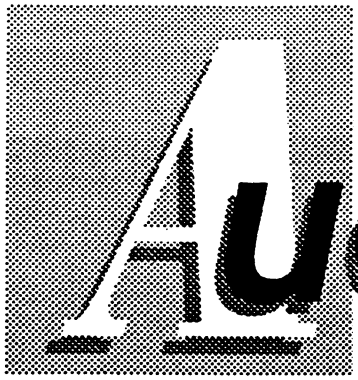

OFFICE OF THE INSPECTOR GENERAL

DEFENSE BUSINESS OPERATIONS FUND EQUITY TRANSFER -- DEFENSE COMMISSARY AGENCY

Report No. 96-160 June 13, 1996

Department of Defense

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OAIG-AUD (ATTN: APTS Audit Suggestions)
Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-2884

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Acronyms

DBOF	Defense Business Operations Fund
DeCA	Defense Commissary Agency
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency

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

June 13, 1996

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

SUBJECT: Defense Business Operations Fund Equity Transfer -- Defense Commissary Agency (Report No. 96-160)

We are providing this audit report for review and comments. The report discusses a material misstatement of revenue identified during our audit of "Revenue Accounts in the FY 1996 Financial Statements of the Defense Business Operations Fund." This is the first in a series of reports on revenue issues in the Defense Business Operations Fund. Management comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Deputy Chief Financial Officer nonconcurred with Recommendations 2.a. and 2.b. He also doubted the need for Recommendation 1. We request that the Under Secretary of Defense (Comptroller) reconsider his position and provide additional comments on the unresolved recommendations by August 13, 1996.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David C. Funk, Audit Program Director, at (303) 676-7445 (DSN 926-7445) or Mr. Byron B. Harbert, Audit Project Manager, at (303) 676-7405 (DSN 926-7405). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman

Robert J. Lieberman
Assistant Inspector General
for Auditing

Report No. 96-160 **June 13, 1996**
(Project No. 5FD-2020.00)

Defense Business Operations Fund Equity Transfer -- Defense Commissary Agency

Executive Summary

Introduction. The issue of equity transfers was identified during our work on the Defense Commissary Agency portion of the audit of "Revenue Accounts in the FY 1996 Financial Statements of the Defense Business Operations Fund" (the Revenue Accounts audit). In FY 1995, the Defense Business Operations Fund reported annual revenues of $76.6 billion. The Revenue Accounts audit is being performed to fulfill the requirements of the Chief Financial Officers Act of 1990 (Public Law 101-576, November 15, 1990), as amended by the Federal Financial Management Act of 1994 (Public Law 103-356, October 13, 1994). This report is the first in a series of reports on revenue issues in the Defense Business Operations Fund.

Audit Objectives. The overall objective of the Revenue Accounts audit was to determine whether revenues on the FY 1996 consolidated financial statements of the Defense Business Operations Fund are presented fairly in accordance with the "other comprehensive basis of accounting" described in Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. Specifically, we were to determine the validity of revenues recognized by the Defense Commissary Agency. Additional objectives of the Revenue Accounts audit were to assess internal controls and compliance with laws and regulations.

Audit Results. At the direction of an official in the Office of the Under Secretary of Defense (Comptroller), the Defense Commissary Agency erroneously reported a $251.6 million transfer of equity from the Defense Logistics Agency segment of the Defense Business Operations Fund as revenue in the FY 1995 financial statements. As a result, in the FY 1995 consolidated financial statements of the Defense Business Operations Fund, revenues and the net results of operations were overstated by $251.6 million.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) establish management controls to ensure that only the Director for Accounting Policy issues instructions to the DoD Components on accounting practices. We also recommend that the Under Secretary of Defense (Comptroller) direct that accounting records and the FY 1995 consolidated financial statements of the Defense Business Operations Fund be corrected by reducing revenues by $251.6 million and increasing equity by the same amount.

Management Comments. The Deputy Chief Financial Officer did not object to the recommendation to establish controls to ensure that only the Director for Accounting Policy issues instructions on accounting practices, but questioned the need for the recommendation. The Deputy Chief Financial Officer nonconcurred with our recommendations to correct the accounting entry and the FY 1995 financial statements. He stated that the equity transfer conformed to congressional direction.

The Defense Commissary Agency provided unsolicited comments, reaffirming that the entry was based on direction by the Under Secretary of Defense (Comptroller) and stating that it would be adjusted if the Under Secretary so ordered. This report discusses management comments in Part I; the full text of management comments is in Part III.

Audit Response. The Deputy Chief Financial Officer's comments were nonresponsive. His comments did not address nonconformance to fundamental accounting principles, nor did they address the effect of the accounting entry on the FY 1995 consolidated financial statements of the DBOF. We believe that the transfer funds directed by Congress was to prevent a disruption to customers, not to prescribe the accounting treatment of the transfer. We request that the Under Secretary of Defense (Comptroller) provide additional comments on the recommendations by August 13, 1996.

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Part I - Audit Results

Audit Background

The issue of equity transfers within the Defense Business Operations Fund (DBOF) was identified during our work on the Defense Commissary Agency (DeCA) portion of the audit of "Revenue Accounts in the FY 1996 Financial Statements of the Defense Business Operations Fund" (the Revenue Accounts audit). The Revenue Accounts audit is being performed to fulfill the requirements of the Chief Financial Officers Act of 1990 (Public Law 101-576, November 15, 1990) as amended by the Federal Financial Management Act of 1994 (Public Law 103-356, October 13, 1994). The Chief Financial Officers Act requires DoD to prepare, on an annual basis, audited financial statements for the preceding year and submit them to the Director, Office of Management and Budget. The financial statements report the financial position and results of operations of the DoD Components and business activities.

Defense Business Operations Fund. DBOF, a revolving fund, was established on October 1, 1991, by the Secretary of Defense. DBOF merged nine existing individual stock and industrial funds, along with five DoD commercial operations or business activities previously funded with appropriated funds.

DBOF business areas receive their initial working capital through appropriations or resources transferred from existing appropriations of funds; they use those capital resources to finance the cost of goods and services. Customer orders generate resources to replenish working capital and permit continuing operations. In FY 1995 the DBOF reported annual revenues of $76.6 billion.

Defense Commissary Agency. The Defense Commissary Agency (DeCA) manages 20,000 employees at more than 300 commissaries worldwide and has annual sales of approximately $5.4 billion.

DeCA is divided into three business areas: Resale Stock, Commissary Operations, and Surcharge Collections. The Resale Stock and Commissary Operations business areas are components of DBOF and are included in the DBOF consolidated financial statements.

The Resale Stock business area, the primary business area of DeCA, accounts for the purchase of resale stock items consisting of groceries and war reserve materiel. The primary source of revenue in the Resale Stock business area is the sale of grocery items to commissary patrons. DeCA manages the Resale Stock business area, and the Defense Finance and Accounting Service (DFAS) Columbus Center provides most accounting services. The Resale Stock business area reported total revenues and financing sources of $5.4 billion for FY 1995.

The Commissary Operations business area accounts for the costs of operating the commissary stores. The primary sources of revenues in the Commissary Operations business area are an annual appropriation and fees that manufacturers pay to DeCA for handling customer discount coupons. DeCA manages the Commissary Operations business area, and the DFAS Columbus

Center provides most accounting services. DeCA reported total revenues and financing sources of $290.1 million for FY 1995 for the Commissary Operations business area.

Audit Objectives

The overall objective of the Revenue Accounts audit was to determine whether revenues on the DBOF consolidated financial statements for FY 1996 are presented fairly in accordance with the "other comprehensive basis of accounting" described in Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. Additional objectives of the Revenue Accounts audit were to assess internal controls and compliance with laws and regulations. The misclassification of revenue resulting from the equity transfer occurred because instructions given by management were erroneous, not because internal controls were deficient. See Appendix A for a discussion of the audit scope and methodology.

Transfer of Equity Between DBOF Business Areas

DeCA erroneously reported a $251.6 million transfer of equity from the Defense Logistics Agency (DLA) segment of DBOF as revenue in the FY 1995 financial statements. This misclassification occurred because a budget official in the Office of the Under Secretary of Defense (Comptroller) instructed DeCA to record a congressionally directed transfer of cash from DLA to DeCA in a revenue account, which was incorrect. As a result, the consolidated DBOF and DeCA FY 1995 Statements of Operations and Changes in Net Position overstated revenues and the net results of operations by $251.6 million. This action materially distorted the results of operations for DBOF and DeCA.

Commissary Operations Revenue

The Commissary Operations business area is a component of DBOF, but is not funded through sales to commissary patrons. Its primary source of funds is an annual appropriation from the U.S. Congress. In previous years, this appropriation adequately funded the costs of operating the commissary stores. However, in the DoD appropriation for FY 1995, the amount provided for commissary operations did not fund all operating costs. To make up for the reduced appropriation, Congress authorized a transfer of $251.6 million from existing DBOF cash balances.

In FY 1995, DeCA erroneously reported the $251.6 million transfer of equity from DLA as revenue. Although this accounting entry was directed by a budget official in the Office of the Under Secretary of Defense (Comptroller), it conflicted with generally accepted accounting principles for the Federal Government. Revenue does not arise from transactions within DBOF, but from external sources. Transfers of equity between DBOF components do not result in revenue to DBOF as a whole. Equity transfers represent a shift of resources from one DBOF component to another, not the inflow or outflow of resources to DBOF. In this case, the transfer was made to provide resources to DeCA to cover operating expenses. The funds transferred represented existing equity of DBOF, not an increase in DBOF resources. In contrast, funds appropriated by Congress for commissary operations are properly recorded as revenue because these resources come to DBOF from an external source.

Reasons for Reporting the Transfer as Revenue

A budget official in the Office of the Under Secretary of Defense (Comptroller) directed the transfer from equity to revenue. He took this action because he

believed that if DBOF reported a loss in its financial statements, the loss would have to be recovered through price increases in the goods and services sold by DBOF.

Effect on the FY 1995 Financial Statements

Because DeCA recorded the $251.6 million equity transfer as revenue, a material misstatement was reported to DFAS for inclusion in the FY 1995 consolidated DBOF financial statements. Revenues and the net results of operations were overstated by $251.6 million. Reversing the incorrect entry and accounting for the transfer as an increase in equity rather than an increase in revenue will correctly reflect the transfer on the accounting records of both DeCA and DBOF. In addition, the correcting entry will ensure the accuracy of the cumulative results of operations carried forward to the financial statements for FY 1996 and future years.

Recommendations, Management Comments, and Audit Response

We recommend that the Under Secretary of Defense (Comptroller):

1. Establish management controls to ensure that only the Director for Accounting Policy issues instructions to the DoD Components regarding accounting practices.

Under Secretary of Defense (Comptroller) Comments. The Deputy Chief Financial Officer questioned whether the recommendation was necessary in light of his nonconcurrence with the finding.

Audit Response. The Deputy Chief Financial Officer's comments were nonresponsive. We continue to believe that the Director for Accounting Policy should be solely responsible for issuing instructions to the DoD Components on accounting practices, and that the supporting recommendation is advisable. We request that the Under Secretary of Defense (Comptroller) reconsider the position on this recommendation and provide additional comments in response to the final report.

2. Direct the Director, Defense Commissary Agency, to:

a. Reverse the misclassification of FY 1995 revenue by requesting that the Defense Finance and Accounting Service correct the Defense Commissary Agency's accounting records to reduce revenues and increase equity by $251.6 million.

b. Request that the Defense Finance and Accounting Service make related corrections to the FY 1995 consolidated financial statements of the Defense Business Operations Fund.

Under Secretary of Defense (Comptroller) Comments. The Deputy Chief Financial Officer nonconcurred, stating that House Report 103-747 did not direct a transfer of equity, but directed that a cash transfer be made in a manner " . . . so that DeCA operations are not adversely affected. . . ." He further stated that, as a result, it was "reasonable to conclude that the Congress intended that the cash transfer be recorded as revenue, and offset operating costs, so that the DeCA financial statements would not be adversely affected." Therefore, the Deputy Chief Financial Officer concluded that the transfer in question conformed to congressional direction.

Audit Response. The Deputy Chief Financial Officer's comments on Recommendation 2.a. and 2.b. were not responsive. The comments did not address the accounting entry's nonconformance to fundamental accounting principles or the effect of the entry on the FY 1995 consolidated financial statements of the DBOF.

The legislation directing this transfer did not indicate any intent of Congress to direct the accounting treatment of the transfer, nor did it state that the transfer should be presented in the financial statements in a manner that departed from accepted accounting practice. The legislation directed that funds be transferred from DBOF cash balances to DeCA. The phrase " . . . so that DeCA operations are not adversely affected . . ." did not mention the effect of the transfer on the financial statements; that phrase referred to the level of service provided by DeCA to its customers, not to the net results of operations reported in the financial statements.

The practice of reporting the transfer of cash from one DBOF component to another as revenue in the financial statements contradicts the fundamental accounting concept of revenue. Revenue represents an inflow of assets to an entity from an external source. The transfer of cash from within DBOF did not result in an inflow of assets to DBOF from an external source; it shifted assets among DBOF components. We request that the Under Secretary of Defense (Comptroller) reconsider the comments to Recommendations 2.a. and 2.b. and provide additional comments in response to this final report.

Other Management Comments. The Defense Commissary Agency provided unsolicited comments on Recommendation 2.b. The comments stated that the original accounting entry was made at the direction of the Under Secretary of Defense (Comptroller), and that the entry will be adjusted upon direction from the Under Secretary of Defense (Comptroller). We agree that the DeCA was following Office of the Under Secretary of Defense (Comptroller) guidance in making the original entry.

Part II - Additional Information

Appendix A. Scope and Methodology

Scope

As part of our financial-related audit of "Revenue Accounts in the FY 1996 Financial Statements of the Defense Business Operations Fund," we examined the accounting practices used for revenue recognition in DeCA. This review included identifying and evaluating sources of revenue for the DeCA segment of the DBOF.

Methodology

We performed our review of DeCA revenues during the period July 1995 through February 1996 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD, and Office of Management and Budget Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial information presented in the consolidated statements is free of material misstatements. We did not use statistical sampling in this review because the problem was limited to a single accounting transaction. We also did not use computer-processed data in this review. Appendix B lists the organizations we visited or contacted.

Prior Audits and Other Reviews

Since the DBOF was established in 1991, no previous audits or other reviews concerning equity transfers have been made.

Appendix B. Organizations Visited or Contacted

Office of the Secretary of Defense

Office of the Under Secretary of Defense (Comptroller), Washington, DC
  Director, Accounting Policy, Washington, DC
  Director, Revolving Funds, Washington, DC

Defense Agencies

Defense Commissary Agency, Fort Lee, VA
Defense Finance and Accounting Service, Arlington, VA
  Defense Finance and Accounting Service Columbus Center, Columbus, OH
Defense Logistics Agency, Fort Belvoir, VA

Appendix C. Report Distribution

Office of the Secretary of Defense

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

Department of the Army

Auditor General, Department of the Army

Department of the Navy

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

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
  Director (Audit Liaison and Follow-up)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Commissary Agency
Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency
Director, National Security Agency
  Inspector General, National Security Agency

Non-Defense Organizations

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

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

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

Part III - Management Comments

Under Secretary of Defense (Comptroller) Comments

COMPTROLLER

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

MAY 17 1996

MEMORANDUM FOR ACTING DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE, OFFICE OF THE DOD INSPECTOR GENERAL

SUBJECT: Draft Audit Report on Defense Business Operations Fund Equity Transfer (Project No. 5FD-2020.00)

Thank you for the opportunity to comment on the subject draft report. The report states that the Defense Commissary Agency (DeCA) erroneously reported as revenue a $251.6 million transfer of equity from the Defense Logistics Agency (DLA). The report further states that this occurred because the DeCA was instructed to record as revenue a congressionally mandated transfer of equity from the DLA.

The source of the draft report's statement that the cash transfer represented a "Congressionally mandated transfer of equity" is not known. However, it is noted that the applicable Conference Report (House Report 103-747) stated, on page 143, that:

> "The conferees direct that funds be transferred from DBOF cash balances to the Defense Commissary Agency (DeCA) so that DeCA operations are not adversely affected by the adjustments described (in the conference report)."

As can be seen from the above language, the conference report did not direct a transfer of equity, but it did direct that the cash transfer be made in a manner "so that DeCA operations are not adversely affected...." Further, as the draft report notes, the purpose of the congressionally authorized transfer was to fund operating costs. As a result, it is reasonable to conclude that the Congress intended that the cash transfer be recorded as revenue, and offset operating costs, so that the DeCA financial statements would not be adversely affected.

Therefore, this office concludes that the transfer in question was in conformance with congressional direction. Accordingly, this office does not concur with Recommendations 2.a. and 2.b. of the subject report, and suggests that the OIG reconsider those recommendations. This office does not object to Recommendation 1; but is uncertain as to whether, absent recommendations 2.a. and 2.b, Recommendation 1, by itself, would warrant the issuance of a separate report.

Alvin Tucker
Deputy Chief Financial Officer

Defense Commissary Agency Comments

DEFENSE COMMISSARY AGENCY
HEADQUARTERS
1300 E AVENUE
FORT LEE, VIRGINIA 23801-1800

REPLY TO ATTENTION OF

IR

MAY 14 1996

MEMORANDUM FOR INSPECTOR GENERAL, FINANCE AND ACCOUNTING DIRECTORATE, 400 ARMY NAVY DRIVE, ARLINGTON, VA 22202-2884

SUBJECT: Draft Audit Report on Defense Business Operations Fund Equity Transfer (Project No. 5FD-2020.00)

Reference: DoDIG Memorandum, dtd April 5, 1996, SAB.

Although subject report was not specifically addressed to DeCA, recommendation number 2 deals with our accounting records. Therefore, we are providing the attached reply to the recommendation. If you have any questions, please contact Mr. Ben Mikell at (804) 734-8103.

for/ Donna J. Wiles
RONALD P. McCOY
Colonel, USAF
Chief of Staff

Attachments:
As Stated

DEFENSE COMMISSARY AGENCY REPLY

SUBJECT: Draft Audit Report on Defense Business Operations Fund Equity Transfer (Project No. 5FD-2020.00)

Recommendation 2. Direct the Director, DeCA, to:

a. Reverse the misclassification of FY 1995 revenue by requesting that the Defense Finance and Accounting Service make a correcting entry to the DeCA's accounting records to reduce revenue and increase equity by $251.6 million.

b. Request that Defense Finance and Accounting Service make related corrections to the FY 1995 consolidated financial statements of the Defense Business Operations Fund.

Action Taken. Nonconcur. The entries made to DeCA's financial records at fiscal year 1995 year-end were made as a result of guidance provided by the Office of the Under Secretary of Defense (Comptroller). DeCA cannot reverse the entries without specific guidance from the organization. If the entries are determined to be inappropriate, adjustments will be made upon direction from the Under Secretary of Defense (Comptroller).

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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