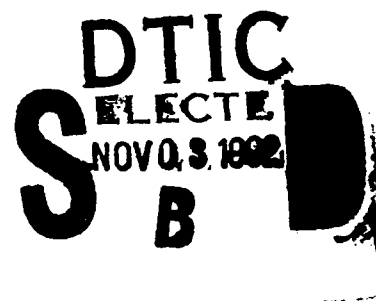


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**NAVAL POSTGRADUATE SCHOOL
Monterey, California**



THESIS

**NEW DEVELOPMENTS IN FINANCIAL MANAGEMENT
IN THE ARMED FORCES**

by

Daniel Thomas Martin

June 1992

Thesis Advisor:

Professor Jerry L. McCaffery

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CDR Louis G. Kalmar

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**New Developments in Financial Management
in the Armed Forces**

by

**Daniel Thomas Martin
Commander, United States Naval Reserve
B.S., United States Naval Academy, 1975**

**Submitted in partial fulfillment
of the requirements for the degree of**

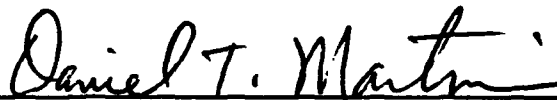
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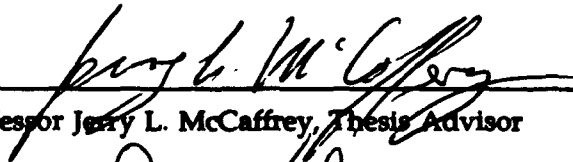
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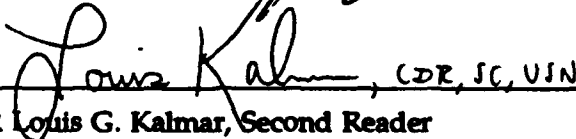


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ABSTRACT

Recent efforts to reform and consolidate many Department of Defense financial management functions have resulted in numerous initiatives designed to provide cost savings as well as to determine the true cost of the Defense Department. The focus of this thesis is to identify and define these changes as they pertain to the field activity comptroller departments. The results of this thesis will be incorporated into the management guide included in the Practical Comptrollership Course (PCC) offered by the Naval Postgraduate School in Monterey, California, and is primarily intended for use by PCC students as a routine management tool.

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I. INTRODUCTION

The purpose of this thesis is to identify recent changes in financial management in the armed forces. The results of this thesis, Chapter III, will be incorporated into the Practical Comptroller Course guidebook offered by the Naval Postgraduate School, Monterey, California.

A. BACKGROUND

Numerous changes are being made in the way that the Department of Defense conducts financial management. Practical Comptrollership Course students have suggested that these changes be included in the PCC guidebook to aid field level comptrollers. The objective of the research was to investigate these changes and then develop a comprehensive chapter to the PCC textbook. The chapter is written in a manner that explains the new initiatives and how they integrate with each other.

B. RESEARCH QUESTION

The primary research question was: What does the field level activity comptroller need to know regarding these changes in financial management?

Subsidiary research questions include:

* What is the Defense Business Operations Fund (now referred to as "the Fund") and how will it operate?

* What are the implications of these changes on Financial Management Education and Training?

* What are the Unit Costing Resourcing (UCR), Capital Budgeting,

and Corporate Information Management (CIM) initiatives?

C. SCOPE AND LIMITATIONS

This thesis is focused on the changes as they affect the field level activity comptroller department, because the majority of the students who will use the information are operating at that level.

In addition, the changes being made are so wide ranging and numerous that this effort is limited to providing the reader with a "chunk" of information to give a general overview and theory behind the initiatives. Many of the details of how these programs will be implemented have not been finalized. However, by providing the reader with the essence of the programs, he/she should have some theoretical basis for future use as the details of these initiatives become operational.

This chapter assumes that the student has some training or experience in financial management or accounting. The reader is directed to the references to provide more detail and areas subject to changes are identified as appropriate.

D. LITERATURE REVIEW AND METHODOLOGY

Information for this thesis was obtained through two research methods: a review of DoD and Navy financial management directives, memorandum, instructions, and other pertinent literature; and field research.

1. Literature Review

A thorough review of available research was conducted to prepare a outline for the chapter. The review included major Navy financial management manuals, the most recent memorandums,

directives, and Defense Management Report Decisions (DMRDs) in the applicable areas, and textbooks used in the Financial Management (837) curriculum at the Naval Postgraduate School.

2. Field Research

Field research included personal and telephone interviews with current Department of Defense and Navy field activity personnel. Invaluable information was provided through this method by receiving the latest information available and not yet found in manuals or instructions.

E. ORGANIZATION OF STUDY

Chapter II identifies the basis for many of the changes being made in financial management in the armed forces and the Navy. Chapter III is the chapter to the PCC book identifying the major changes developing in this field. Chapter IV provides conclusions and recommendations.

II. BACKGROUND FOR CHANGES IN FINANCIAL MANAGEMENT

Numerous changes are being made in the way that the Department of Defense conducts financial management. The reason for these changes are many and varied, but primarily they are the result of a considerable amount of legislation enacted by Congress to improve the federal financial management process. The Defense Department has become a leader in implementing recent legislation to institute the required reforms. This chapter will explain the general reasons for change in light of federal financial management initiatives such as Executive Order 12637 of April 1988 and the Chief Financial Officers Act of 1990. A discussion of specific reasons for change within the DoD will follow in addition to DoD goals and initiatives to implement the changes.

A. EXECUTIVE ORDER 12637

Executive Order 12637 was signed by the President April 27, 1988. Its purpose is to require the establishment of a government-wide program to improve the quality, timeliness, and efficiency of services provided by the Federal Government. This Order is related to the recognition in recent years that if an organization wishes to become more competitive and efficient, its performance must be rapidly and continuously improved. Approaches such as Total Quality Management which has evolved into Total Quality Leadership in the U. S. Navy are but one of the recent initiatives designed to spur an organization towards a more efficient and effective output. However, this alone may not be enough to bring about the needed changes in general and financial management. Consequently, the

Congress passed additional legislation that provided a framework and assigned responsibility for carrying out the required reforms with the passage of the Chief Financial Officers Act of 1990.

B. THE CHIEF FINANCIAL OFFICERS ACT OF 1990

1. Overview of the CFO Act.

The Chief Financial Officers (CFO) Act of 1990 was enacted into public law as the latest effort by the House of Representatives Committee on Government Operations to improve the general and financial management of the United States Federal Government. This act can be viewed as part of an ongoing effort by the Congress to strengthen financial management in the Federal Government. Previous reform initiatives include legislation such as the Inspector General Act, Prompt Payment Act, Federal Managers Financial Integrity Act, Competition in Contracting Act, Debt Collection Act, and Single Audit Act.

Hearings held by the Committee on Government Operations and several General Accounting Office (GAO) and Inspector General (IG) reports found that there was a dire need for financial management reform. General findings by Congress that helped precipitate the act included the following:

* Financial management functions of the Office of Management and Budget need to be significantly enhanced to provide overall direction and leadership in the development of a modern Federal financial management structure and associated systems.

* Billions of dollars are lost each year through fraud, waste, abuse, and mismanagement among the hundreds of programs in the

Federal Government.

* These losses could be significantly decreased by improved management, including improved central coordination of internal controls and financial accounting.

* The Federal Government is in great need of fundamental reform in financial management requirements and practices as financial management systems are obsolete and inefficient, and do not provide complete, consistent, reliable, and timely information.

* Current financial reporting practices of the Federal Government do not accurately disclose the current and probable future cost of operating and investment decisions, including the future need for cash or other resources, do not permit adequate comparison of actual costs among executive agencies, and do not provide the timely information required for efficient management of programs.

[Ref. 1: Section 102]

The causes of these problems are numerous, but the CFO Act is designed to get at the root of these problems and provide a framework to implement the needed changes. Before discussing the specifics of the CFO Act, however, it is necessary to define what the government includes as financial management.

2. Federal Financial Management Defined.

The Office of Management and Budget has defined Federal financial management to include the following:

- * Cash and credit management
- * Internal controls against fraud, waste and abuse
- * Budget and financial systems, which encompasses:

Budget formulation and execution; Financial management information and systems; Program and administrative accounting, personnel, payroll, grants, cash, credit, property and asset management.

* Financial management organization

The OMB is tasked with monitoring of fiscal obligations within the federal government equal to annual expenditures of approximately one-fourth of the Gross National Product. The scope of this responsibility is huge. For instance, they watch over a cash flow of \$2 trillion, 900 million payments per year, five million civilian and military personnel, 1,962 separate budget accounts and 253 separate financial management systems.

3. Implementation of the Chief Financial Officers Act.

The goals of the Congress with the CFO Act are to strengthen the general and financial management practices of the federal government in order to make government operations more efficient. The Act establishes a centralized financial management structure within the Office of Management and Budget and in major departments and agencies. This structure is headed by a new Deputy Director for Management who is also designated as the Chief Financial Officer of the United States Government.

This act also creates an Office of Federal Financial Management within OMB. This Office of Federal Financial Management under the direction and control of the Deputy Director for Management of the OMB, known as the Controller, shall carry out the financial management functions designated in the CFO Act. The CFO

and the Controller will have an organization of CFOs under them located in the fourteen departments and nine major agencies of the executive branch including the Department of Defense. The Chief Financial Officer in each agency of the Federal Government reports directly to the head of the agency regarding financial management matters and oversees all financial management activities related to the programs and operations of the agency. The Chief Financial Officer's duties will include development of an integrated accounting and financial management system that provides information prepared on a uniform basis and which is responsive to financial information needs of management. In addition, the system must provide timely and reliable cost information and a systematic measurement of performance.

Agency Chief Financial Officers are to be appointed by the President or designated by agency heads, as required by law, and must possess demonstrated knowledge, ability, and extensive practical experience in the financial management practices in large business or governmental entities. In the case of the DoD, Mr. Sean O'Keefe, the DoD Controller was appointed the DoD's Chief Financial Officer on January 7, 1991.

The focus of the Act is to establish these Chief Financial Officers within each agency of the Federal Government. By doing so, the Congress places the responsibility for making the necessary changes squarely on the CFO's shoulders. To guide the CFO in his requirements, the Act establishes policies designed to enhance financial management internal controls by mandating the following:

* The preparation of five year financial management systems improvement plans both government-wide and in all 23 agencies covered under this act.

* The preparation of financial statements and audits of agencies to hold agency heads accountable for their operations.

* Annual reporting to the President and Congress on the status of general and financial management in the Federal Government.

In addition, as a result of the Act the Federal Accounting Standards Advisory Board (FASAB) was established by the Secretary of the Treasury, the Office of Management and Budget, and the General Accounting Office. The mission of the FASAB is to consider and recommend accounting standards and principles for the Federal Government. Membership on the board includes government personnel and non-government representatives from the general financial community. To date, the board has provided recommended accounting guidance to federal agencies through exposure drafts and other communications.

C. DEPARTMENT OF DEFENSE INITIATIVES.

1. Reasons for change

The Defense Department recognized the need to revitalize the DoD financial management infrastructure and has become a leader in implementing the provisions of Executive Order 12637 and the Chief Financial Officers Act.

Some specific factors that have furthered the DoD effort to become more efficient include:

* The Congressional desire for the Department of Defense to use

mission budgeting.

* General Accounting Office criticism of the DoD financial systems and a strong desire for capital budgeting to be instituted within the Department.

* The Office of Management and Budget push for establishment of business type accounting systems.

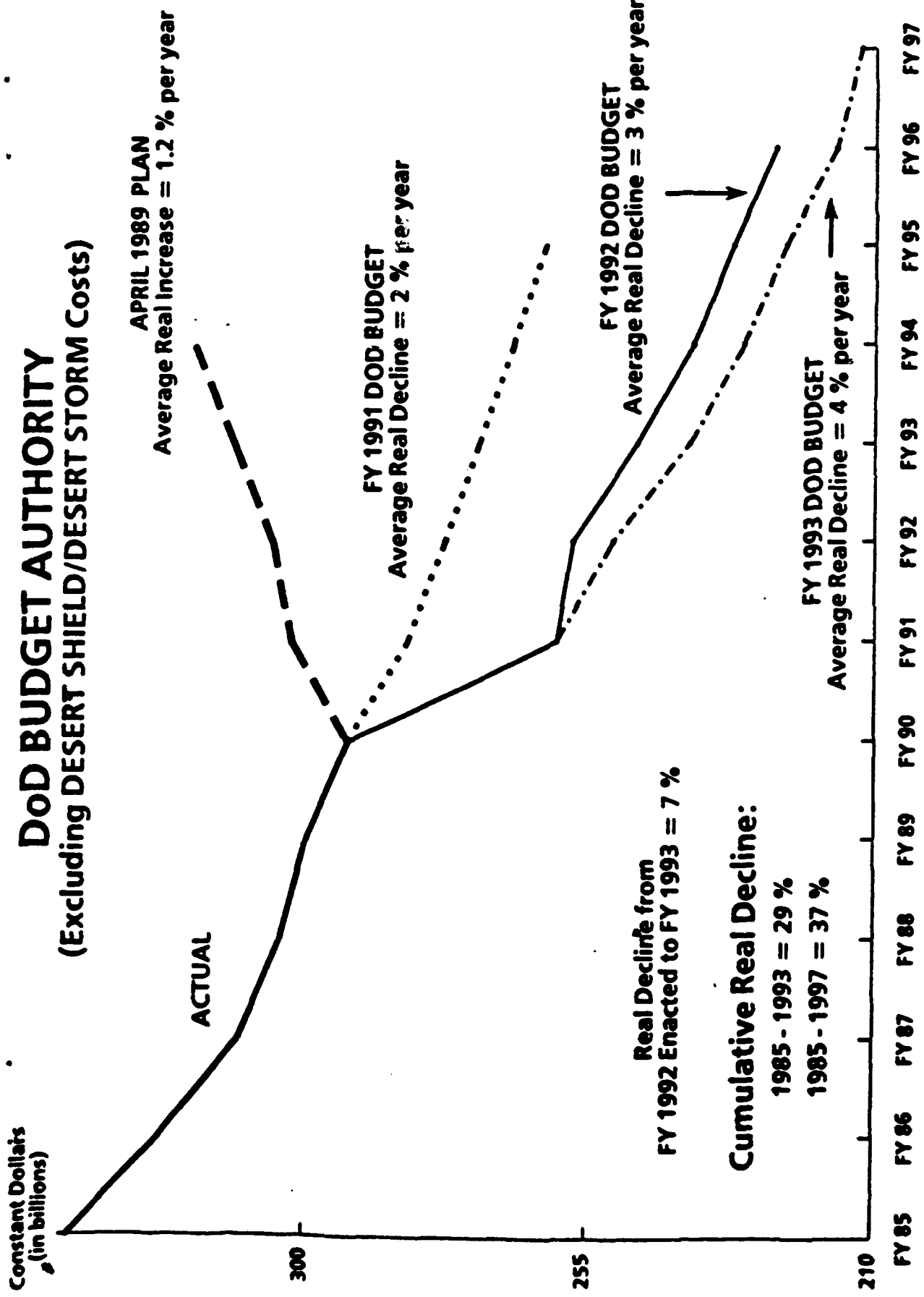
* The Department of Defense is in a period of declining resources. Significant changes in international power structures and a U.S. economy that is only just now emerging from a long recession has put tremendous pressure on the Department of Defense to find ways to cut costs. An example of the severity of the resource decline is illustrated on the following page regarding the DoD Budget Authority. Study of this chart reveals that the decrease in budget authority in constant dollars will be in excess of \$100 billion from 1985 to 1997 which translates to a real decline of 37 percent.

* A fallout of this resource decline is the need to associate the support costs of the DoD to the mission. Approximately fifty percent of Operations and Maintenance (O&M) and Military Personnel (MilPers) costs are not identified to the operating forces that they support. In addition, cost model allocations are not used in the budget execution phase or in many other budget decisions. The result of this is an inadequate flow of cost data to the users of the information.

2. Activity-Based Costing

Related to this increased awareness of the need to become

DOD BUDGET AUTHORITY (Excluding DESERT SHIELD/DESERT STORM COSTS)



more efficient and effective is the emergence of a concept called Activity-Based Costing or ABC. The following discussion of Activity-Based Costing relates the principles of ABC to the changes happening in the DoD such as the Unit Cost Resourcing concept. ABC is an approach for understanding cost behavior in terms of human and other actions that cause costs to occur [Ref 2: p. 102]. ABC has been effectively implemented in many organizations in the private sector, however, it can be designed to fit any organization that incurs costs to meet objectives in the public sector as well.

The basic concept of ABC is:

- * All activities in an organization cause costs, and
- * All activities are incurred to create products (in a manufacturing firm) or to deliver services (in a service organization): therefore,
- * All costs are product or service costs. [Ref. 3: p. 23]

The notion of Activity-Based Costing is that activities within an organization are viewed on a macro scale rather than being confined to a specific branch or division of the organization. The result is that for each of the activities, causes of costs or cost drivers are discovered and related to the output of the organization, i.e. the products and services.

Traditional cost accounting systems identify costs incurred by responsibility centers and then allocate these costs to the products or services utilizing some allocation basis such as direct labor hours or machine hours. In the government case, these costs are generally related to some organizational element where the

focus is on some function or purpose rather than related to products or services.

ABC on the other hand simply states that the costs of organizational activities is a function of the usage of the activities utilized to create the product or service. This change has evolved as a result of managers realizing that the more traditional cost accounting systems were not providing the necessary relevant information to make good decisions and control costs. ABC requires an intensive and constant review of all the costs of an organization and as a result is intended to provide a much clearer picture about the costs associated with an entity's activities. Visibility of costs is a key objective of ABC.

In environments where costs of products or services are required, the Activity-Based Costing approach should prove to be successful in the public sector. An example of this is the industrial fund and the stock fund that have been incorporated into the Defense Business Operations Fund. ABC can provide more accurate cost information for funding and pricing decisions in this environment.

The concept of ABC can probably be applied most effectively to a public entity's internal cost structure. Efficiency and effectiveness improves as a result of the analysis of an organization and its activities. The value that an activity adds to a product or service is analyzed and evaluated and is directly related to Total Quality Management concepts that are being implemented within the DoD.

The concepts behind Activity-Based Costing help to explain the rationale for the new initiatives in the DoD in financial management. Unit Cost Resourcing (UCR) is a derivative of ABC where the focus is on the total cost of an entity and relating these costs to the product or services. Like ABC, UCR is customer based. The key to the process is to look at each activity from a customer perspective and eliminate those steps that do not add value or user satisfaction to the end product. Where the activity does not add value, it must be eliminated to improve the performance of the organization [Ref 3: p. 27]. Thus, the costs of an entity are ultimately linked to the output and the organization can then seek the lowest possible cost while still providing a quality output.

This is precisely in line with the stated objectives of the DoD Comptroller to streamline department operations, cut costs without cutting capability and to cut overhead. This objective translates into the same or better support at a reduced cost while reducing the amount of program reductions to the force structure and procurement of weapons systems.

3. Summary

Executive Order 12637, The Chief Financial Officers Act, and Dod initiatives in financial management bring together many of the principles and elements needed to reform financial management. First, it assigns accountability and responsibility for reform. Second, it puts a powerful structure in place to implement the reforms, and third, it requires financial management plans and

annual reports on progress.

Indeed, these initiatives represent major steps forward in improving the quality and performance of the Department of Defense in financial management. However, the greatest challenge is the monumental task of implementing these initiatives to meet the goals of improved financial management and accountability. Chapter III discusses the DoD initiatives designed to implement these changes and improve DoD performance.

III. NEW DEVELOPMENTS IN FINANCIAL MANAGEMENT
IN THE ARMED FORCES

This chapter will explain the operation of the Defense Business Operations Fund (DBOF) as envisioned by OSD and provide an explanation of the tools that will be used to carry out the change. Examples of these tools are initiatives in Unit Cost Resourcing (UCR), Capital Budgeting, and Corporate Information Management (CIM). The chapter will also discuss the changes in Financial Management education and training.

A. THE DEFENSE BUSINESS OPERATIONS FUND

1. History of the Defense Business Operations Fund

The Defense Business Operations Fund was established on October 1, 1991, by the Department of Defense to expand the use of businesslike financial management practices throughout the DoD. The Fund operates with financial principles that provide improved cost visibility and accountability to enhance business management and improve the decision making process. The Fund is based on revolving-fund principles formerly used by industrial and commercial-type activities.

The primary objective of this initiative is to produce a management structure that provides incentives to managers and employees of the DoD businesslike organizations to provide products and services at the lowest cost. By increasing cost visibility, managers will be better able to make informed decisions. The emphasis of the Fund is on increased awareness of providing quality services and realizing significant monetary savings through

better business practices. Reduced costs will mean that the DoD will be able to accomplish its mission more effectively within the available resource constraints.

The goal of the Fund is to provide support to the customer and supplier relationship through improved information flow between the operating and support forces. Improved customer service at reduced cost is the focus.

The Defense Business Operations Fund operates on the revolving fund concept. This concept was first put to use in the DoD in 1951. In FY 1992, industrial funds and stock funds - two types of revolving funds - were moved into the Defense Business Operations Fund. The industrial fund activities included the following: shipyards, ordnance plants, printing plants, repair and overhaul facilities, traffic management and terminal services, research and development activities, real property maintenance services and airlift and sealift transportation. Types of material provided under stock funds included: clothing, medical supplies, fuels, subsistence supplies, construction supplies, electronic supplies, ordnance repair parts, aircraft and missile parts, tank and automotive supplies, and general retail supplies.

2. Overview of the Defense Business Operations Fund Concept

The Fund is composed of the business areas that were incorporated with the industrial and stock funds and some further Defense Agency functions that can utilize the business management approach. The operation of the Fund is being evaluated, therefore, no new activities will be included in the Fund prior to FY 1994.

The business areas incorporated in the Fund already are:

Supply Management (A, N, AF, DA)

Distribution Depots (A, N, AF, DA)

Depot Maintenance (A, N, AF)

Base Support (N, AF)

Transportation (A, N, AF)

Research and Development Activities (N)

Printing and Publication Services (N)

Information Services (N, DA)

Defense Commissary Agency (DA)

Defense Clothing Factory (DA)

Defense Finance and Accounting Service (DA)

Defense Technological Information Center (DA)

Defense Reutilization and Marketing Service (DA)

Defense Industrial Plant Equipment Center (DA)

(Legend: "A" = Army, "N" = Navy, "AF" = Air Force, "DA" = Defense Agency)

Future expansion of fund activities and addition of new support activities is under review. However, no additional business activities will be added in fiscal years 1992 or 1993 at the request of Congress and the General Accounting Office.

The essence of the Defense Business Operations Fund is to combine existing commercial and business operations into a single revolving, or business management fund. Previous organizational reporting structures and command authority relationships are not changed with its implementation, but business activities are

consolidated under a single Treasury code. Cash management is also consolidated, however, functional and cost management accountability will remain with the various service departments and agencies. Prices for goods and services within the individual business areas will be set by each component on a break-even basis. Price adjustments in subsequent years will be made to allow for profits and losses in previous years.

For those operations previously managed as industrial and stock funds, the establishment of the Fund has no organizational impact. For those who have been managed as appropriated fund accounts, though, the change to a customer/provider relationship with financial system adjustments to match business functions, will require major adjustments. The Department of Defense does not expect managers to adapt to these changes overnight, but this is seen as part of the Department's move toward total quality management. Customers will be in the position of controlling funding over requirements for products and services. The expected result is that the provider will be more aware of the customer needs and better able to control costs, thus, improving customer support.

In addition to this greater customer awareness, financial procedures of the Fund will provide managers with greater flexibility and management discretion. Each business component will have an operating and a capital budget. This breakout of capital investments and operating costs provides management with increased visibility and identification of operating costs at all

management levels. Total costs of each business area will also be available and, if possible, unit cost resourcing goals will be supplied for the primary outputs of the business area.

The amount of orders by the customer will determine the resources used by each component. Each manager is expected to hold costs within the product of approved cost goals times the customer determined work load. As a result, managers will be better able to make trade-off decisions that provide the best operating results for their area rather than being driven by restrictions between cost elements that may have resulted in inefficient decisions in the past.

3. Defense Business Operations Fund Policy and Procedures

a. Existing Policy and Guidance

A Defense Business Operations Fund Policies Board has been established to ensure involvement in Fund management from the Military services and Defense agencies. Chairman of the Board is the responsibility of the Principal Deputy Comptroller of DoD. The Board is used as a forum for information exchange on problems and experiences and as an avenue for policy and procedure proposal review. It is also used for making recommendations prior to final policy decisions.

Financial policies of the Fund are established by the DoD Comptroller. Policies that were in place for industrial and stock funds were adopted for the Defense Business Operations Fund. Additional interim policy guidance was provided in DoD Comptroller memoranda dated August 19 and September 27, 1991.

As new policies and procedures are developed, DoD regulatory documents requiring revision will be addressed in DoD Policy Memorandums. Documents currently under revision include: (1) DOD 7420.13-R, "Stock Fund Operations", (2) DOD Instruction 7420.12, "Billing, Collection and Accounting for Sales of Material from Supply System Stock", (3) DOD 7220.9-M, "DoD Accounting Manual", and (4) DOD 7110-1M, "DoD Budget Guidance Manual."

Standardized policies for all business components will be promulgated through interim policy memoranda, which will then be incorporated into regulatory documents.

b. Implementation of Policies and Procedures

Several management, accounting, policy, and procedural changes have already been implemented that modify operations of the adopted policies of the stock and industrial funds. These changes include:

1. Execution Budgets for Activities Previously Industrially Funded. Prior to fiscal year 1992, industrial fund activities were not issued any funding document. Rather, they received obligational authority from customer orders. With the adoption of the Fund, official management cost goals have been disseminated to the various Services and agencies through "operating budgets." However, customer orders still remain as the basis for any costs incurred by these activities. Because there are different types of cost objectives possible for individual activities, the various components are now in the process of assigning goals.

2. Unit Cost Budgets for New Revolving Fund Activities. For fiscal year 1992, the Defense Finance and Accounting Service, Defense Technical Information Center, Defense Reutilization and Marketing Service, Defense Industrial Plant Equipment Center, and the Defense Commissary Agency were included in the Fund. In the past, these areas were funded with a fixed amount depending upon work load estimates. Future funding is now based upon costs of the actual work load performed.

3. Real Property Maintenance (RPM) Funding Procedures. Beginning with the fiscal year 1993 budget, actual RPM projects will be funded in a separate section of the budget. Procedures have been disseminated which will require RPM costs to be expensed to a prepaid reserve account. The objective of this procedure is to avoid large deviations in operating costs and prices, and to make actual RPM costs more visible to management.

4. Minor Construction Funding Procedures. In the past minor construction projects have been treated as operating costs. New policies are being put into place for projects with a cost of greater than \$15,000 to be funded through the capital budget and depreciated.

5. Funding of Central Design Activities and Other Software Acquisitions. Policy changes have been issued that require that costs for the development of new software be treated as investments and not as operating costs. As a result, costs of software releases will be moved to the capital budget and depreciated once they are put into operation. This change is

expected to be instituted with the fiscal year 1993 budget submission.

6. Capital Budgeting. A major initiative included in the Fund is for the addition of capital budgeting. The policy requires that budgets be separated into an operating budget and a capital budget. Investment expenses related to equipment, computer software, minor construction, and other improvements costing over \$15,000 will be funded with the capital budget. Qualifying assets installed on October 1, 1991 and later will be accumulated in the new unit cost accounts. These assets will then be amortized or depreciated over a set period. Asset useful lives for depreciation and amortization purposes have not been finalized, however, the straight line method was expected to be used. Examples of intangible assets include management initiatives, organization of new functions and reorganization of old functions. At the time of this writing, many of the issues concerning capital budgeting were under development.

7. Mobilization and Surge Costs. A proposed change to the pricing policy for fiscal year 1993 is to separately fund costs related to mobilization and surge capacity for war-time requirements. The prices of the outputs will reflect peacetime operating costs only. Customers of the funds will pay for the items they procure. The goal is to give managers a better awareness of the surge and readiness requirements. Funding for these costs will be through direct appropriations.

8. Military Personnel Costs. In order to ensure that

the total costs of a business were being included, military personnel costs were added to revolving funds starting in fiscal year 1991. Military personnel costs included in the Defense Business Operations Fund are reimbursed to the Military Personnel appropriations account, and the budget request for those appropriations is reduced accordingly. For military personnel billets that are required only to provide mobilization capability, sea/shore rotation flexibility or for career progression, only the equivalent civilian costs will be reimbursed to the military personnel account. Any costs over this civilian equivalent cost will be funded in the Military Personnel appropriations. The rationale for this policy is that some positions could be staffed with civilians at a lower cost were it not for the requirements listed above. As before, this will make costs more visible to the appropriate managers by separately identifying the reasons that military personnel are assigned. This policy is still under consideration with the process in development with the Policy Board. Implementation is projected for fiscal year 1994. The various components will be required to identify which billets will be funded at the civilian equivalent costs.

9. Ownership and accountability of assets. Industrial and stock fund assets were transferred to the Defense Business Operations Fund at its inception. Asset accountability is governed by the present DoD regulations regarding industrial and stock funds. Any capital assets utilized by the Fund activities will be amortized or depreciated per generally accepted accounting

standards. A Capital Asset Working Group was established by the DoD for management policy and procedure review of the Fund capital assets. Draft copies of their report with their review of required changes was required to be submitted to GAO representatives by 31 January 1992. The new issuance will provide detailed guidance and procedures regarding the acquisition, transfer, sale, depreciation, and amortization of Defense Business Operations Fund capital assets. DoD comptroller memorandum will promulgate the new guidance which will be incorporated into the DoD Accounting manual at a later date.

10. Full cost recovery. A long standing policy within the Department of Defense has been that certain business functions will establish prices based upon a break-even basis. In the past, stock and industrial fund operations were anticipated to break-even on a long term basis. However, previous year operations have not always resulted in this and substantial losses have been carried on the financial records for long periods. The policy of the Fund is to assert again that activities will budget on a break-even basis. Thus, prices in future year budgets will reflect the results of prior year gains or losses. The objective is full recovery of costs by the end of the budget year. The prices and rates established at the beginning of the year will be fixed for the entire year.

This establishment of rates based upon costs is expected to give the individual program managers and customers the guidance they require to make cost effective program decisions.

Examples of the kinds of decisions could include choosing from alternative goods or services, or choosing alternative sources of these goods or services. Another alternative available to the manager could be to repair or replace an item. Again, this cost visibility to management is expected to focus more emphasis on the total costs of doing business. If customers are free to search out the low cost producers, then the end result should be that prices charged will be reduced and the cost of operating forces will be reduced.

c. Policy and Procedures Being Developed.

The previous section discussed policies and procedures already implemented. Additionally, numerous other improvements are being studied for implementation. These areas are listed below and briefly discussed. The improvements are primarily being developed by OSD, Service, and Agency personnel. Task descriptions and development milestones are itemized below. All of these tasks are being developed in consonance with GAO coordination and participation. The information provided below is current as of this writing, however, the reader should be aware that changes could result upon further review.

1. Intrafund Transactions 28 February 1992

Purchases and sales of goods and services between business areas with the Defense Business Operations Fund will be recorded as expenses of the customer and revenue by the provider of those goods and services. This will occur without the exchange of cash or the recording of obligations normally associated with such

a transaction. At this writing specific procedures were not available with respect to the individual business relationships between the Fund activities. Thus, entities are still required to transact business on an obligation/payment basis until these procedures are developed.

2. Common Costs

31 March 1992

The Fund has several common costs incurred on a regular basis by its several business areas or activities that could be paid in a consolidated method. These costs will be collected and paid at the corporate level. An example of a common cost is the Military Personnel appropriation reimbursement for the cost of military personnel assigned to the various Fund activities. This does not change the nature of the cost of the business or the expenses recorded, but is a system being developed to streamline the payment system. Until procedures are developed for individual categories of cost, obligations and payments will continue to be made at the local or component/business area level.

3. Cash Management

30 April 1992

Previous policy has been that cash management was done at the individual business activity level. The DoD Comptroller now has responsibility for total cash management. This initiative will allow each business area more time to concentrate on the management of total cost. Additionally, it will result in the creation of separate general ledger accounts to identify cash balances related to capital, operations, real property maintenance and other management interest items. Cash impact reports by each

business entity are also under development.

4. Mobilization Requirements 30 April 1992

The Fund activities costs that pertain to maintaining a capacity for mobilization requirements, including war reserve material costs, are to be funded from direct appropriations to the Fund. This initiative will provide more detailed guidance and definitions, as well as detailed accounting procedures for identification of these costs.

5. Budget Authority 30 April 1992

Funding documents now being issued will provide management cost goals to the various business areas previously in the industrial fund. In addition, capital budgets will also be provided to the Fund activities. This initiative is intended to document the process.

d. Financial Reporting

All DoD organizations that previously used industrial and stock funds will prepare financial reports and statements. Additionally, the Defense Finance and Accounting Service (DFAS), the Defense Commissary Agency, the Defense Technical Information Center, and two Defense Logistics Agency functions (the Defense Reutilization and Marketing Service, and the Defense Industrial Plant Equipment Center) will prepare individual financial reports and statements.

Responsibility for consolidating financial statements for the DBOF, in addition to evaluating systems for reporting under the Federal Managers' Financial Integrity Act has been assigned to

DFAS. Financial statements for the Fund will be prepared at the close of the 1992 fiscal year. The DoD Inspector General will perform its financial audit of the Fund financial statements for fiscal year 1992 according to the guidance found in the Chief Financial Officer's Act of 1990 and in conformance with the DoD Inspector General Audit plan. [Ref. 4: p. 67]

4. Cost and Performance Measurement

The goal of reducing cost in the Fund cannot be accomplished unless managers have a clear understanding of the goals through consistent and reliable cost measurement tools. A significant number of activities have established cost per output measures. This subject will be discussed in more detail in the section on unit cost resourcing.

In addition to cost measurements, the DoD long range plan specifies that performance and quality goals be incorporated into the operating budgets as a single business plan. Until this long range development plan is completed, performance measurements will remain as they have in the past. Familiar indicators now utilized include interest paid, discounts lost, outstanding backorders, supply requisition fill ratios, and depot maintenance funded backlog.

B. UNIT COST RESOURCING

1. Background and Implementation of Unit Cost Resourcing

The Principal Deputy Comptroller of the Department of Defense issued a memorandum dated August 10, 1989, advising the Services and the Defense Agencies that a DoD-wide cost per output

or unit cost resourcing system was being developed. This new system would apply to several major functional or business areas to further the effort to enhance the visibility of costs and manage resources more effectively. The justification for unit cost resourcing was established with the signing in 1988 of Presidential Directive 12637. This directed all federal agencies to improve efficiency by aligning costs to outputs and establishing productivity goals. Additionally, the DoD recognized the need to reduce the support budget because the inefficiencies in the support system are detracting from the budget for force structure. A further argument advanced by unit cost resourcing proponents is that O&M funding is separately justified from funding for forces. A consequence of this is an implied imbalance between resource requirements and resource allocation. Thus, it is proposed that unit cost resourcing can fix this imbalance by linking support costs to outputs. An example of this might be base support functions. With unit cost resourcing, base support customers would pay for some desired level of support output consistent with their force structure.

Unit cost resourcing is not a new concept to the Department of Defense. In fact, it has been in place in the revolving funds for some time. However, what is new is the OSD goal to apply unit costing to all support functions. Consequently, if unit cost resourcing is fully implemented, it has potential impact on financial management throughout the DoD due to the new focus on "customers" and the goods and services they purchase from the

various support functions.

A later Department of the Navy, Office of the Comptroller memorandum dated August 30, 1989 discussed the financial management system in light of this initiative. This system is intended to be utilized to make resource decisions, during both budget formulation and execution, for support functions which are common throughout DoD. The objectives are to eliminate management inconsistencies, tie resource decisions to output, and foster a cost reduction culture. [Ref. 5: p. 17]

Unit cost resourcing has been in place in the Defense Logistics Agency (DLA) for some time, thus, DLA was selected as the prototype organization for implementation.

The Defense Manpower Data Center (DMDC) located in Monterey, California is a management information support group to the Office of the Assistant Secretary of Defense (Force Management and Personnel). The DMDC at the direction of the Department of Defense Comptroller is responsible for the development of a financial management system based on total cost per output for major functional areas of the DoD. The DMDC support of the unit cost resourcing initiative is basically threefold. The DoD has tasked DMDC with:

- * developing the financial information data base at the installation level for all appropriations. This includes the detail on the total cost of operations.

- * developing cost models in functional areas and collecting workload information.

* developing the unit cost reporting system. This system will provide the data to develop budgets and monitor budget execution.

The progress and status of the unit cost resourcing initiative has been as follows:

* Supply depots and Inventory Control Point operations were implemented on 1 October 1991.

* Training, Recruiting, Medical, and the Commissaries were implemented in fiscal year 1992.

* Base operations and General and Administrative costs were reimbursable in fiscal year 1992. Data by individual installations is currently being developed.

2. Unit Cost Resourcing Definitions

Financial terminology within different organizations has different meanings. In order to understand the Unit Cost Resourcing concept, it is necessary to establish consistent usage of key terms. The following paragraphs describe terms as used in the unit cost resourcing system. These definitions were taken from the DMDC guide to unit cost resourcing. [Ref. 6: Section 1.2]

* Activity - A Unit Cost Activity is a major functional area identified by the OSD Comptroller as a target area for cost per output implementation. For the Fiscal Year 1991, these were DoD Supply Depots and DoD Supply Operations (Inventory Control Points (ICPs)). Fiscal Year 1992 targeted functional areas include Military Training, Medical Care, Defense Finance and Accounting Agency, and Recruiting. These are consistent with Budget Activity areas as shown in the President's Budget under both Stock Fund and

Operations and Maintenance Budget Appropriations. The term Unit Cost Activity was chosen to relate to a Budget Activity.

* Output - The term Unit Cost Output is based on the concept that each cost incurred in a Unit Cost Activity will find its way into some Output measure. The goal is to have each product or service bear as accurate a cost as possible so that as workload fluctuates, the revenue and costs will remain in balance. Outputs are subcategorized into two groups: primary Outputs and other Outputs.

A primary Output reflects the primary mission of a Unit Cost Activity. This is determined by answering the question, what is the main thing this organization does? It is important to have as few primary Outputs identified as possible to avoid fragmenting the organization and defeating the purpose of managing total costs. Primary Outputs are referred to as (A) goals in the Unit Cost Budget.

Other Outputs reflect tasks performed other than those identified as primary outputs. These other output costs must be identified to ensure that all costs are being captured. Outputs that have no workload measure, or outputs that do not relate to the primary output measure are considered other outputs. Outputs that consume resources at a significantly different rate than the primary Output can be identified as other outputs. Other outputs may be expressed in a cost per unit basis, on a reimbursable basis, or up to the amount reimbursed, or up to a preset budget ceiling referred to in the Unit Cost budget as a (B) goal.

* Categories of Cost - Business expenses are generally divided

into three categories of cost: direct, indirect, and general and administrative (G&A). Indirect costs are difficult to define. Since the Defense Manpower Data Center (DMDC) is using existing accounting systems, Unit Cost definitions must be flexible in order to be consistent with the service or agency definitions as well as the DoD unit cost definitions. These cost definitions apply to both labor and non-labor costs:

a. Direct Costs. These costs are clearly identified to a product or output and are incurred 100% by the function that produces the output, such as hands-on labor or material used in the product.

b. Indirect costs. Where a service or agency accounting system charges indirect costs and they are clearly identified in that system, DMDC will record those costs as indirect and add them to the indirect costs or allocated indirect costs calculated by DMDC. Allocated indirect costs are those mission costs which cannot be identified to a single output. These costs are allocated over a select number of outputs.

c. General and Administrative costs. These costs cannot be reasonably associated with any group of outputs, but are allocated over all outputs. G&A costs usually include such functions as local command and control personnel, comptroller, installation security, facilities engineering, custodial services, entomology services, or other common support functions provided as part of the base operations.

* Military Costs - Military costs are always included based on

173 hours per month and based on composite military rates multiplied times the average assigned military strength. Some DoD financial systems include military costs directly charged to a specific output; others do not. When military costs are absent from the accounting tapes, but military personnel are assigned to a Unit Cost Activity, with OSD direction, DMDC can compute military costs based on the guidance in DoD 7220.9-M, chapter 26 of the DoD accounting manual. They will appear in the Unit Cost computation defined as military costs, direct, indirect or G&A and treated the same as civilian labor. (Ref. 6: Section 1.2.4)

3. Unit Cost Resourcing Concepts

The unit cost resourcing initiative goal is to achieve reduced costs and increased productivity by providing visibility of costs and a focus on the mission. The concept is viewed as a tool to be applied to activities within the DoD to address the total cost of a function. By analyzing data for individual units of cost within an entity, the total cost of operations can be affected and reductions can be correctly implemented.

Unit cost resourcing is based upon the concept that the cost of an activity is related to its primary output(s). All of an activity's costs are allocated to these primary output(s) through the cost accounting system. From this information, the activity can establish a unit cost per the selected output. Future budgets will be determined by applying this unit cost allocation to future output levels. Thus, a unit cost for an entity will be determined at a fixed level of output and applied to a future output level.

This future output level, whether expressed as budget or workload, may or may not be the same as in previous years.

Unit cost resourcing treats all costs as variable with no distinction made between the fixed and variable portions of these costs. As output levels change, unitized fixed costs over this new level of output will change. For example, decreasing output will increase unit fixed costs while increasing output will decrease unit fixed costs. Managers should be aware of the level of fixed costs within their activity, because the percentage of fixed costs could have a large impact upon future funding levels. For instance, an activity with relatively large fixed costs would generally receive excess funding as output increased, however, as output is decreased, that same activity may find it difficult to meet mission requirements when those large fixed costs are unitized over a smaller output. Likewise, an activity with a relatively smaller portion of total costs being fixed, should not expect to see as much variation in funding levels. This is provided that the output is in some relevant range where variable costs are not changing significantly.

Another aspect of unit cost resourcing is that individual activity's budgets will be charged for depreciation, or capital consumption, under the capital budgeting concept. The goal of this initiative is to promote effective employment of resources such as high cost capital assets.

Managers should, therefore, exercise due care in making decisions to reallocate resources. Information regarding the fixed

and variable cost components must be available and managers need to be aware of the implications of their decision making. Without the appropriate information available, decisions could be made that could lead to higher rather than lower total program costs. The ultimate objective of unit cost resourcing is achievement of economic efficiency through minimizing total program costs. Every dollar spent on support capability is one less dollar available for operating forces. In an environment of declining resources, managerial efficiency will be an important factor in how resources are allocated in a unit cost resourcing system.

C. CORPORATE INFORMATION MANAGEMENT

1. The Corporate Information Management Initiative

On October 4, 1989, the Department of Defense initiated by memorandum the Corporate Information Management (CIM) initiative. This memorandum expressed the need to improve the standardization, quality, and consistency of data from DoD's multiple management information systems. Achieving greater effectiveness with information management is a high priority within the DoD.

A method of realizing more effectiveness is to eliminate unnecessary redundancy by establishing common data requirements and common formats. This approach is designed to reduce the expenditure of resources maintaining multiple systems that are providing information to meet the same functional requirements. This appears to be another program to centralize an area with the ultimate goal of reducing the cost of support operations.

This memorandum established an executive level group (ELG) to study the problem and provide necessary corrective measures. This group consisting of outside experts and DoD officials was tasked with the following actions:

- * recommend an overall approach and action plan to enhance the availability and standardization of information in common areas through a Corporate Information Management program for the DoD;

- * review the procedures of functional groups described below and, as needed, the products of the groups, including information requirements and data formats;

- * review the processes and procedures used for overseeing the

development of new information systems and software in DoD; and, where applicable,

* recommend corrective actions.

In addition, the Information Resources Management staff was tasked with drafting a management plan for developing integrated information management systems. Functional groups were established in technical areas and common business areas to support the executive level group by reviewing information requirements of the OSD, Services, and Defense Agencies for compatibility and redundancy within each area. Their primary task is to develop uniform and consistent information requirements and data formats within each functional area.

As an interim measure, the Major Automated Information System Review Council (MAISRC) was established as a committee of the Defense Acquisition Board (DAB). This committee is responsible for reviewing all automated information systems and telecommunications programs prior to DAB meetings.

On September 11, 1990, the Executive Level Group for Defense Corporate Information Management submitted their draft plan to the Department of Defense. The plan was subsequently endorsed by the Secretary of Defense on November 16, 1990 as the guide for implementation of corporate information management principles. The DoD objective is to centralize policies while maintaining decentralized system management. The various DoD components will maintain responsibility for the operation of data processing centers. Responsibility for implementing corporate information

management throughout the DoD was assigned to the Assistant Secretary of Defense for Command, Control, Communications and Intelligence.

The effort to date in this area has been significant in identifying areas of potential consolidation and subsequent savings. Defense Management Report Decision number 924 addressed consolidating automated data processing design and operations in DoD. The alternatives in this report estimated savings from \$1.4 to \$1.7 billion for fiscal years 1991 to 1995. Results to date were not available at the time of this writing, however, the majority of the savings expected to be realized were in the latter years of the above period.

D. FINANCIAL MANAGEMENT EDUCATION AND TRAINING

1. Financial Management Education and Training initiatives

Sweeping changes in the Department of Defense financial management practices are necessitating changes in the financial management community workforce. As a result, the DoD Comptroller directed a top-to-bottom review of financial management education and training. Finding more efficient and more effective ways to accomplish training is the goal of the review. This section describes the actions and recommendations to date to accomplish this goal.

Like other areas of the Defense Department, the financial management workforce is becoming smaller and yet is tasked with managing significant changes in the methods of doing business. Implementation of the Defense Business Operations Fund along with the Unit Cost Resourcing and Corporate Information management initiatives are significantly changing the way support activities operate. A natural consequence of this is that the financial management education and training program must adapt to meet the challenge of providing quality training with limited resources. As with other support activities, training will see consolidations to achieve economies across the DoD.

In December 1990, Defense Management Report Decision number 985, Financial Management Education and Training, was approved by the DoD Comptroller. The purpose of this DMRD was to create a management structure to ensure that the education and training programs for members of the financial management community meet

their needs. This DMRD centralized oversight responsibility for this training with the DoD Comptroller. The Defense Resources Management Education Center (DRMEC), now called the Defense Resources Management Institute (DRMI), is to act as a consultative and review agent for this process. Staff responsibility for design, implementation, and operation of the new management structure lies with the Office of the DoD Comptroller.

The initial evaluations of the current financial management education and training program indicated a lack of standardization and duplication of course content and that the system relies upon traditional teaching systems. Centralizing of the management function and utilizing more cost effective instructional delivery systems can achieve some economies that are estimated to provide \$4 to \$5 million in savings over the FYDP period.

Several working groups and one permanent committee were created to review and recommend changes areas such as career fields and development, new and revised offerings required, curricula configuration control and quality assurance, independent study opportunities, conceptual and procedural issues related to reimbursability, and instructional technologies. [Ref. 7: p. 12]

The following year's DMRD 985 which was approved in December 1991 by the DoD Comptroller provided the following:

- * formalized the management structure for the total review and improvement effort

- * established a Defense Support Activity (DSA) called the Defense Resources Management Institute (DRMI) in accordance with DoD

Directive 5100.81, and

* provided for the expansion of innovative curriculum development methods and expands the use of technology in delivering instruction.

At the field level, personnel need to be aware of the functions of DRMI because it will be an integral part of this initiative. DRMI is located at the Naval Postgraduate School in Monterey, California. DRMI's role has been broadened considerably in support of financial management education and training. The DMRD 985 provides that the institute will perform the functions explained below: [Ref. 8: p. 2]

* DRMI will function as a clearinghouse for review of new financial management education and training course development proposals by the Services and Agencies. It would provide expertise on new curriculum development in the form of assuring that the proper functional experts are contacted for input and review of materials during development and production and would assure that new materials developed are widely publicized and disseminated. DRMI may also recommend development of new courses for consideration by the appropriate standing committee.

* DRMI would continue in the role of Executive Secretary to the standing committees as they are formed and become fully operational. DRMI would also serve on the Coordinating Board as it becomes operational. This would involve assisting the Standing Committees with preparation of recommendations on issues brought to the Coordinating Board and then later to the Financial Management

Steering Committee.

* DRMI would assume the function of the periodic production of the Catalog of Financial Management Education and Training and would coordinate the activities of the Training Performance Data Center and the Defense Activity for Nontraditional Educational Support in this effort.

* DRMI would encourage innovative curriculum development by creating and administering a program through which DoD institutions may apply for funding of projects. Cost of this program is estimated at \$500K annually.

The Superintendent of the Naval Postgraduate School would also act as the Director of the Defense Resource Management Institute. An implementing DoD directive was due to be issued by March 1992.

The future in financial management education and training will be dynamic as the environment and systems change. Obviously, a difficulty exists in that until systems and processes in the Defense Business Operations Fund, Unit Cost Resourcing, and Corporate Information Management are chosen and well defined, the institutions responsible for education and training must necessarily wait to develop curriculum and course material. Thus, a key to the success of this program is how well the education and training systems innovate to produce constructive change. Open and stimulating discussion is encouraged at all levels and field level personnel should make their needs known in a constructive manner to the education and training community to help effect this change.

IV. CONCLUSIONS AND RECOMMENDATIONS

The purpose of this thesis was to provide some background and reasons for change, in addition to providing information on the details of specific new directions in financial management. The realization was always there, however, that financial management is a dynamic environment in the armed forces. Numerous new initiatives are being implemented to align the DoD towards a more business-like and customer oriented atmosphere. Clearly the goal is to reduce costs and bring greater efficiency to the Department of Defense.

With an environment characterized by decreasing fiscal resources and changing rules and regulations, field level personnel must be kept abreast to the maximum extent possible of these changes. In light of this fact, this researcher recommends that the information provided here be reviewed and updated on an annual basis.

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