purchase option recovered by the Army when the lease is terminated. The amortization schedule decreases the building's residual value over the life of the 100-year lease period if the purchase or prepayment option is exercised. Because the Army must maintain and return the building in at least the same condition when purchased or prepaid, the Palm Hospitality Company will not allow the building to deteriorate. Therefore, the building should not be amortized and devalued below the original purchase price.

Cost if the Lease is Terminated. The Army cannot obtain the fair market value of the building and will lose a substantial amount of the purchase price if the lease is terminated. Because the Army may not sell the building without the prior written approval of the Palm Hospitality Company, the Army cannot profit from the purchase of the property. For example, if the Army purchases the building in the beginning of lease year 4 for $ * , and terminates the lease at the end of lease year 15, an estimated 53 cents on the dollar ($ *) would be forfeited because the Palm Hospitality Company only reimburses the Army the purchase price less the termination and amortization costs. The costs if the lease is terminated will also continue to increase each year until the lease expires.

Tables 7 and 8 show the termination, amortization, and total costs if the building purchase option is exercised in the beginning of lease year 4 for $ * and is terminated on the last day of the respective lease year. Table 7 shows that the Army's costs increase annually if the Army terminates the lease. The cost to the Army equals the sum of the amortized amount and termination costs, because the Army does not retain the amortized amount.

*Proprietary data deleted.

Table 7. Cost if the Army Terminates the Lease

Lease Year	Termination Costs	Amortized Costs	Total Costs
4	$ *	$ *	$ *
5	*	*	*
6	*	*	*
7	*	*	*
15	*	*	*
25	*	*	*
50	*	*	*
99	*	*	*

The Palm Hospitality Company costs are lower than the Army's costs because the Palm Hospitality Company retains the amortized amounts, and the termination costs for the Palm Hospitality Company are lower. Therefore, the cost to the Palm Hospitality Company is the difference between the termination cost and the amortized amount. Table 8 shows that the costs to the Palm Hospitality Company are significantly lower than the Army's costs and decrease annually through lease year 25.

Table 8. Cost if the Palm Hospitality Company Terminates the Lease

Lease Year	Termination Costs	Amortized Costs	Total Costs
4	$ *	$ *	$ *
5	*	*	*
6	*	*	*
7	*	*	*
15	*	*	*
25	*	*	*
50	*	*	*
99	*	*	*

Tables 7 and 8 show that the Army risk of doing business is much higher than the risk assumed by the Palm Hospitality Company. The tables do not show the interest earned by the Palm Hospitality Company and lost by the Army because of the cash purchase of the building. Tables 7 and 8 termination costs would increase substantially if the actual * exceeds the Army estimate of 4 percent. See Appendix A for the Army's termination costs using a 4-percent, 5-percent, and 6-percent * .

*Proprietary data deleted.

Availability of NAF to Exercise Options

The Army MWR Fund and the Army Recreation Machine Trust Fund (Trust Fund) will not have sufficient cash balances to pay for the lease options before FY 1999. CFSC has not budgeted for the cost of the lease options to include the purchase of the building, the prepayment of building rent, the prepayment of land rent, and the termination costs. CFSC personnel stated that AFRC-Orlando will compete with other NAF projects for MWR funding of the lease options.

Cash Balance of Army MWR Fund. The Army does not have sufficient balances in the MWR Fund to exercise the building purchase option or any type of lease prepayment option before FY 1999 unless funds are borrowed from the Army Banking Investment Fund. The MWR Fund will have an estimated $17.2 million and $8.4 million in negative cash balances in FYs 1995 and 1996, respectively. The CFSC Resource Management Directorate plans to borrow an estimated $25.6 million from the Army Banking Investment Fund to cover the shortage in the MWR Fund. The Army Banking Investment Fund, commonly referred to as the bank, is the aggregate of all NAF accounts including the MWR Fund, the Trust Fund, and all single funds from installations. CFSC management plans to repay the loan in FYs 1997 and 1998. The planned loan in FY 1995 would be the first loan transaction completed between the MWR Fund and the Army Banking Investment Fund.

CFSC allocates about $25 million each fiscal year for approved NAF major construction projects. Once approved, the NAF projects are usually budgeted and financed over a 4-year period. However, the lease option costs for the AFRC-Orlando project have not been budgeted or approved. In addition, the lease options must be paid with a single payment. Therefore, the AFRC-Orlando project would exceed an entire fiscal year allocation for NAF major construction projects in the MWR Fund.

Cash Balance of the Trust Fund. The Trust Fund will not have the sufficient funds to subsidize the lease options for AFRC-Orlando. The Trust Fund, which generates revenue from slot machines, video games, and interest earned, has subsidized AFRCs, major NAF construction projects, and other unique requirements (start up costs, severance pay for foreign employees, and grand opening costs). Beginning in FY 1993, CFSC was required to transfer the majority of the Trust Fund's residual cash balances to increase the resources of the MWR Fund. In addition, the Trust Fund has certified an estimated $77 million in FYs 1994 and 1995 for a NAF project at AFRC in Hawaii. Therefore, the Trust Fund ending cash balance for FY 1995 and beyond will not exceed $3.1 million, well below the $ * to $ * needed to pay for the building purchase and prepayment of land rents.

*Proprietary data deleted.

Army Audit Agency Review of NAF Cash Balances. A 1994 Army Audit Agency consulting report stated that the forecasted Army Banking Investment Fund cash balances for FYs 1995 through 1996 were decreasing below a sound financial position. The report recommended that CFSC personnel develop a plan of action to address the shortfalls in the forecasted years or Army MWR programs may become insolvent.

The report estimated that the unencumbered cash balance in the Army Banking Investment Fund would decrease from about a positive $33 million in FY 1994 to about a negative $52 million in FY 1996. Therefore, we believe that the Army Banking Investment Fund may not have sufficient unencumbered funds to loan AFRC-Orlando the money to purchase the building or prepay the rents.

Cost to Purchase the Building and to Prepay the Land Rent. The cost of the existing building purchase option and a land rent prepayment could put a severe strain on the MWR Fund. The cost of the building purchase and prepayment options range between $ * and $ * . If land prepayment is negotiated, we estimate the cost to be between the $ * appraisal amount and the $ * present-value amount. Therefore, AFRC-Orlando will require between $ * and $ * in additional funds to purchase the building and prepay the land rent. In addition, *
*
*
*

Cash Available and Cash Required. The MWR Fund and the Trust Fund will not have cash available to pay for the purchase of the building and prepayment of the land rent until FY 1999 at the earliest. If the MWR Fund approves future projects or if the prepayment of land exceeds the appraisal value, then the Army may not be able to exercise the purchase or prepayment options before they expire in FY 2001.

Table 9 shows the estimated cash available in the MWR Fund and the Trust Fund for FYs 1994 through 1999 and the cash required to purchase the building and prepay the estimated land rent. The table also shows the shortfall in cash available if the rent prepayment is $ * and $ * . The cash available in Table 9 does not consider the anticipated funding for other FYs 1995 through 1999 MWR Fund projects. The cash available includes the amounts transferred from the Trust Fund to the MWR Fund and the amount borrowed from the Army Banking Investment Fund for the MWR Fund.

*Proprietary data deleted.

Table 9. Cash Available From NAF, Cash Required for the Lease, and Shortfall in Cash Available
(millions)

	FY 1994	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999
Cash available						
MWR Fund[1]	$ 8.9	$ 9.3	$15.5	$21.9	$28.3	$64.6
Trust Fund	10.0	1.2	2.4	3.1	2.9	2.9
Total available	**$18.9**	**$10.5**	**$17.9**	**$25.0**	**$31.2**	**$67.5**
Cash required if cost to prepay land rent is $ *						
Purchase building	$ *	$ *	$ *	$ *	$ *	$ *
Prepay land[2]	*	*	*	*	*	*
Total required	**$ ***	**$ ***	**$ ***	**$ ***	**$ ***	**$ ***
Cash available shortfall	**$ ***	**$ ***	**$ ***	**$ ***	**$ ***	**n/a**
Cash required if cost to prepay land rent is $ *						
Purchase building	$ *	$ *	$ *	$ *	$ *	$ *
Prepay land[3]	*	*	*	*	*	*
Total required	**$ ***	**$ ***	**$ ***	**$ ***	**$ ***	**$ ***
Cash available shortfall	**$ ***	**$ ***	**$ ***	**$ ***	**$ ***	**$ ***

[1]Considers $25.6 million loan in FYs 1995 and 1996 and payback in FYs 1997 and 1998.
[2]Assumes that prepayment of land was negotiated at appraisal amount.
[3]Assumes that prepayment of land was negotiated at present value of land lease payments.

Benefit from Investment

The benefit received from investing in AFRC-Orlando does not justify the cost. The number of active-duty military who benefit from AFRC-Orlando is a very small percentage of the military population. Also, the AFRC-Orlando inability to be profitable or self-sustaining increases the risk of the investment to the MWR Fund.

*Proprietary data deleted.

Demographics of Hotel Guests. Only about 64 percent of the occupants for February through May 1994 were active duty, reserve, and National Guard personnel. Active, reserve, and retired military personnel, and DoD civilians are authorized to stay at AFRC-Orlando. About 27 percent of the occupancy was retirees and about 9 percent was DoD civilians. Of the active-duty personnel, 34 percent was Army, 35 percent was Air Force, 24 percent was Navy, 5 percent was Marines Corp, and 2 percent was Coast Guard. AFRC-Orlando also is required to provide hotel accommodations for the Professional Golf Association for about three weeks each year. As of June 19, 1994, the Professional Golf Association has confirmed more than 2,200 room nights at the $92 rate.

Benefit of AFRC-Orlando to Active-Duty Military. The majority of the active-duty military will not benefit from the recreational experience available at AFRC-Orlando. The Army established AFRC-Orlando to provide a tangible benefit during a period of significant turbulence in the military. Additionally, the Army believed that AFRC-Orlando would be a positive factor influencing personnel readiness and retention. It is clear that AFRC-Orlando is highly popular and well publicized, but it can only serve about 1 percent of active-duty military personnel each year. The continuation of AFRC-Orlando will reduce funding available for other NAF projects by about $ * to $ * .

Conclusion

AFRC-Orlando cannot continue to operate the hotel under the existing lease terms without increasing prices, reducing services, or receiving significant subsidies. AFRC-Orlando operations will not succeed unless land and building lease costs are controlled. The lease limits the Army's ability to decrease expenses because the Army is responsible for maintaining the land, building, and operations to specified lease standards. The lease also does not allow the Army to receive the monetary benefits that result from the appreciation of purchased real property because of the fixed amortization schedule and termination costs. Therefore, the lease is unfavorable in the long term to the Army and does not provide a practical alternative for continuing operations.

The Army has not yet provided a plan that details whether and when the purchase of the building, prepayment of the building and land rents, or termination of the lease will occur. CFSC also has not budgeted for the lease options (estimated at $ * to $ *) if the Army purchases the building and negotiates a prepayment of land rent within the first 7 years. If the decision is not timely or if funds are not available, NAF (soldier's money) will lose in excess of $ * in termination costs.

*Proprietary data deleted.

Recommendations, Management Comments, and Audit Response

Revised Recommendation. As a result of management comments, we revised draft report Recommendations B.1.e. and B.2.c. to the Commander, Army Community and Family Support Center and to the Under Secretary of Defense for Personnel and Readiness, to change the date to terminate the lease.

1. We recommend that the Commander, Army Community and Family Support Center:

a. Assess Armed Forces Recreation Center in Orlando operations and establish a plan with milestones for the future of the Armed Forces Recreation Center in Orlando operations. The plan should:

(1) Assess whether Armed Forces Recreation Center in Orlando can meet the Morale, Welfare, and Recreation Category C standards and establish a deadline for the Armed Forces Recreation Center in Orlando to be self-sustaining. The plan should detail the actions to be taken to become self-sustaining.

Management Comments. The Army partially concurred. The Army stated that AFRC-Orlando will either meet Army MWR Category C financial standards or the operation will be terminated prior to the end of * (*).

Audit Response. The Army comments are not fully responsive. The commitment on meeting the MWR Category C standards in reply to this recommendation is not consistent with the Army's stated willingness to underwrite cash losses. If the Army is underwriting losses then AFRC-Orlando is not self-sustaining and therefore is not meeting the MWR standards. The Army did not state what actions will be taken for AFRC-Orlando to become self-sustaining. We request the Army to clarify this apparent inconsistency and provide additional comments when responding to the final report.

(2) Determine whether sufficient funds will be available to purchase the building and prepay the land rents or pay termination costs without restricting the Army Morale, Welfare, and Recreation Fund. The plan should identify the source of money to be used for Armed Forces Recreation Center in Orlando and should identify when the money will be available for use.

Management Comments. The Army concurred. The Army stated that a specific plan identifying costs and funding sources will be presented to the Army MWR Board of Directors in March 1995.

(3) Recommend the termination of the lease if the results of Recommendations 1.a.(1) and 1.a.(2) do not support the continuation of the Armed Forces Recreation Center in Orlando.

*Proprietary data deleted.

Management Comments. The Army concurred. The Army stated that the lease will terminate by * , unless the Army leadership, Army MWR Board of Directors, DoD officials, and Congressional oversight committees concur and approve funding to purchase the building and prepay land rents.

b. Submit the completed plan to the Under Secretary of Defense for Personnel and Readiness by June 30, 1995.

c. Not exercise the option to prepay the building rent.

Management Comments. The Army concurred.

d. Not exercise the option to purchase the building unless:

(1) Army personnel negotiate a reasonable land prepayment price, building ownership rights, termination costs, amortization terms, and rental contingency terms.

Management Comments. The Army partially concurred. The Army stated that a reasonable land prepayment price will be negotiated. However, the building ownership rights, termination costs, amortization terms, and rental contingency terms have been previously negotiated and were found to be acceptable to the Army.

Audit Response. The Army comments are not fully responsive. We believe that the terms become unacceptable if the Army purchases the building and prepays the land rents because certain lease terms will become effective when the Army purchases or prepays rents. The Army's termination costs are higher than the Palm Hospitality Company's termination costs and are not reasonably proportionate to the value of the property. The amortization terms are not equitable to the Army because the amortization schedule decreases the building's residual value over the life of the 100-year lease period if the purchase or prepayment option is exercised. However, the Army must maintain and return the building in at least the same condition when purchased or prepaid and the Palm Hospitality Company will not allow the building to deteriorate. We believe that the Army should receive a benefit for the high standards required to maintain the building and that the building should not be amortized and devalued below the original purchase price. Although the results of renegotiation cannot be forecast, the Army's bargaining power increases with the purchase of the building and prepayment of land rents. The Army should use its economic leverage to try to obtain more favorable terms such as building ownership rights, termination costs, amortization terms, and rental contingency terms and potentially profit in the future from the purchase of the property. We believe that the current terms are not equitable to the Army. We request the Army to reconsider its position on this recommendation and provide additional comments when responding to the final report.

(2) A waiver of DoD Instruction 1015.6 "Funding of Morale, Welfare, and Recreation Programs," is obtained to purchase the building on commercial property.

*Proprietary data deleted.

(3) The Under Secretary of Defense for Personnel and Readiness; the Morale, Welfare, and Recreation Board of Directors; and the House Armed Services Committee Morale, Welfare, and Recreation Panel approved the purchase of the building.

Management Comments. The Army concurred. The Army stated that a waiver of DoD Instruction on "Funding of Morale, Welfare, and Recreation Programs" will be obtained and appropriate approvals including the Senate Committee on Armed Services will be obtained.

e. Terminate the lease * , and provide written notice to the Palm Hospitality Company if the option to purchase has not been approved by * .

Management Comments. The Army concurred in principle by stating that appropriate notification to the Palm Hospitality Company to terminate the lease will be provided should the Army be unable to purchase the building and prepay the land rent prior to the end of * .

Audit Response. The alternative action proposed by the Army is responsive and we have revised the recommendation to reflect the later date for termination proposed by the Army. No additional comments are needed.

2. We recommend that the Under Secretary of Defense for Personnel and Readiness:

a. Review the plan submitted by Army Community and Family Support Center.

b. Disapprove the option to purchase the building unless Recommendations 1.d.(1) and 1.d.(2) are completed and unless sufficient funds are available to purchase the building without restricting the Army Morale, Welfare, and Recreation Fund.

c. Recommend the termination of the lease if the option to purchase the building has not been approved by * .

Management Comments. The Assistant Secretary of Defense (Force Management Policy), responding for the Under Secretary of Defense for Personnel and Readiness, concurred. The Assistant Secretary stated that the office will ensure that the Army will terminate the existing lease unless the building has been purchased and the land has been prepaid prior to the end of * . The Assistant Secretary also requested that the Inspector General, DoD, revalidate the financial and operational projections for AFRC-Orlando after May 1995. This will allow a better judgment of the project and allow the Army to make adjustments based on operations.

*Proprietary data deleted.

Audit Response. The Assistant Secretary of Defense (Force Management Policy) comments are responsive. We plan to revalidate the financial and operational projections in June 1995. The review will consider the audited and unaudited financial statements.

Response Requirements Per Recommendation

		Response Should Cover:		
Number	Addressee	Concur/ Nonconcur	Proposed Action	Completion Date
1.a.(1)	Army	X	X	X
1.d.(1)	Army	X	X	X

Part III - Additional Information

Appendix A. Lease Costs Based on 4-Percent, 5-Percent, and 6-Percent *

The Army assumed that the lease costs would be based on a 4-percent * during the approval process. Table A-1 shows the cumulative land and building rents using a 4-percent, 5-percent, and 6-percent * .

Table A-1. Cumulative Rents: 4-Percent, 5-Percent, and 6-Percent *

Lease Year	4-Percent * Cumulative Rent	5-Percent * Cumulative Rent	6-Percent * Cumulative Rent
4	$ *	$ *	$ *
5	*	*	*
6	*	*	*
7	*	*	*
15	*	*	*
25	*	*	*
50	*	*	*
99	*	*	*

Table A-2 shows the Army termination costs using a 4-percent, 5-percent, and 6-percent * .

Table A-2. Termination Costs: 4-Percent, 5-Percent, and 6-Percent *

Lease Year	4-Percent * Termination Cost	5-Percent * Termination Cost	6-Percent * Termination Cost
4	$ *	$ *	$ *
5	*	*	*
6	*	*	*
7	*	*	*
15	*	*	*
25	*	*	*
50	*	*	*
99	*	*	*

*Proprietary data deleted.

Appendix B. Summary of Prior Audits and Other Reviews

General Accounting Office

Report No. NSIAD-94-120 (OSD Case No. 9621), "Morale, Welfare, and Recreation Declining Funds Require DoD to Take Action," February 28, 1994. The report states that the financial outlook of the MWR program appears to be worsening. The audit determined that revenue generated by MWR activities is likely to decrease in the 1990s because of the downsizing of forces and increasing private sector competition. Also of concern are cash balances of more than $300 million that Army installations have accumulated. The report recommended that the Secretary of Defense review and implement guidance to improve the management and oversight of the MWR program, and to ensure that the Services have sound management strategies that anticipate the likelihood that MWR funding will decline faster than costs. The report also recommended that the Secretary of the Army delay the further obligation of funds for MWR capital improvement and construction projects until such projects are shown to be sound investments and redirect funds to efforts that will increase MWR profits or lower MWR expenses. Army management concurred with the intent of the recommendations to fund projects that are sound investments and that will increase profits. The Army stated that some exceptions may be made, such as quality of life services, because the best use of funds encompasses more than profitability.

Inspector General, DoD

Report No. 94-047, "Armed Forces Recreation Center-Europe," February 28, 1994. The report states that the AFRC incorrectly used $1.6 million of appropriated funds to maintain, clean, and improve the facilities in FYs 1991 and 1992. The audit determined that the AFRC was not capable of being self-sustaining and received substantial subsidies. The report recommended that the Under Secretary of Defense for Personnel and Readiness determine the appropriate classification for each activity and department within the AFRC. The report also recommended that CFSC repay the appropriated funds that were used incorrectly. In addition, the report recommended that Assistant Secretary of the Army (Financial Management) conduct a study to determine whether the AFRC in Europe can be self-sustaining, and whether recreational services can be provided more cost-effectively by the use of local accommodations and facilities. Management nonconcurred to repay the $1.6 million, but agreed that appropriated funds will not be incorrectly used in the future. Management agreed to the other report recommendations.

Army Audit Agency

Report No. SR 94-C17, "Review of Nonappropriated Fund Cash Levels," June 14, 1994. The report states that the Army's nonappropriated fund cash balances were within reasonable limits for FYs 1993 and 1994. However, forecasted cash balances decreased below a sound financial position for FYs 1995 through 1998. The report also states that CFSC is not appropriately showing nonappropriated fund cash balances and solvency ratios in their cash flow statements. CFSC did not consider the cash necessary to pay current and long-term liabilities to include unexpected contingencies. The report suggested CFSC to include in the quarterly cash flow statement solvency ratios with footnotes and planned actions to adjust the cash balances for anticipated excess or shortfalls in operations. Other suggestions included review and approval of cash flow projections, revision of the minimum operating cash requirement guidance, and presentation of the guidance in a clear format. CFSC agreed to all the suggestions.

Report No. NR 93-802, "Contracting Operations - Armed Forces Recreation Center Europe," June 30, 1993. The report states that AFRC generally did not implement NAF contracting policies and procedures effectively, purchases were not adequately controlled, contracting officer's representatives did not effectively monitor service and concession contracts, and the AFRC implementation of the Army's internal management control program was not effective. The report recommended increased use of comparisons and competition, controls on the ordering and shipping of goods, preparation and use of surveillance systems, evaluation of inspection systems, and refresher training for contracting officer's representatives on the preparation and certification of invoices. All recommendations were linked to supervisory and major command oversight. CFSC concurred with the recommendations.

Appendix C. Summary of Potential Benefits Resulting From Audit

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
A.1.a.	Economy and Efficiency. Reduces the risk to the Army MWR Fund and Trust Fund.	Undeterminable. Future losses cannot be reasonably estimated.
A.1.b. and A.1.c.	Economy and Efficiency. Increases AFRC-Orlando self-sustaining ability.	Undeterminable. Future savings resulting from the negotiation of ticket agreements cannot be reasonably estimated.
A.1.d. and A.1.e.	Internal Controls. Establishes safeguards over attraction tickets.	Undeterminable. Losses from incorrect inventory cannot be reasonably estimated.
A.1.f. and A.2.	Internal Controls. Provides accurate condition of operations to decision makers.	Undeterminable. Results of incorrect disclosure cannot be reasonably estimated.
B.1.a.(1)	Compliance. Prevents AFRC-Orlando operations from being subsidized.	Undeterminable. Losses cannot be reasonably estimated.
B.1.a.(2)	Economy and Efficiency. Prevents MWR Fund from becoming insolvent.	Funds put to better use of about $ * to $ * depending on the decision and purchase date.
B.1.a.(3), B.1.b., B.2.a. and B.2.b.	Economy and Efficiency. Reduces the risk of the MWR Fund.	Funds put to better use of about $ * to $ * depending on the decision and purchase date.

*Proprietary data deleted.

Appendix C. Summary of Potential Benefits Resulting from Audit

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
B.1.c.	Economy and Efficiency. Reduces amount of NAF spent to occupy building.	Funds put to better use of about $ * to $ *, depending on the purchase date.
B.1.d.(1)	Economy and Efficiency. Reduces costs associated with land rents, amortization, and termination.	Undeterminable. Savings resulting from the negotiation of lease terms cannot be reasonably estimated.
B.1.d.(2) and B.1.d.(3)	Compliance. Enforces NAF regulations concerning the purchase of real property.	Undeterminable. The result from compliance will determine amount.
B.1.e. and B.2.c.	Economy and Efficiency. Prevents the payment of termination costs.	Funds put to better use of about $ * to $ * depending on the termination date.

*Proprietary data deleted.

Appendix D. Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense for Personnel and Readiness, Washington, DC

Department of the Army

Assistant Secretary of the Army (Financial Management), Washington, DC
Assistant Secretary of the Army (Installations, Logistics, and Environment), Washington, DC
General Counsel, Department of the Army, Washington, DC
Inspector General, Department of the Army, Washington, DC
Army Audit Agency, Alexandria, VA
Army Community and Family Support Center, Alexandria, VA
Armed Forces Recreation Center in Orlando, FL

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Personnel and Readiness
Under Secretary of Defense (Comptroller)

Department of the Army

Secretary of the Army
  Assistant Secretary of the Army (Financial Management)
  Assistant Secretary of the Army (Installations, Logistics, and Environment)
  Assistant Secretary of the Army (Manpower and Reserve Affairs)
Commander, Army Community and Family Support Center
  General Manager, Armed Forces Recreation Center in Orlando
Auditor General, Department of the Army

Non-Defense Federal Organizations and Individual

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

Chairman and Ranking Minority Member of Each of the Following Congressional Committees and Subcommittees:

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

Part IV - Management Comments

Under Secretary of Defense for Personnel and Readiness Comments

ASSISTANT SECRETARY OF DEFENSE
4000 DEFENSE PENTAGON
WASHINGTON, DC 20301-4000

FORCE
MANAGEMENT

NOV 28 1994

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD IG

SUBJECT: Draft Audit Report on Armed Forces Recreation Center-Orlando (Project No. 4CK-5012)

We have reviewed the draft report and provide the following comments for USD(P&R):

Finding B2a, Concur. OUSD(P&R) will review the plan concerning operations and funding sources for purchase of the Shades of Green submitted by the Army Community and Family Support Center.

Finding B2b, Concur. Prior to USD(P&R) consideration of any purchase option regarding Shades of Green, the Army will be required to negotiate reasonable settlement costs, a waiver of existing DoD funding policy, and provide assurance of the availability of NAF funds for the purchase.

Finding B2c, Concur. USD(P&R) will ensure the Army will terminate their existing lease unless they have purchased the building and prepaid land rent prior to the end of lease year *

Request your office revalidate the financial and operational projections for the Shades of Green after the close of business for May 1995. This will allow a full 15 months of operational data to be available to better judge this project and allow the Army to make adjustments based on operations. After your follow up, this office will be in a better position to exercise our oversight role.

F. Pang

*Proprietary data deleted.

Department of the Army Comments

DEPARTMENT OF THE ARMY
U.S. ARMY COMMUNITY AND FAMILY SUPPORT CENTER
ALEXANDRIA, VA 22331-05

REPLY TO ATTENTION OF

November 18,1994

MEMORANDUM THRU ASSISTANT CHIEF OF STAFF FOR
~~INSTALLATION MANAGEMENT~~
~~DIRECTOR OF THE ARMY STAFF~~ 28 Nov 94
THOMAS W. HUGHES, LTC, ADAS
ASSISTANT SECRETARY OF THE ARMY
(MANPOWER AND RESERVE AFFAIRS) 29 NOV 1994
Sara E. Lister
Assistant Secretary of the Army
(Manpower and Reserve Affairs)

FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE (AUDITING)

SUBJECT: Inspector General, Department of Defense (DODIG) Draft Audit Report, Armed Forces Recreation Center-Orlando (AFRC-O), Project No. 4CK-5012, dated September 22, 1994 --INFORMATION MEMORANDUM

We appreciate the opportunity to comment on the subject audit. As noted in your report, financial results of AFRC-O are less successful than pre-opening projections. Financial shortfalls are primarily a function of initially underestimating the occupancy demand of junior enlisted personnel and overestimating demand by the most senior personnel. These conditions have caused revenue shortfalls resulting in initial negative cash flow. However, AFRC-O has identified potential cost avoidances and new revenue enhancements that will ameliorate some of this revenue shortfall. Moreover, since opening in February 1994 AFRC-O has averaged a 96 percent occupancy rate and based on future reservations, this demand level will continue.

Unlike other Armed Forces Recreation Centers, AFRC-O is the only one that pays monthly building and land lease costs. Although initially negotiated building and land lease costs are very favorable, it was always our intent to validate patron demand; then ensure financial success by exercising our option to purchase the building and negotiate an option to prepay land rent for the entire 100-year lease term. Negotiations are ongoing to establish the land rent payment option. It is our intent to exercise both options prior to the end of lease year

*

94223

*Proprietary data deleted.

Patron demand has been validated. The Army has adequate nonappropriated funds available to exercise both options if that expenditure will ensure long-term self-sufficiency and is approved by Army leadership, the Army Morale, Welfare, and Recreation Board of Directors and Congressional oversight committees.

We appreciate and share your concern for protecting expenditure and investment of soldier generated capital. It is our belief however, that the report was overly pessimistic and is largely based on worst-case scenarios. Moreover, the report does not acknowledge the overwhelmingly positive support of AFRC-O by Department of Defense (DoD) servicemembers and their families. Finally, the report does not acknowledge the Army's recognition of required investment initiatives to achieve long-term success.

The Senate Armed Services Committee, in its report on the National Defense Authorization Act for Fiscal Year 1995, specifically praised the Army for the establishment of AFRC-O as an "endeavor (which) represents the finest tradition of the military taking care of its own at no cost to the American taxpayer." Also, for "keen foresight in positioning this morale building benefit for a defense force that will be increasingly based in the United States and displaying tenacity in pursuing a quality recreational opportunity for all ranks, especially junior enlisted."

The Army is acutely aware of its financial obligations in this potential permanent investment and intends to act in the best interest of servicemembers. The final decision regarding AFRC-O will be appropriately reviewed by Army leadership, Department of Defense, and Congressional oversight committees.

Responses to specific recommendations contained in your report are enclosed at Tab A.

JOHN G. MEYER, JR.
Brigadier General, USA
Commanding

Enclosure

Army Response to DODIG Draft Audit
Armed Forces Recreation Center-Orlando (AFRC-O)
Project No. 4CK-5012, 22 September 1994

Finding A. Hotel Financial Operations. "AFRC-Orlando did not comply with the Army MWR standards to be self-sustaining and financially sound. AFRC-Orlando was not self-sustaining and financially sound because management underestimated total expenses and did not establish rates for services to cover the actual expenses. Further, AFRC-Orlando operations have limited profit potential for the future. In addition, the lack of internal controls contributed to inaccurate financial statements. As a result, AFRC-Orlando had a net loss of about $535,000 during the first 4 months of operations and will have an estimated first-year loss of about $1.6 million. We also estimate that AFRC-Orlando will not be able to become self-sustaining in the foreseeable future unless the charges for services are increased or subsidies are received."

Recommendation A1. "We recommend that the General Manager, Armed Forces Recreation Center-Orlando:"

a. "Evaluate existing room rate structure and take actions necessary to make operations self-sustaining. The actions should include:

(1) Increase room rates immediately to the levels required to be self-sustaining without subsidies from Army Community and Family Support Center."

USACFSC Comments: Nonconcur: Increasing room rates may be unnecessary until the effects of management initiated revenue enhancements and cost avoidances are evaluated. Regardless, the underlying principle of AFRC-O is to provide an affordable, wholesome, quality vacation opportunity to servicemembers and their families during a period of significant turbulence and stress. Long-term financial self-sufficiency is virtually assured if building and land rents are eliminated which is the Army's goal. The Army is willing to underwrite modest cash losses which may be incurred until such time as rents are eliminated, positive cash flow is achieved, or the lease is terminated.

Recommendation A-1.a (2) "Increase room rates for reservations made for future periods to reflect changes in budgeted expenses. The adjustments should consider the level required to be self-sustaining without subsidies from Army Community and Family Support Center."

USACFSC Comments: Nonconcur: See response recommendation A-1.a.(1).

Recommendation A-1.a.(3) "Reevaluate the current rate category structure and transfer military ranks and civilian grades to a higher level room rate category to meet the average daily rate needed to be self-sustaining."

USACFSC Comments: Concur in principle: AFRC-O will adopt a three tier room rate structure by July 1995.

Recommendation A-1.a.(4) "Establish controls in the reservation system to ensure that the number of rooms available in each category is limited to obtain the average daily rate needed to be self-sustaining."

USACFSC Comments: Nonconcur: AFRCs, like all other morale, welfare, and recreation facilities are operated for the benefit of all authorized patrons without limitations relative to grade.

Recommendation A-1.b. "Negotiate with the attraction ticket vendors a guaranteed price or discount percentage for tickets."

USACFSC Comments: Concur: AFRC-O currently has negotiated discount ticket arrangements with 40 Orlando area restaurants, theaters, and attractions (other than on Walt Disney World® Resort). In every case we have a negotiated fixed price agreement. AFRC-O receives a stock of tickets on consignment at a negotiated discounted price. AFRC-O then adds a markup percentage and sells the tickets to customers. The customer receives a substantial savings below the normal rate and avoids payment of local taxes. As the tickets are on consignment, the attraction receives their negotiated price only after the ticket is sold.

Recommendation A-1.c. "Negotiate with Magic Kingdom, Incorporated, a change in the length-of-stay sales formula to achieve additional discounts."

USACFSC Comments: Concur: AFRC-O is renegotiating the length-of-stay ticket contract formula to achieve additional discounts. Negotiations should be completed by January 1995.

Recommendation A-1.d. "Review the new point-of-sales inventory system for attraction ticket sales to ensure that the system provides adequate accountability for inventory."

USACFSC Comments: Concur: Appropriate controls and management review of automated system are implemented. Validation of system controls and adequacy of accountability is a specific requirement for the commercial audit firm whose audit commenced on 14 November 1994.

-3-

Recommendation A-1.e. "Review the adequacy and implementation of the internal controls over the attraction ticket department. Change the internal controls over the attraction ticket department as necessary."

USACFSC Comments: Concur: Appropriate controls and management oversight have been implemented. Validation of ticket department controls is a specific requirement for the commercial audit firm whose audit commenced on 14 November 1994.

Recommendation A-1.f. "Direct the Comptroller, AFRC-O to:"

(1) "Use the accrual method for accounting and record all expenses incurred in the period incurred."

USACFSC Comments: Concur: AFRC-O has implemented the proper accrual method accounting system and corrected errors make during initial start-up period. Validation of accounting system procedures is a specific requirement for the commercial audit firm whose audit commenced on 14 November 1994.

Recommendation A-1.f.(2). "Adjust the fiscal year 1994 financial statements to include telephone expense for $119,941, transportation expense for $6,667, and insurance expense for $13,162."

USACFSC Comments: Concur in principle: Transportation and insurance expenses of $6,667 and $13,162 respectively, which were erroneously charged to pre-opening expenses, have been properly adjusted in the June 1994 accounting period. The telephone expense of $119,941 remains as a pre-opening expense as it was incurred prior to commencement of lease. Validation of these accounting treatments are specific requirements of the commercial audit firm whose audit commenced on 14 November 1994.

Finding B. Affordability of Armed Forces Recreation Center-Orlando. "The Army cannot afford to continue to operate the AFRC-Orlando under the current lease terms. Further, the options in the lease to purchase the building or prepay the building rents are not economically viable. AFRC-Orlando is not affordable because the lease terms place significant financial burdens on the operation's ability to be self-sustaining. The termination and amortization lease terms prevent the Army from obtaining a monetary benefit from purchasing the building. The MWR Fund also does not have sufficient NAF available to exercise either option before termination costs apply. CFSC will be risking an estimated $ * to $ * of the soldier's money to provide a recreational facility for about 1 percent of the active-duty military."

*Proprietary data deleted.

Recommendation B1. "We recommend that the Commander, Army Community and Family Support Center:"

a. "Assess AFRC-O operations and establish a plan with milestones for the future of the AFRC-O operations. The plan should:"

(1) "Assess whether AFRC-O can meet the Morale, Welfare, and Recreation Category C standards and establish a deadline for the AFRC-O to be self-sustaining. The plan should detail the actions to be taken to become self-sustaining."

USACFSC Comments: Concur: AFRC-O will either meet Army MWR Category C financial standards or the operation will be terminated prior to the end of lease year three *

Recommendation B-1.a.(2). "Determine whether sufficient funds will be available to purchase the building and prepay the land rents or pay termination costs without restricting the Army Morale, Welfare, and Recreation Fund. This plan should identify the source of money to be used for AFRC-O and when the money will be available."

USACFSC Comments: Concur: A specific plan identifying costs and funding sources to purchase building and prepay land rent will be developed and presented for approval to the Army Morale, Welfare, and Recreation Board of Directors in March 1995.

Recommendation B-1.a.(3) "Recommend the termination of the lease if the results of Recommendations 1a(1) and 1a(2) do not support the continuation of AFRC-O."

USACFSC Comments: Concur: AFRC-O lease will be terminated by the end of lease year * unless the Army leadership; Army Morale, Welfare, and Recreation Board of Directors; Department of Defense; and Congressional oversight committees concur and approve funding to purchase building and prepay land rent.

Recommendation B-1.b. "Submit completed plan to Under Secretary of Defense for Personnel and Readiness by June 30, 1995."

USACFSC Comments: Concur

Recommendation B-1.c. "Not exercise the option to prepay the building rent."

USACFSC Comments: Concur

*Proprietary data deleted.

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Recommendation B-1.d. "Not exercise the option to purchase the building unless:"

(1) "Army personnel negotiate a reasonable land prepayment price, building ownership rights, termination costs, amortization terms, and rental contingency terms."

(2) "A waiver of DoD Instruction 1010.6 'Funding of Morale, Welfare, and Recreation Programs,' is obtained to purchase the building on commercial property."

(3) "The Under Secretary of Defense for Personnel and Readiness; the Morale, Welfare, and Recreation Board of Directors; and the House Armed Services Committee, Morale, Welfare, and Recreation Panel approved the purchase of the building."

USACFSC Comments: Concur in principle: The Army is in the process of negotiating a reasonable land prepayment price. Building ownership rights, termination costs, amortization terms, and rental contingency terms have been previously negotiated and found to be acceptable to the Army. Waiver of DoD Instruction 1010.6 will be obtained if building is purchased and appropriate approvals including Senate Armed Service Committee will be obtained.

Recommendation B-1.e. "Terminate the lease by December 31, 1995, and provide written notice to the Palm Hospitality Company if the option to purchase has not been approved by September 30, 1995."

USACFSC Comments: Concur in principle: Appropriate notification to Palm Hospitality Company will be provided should the Army be unable to purchase the building and prepay land rent prior to the end of lease year three *

*Proprietary data deleted.

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