Audit Report

OFFICE OF THE INSPECTOR GENERAL

NAVY SHIP STORES OPERATIONS

Report No. 96-123

May 17, 1996

Department of Defense

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Acronyms

NEXCOM	Navy Exchange Service Command

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

May 17, 1996

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Audit Report on Navy Ship Stores Operations (Report No. 96-123)

We are providing this report for your information and use. This audit was performed in response to a request from the House Committee on National Security in the FY 1996 National Defense Authorization Act Committee Report. We considered management comments on a draft of this report in preparing the final report.

Comments on a draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, additional comments are not required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. John A. Gannon, Audit Program Director, at (703) 604-9427 (DSN 664-9427) or Mr. Tilghman A. Schraden, Audit Project Manager, at (703) 604-9436 (DSN 664-9436). The distribution of this report is listed in Appendix H. The audit team members are listed on the inside back cover.

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Deputy Assistant Inspector General
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Office of the Inspector General, DoD

Report No. 96-123 **May 17, 1996**
(Project No. 6LB-5004)

Navy Ship Stores Operations

Executive Summary

Introduction. This audit was performed in response to a request from the House Committee on National Security to evaluate the cost and benefits of converting the Navy ship stores program to a nonappropriated fund organization. The FYs 1994 and 1995 National Defense Authorization Acts required the Navy to convert the financial support for ship stores operations from appropriated funds to nonappropriated funds by December 31, 1995. Navy ship stores provide ships personnel a convenient source for buying various goods and services at reasonable prices. Profits from retail sales support recreation activities for ships personnel through contributions to the morale, welfare, and recreation fund. Total revenues for Navy ship stores was $104 million and $100 million in FY 1994 and FY 1995, respectively. The FY 1996 National Defense Authorization Act repealed the requirement for the Navy to convert ship stores to a nonappropriated fund instrumentality.

Audit Objective. The audit objective was to evaluate the costs and benefits of converting the operation of all Navy ship stores from appropriated to nonappropriated fund support under the Navy Exchange Service Command as required by the National Defense Authorization Act for FY 1994 and amended by the National Defense Authorization Act for FY 1995.

Audit Results. Had the Navy ship stores operations converted to a nonappropriated fund instrumentality in FY 1994, total annual operating costs would have increased from $86.3 million to an estimated $93.8 million, reducing total profit and contributions to morale, welfare, and recreation from $17.6 million to $10.1 million. Conversely, the conversion would have provided potential benefits from the coordinated acquisition of automated data processing services, consolidated contracting support, use of the Navy Exchange Service Command distribution system, added financial services available to nonappropriated funded activities, and the staff integration of ship stores with Navy Exchange Service Command (Finding A).

The Bureau of Naval Personnel's $3.43 million assessment in FY 1994 on the gross retail sales revenue of the ship stores may not be proportionate to benefits received. The assessment rates were about 30 years old. As a result, the Bureau of Naval Personnel may be collecting more monies than necessary from ship stores, which contributes to lower profits provided directly to crews of ships for morale, welfare, and recreation (Finding B).

The recommendation in this report, if implemented, could improve the benefits provided to the shipboard sailors through the operations of the ship stores. We could not quantify the potential monetary benefit because sufficient management data were not available to establish an appropriate assessment rate for Navy ship stores contributions to a central fund for morale, welfare, and recreation.

Summary of Recommendations. We made no recommendations on the costs and benefits of converting the Navy ship stores to a nonappropriated fund instrumentality because the benefits were unquantifiable and the National Defense Authorization Act for FY 1996 repealed the requirement for the conversion. We recommend that the Chief of Naval Operations, in coordination with the Bureau of Naval Personnel, the Naval Supply Systems Command, and the Navy Exchange Service Command, periodically evaluate the appropriateness of the Navy ship stores assessment to the Bureau of Naval Personnel and Navy Exchange Service Command for centrally managed general services.

Management Comments. The Navy agreed with the recommendation to periodically evaluate the Navy ship stores assessment for centrally managed general services. It stated that the Bureau of Naval Personnel will strengthen the periodic review of the sources and uses of funds from the Navy ship stores for morale, welfare, and recreation purposes during the annual nonappropriated fund budget process. See Part I for a summary of management comments, and Part III for the complete text of management comments.

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Part I - Audit Results

Audit Background

The Navy Ship Stores Program (The Program) was authorized 87 years ago to appropriate monies for the purchase and sale aboard ship of necessary items for sailors. The Program provides quality of life goods and services, including barber and laundry services, basic sundries and other convenience store items, tobacco and vending machine products, and uniforms, at reasonable prices. Ship stores are tailored to the size of the ships and ships crew, and vary in size and products provided to sailors.

The Program operates as an independent entity under the auspices of the Navy Exchange Service Command (NEXCOM). NEXCOM is part of the Naval Supply Systems Command, which delegated authority to NEXCOM for providing administrative assistance and technical guidance for operation of The Program. Naval Supply Systems Command Publication 487, "Ships Stores Afloat," December 1992, provides guidance for the operation of ship stores.

The Bureau of Naval Personnel develops and implements Navy-wide programs for improved human relations and quality of life. The Bureau of Naval Personnel Instruction 5400.6E, "Bureau of Naval Personnel Organization Manual," October 15, 1993, provides for the administration of the central nonappropriated funds available for the welfare and recreation of Naval personnel. The instruction also requires the Bureau of Naval Personnel to provide administrative and technical guidance for morale, welfare, and recreation activities throughout the Navy.

The National Defense Authorization Act for FY 1994 required the Navy to convert the operation of ship stores from appropriated to nonappropriated funding by October 1, 1994. The National Defense Authorization Act for FY 1995 extended the conversion completion date to December 31, 1995. The Acts allow the Secretary of the Navy to provide financial services, labor, space, and utilities to ship stores on a nonreimbursable basis. The legislative history required the Inspector General, DoD, to evaluate the costs and benefits for converting the ship stores to a nonappropriated fund instrumentality and the history implied that the evaluation should be from the sailors' perspective. The National Defense Authorization Act for FY 1996 repealed the requirement for the Navy to convert the ship stores to a nonappropriated fund instrumentality. More details on the legislative history of The Program are in Appendix C.

Of the 395 ships with about 200,000 assigned personnel in the fleet in 1994, 230 ships had operating ship stores providing sundry services to 173,500 personnel. Four additional ship stores are located at remote land bases in Alaska, Antarctica, Bahrain, and Diego Garcia. Total revenues for FY 1994

and FY 1995 were $104 million and $100 million, respectively. Profits from sales totaled $17.6 million in FY 1994 and $15.6 million in FY 1995. The decrease in profits was caused primarily by the downsizing of the fleet. Profits generated from the operation of ship stores are provided to the ship captains or installation commanders for the morale, welfare, and recreation of ship personnel and those assigned to remote installations. The Defense Finance and Accounting Service prepared and we consolidated an FY 1994 summary profit and loss statement for The Program (see Appendix D).

Audit Objective

The audit objective was to evaluate the costs and benefits of converting the operation of all ship stores from appropriated to nonappropriated fund support under the NEXCOM as required by the National Defense Authorization Act for FY 1994 and amended by the National Defense Authorization Act for FY 1995. The audit scope and methodology are discussed in Appendix A and the summary of prior audit coverage and other reviews related to the audit objective are in Appendix B.

Finding A. Navy Ship Stores Conversion From Appropriated to Nonappropriated Funding

The conversion from appropriated fund support to a nonappropriated fund instrumentality in FY 1994 would have increased the Navy ship stores total operating expenses from $86.3 million to an estimated $93.8 million, an 8.7-percent increase. The conversion would have affected expenses for services such as automated data processing, contracting support, distribution of goods, inventory losses, and program management. As a result of the change in the method of funding for The Program, profits for the individual ships' morale, welfare, and recreation funds would have decreased from $17.6 million to $10.1 million, a 43-percent decrease in profits available to shipboard personnel. In contrast, the conversion would have provided potential benefits from the coordinated acquisition of automated data processing services, consolidated contracting support, use of the NEXCOM distribution system, added financial services available to nonappropriated funded activities, and the staff integration of ship stores with NEXCOM.

Navy Ship Stores Conversion Costs

The conversion from appropriated fund support to a nonappropriated fund instrumentality in FY 1994 would have increased the ship stores total operating expenses an estimated $7.5 million annually (see Appendix E for details), from $86.3 million to $93.8 million, an 8.7 percent increase. As an appropriated activity, The Program did not reimburse the source appropriations for all reoccurring expenses, such as some automated data processing services. Accordingly, gross proceeds from the sales of goods and services are not adjusted for the total expenses that the Navy incurs for providing those goods and services. We calculated the additional costs that would be incurred as a result of converting The Program to a nonappropriated fund instrumentality. We did not cost out certain financial services, labor, space, and utilities because the National Defense Authorization Act for FY 1994 allows the Secretary of the Navy to provide those incidental services to ship stores on a nonreimbursable basis.

The estimated total costs for converting ship stores from appropriated to nonappropriated funding will be about $7.5 million in annual expenses associated with operating The Program. An additional one-time cost of $19,000 will be incurred in the first year.

One-Time Costs. The Navy will incur one-time costs of $19,000 for converting guidance on operating nonappropriated fund instrumentalities. Navy ship servicemen and supply officers are trained to operate ship stores at Navy training centers. The curriculum at the training centers would have to be changed. We assumed that the cost for the curriculum change would be absorbed by the training command. However, new guidance on operating a nonappropriated fund instrumentality will need to be issued for the ships personnel. The estimated cost for issuing the new guidance would be $19,000.

Annual Operating Expenses. The Program could incur about $7.5 million in additional annual operating expenses as a nonappropriated fund instrumentality for costs that are appropriated on a nonreimburseable basis for ships operations and for other Government operations supporting ship stores. The annual operating expenses that would be affected are automated data processing, contracting support, distribution of merchandise, inventory losses, and program management.

Automated Data Processing. The ship stores use the Retail Operations Management System, a computer system, to record data on the sales and expenses of merchandise aboard ships. The Retail Operations Management System is supported by the Navy Management Systems Support Office. For FY 1994, equipment; labor; printing; supplies; travel; and other contract related costs for software installation and maintenance of the computer system were $272,580.

The ship stores budgeted for the acquisition of new and replacement equipment, such as computers and cash registers, for installation aboard ships. The equipment would be depreciated at an estimated annual expense of $500,000. Although the depreciation should be included as an annual operating expense for the future, we did not include the depreciation as an annual operating expense for FY 1994 because the equipment had not been purchased.

Contracting Support. The Navy paid the Fleet Industrial Supply Center $149,075 for contracting services in FY 1994 in support of the ship stores. The Center negotiates the contracts for merchandise for resale to personnel aboard ship.

Distribution of Merchandise. The ship stores would use some portion of the NEXCOM distribution system for merchandise delivery to ship stores. We assumed NEXCOM would charge The Program for distribution using established procedures. The costs of distribution are allocated among

customers at a rate proportional to the issues of merchandise from stock to the customers. Assuming all the FY 1994 ship stores inventory for the continental United States had been distributed through the NEXCOM distribution centers, ship stores would have been charged a distribution fee of about $3.68 million. The distribution fee for the NEXCOM system includes an estimated adjustment to accommodate deliveries to the ships on short notice and to provide small quantities. We also assumed that ship stores would have been charged an estimated $600,000 for overseas warehousing and distribution of goods by the Fleet Industrial Supply Center.

Inventory Losses. The ship stores can incur inventory losses from fire, major disasters, shrinkage, and theft. For FY 1994, the Defense Business Operations Fund showed losses of about $2.16 million that occurred in warehouses, on resupply ships, and in ship stores operations. Based on revenues of $104 million, we assumed that this approximately 2 percent cost of operations (inventory losses) would continue. The ship stores consolidated financial statements showed that only $116,000 of the total losses were reimbursed from the ship stores profits. As a result, about $2 million in losses were not reimbursed by the ship stores. Under established NEXCOM procedures, the total losses would be paid through self-insurance for the ship stores.

Program Management. The ship stores employs 17 personnel (excluding part-time employees) at its headquarters and regional offices for administration and program oversight. Appropriated funded payroll costs for the 17 personnel and part-time employees were $754,350 for FY 1994. The ship stores office also received appropriated funds of $29,965 in FY 1994 for general and administrative expenses for the headquarters staff. The expenses included rented space, maintenance, phones, travel, and supplies.

Potential Benefits

The Navy had the potential to benefit in several areas from converting to a nonappropriated fund instrumentality. However, before the benefits can be quantified, the Navy must establish the operating organizational structure and perform a detailed management analysis of the areas. The areas with potential for benefits are automated data processing services, contracting, the NEXCOM distribution system, financial services, and the integration of the staff of ships stores program management into the NEXCOM organization.

Automated Data Processing. Ship stores could benefit from the implementation of a NEXCOM retail product scanning system and central accounting system. Both ship stores and NEXCOM had budgeted funds to

install retail sales scanning systems in the ship stores and Navy exchanges that would provide data to different accounting systems. If The Program had converted to a NEXCOM nonappropriated funded instrumentality, the ship stores could have implemented a retail product scanning system similar to the system being implemented at the Navy exchanges and could have used the NEXCOM central accounting system. This single system could have provided a potential for benefits from the reduction in acquisition and maintenance costs for similar automated data processing hardware and software for both organizations.

Contracting. Ship stores could benefit from using the contracting procedures that NEXCOM uses for resale merchandise. At NEXCOM, contracting specialists stated that vendors provide certain retail goods through price agreement bulletins, which are not contracts. Vendors periodically publish price agreement bulletins on merchandise available for sale to retailers. NEXCOM buyers agree to purchase merchandise at the listed prices in the bulletins, instead of negotiating indefinite quantity contracts for the merchandise and separate indefinite delivery. If ship stores followed the NEXCOM procedures, certain contracts for ship stores could be eliminated with some savings in reduced administrative procedures. However, ship stores' contracts, negotiated under the Federal acquisition regulation, extend some benefits to the ship stores, such as mandatory schedules for deliveries from the vendors and protection against arbitrary price increases that are not afforded by NEXCOM procedures. Consequently, ship stores contracts would have to be carefully evaluated before changing to NEXCOM procedures.

NEXCOM Distribution System. The ship stores distribution system could be merged with the NEXCOM distribution system, which would normally provide price discounts resulting from economies of scale for goods and services. The ship stores use a system of direct delivery from vendors to ships for goods and services, while NEXCOM uses a combination of direct vendor delivery to Navy exchanges and a system of distribution centers. The benefit from the NEXCOM system would be the potential discount prices for goods purchased in large quantities. The NEXCOM system would have to accommodate deliveries to the ships on short notice and provide small quantities, which could offset some of the potential benefits in price discounts. We could not identify any management analyses related to this area and ship stores did not have the management information available to evaluate the pricing of goods and services and the distribution system.

Financial Services. The NEXCOM could provide additional morale, welfare, and recreation income and credit services to Navy personnel that is not readily available to ship store customers. For instance, NEXCOM invests daily sales receipts for Military Sealift Command exchanges (nonappropriated fund ship stores) in short-term certificates of deposits. The interest gained from the investments provides additional profits for morale, welfare, and recreation for shipboard personnel. NEXCOM also provides credit card services to personnel

in Navy exchanges. Neither of those services had been provided to shipboard personnel, but may be extended to the shipboard personnel through the Navy exchange system.

Integration of Staff of Ship Stores. Under the current organization, ship stores operate independently of NEXCOM. If the operations of ship stores are fully integrated into the NEXCOM nonappropriated fund organization, some staff positions may be unnecessary. We identified, through position descriptions, jobs being performed at NEXCOM, or other Government organizations, and the ship stores that may overlap or duplicate service support. Those jobs include accountants, auditors, contract specialists, division directors, laundry providers, merchandise buyers, and secretaries. A complete management analysis of the work load relative to functions assigned under the NEXCOM organization would have to be performed by personnel specialists to determine the appropriate staffing. Neither NEXCOM nor ship stores management had any analysis of the potential future nonappropriated fund organization.

Conclusion

Our analysis of the costs and benefits of converting the ship stores to a nonappropriated fund instrumentality showed that the conversion could be accomplished without having to adjust prices of goods and services and with some potential, unquantified benefits. The conversion would be consistent with the funding method used for Military Sealift Command exchanges aboard ships staffed with civilians (see Appendix F for details).

The total shift of expenses from taxpayers to the sailors would have increased by 8.7 percent of the total operating costs for ship stores in FY 1994. If the total annual operating costs of an estimated $7.5 million for the conversion were proportioned (without any offsets in benefits) to the 173,500 personnel assigned to the ships with stores, the increase in expenses would have been about $45 annually per person, assuming the same profit margin was maintained. However, in FY 1994, The Program had sufficient profits to absorb that increase in expenses and still would have generated about a 9.7 percent profit on gross revenues. No recommendations were made to the Navy because the requirement for the Navy to convert the ship stores to a nonappropriated fund instrumentality was repealed in the National Defense Authorization Act for FY 1996.

Management Comments on the Finding and Audit Response

Navy Comments. The Navy nonconcurred with the finding statement that conversion would have provided potential benefits. The Navy believed that the report could not accurately predict the future because the potential benefits discussed in the report were based on unquantified and unsubstantiated data.

Audit Response. The Navy provided no quantified data or analysis that would objectively refute the potential for benefits. In the report, we state that the Navy needs to establish the organizational structure for the ship stores within NEXCOM before a complete benefit analysis can be accomplished within the identified areas. Additionally, we report that the Navy ship stores did not collect sufficient management data to perform complete analyses of potential benefits. Consequently, we could not quantify benefits but attempted to show areas with reasonable potential for benefits.

For example, Navy ship stores and NEXCOM had a requirement to upgrade their automated data processing equipment to account for sales and expenses. Before any analysis can be performed, management needs to baseline Navy ship stores as an operating element of NEXCOM. Navy ship stores could operate as an independent element, as a fully integrated element (utilizing all services of NEXCOM, such as bill paying functions), or as a partially integrated element. The operating baseline decision dictates the design of the system hardware and software requirements for the Navy ship stores. We believe that if the Navy ship stores were fully integrated into NEXCOM, then it is reasonable to expect benefits from economies of scale on purchases of hardware and some design savings on software for similar services, as well as less administrative and maintenance expenses for similar equipment. After considering Navy comments, we revised our report to clarify our position on automated data processing.

None of the prior Navy studies and reviews on the Navy ship stores conversion identified any potential benefits or analyses that discounted any potential benefits in the areas we reported. While we recognize that there are management risks associated with benefit analyses, we believe the Navy has a responsibility to evaluate alternatives that could produce benefits for a nonappropriated fund instrumentality, if the conversion were required.

Finding B. Morale, Welfare, and Recreation Fund Assessment

The Bureau of Naval Personnel $3.43 million assessment in FY 1994 on the gross retail sales revenue of the ship stores may not be proportionate to the benefits received. The Naval Supply Systems Command Publication 487 requires that the ship stores pay a fee of from 4.0 percent to 5.5 percent of gross retail sales revenue per store to the Bureau of Naval Personnel and NEXCOM. The Navy did not periodically evaluate the assessment on gross retail sales revenues to determine whether the rate could be adjusted. As a result, the Bureau of Naval Personnel may be collecting more monies than necessary from ship stores, which contributes to lower profits provided directly to crews of ships for morale, welfare, and recreation.

Background on Morale, Welfare, and Recreation

Promotion of Mental and Physical Well-Being. The Navy promotes and maintains the mental and physical well-being of military and civilian personnel through the morale, welfare, and recreation program. In 1993, the Chief of Naval Operations appointed a board of directors to provide oversight of Navy nonappropriated fund operations including the morale, welfare, and recreation programs and the Navy exchanges. The board is chaired by the Vice Chief of Naval Operations and consists of the fleet commanders and other senior Navy flag officers. The Chief of Naval Personnel reports to the board of directors, acts as an agent for the Chief of Naval Operations, and provides technical and administrative guidance on welfare and recreation programs in the Navy, afloat and ashore.

Central Funds. The Navy assesses fees from nonappropriated (Navy exchanges) and appropriated (ship stores) organizations to provide centrally managed funds used for general service support of morale, welfare, and recreation programs. The fees assessed the Navy exchanges are paid to the Central fund of the Board of Directors. The Central fund of the Board of Directors provides funds for general services that include capital improvement projects; financial services, such as banking and investment support and loans and grants to field activities; motion pictures; and recreational sports and fitness programs. The fees assessed the ship stores are paid into two separate funds, as discussed below.

The Naval Supply Systems Command Publication 487 requires that monies be collected from the ship stores for two separate funds managed by the Bureau of Naval Personnel and by NEXCOM. The funds paid to the Bureau of Naval Personnel provide the same type of general services to the ship stores that the Central fund of the Board of Directors provides to base commanders and Navy exchanges. The funds paid to NEXCOM provide primarily for administrative and technical services that include loans and grants to ships for investments in equipment and for training in support of ship stores operations.

The Naval Supply Systems Command Publication 487 provides that cash received from retail sales of individual ship stores will be assessed fees payable to the Bureau of Naval Personnel and to NEXCOM in accordance with the gross assessment percentages shown in Table 1.

Table 1. Gross Assessment Percentages

Personnel Billets Authorized per Ship	Percentage of Gross Retail Sales
Above 1,500	5.5
500-1,500	5.0
Under 500	4.0

The average assessment received from all ships was about 4.84 percent ($3.83 million assessment on $79 million in gross retail sales) for FY 1994. The Naval Supply Systems Command Publication 487 provides that an amount equal to 1/2 of 1 percent of the total assessment on retail sales is allocated to the Ships' Stores Profits, Navy, General fund, managed by NEXCOM for technical and administrative services for ship stores operations. The balance of the total assessment, about 4.3 percent of retail sales in FY 1994, was allocated to the Bureau of Naval Personnel for centrally managed general services for morale, welfare, and recreation programs. The Bureau of Naval Personnel portion of the FY 1994 total assessment of $3.83 million was $3.43 million.

Assessments for Morale, Welfare, and Recreation

The Bureau of Naval Personnel $3.43 million assessment in FY 1994 on the gross retail sales revenue of the ship stores may not be proportionate to benefits received. Also, compared to the Navy exchanges, the assessment for ship stores to fund centrally managed general services is proportionately more than the assessment for the Navy exchanges for similarly funded general services.

Benefit. From summary data provided, we could not establish a direct correlation between funds provided from ship stores ($3.43 million in FY 1994) to the Bureau of Naval Personnel and benefits provided to ship stores. However, funds provided were not directly proportionate to the benefits received. For example, in FY 1994 and FY 1995, the Bureau of Naval Personnel summary data showed $4.1 million and $4.2 million, respectively, in support of ships and remote decentralized recreation programs. Of that amount $2.3 million in FY 1994 and $2.2 million in FY 1995 were related to movie programs. For FY 1995, Navy officials stated that $1.6 million (38.5 percent of the $4.2 million) was for salaries and benefits of personnel at a central movie degaussing and disposition facility. That central facility supported movies shown at movie theaters on base and aboard ship. Therefore, Navy shipboard personnel were assessed $3.43 million but received a maximum of $2.6 million in direct support.

Because no direct audit trail was maintained and because complete, official records were not available, we could not determine with certainty whether the Bureau of Naval Personnel expenditures for the ship stores movie program and other support, such as overhead, were proportional to expenditures for other supported nonappropriated fund instrumentalities such as the Navy exchanges. For the same reason, we could not determine whether the assessment charged the ship stores for the general services provided was appropriate for the benefits the stores received.

Assessments. In FY 1994, the average percentage of gross retail sales revenue that the board of directors charged the Navy exchanges for centrally managed general services was about 1 percent less than the average percentage charged the ship stores as shown in Table 2.

Table 2. Assessment Fees Paid to Central Funds

	Navy Exchanges	Navy Ship Stores
FY 1994 gross retail sales	$1,478,809,000	$78,990,711
Gross fees paid to central funds	49,180,000	3,430,000
Fee as a percentage of gross retail sales	3.3	4.3

Evaluation of Assessments

Ship Stores Assessments. The Naval Supply Systems Command, the Bureau of Naval Personnel, and NEXCOM did not coordinate to periodically evaluate the assessment of ship stores gross retail sales revenues for the morale, welfare, and recreation central funds to determine whether the rate could be adjusted. Officials at the Bureau of Naval Personnel and NEXCOM could not determine how the assessment rate for the ship stores fee to the morale, welfare, and recreation central fund was first established. Officials at the Bureau of Naval Personnel stated that the rates had been in place for about 30 years and they had no input on setting the rates in Naval Supply Systems Command Publication 487. Without any documentation, we were unable to establish whether the rates originated in the Bureau of Naval Personnel, Naval Supply Systems Command, or NEXCOM.

Navy Exchange Assessment. Contrary to the lack of evaluations of the ship stores assessment, the assessments of gross retail sales revenues of Navy exchanges were periodically evaluated. As a result of a 1992 review of the morale, welfare, and recreation program, a team of representatives from Navy major commands, the Bureau of Naval Personnel, and NEXCOM had recommended that the method for funding centrally managed general services (the revenue assessment system) for Navy exchanges be revised and that the Chief of Naval Operations establish a board of directors to oversee the revenue assessment system and provide major business decisions. The Bureau of Naval Personnel revised the revenue assessment system on October 1, 1993, to improve the collection of monies for general services and the recapitalization of the morale, welfare, and recreation fund for Navy exchange programs. The changes in the revenue assessment system included a provision for the Board of Directors to set the official rate of assessment based on detailed guidelines for calculating the assessment.

A subsequent evaluation of the revenue assessment system by the Board of Directors resulted in the Chief of Naval Operations establishing a profit sharing plan on October 1, 1995. The new profit sharing plan provided for the distribution of profits from the Navy exchanges to morale, welfare, and recreation organizations based on assessment percentages by the Board of Directors updated annually for the individual Navy exchanges. The profit sharing plan was established for the shore-based Navy exchanges and did not apply to the ship stores.

Conclusion

The Bureau of Naval Personnel may be collecting more monies for centrally managed general services than the ship stores proportionate share based on the direct benefits that the ship stores received. Had the gross retail sales revenue of the ship stores been assessed the same 3.3 percent that the Navy exchanges were effectively assessed on gross retail sales revenue in FY 1994, the ship stores assessment for the central fund would have been about $800,000 less for the year (decreased from $3.4 million to $2.6 million). As a result, the ship stores profits would have been higher in FY 1994 providing more funds directly to the crews of ships for morale, welfare, and recreation. At a minimum, the rate for assessing ship stores should be evaluated periodically, the same as the Navy exchanges, to ensure that the rate is appropriate for the services rendered.

Recommendation and Management Comments

We recommend that the Chief of Naval Operations, in coordination with the Bureau of Naval Personnel, the Naval Supply Systems Command, and the Navy Exchange Service Command, evaluate the ship stores assessment from the Navy ship stores to the Bureau of Naval Personnel and Navy Exchange Service Command central funds for morale, welfare, and recreation and establish an appropriate rate of assessment. After the appropriate assessment rate is established for Navy ship stores, the Chief of Naval Operations should establish a mechanism to periodically reevaluate the rate to determine any necessary adjustments.

Navy Comments. The Navy concurred with the recommendation. It stated that the Bureau of Naval Personnel would strengthen the review of the sources and uses of morale, welfare, and recreation funds for the Navy Morale, Welfare, and Recreation and Navy Exchange Service Command Board of Directors during their annual nonappropriated fund budget process.

Part II - Additional Information

Appendix A. Audit Process

Scope and Methodology. We reviewed FY 1994 financial and management data to evaluate the costs and benefits associated with converting The Program to a nonappropriated fund instrumentality. Because FY 1995 operations data are not reconciled until 6 weeks after the end of the fiscal year, we used only the FY 1995 financial and management data for general background information when it was available and deemed appropriate for a more recent, historical perspective. The total assets on hand for The Program for FY 1994 were $45.9 million, comprised of the Navy Stock fund and the Ships' Stores Profits, Navy, fund.

The FY 1994 National Defense Authorization Act required the Secretary of the Navy to transfer the value of ship stores assets in the Navy Stock fund and the residual cash in the Ships' Stores Profits, Navy, fund to NEXCOM without cost. Therefore, we excluded costs associated with transferring the assets in the Navy Stock fund and Ships Store Profits, Navy, fund in our analysis.

We also excluded an evaluation of the costs for reimbursing financial services (accounting services and bill processing) provided by other Government organizations, and space, utilities, and military labor support provided aboard ship to ship stores operations. Those costs were excluded because legislation for converting the ship stores to a nonappropriated fund instrumentality allows the Navy to provide those services on a nonreimbursable basis. Legislative history, prior Navy studies, and discussions with Navy management provided no indication that the law or policy on those nonreimbursable services would change in the future. We evaluated $54.76 million in nonreimbursable services provided to the ship stores in FY 1994 that the Naval Audit Service reported in Audit Report No. 028-95, "Ships Stores Conversion," March 6, 1995, and we generally agree with the assumptions, methodology, and calculations used in the report. However, we believe an additional $2.17 million in billing and account reconciliation services by the Defense Finance and Accounting Service and an estimated $60,000 in annual certified public accountant audits could be included in nonreimbursable financial services and, therefore, excluded as costs of conversion.

We reviewed DoD and Navy policies affecting NEXCOM exchanges, ship stores, and the Military Sealift Command ship stores to compare and evaluate the operations of those activities. We had discussions with Navy officials and examined documentation on accounting, auditing, contracting, distribution, financing, investments, inventory, management oversight, pricing, procurement, personnel staffing, training, transportation, and warehousing from November 1990 to September 1995 to determine changes in procedures and practices that could affect the costs and benefits of converting the ship stores.

We also reviewed procedures on allocating profits from ship store operations to the Navy morale, welfare, and recreation organizations and on the distribution of morale, welfare, and recreation services to Navy personnel.

Computer-Processed Data, Statistical Sampling, and Management Control Program. From our limited tests and review of management controls, we determined that the Navy Stock Fund computer-processed data tested were reliable. However, we could not establish the reliability of the computer-processed data associated with the Ships' Stores Profits, Navy, fund because the fund is an aggregate of the profits for the 234 ship stores and the total is not audited on a regular basis. Even though we could not establish reliability of the data, we believe variances in the balance of the Ships' Stores Profits, Navy, fund would not materially affect the results of our audit. We did not use statistical sampling procedures for this audit. A review of the management control program affecting the operation of The Program was not in the scope of our audit.

Audit Period, Standards, and Locations. This economy and efficiency audit was performed from October 1995 through January 1996. We conducted this audit in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. We included tests of management controls considered necessary. Appendix H lists the organizations visited or contacted during the audit.

Appendix B. Summary of Prior Audits and Other Reviews

In the past 5 years, several reports and reviews were issued on The Program. They are summarized below.

Naval Audit Service

The Naval Audit Service issued Audit Report No. 028-95, "Ships Stores Conversion," on March 6, 1995. The audit was conducted in response to the legislative requirement in the FYs 1994 and 1995 National Defense Authorization Acts (Public Laws 103-160 and 103-337), for the Navy to convert the operations of ship stores from appropriated funding to nonappropriated funding. The audit objective was to determine the conversion and operating costs and the resulting impact on shipboard personnel. The audit focused on events occurring in FYs 1993 and 1994.

The report stated that the conversion legislation allowed for a wide range of continued mission funded (appropriated funds) support. As a result, the Naval Audit Service concluded that the financial advantage gained by a conversion to nonappropriated funding is greatly reduced if the majority of the mission funded costs remain mission funded or not segregated as ship stores costs. However, if mission funding for all segments of the ships store operation is discontinued (including military labor to operate the ship stores) the financial savings to the Navy might be offset by morale problems resulting from the increased costs to Navy personnel and reduced morale, welfare, and recreation programs for shipboard personnel. Because the audit report contained no recommendations, no comments were required and none were received.

Inspector General, DoD

The Office of the Inspector General, DoD, reviewed the Naval Audit Service Report No. 028-95. In a memorandum to the Naval Audit Service, the Inspector General, DoD, concluded that the Naval Audit Service report focused on the costs of the ship stores conversion rather than the costs and benefits, as required by the FY 1994 National Defense Authorization Act. The Inspector General, DoD, further concluded that the audit did not comply with generally

accepted auditing standards, reporting that some of the audit findings regarding procurement efficiency of ship stores and per annum costs to convert from appropriated to nonappropriated funding were based on testimonial evidence rather than independent evaluation of source evidence. The Inspector General recommended that the Navy withdraw the report and expand the coverage to fully comply with auditing standards. In response, the Naval Audit Service issued an addendum to the report addressing the Inspector General's concerns.

Naval Supply Systems Command

A Navy Command Inspection of NEXCOM was conducted from October 23 through November 2, 1995, by the Office of the Inspector General, Naval Supply Systems Command (the Supply Command). The Supply Command reported that NEXCOM was not in full compliance with Navy instructions for conducting reviews and command inspections. Secretary of the Navy Instruction 7510.9 requires commanding officers to assess the efficiency and integrity of all command functions. Although NEXCOM approved a review in FY 1994 of the Ships' Stores Profits, Navy, General fund, no review was conducted. The Supply Command recommended that NEXCOM complete FY 1995 reviews in progress or defer them to future periods. The Supply Command also recommended that NEXCOM provide quarterly reports to the Supply Command on the accomplishment of completed reviews and inspections.

Appendix C. Legislative History

United States Code, title 10, section 7604, August 10, 1956, stated that a profit of not more than 15 percent may be charged on sales from ship stores. On vessels of the Navy, ship stores profits shall be used equitably for the welfare of officers and enlisted members of the naval service. At other naval organizations, the profits shall be used for enlisted members only.

Public Law 101-510, section 329, FY 1991 National Defense Authorization Act, November 5, 1990, amends United States Code, title 10, section 7604, to allow the Secretary of the Navy to establish the regulations and prices for the sale of goods and services from ship stores. The law also requires the Secretary of the Navy to submit to Congress a report reviewing the operations of all ship stores. The review was required to consider the procurement and pricing policies of the ship stores, the manner of organizing and managing the ship stores, and alternative methods by which the operations of the ship stores may be funded.

Public Law 103-160, section 371, FY 1994 National Defense Authorization Act, November 30, 1993, directs the Secretary of the Navy to convert ship stores operations to the NEXCOM as a nonappropriated fund activity by October 1, 1994. The law also directs the Secretary of the Navy to transfer, without cost, to the NEXCOM from the Navy Stock Fund, an amount equal to the value of existing ship stores assets in that fund; and transfer residual cash from the Ships' Stores Profits, Navy Fund. The law also inserts in United States Code, title 10, section 7604, items that must be sold in ship stores, and lets the Secretary of the Navy provide incidental services, such as financial services; space; utilities; and labor, to ship stores on a nonreimbursable basis.

The House Armed Services Committee May 10, 1994, report, on FY 1995 National Defense Authorization Act proposed extending the conversion deadline for funding the ship stores operations to October 1, 1995. In the report, the Committee requests the Inspector General, DoD, to submit a report on the impact of the decision on shipboard personnel by April 15, 1995.

The Senate Armed Services Committee June 14, 1994, report, on the FY 1995 National Defense Authorization Act recommended repealing the sections in Public Law 103-160 that require ship stores to convert. The committee believed that mandated conversion could have unintended negative consequences on sailors and marines.

The House Conference Committee August 12, 1994, report, on the FY 1995 National Defense Authorization Act recommended extending the deadline to convert ship stores to a nonappropriated fund activity to December 31, 1995. The Senate proposed an amendment that required the Naval Audit Service to provide a report on the costs and benefits of the conversion.

Public Law 103-337, section 374, FY 1995 National Defense Authorization Act, October 5, 1994 extended the deadline to convert ship stores to a nonappropriated fund activity to December 31, 1995, but did not specify that a report should be provided by any agency.

The House National Security Committee June 1, 1995, report on the FY 1996 National Defense Authorization Act recommended extending the conversion deadline to December 31, 1996. The report stated that the Inspector General, DoD, should be required to submit a report to Congress by April 1, 1996, with its evaluation of the costs and benefits of converting ship stores to a nonappropriated fund activity and its review of the Naval Audit Service report regarding the conversion.

The Senate Armed Services Committee July 12, 1995, report on the FY 1996 National Defense Authorization Act recommended a provision to repeal the requirement to convert ship stores operations to a Navy exchange system agency.

Public Law 104-106, Section 340, FY 1996 National Defense Authorization Act, February 10, 1996, repealed the requirement to convert ship stores operations to a nonappropriated fund instrumentality and required the Inspector General, DoD, to submit to Congress its review of the Naval Audit Service report on the costs and benefits of converting ship stores to a nonappropriated fund instrumentality.

Appendix D. Navy Ship Stores Profit and Loss for FY 1994

Revenue

Retail sales	$ 78,990,711.97
Vending machine sales	22,581,940.87
Amusement machines	1,203,306.62
Rebate checks and contributions	636,921.10
Grants and loans	370,403.97
Accounting adjustments	68,428.96
Total	**$103,851,713.49**

Expenses

Cost of sales - retail	$ 66,399,463.61
Cost of sales - vending	11,654,119.93
Amusement machine contractor	452,490.56
Dishonored checks	5,914.05
Equipment Purchases	851,706.30
Laundry claims and service charges	218,278.95
Operating expenses (markdowns)	2,583,423.54
General fund assessment*	3,832,467.39
Loan repayment	265,359.59
Total	**$ 86,263,223.92**

Profits

Cash Available from FY 1994 for ships' morale, welfare, and recreation fund	**$ 17,588,489.57**

*An assessment on retail sales for morale, welfare, and recreation services provided by the Bureau of Naval Personnel and NEXCOM. About $3.43 million (4.3 percent of retail sales) was allocated to the Bureau of Naval Personnel and about $395,000 (0.5 percent of retail sales) to NEXCOM.

Appendix E. Estimated Audit Adjustments to Navy Ship Stores Profit for FY 1994 as a Result of Conversion From Appropriated to Nonappropriated Fund Support

Profits Before Audit Adjustments

Cash available in FY 1994 for ships' morale, welfare, and recreation fund	**$17,588,489.57**

One-Time Cost of Conversion

Converting guidance for nonappropriated fund operations	**$ 19,000.00**

Audit Adjustments for a Nonappropriated Fund Instrumentality

Automated data processing	$ 272,580.00
Contracting support	149,075.00
Distribution of merchandise	3,678,000.00
General and administrative	29,965.00
Inventory losses	2,000,000.00
Overseas warehousing	600,000.00
Program management	754,350.00
Total Recurring Expenses	**$ 7,483,970.00**

Profits After Audit Adjustments

Estimated cash available in FY 1994 for ships' morale, welfare, and recreation fund	**$10,085,519.57**

Appendix F. Military Sealift Command Exchange Program

The Military Sealift Command (MSC) has an exchange program that operates resale stores onboard ships staffed with civil service personnel. The MSC exchange program is supported by nonappropriated funds and operates under the technical guidance and administration of NEXCOM. The MSC shipboard exchange program is similar to The Program except it is supported by nonappropriated funds and it is a smaller operation.

The MSC exchange program has been operating for about 20 years and has 30 ships with ship stores. Annual sales for the MSC exchange program totaled $1.4 million in FY 1994, or about $46,000 per ship. Profits generated from the MSC exchange program are used in a welfare and recreation program designed to promote personnel morale on all MSC ships. Military Sealift Command Instruction 4000.2A, "Supply Procedures Manual," December 26, 1994, provides guidance for the welfare and recreation program and for exchange operations for MSC ships.

The MSC Atlantic and Pacific area commands are responsible for establishing a committee to ensure the integrity of the welfare and recreation fund for MSC ships. Expenses are paid from monthly profits of the MSC exchange program that are deposited in a checking account at a bank insured by the Federal Deposit Insurance Corporation. Excess cash is deposited in savings accounts or certificates of deposit to maximize interest income on the profits. The interest income from the investments is distributed at the end of the year as directed by the MSC commanding officer. Additionally, all MSC ships receive a quarterly allowance of $5 per person for welfare and recreation. The nonappropriated funds are audited annually by certified public accountants.

The MSC exchange operators are paid a 7 percent commission on sales monthly, less the cost of shortages, for their voluntary services. NEXCOM guidance is used to establish retail prices on resale items sold in stores. The average markup on MSC exchange inventory is 35 percent. The primary source of supply is the area command. However, requisitions can be made from emergency sources for articles and services considered necessary for the daily health or comfort of personnel with approval from the area command. The emergency sources, in order of priority, are: U.S. Navy Mobile Logistics Support Force, Fleet Industrial Supply Centers, Ashore Navy Exchanges, other MSC ships, U.S. Navy ships with a ships store afloat operation, the Army and Air Force Exchange Service, and commercial sources. Inventory obtained from either the area command or emergency sources is shipped with an established retail price that includes shipping costs based on NEXCOM pricing guidance.

Exchanges on MSC ships operate a minimum of 1 to 3 hours daily depending on the number of personnel aboard ship. When an exchange reaches sales of $2,500, excess funds must be forwarded to NEXCOM for deposit. NEXCOM also provides accounting services for MSC ships. Unlike The Program aboard warships, MSC ships make no allocation to either the Bureau of Naval Personnel or to NEXCOM, except direct funded reimbursement for services such as financial services.

Appendix G. Organizations Visited or Contacted

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller), Arlington, VA
Bureau of Naval Personnel, Washington, DC
Naval Supply Systems Command, Arlington, VA
  Fleet Industrial Supply Center, Norfolk Naval Base, VA
  Navy Exchange Service Command, Virginia Beach, VA
    Navy Ship Stores Program Office, Norfolk Naval Base, VA
  Naval Transportation Support Center, Norfolk, VA
Space and Naval Warfare Systems Command, Arlington, VA
  Navy Management Systems Support Office, Chesapeake, VA
Naval Audit Service, Arlington, VA
USS Hawes, FFG-53, Norfolk Naval Base, VA
USS Theodore Roosevelt, CVN-71, Norfolk Naval Base, VA

Unified Commands

Commander-in-Chief, U.S. Atlantic Forces, Norfolk, VA
  Naval Surface Forces, U.S. Atlantic Fleet, Norfolk, VA
U.S. Transportation Command, Scott Air Force Base, IL
  Military Sealift Command, Washington, DC

Other Defense Agencies

Army and Air Force Exchange Services, Dallas, TX
Defense Finance and Accounting Service, Arlington, VA
  Defense Finance and Accounting Service, Cleveland, OH
    Norfolk Operating Location, Norfolk Naval Base, VA

Appendix H. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Under Secretary of Defense (Personnel and Readiness)
Assistant to the Secretary of Defense (Public Affairs)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Chief of Naval Operations
Assistant Secretary of the Navy (Financial Management and Comptroller)
Naval Supply Systems Command
  Navy Exchange Service Command
    Navy Ship Stores Program Office
Bureau of Naval Personnel
Auditor General, Department of the Navy

Department of the Air Force

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

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, National Security Agency
    Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

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

Chairman and ranking minority member of each of the following congressional committees and subcommittees:
    Senate Committee on Appropriations
    Senate Subcommittee on Defense, Committee on Appropriations
    Senate Committee on Armed Services
    Senate Committee on Governmental Affairs
    House Committee on Appropriations
    House Subcommittee on National Security, Committee on Appropriations
    House Committee on Government Reform and Oversight
    House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
    House Committee on National Security

Part III - Management Comments

Department of the Navy Comments

Final Report Reference

THE ASSISTANT SECRETARY OF THE NAVY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, D.C. 20350-1000

18 APR 1996

MEMORANDUM FOR DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: DoDIG Draft Report on Navy Ships Stores Operations (Project 6LB-5004) - INFORMATION MEMORANDUM

We have reviewed the findings and recommendations in the subject report provided by Attachment 1. In summary:

a. We concur with statements in Finding A that relate to conversion expenses. The $7.5 million annual cost to afloat Sailors would have reduced available profits in 1994 by 43 percent, a substantial cost to afloat Sailors.

b. We do not concur with the statement in Finding A that conversion "would have provided potential benefits" from the areas listed. The report's ability to accurately predict the future is doubtful based on unquantified and unsubstantiated data contained in the report.

c. While we concur with the recommendation in finding B to periodically review the MWR assessment, we do not concur in the analyses and calculations used by the audit service in arriving at their recommendation.

Detailed comments are in Attachment 2.

Deborah P. Christie

DEBORAH P. CHRISTIE

Attachment deleted

Attachments:
1. DoDIG memo of 19 Mar 96
2. Department of the Navy Comments

Copy to:
NEXCOM
BUPERS (PERS-65)

DEPARTMENT OF NAVY RESPONSE

TO

DODIG DRAFT REPORT OF 19 MARCH 1996

ON

NAVY SHIPS STORES OPERATIONS
(PROJECT 6LB-5004)

Finding A: Navy Ship Stores Conversion From Appropriated to Nonappropriated Funding

The conversion from appropriated fund support to a nonappropriated fund (NAF) instrumentality in FY 1994 would have increased the Navy ship stores total operating expenses from $86.3 million to an estimated $93.8 million, an 8.7 percent increase. The conversion would have affected expenses for services such as automated data processing, contracting support, distribution of goods, inventory losses, and program management. As a result of the change in the method of funding for the program, profits for the individual ship' morale, welfare, and recreation (MWR) funds would have decreased from $17.6 million to $10.1 million, a 43 percent decrease in profits available to shipboard personnel. In contrast, the conversion would have provided potential benefits from the coordinated acquisition of automated data processing services, consolidated contracting support, use of the Navy Exchange Service Command (NEXCOM) distribution system, added financial services available to NAF activities, and the staff integration of ships stores with NEXCOM.

Department of the Navy comment:

We concur with statements that relate to conversion expenses. The $7.5 million annual cost to afloat Sailors would have reduced available profits in 1994 by 43 percent, a substantial cost to afloat Sailors. The draft report also validates the conclusion of the Naval Audit Service report as it related to cost in that: "... any costs not passed on as price increases would reduce the shipboard MWR proceeds. Increased prices for shipboard Sailors and/or reduced MWR activities could have an adverse impact on shipboard morale."

It is noted that although the report did not cost out financial services, labor, space and utilities, because the National Defense Authorization Act for FY 1994 allowed Secretary of the Navy to provide those incidental services to ships stores on a non-reimbursable basis. However, this financial report was not guaranteed beyond FY 1994. As these costs are integral parts of ships store operations, discontinued mission funding for these costs would significantly raise annual operating costs which would impact the shipboard Sailor through even higher prices increased or reduced MWR proceeds

We do not concur with the statement that conversion "would have provided potential benefits" from the areas listed. The report's ability to accurately predict the future is doubtful based on unquantified and unsubstantiated data contained in the report. Comments and examples related to this inaccuracy were communicated to the report originators via NEXCOM's written response to the working draft of this audit report. Excerpts are as follows:

a. Omission of risk. The report does not include any mention of risk in the discussion of benefits. It is believed that in any endeavor there are both benefits and risks that must be identified before an assessment of benefit can be made.

b. Navy Ships Store Conversion Costs (Automated Data Processing, page 5). The report estimated a $500,000 yearly cost for ADP equipment depreciation but did not include this cost in a yearly projected cost because the equipment had not been purchased. The exclusion of this cost is noted as an example of the logic problems any study has in taking a snapshot approach to a dynamic continuum. This $500,000 would be a yearly cost that would have increased the projected expenses to $7.9 million. Likewise replacement costs, etc. were not figured in but would be a future cost factor.

c. Potential Benefits (Automated Data Processing, page 6). The report ignored or omitted several major facts. The first is that the NCR contract with NEXCOM specifically excluded the Navy Lodge and ships store program from participation in that contract. When the contract was awarded, neither of those programs was included in the contract and any such addition would represent a major modification (in scope and cost) to the contract. Second, while there could be some common hardware usage, there would be no commonalty with the software. The

software developed for both the front end cash register and back room could not be used by the ships store program due to the vast differences of business operation. NEXCOM software reflect the needs of a $1.7 billion company vice the needs of a $100 million company. Third, the concept of operation of both companies is different due to operational necessity.

d. Potential Benefits (Contracting, page 7). The report stated that the review team had no substantiation to show any increased economies of scale that would be achieved by the addition of ships store purchases to the buying power of an existing $1.7 billion company. No substantiation of potential benefit to NAF was identified.

e. Conclusion, page 8. The report states that through analysis of cost and benefits the conversion could be accomplished without having to adjust the prices or goods or services, it would have potential, unquantified benefits, and would be consistent with the Military Sealift Command funding method. This conclusion appears to be based on the acceptance that a loss of 43 percent of profits provided for the recreation and welfare to afloat sailors is in the Sailors best interest, one does not need quantification of a benefit to justify it and that the Military Sealift Command with a higher markup on goods and, less benefits provided to its customers is a good role model. It would appear that a different conclusion could be reached: that given the cost and questionable benefit to the Sailor, a conversion should not be accomplished.

Finding B. Morale, Welfare, and Recreation Fund Assessment

The Bureau of Naval Personnel (BUPERS) $3.43 million assessment in FY 1994 on the gross retail sales revenue of the ships stores may not be proportionate to the benefits received. Naval Supply Systems Command Publication 487 requires ship stores to pay a fee of from 4.0 percent to 5.5 percent of gross retail sales revenue per store to the BUPERS and NEXCOM. The Navy did not periodically evaluate whether the rate could be adjusted. As a result, BUPERS may be collecting more moneys than necessary from ship stores, which contributes to lower profits provided directly to crews of ships for morale, welfare, and recreation. We recommend that the Chief of Naval Operations, in coordination with the BUPERS, the Naval Supply Systems Command, and NEXCOM, evaluate the ship stores assessment from the Navy ship stores to the BUPERS and NEXCOM central funds for MWR and establish an appropriate rate of assessment. After the appropriate assessment rate is established for Navy ship stores, the Chief of Naval Operations should establish a mechanism to periodically reevaluate the rate to determine any necessary adjustments.

Department of the Navy comment:

Partially concur. While the Navy concurs in the need to periodically review the MWR assessment, we do not concur in the analyses and calculations used by the audit service in arriving at their recommendation. Currently, the Navy MWR/NEX Board of Directors approves the annual NAF budget. This board includes the two Fleet Commanders in Chief. As an improved business practice, BUPERS will strengthen the periodic review of sources and uses of these funds during the annual NAF budget process. Particular emphasis will be placed on the use of assessment income to meet the annual estimated requirements of afloat units which generate little or no NAF revenue by ship stores operations.

Audit Team Members

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

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