

NAVAL POSTGRADUATE SCHOOL
Monterey, California



THESIS

**STATE OF THE ART OF PROPRIETARY
FINANCIAL REPORTING IN THE DEPARTMENT
OF THE NAVY**

by

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December, 1996

Thesis Advisor:

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**STATE OF THE ART OF PROPRIETARY FINANCIAL REPORTING IN
THE DEPARTMENT OF THE NAVY**

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Submitted in partial fulfillment
of the requirements for the degree of

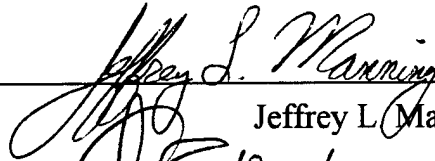
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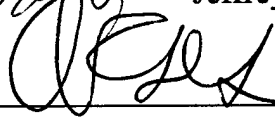
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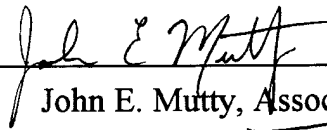


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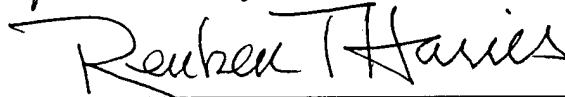
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ABSTRACT

With the enactment of the Chief Financial Officers (CFO) Act of 1990, the Department of the Navy (DON) is required to produce proprietary financial statements for fiscal year 1996 and beyond. Proprietary financial reporting focuses on the creation, management, and use of all resources (assets) of an organization, not just on expendable funds. This thesis provides a comprehensive overview of the state of the art of proprietary financial reporting in the DON. To address this issue, a review of the laws, policies and agencies which effect proprietary reporting was conducted, along with a comparison between Federal government and private sector financial reporting. An analysis of the form and content of the primary proprietary reports, the Statement of Financial Position and the Statement of Operations and Change in Net Position, and an analysis of the information systems, which are used to gather the data, was conducted. The DON is operating in a time of expanding requirements with limited resources. This review of proprietary financial reporting in the DON has shown that the statements required by the CFO Act can be produced. However, the deficiency of the information systems, which affect the accuracy of the data, combined with inadequate performance measurements, lessens the current value of the proprietary financial statements.

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I. INTRODUCTION

A. GENERAL

The Federal government is operating in a time of expanding requirements with limited resources. The Federal budget is divided into two categories, entitlements and discretionary authority. Entitlements are those payments that are insulated from the vagaries of the annual budget process. All entitlements have several common features: (1) eligible recipients have a legal right to payment from the government; (2) the size of the payments are determined by criteria, such as formulas, written into law; (3) the Federal government is obligated to make the mandated payment. A few entitlements are capped, their cost is limited, regardless of the number of eligible recipients. Most, however, are open-ended, so that the total expenditure is the sum of the mandated payment. Thus, total expenditure equals entitlement authority.

Discretionary authority, unlike entitlements, is subject to the annual budget process. Thereby, authorized and appropriated authority (Department of Defense funds) are under annual review. Thus, the amount authorized may not be exceeded by the total expenditure.

The budget situation is further complicated by the fact that elected Federal officials are continually unable to reduce and control the largest growing segment of the Federal budget, entitlements, because they can not agree on the

legislation. The only avenue available to provide any type of relief to the Nation's fiscal dilemma is to severely constrict discretionary spending. Thus, allocating resources effectively and efficiently is critical in determining the best use of available discretionary funds.

Primarily for the discretionary segment of the budget, the Chief Financial Officers Act of 1990 marks the beginning of what promises to be a new era, not only in Federal management and accountability, but also in efforts to gain financial control of government operations. The Chief Financial Officers Act introduces proprietary financial reporting into the entire Federal government.

B. OBJECTIVES OF THE RESEARCH

The main objective of this thesis is to answer the primary question "What is the state of the art of proprietary financial reporting in the Department of the Navy (DON)?"

Secondarily, the thesis will answer the following subsidiary questions:

- What is proprietary financial reporting as defined by the Federal government?
- What is the current environment of Federal government/DON proprietary financial reporting?
- What are the differences between Federal government/DON proprietary financial reporting and the private sector?
- Who evaluates proprietary financial reporting practices?

- What are the requirements of Federal government/DON proprietary financial reporting?
- What Federal government organizations are involved in proprietary financial reporting?
- What responsibilities does the DON have for proprietary financial reporting?
- What are the form and content of proprietary financial reports?
- What types of information systems support proprietary financial reporting in the DON, and are they adequate?

C. METHODOLOGY

The thesis will document the state of the art of proprietary financial practices in the DON. Data and material from the CFO Act of 1990 and General Accounting Office (GAO) reports, together with the Office of Financial Operations (FMO) for the Navy Comptroller, Headquarters Marine Corps and the Defense Finance and Accounting Service (DFAS) provided the primary sources for this study. Specifically, the primary sources for this study were: Ms. Barbara Hill, FMO CFO project coordinator; Major Pamela Miller, USMC Fiscal Division, RFL; Mr. Lou Ockunzzi, DFAS Cleveland; Mr. Jim DePodesto, DFAS Cleveland; Ms. Candice Maroney, DFAS Kansas City; and Mr. Robert L. Williams, GAO-DFA. Additional information was obtained through a review of current professional periodicals, journals, and news briefs. A

comprehensive compilation of this data provided the basis of the information needed to answer the research questions posed in the thesis.

D. ORGANIZATION OF THESIS

The first chapter of this thesis provides an introduction to the topic. The remaining chapters will address the primary research question as well as the subsidiary research questions.

Chapter II delves into the environment of financial management in the Federal government. The definition of proprietary financial reporting for the Federal government is derived, in this chapter.

Chapter III provides a comparison and contrast between the private sector and the Federal government on the issue of proprietary financial reporting. This chapter provides an in-depth explanation on significant differences between the two.

Chapter IV discusses the requirement for proprietary reporting in the DON. Specifically, the major laws and agencies responsible are reviewed.

Chapter V provides a view of the type of reports which will be submitted by the DON. The chapter further elaborates on the form and content, which differs somewhat from traditional private sector reports.

Chapter VI provides insight into the accounting information systems which the DON uses for proprietary

financial reporting. The chapter will address weaknesses which the DON must overcome in an effort to produce meaningful proprietary financial statements.

Finally, Chapter VII contains the summary, conclusions, and recommendations for further research.

II. PROPRIETARY FINANCIAL REPORTING DEFINED AND THE FEDERAL GOVERNMENT

I think it an object of great importance...to simplify our system of finance, and to bring it within the comprehension of every member of Congress...the whole system [has been] involved in impenetrable fog. There is a point...on which I should wish to keep my eye...a simplification of the form of accounts...so as to bring everything to a single centre[;] we might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them to investigate abuses, and consequently to control them.

Thomas Jefferson
April, 1802

A. OVERVIEW

As Thomas Jefferson so eloquently stated, the finances of the Union should be as clear as a merchant's books. Now, some 194 years later our Nation continues to wrestle with the same fundamental financial issues that our forefathers were concerned with. In this chapter a foundation will be provided to explain the current environment of financial management in the Federal government. I will also provide a working definition of proprietary financial reporting within the Federal government in order to develop a frame of reference for this thesis.

B. ENVIRONMENT OF FINANCIAL MANAGEMENT IN THE FEDERAL GOVERNMENT

To develop an appreciation for the environment in which the Federal government conducts its financial management

operations, we will slice it into three sections. First, the roles and responsibilities for both the legislative and the executive branches will be discussed. Secondly, we will examine the shrinking discretionary budget of the Federal government. Then finally, an examination of the state of Federal financial management will be conducted.

1. Roles and Responsibilities

To develop an understanding of the Federal government's concerns for its financial management, and in particular those of the Department of Defense, we must first discuss the fiscal responsibilities of the legislative and the executive branches.

The legislative branch, comprised of the Senate and the House of Representatives, has the responsibility of authorizing, appropriating, and monitoring the financial activities for DOD. Authorizing provides the legislative authority to establish or maintain a program or agency. Authorization acts define the scope of programs and authorize funding levels for programs either in terms of specific amounts or for "such funds as may be necessary" to implement the program [Ref. 1]. Authorization does not create budget authority. Appropriating provides budget authority to fund programs such as defense. Lastly, monitoring of the execution appropriated funds is conducted by the Congressional Budget Office (CBO) and the General Accounting Office (GAO).

The Executive Branch, which incorporates the DOD and the Office of Management and Budget (OMB), provides for the submission of a budget to Congress. The DOD utilizes the Planning, Programming, and Budgeting System (PPBS) in order to establish an internal financial plan. The PPBS process not only is reviewed annually for a biennial submission for Congressional consideration, but also is used as a long term financial plan for the DOD and the services. The financial plan looks out over a six year period and is known as the Future Years Defense Plan (FYDP).

The planning phase of PPBS is designed to integrate assessments of potential military threats facing the country, overall national strategy and defense policy, ongoing defense plans and programs, and projected financial resources into an overall statement of policy. The formal outcome of the process is the Defense Planning Guidance (DPG), which provides the basic rationale for the DOD programs and budgets in the next FYDP.

The programming phase of the PPBS process details by service in the Program Objective Memorandums (POM) the specific forces and programs that the services propose over the FYDP period to meet the military requirements identified in the DPG, adhering to the financial limits that are mandated by the Secretary of Defense.

Budgeting is the final phase in the PPBS cycle. The

budget expresses the financial requirements necessary to support approved programs which were developed during the preceding phases of planning and programming. It is through the budget that planning and programming are translated into annual funding requirements. [Ref. 2]

Lastly, the DOD, in conjunction with the OMB, monitors the execution of budgeted authority. This is to ensure not only that budget authority is adhered to but also that various other executive mandates and legislative laws are conformed with. Table 2.1 depicts an overview at the DOD level of the PPBS process and its time line. Knowing the roles and responsibilities of the Federal Government, we will now explore the budget of the Federal government.

| TABLE 2.1 DEPARTMENT OF DEFENSE PPBS TIME LINE* | | | |
|---|---|--|---|
| | PLANNING | PROGRAMMING | BUDGETING |
| DATES | August - January | February - July | August - December |
| ACTION | Inputs from OSD, Service, and JCS | Program Objective Memorandum (POM) developed to meet requirements of DPG | Review of POMs and PDMs; restructuring of program elements into appropriations accounts |
| ACTOR | Office of the Under Secretary of Defense for Policy | Defense Resources Planning Board | DOD Comptroller and OMB |
| OUTCOME | Defense Planning Guidance (DPG) | Program Decision Memorandum (PDMs) | Budget (and) justification materials |
| *For the first year of the biennial budget cycle. An amended process is used for the second year of each cycle. | | | |

2. The Shrinking Budget

Given the responsibilities of the Executive and Congressional leaders for directing and monitoring the financial management of the Federal government, we can explore the broad picture of the nation's fiscal posture. In Table 2.2 are the recent budget authority (BA) figures for the DOD, discretionary BA, and total Federal BA, along with the annual deficit figures which were extracted from the historical tables for fiscal year 1997. Fiscal year 1996 numbers represent estimates. There have been broad trends in each of the areas over the recent years. Since 1992, there has been a decrease in the DOD BA of \$30.1B. Since 1991, discretionary BA has declined by \$43.7B. However, since 1989, the total Federal BA has increased by \$374.5B. The United States annual deficit, since exploding to a record high in 1992 of \$290.4B, has fallen to an estimated \$145.6B, a decrease of \$144.8B. Congressional and Executive leaders feel that the deficit remains a threat to our nation's economic and financial security.

| TABLE 2.2 | | | | |
|---|--------|------------------|--------------|--------------|
| HISTORICAL BUDGET AUTHORITY TABLES FOR FY 1989-96 | | | | |
| Fiscal Year | DOD BA | DISCRETIONARY BA | TOTAL FED BA | U.S. DEFICIT |
| 1989 | 290.80 | 463.70 | 1,197.10 | 152.50 |
| 1990 | 293.00 | 494.20 | 1,286.00 | 221.10 |
| 1991 | 276.20 | 543.50 | 1,385.30 | 269.40 |
| 1992 | 281.90 | 529.30 | 1,466.60 | 290.40 |
| 1993 | 267.40 | 521.70 | 1,473.50 | 255.10 |
| 1994 | 251.40 | 512.10 | 1,528.40 | 203.10 |
| 1995 | 255.70 | 504.90 | 1,543.30 | 163.90 |
| 1996* | 251.80 | 499.80 | 1,571.60 | 145.60 |

\$ in billions. *Represents estimates for FY-96.

In order to achieve deficit reduction, and a secure economic and financial base, the Federal government must efficiently and effectively manage its resources. Unfortunately, DOD suffers from serious and pervasive financial management problems, ranging from the inability to account for billions of dollars in disbursements to a weakness in the protection of assets from waste, fraud, and abuse. The DOD needs accurate financial information and appropriate internal controls to effectively manage its vast resources, e.g. more than \$1 trillion in assets, 3 million in military and civilian personnel, and a budget of more than \$250 billion for fiscal year 1995. [Ref. 3]

3. The State of Financial Management

a. *The Foundation*

The state of the federal financial management system has been well documented. To be specific, the GAO in February 1985 produced a two volume report which addressed the concerns about the financial management structure. The problems stated in the report are still relevant today. The major problems addressed were:

1. Lack of Cost Information.
2. Lack of Reliable Information on Weapon Systems.
3. Inadequate Disclosure of Costs and Liabilities.
4. Unstructured Planning for Capital Investment.
5. Antiquated Financial Management Systems.

The weaknesses addressed above clouded an already complex and complicated process. The weaknesses were shown by the inability of the Federal government to accurately identify its costs and assess the capital assets both in its possession and in the process of procurement. Also, the weaknesses were demonstrated by the inability of the Federal government to generate relevant financial reports that would help depict the fiscal posture of individual segments and the Federal government as a whole. Ultimately, the weaknesses hampered efforts by decision makers to analyze the budget and recommend solutions to problems.

As discussed in the 1985 GAO report, previous efforts at remedies had been piecemeal and partial. The GAO said that successful reform requires a comprehensive, integrated approach. It should be government-wide in scope, serving the needs of both the Congress and the executive branch, by ensuring that consistent data are available across agency and department lines.

Four key elements for reform were recommended. They were:

1. Strengthened Accounting, Auditing, and Reporting.
2. Improved Planning and Programming.
3. Streamlined Budget Process.
4. Systematic Measurement of Performance.

The above elements together form the conceptual foundation of a new financial management structure. [Ref. 4]

Reform will not be achieved simply by acknowledging problems and needs. One of the reasons that the financial management system is in disarray is because implementation of proposed reforms is difficult. Systems development efforts, organizational changes, and investment in people are all costly.

b. Current Initiatives

Some of the shortcomings listed by GAO and its recommended corrections have been addressed. A few of the current initiatives which have been enacted to overcome those shortcomings are:

- The Chief Financial Officers (CFO) Act 1990
- The Government Performance and Results Act (GPRA) 1993
- The Government Management Reform Act (GMRA) 1994

One intent of the above initiatives is to provide the Congressional and Executive leaders with accurate and relevant information that would help them focus their efforts and result in better informed decisions. These initiatives will be discussed in detail later in the thesis.

C. FEDERAL GOVERNMENT PROPRIETARY REPORTING

Within Federal government financial management there are two types of financial reporting: Budgetary and proprietary. Budgetary reporting is the reporting of appropriations by category or other budget authority. The central objective of budgetary reporting is to track and report on the status of expendable funds granted to agencies through the appropriations process. This is accomplished by agencies reporting:

1. the amount of authority,
2. the amount of obligations,
3. the amount of expended appropriations,
4. the amounts of outlays incurred during specified periods,
5. the amount of unused budget authority.

Thus budgetary reporting is focused narrowly on the spending of funds that have been granted to agencies. The budgetary

reporting model is based on the following relationship:

Budgetary Resources = Status of Authority.

Proprietary reporting is much wider in scope than budgetary reporting. The purpose of proprietary reporting is to provide a comprehensive picture of the financial position and operations of an entity. Thus proprietary reporting is focused broadly on the creation, management and use of all resources (assets) of an organization, not just expendable funds. The intent of proprietary reporting is to report on the financial condition by measuring the assets, liabilities, and net position of an organization and to report on operations by tracking the changes in those assets, liabilities, and net position. The basic proprietary reporting model is:

Assets = Liabilities + Net Position.

1. Elements and Components of Proprietary Reporting

Proprietary principles and standards cover assets, liabilities, net position, revenue, expenses, gains and losses, and other items. The two primary objectives of proprietary accounting are to provide information useful in: (1) allocating resources and (2) assessing management's performance and stewardship. The financial statements constructed for proprietary reporting are:

1. Statement of Financial Position
2. Statement of Operations and Change in Net Position
3. Statement of Cash Flows.

The objectives, principles, standards, and statements together comprise proprietary accounting and reporting in the Federal Government.

2. Organizations Involved in Proprietary Reporting

The proprietary principles, standards, and requirements are required by law to be promulgated by GAO. The current process, however, calls for the principles and standards to be developed by the Federal Accounting Standards Advisory Board (FASAB); approved by the heads of the Office of Management and Budget (OMB), Treasury, and GAO; and promulgated by OMB and GAO. GAO also develops and promulgates requirements such as those for accounting systems and internal controls. OMB is required by law to promulgate the requirements for the "form and content" of financial statements. [Ref. 5]

3. Similarities to the Private Sector

The private sector model for proprietary reporting is comprised of $\text{Assets} = \text{Liabilities} + \text{Equity}$. The government model replaces equity with net position in the basic equation. However, the components of assets and liabilities are used in both the private and government sector. As we proceed to the next chapter we will examine the similarities and differences between the two models in an effort to gain a better understanding of proprietary reporting in the Federal government.

III. THE FEDERAL GOVERNMENT VS. THE PRIVATE SECTOR

A. OVERVIEW

The financial statements of a company provide the information needed to determine the financial condition of a company, much like a report card for a high school student provides the parents with information to determine the degree of success of their child. Most people are familiar with private sector proprietary reporting and its objectives and how it operates in our market economy. The objective of this chapter is to provide an understanding of differences between private sector and the Federal government proprietary reporting. Included will be a discussion both of private sector and the Federal government objectives, the nature of financial operations, control of activities, users of financial reports and conceptual accounting models. This will assist us in painting a picture of the differences that exist between the private sector and the Federal government proprietary reporting.

B. THE OBJECTIVES

An organization's basic objectives, its reasons for being in business, may not be as clear as one would assume. Is the organization operating for profit or not for profit? Is the organization receiving funding as a sole proprietor, a partnership, a corporation, or appropriated funds? Those are

just a few differences that could affect the basic objectives of an entity. The objectives for the private and government sectors will be discussed based on four distinct categories. They are; (1) ownership, (2) motivation of owners, (3) objective of entity, and (4) benefits for whom.

1. Private Sector Objectives

For the purposes of comparison in this paper, we will consider the private sector entity to be a corporation operated for a profit with shares of the entity being sold to investors on the open market.

The main motivation of owners is the return on the investment. The objectives of the entity are to maximize profits and increase the wealth of the entity. By accomplishing this, the entity will increase the chances of satisfying the motivation of owners. Thus, the owners would benefit.

2. Federal Government Objectives

Ownership in the Federal government is collective. The tax-paying citizens (constituents) are the "owners" of the government. The motivation of the citizens is that government provides public goods (products and services) that are not adequately provided by the natural workings of the private sector. An example of this is the DON patrolling the Persian Gulf in an effort to keep the sea lanes open for commerce, specifically oil. In this case the Navy is

performing a task which our elected officials, representing the citizens, feel is important to our national interest. The objective of entities or agencies in the Federal government is to maximize the goods and services they provide given available resources. Ultimately, the constituents as a whole are meant to benefit from the activities of government agencies. The DON ensures that the sea lanes are kept open for commerce. If the Navy did not perform this task, or was unable to, then our economy could be detrimentally affected by the lack of oil available from the Persian Gulf region.

A summary of the contrasts between the ownership and the objectives of the private and government sectors are displayed in Table 3.1.

| TABLE 3.1 CONTRASTS: OWNERSHIP AND OBJECTIVES | | |
|--|--|---|
| | <u>COMMERCIAL</u> | <u>GOVERNMENTAL</u> |
| OWNERSHIP: | *Individual | *Collective |
| MOTIVATION OF OWNERS: | *Return on Investment *Return of Investment | *Service to Constituents |
| OBJECTIVE OF ENTITY: | *Maximize profits *Increase wealth | *Maximize goods & services, given available resources |
| RUN FOR: | *Benefit of owners | *Benefit of Constituents |

C. NATURE OF FINANCIAL OPERATIONS

The discussion of the nature of financial operations in the private and government sector will be evaluated from their central focus, flow of funds linkage, and source of financing.

1. Nature of Private Sector Financial Operations

The nature of financial operations for commercial firms in the private sector is qualitatively different than that in the public sector. The central focus of activities is on the generation of revenues and the control of expenses, thus the maximization of profit. In pursuing this end, private sector commercial operations involve a series of direct exchanges with various parties. Examples of this are:

- Owners invest, providing a source of financial resources required to conduct business. In return owners expect a return on investment in the form of dividends. Lenders are also a source of financial resources. In return, lenders expect a return on their investment in the form of interest (as well as a return of principal).
- The customer supplies cash and in return receives a service or product.

Note that there is a direct exchange in each case, with each party providing something in a fair exchange for something received. There are "tight linkages" between what is given and what is received in each exchange. Additionally there is a clear distinction between financing activities (raising

resources from investors to lenders) and operating activities (providing goods and services to customers).

2. Nature of Federal Government Financial Operations

Activities in the government are focused on acquiring and using financial resources. This supports the objectives of citizens to have services provided which they believe are necessary. But in contrast to the private sector, the linkages between what individuals provide and what they receive is loose. Citizens provide resources via taxes roughly in proportion to their ability to pay. Citizens receive benefits perhaps in proportion to their need, or on some other basis unrelated to their ability to pay. Exchanges are perhaps one sided, with taxes being paid without something expected directly in return, and services being provided typically without payment expected in return. The Federal government might spend money in terms of Navy personnel, ship maintenance, and other associated costs to deploy forces in order to maintain open sea lanes to allow for relatively free commerce. However, there is no direct association between the taxes paid and the benefits received by the individual citizen from the effort to maintain open sea lanes. The loose linkage between inflows and outflows suggests that financing is a certain aspect of operating. The government must finance any operation it intends to undertake. Table 3.2 represents the summary of the contrasts of the nature of financial operations between the private and government sectors.

| TABLE 3.2 CONTRASTS: NATURE OF FINANCIAL OPERATIONS | | |
|--|---|---|
| | <u>COMMERCIAL</u> | <u>GOVERNMENTAL</u> |
| FOCUS ON: | *Generating revenues & controlling expenses | *Acquiring and using Financial Resources |
| INFLOW/OUTFLOW LINKAGE: | *Tighter linkage (Owner invests-- -->gets dividends) (Customer pays-- ->receives service) | *Loose linkage (Citizen taxes-- -->Citizen may Receive) |
| SOURCE OF FINANCIAL RESOURCES: | *Clear Distinction Financing vs Operating | *Less Clear Financing vs Operating |

D. CONTROL OF ACTIVITIES

Control is the process by which organizational activities are shaped toward organizational objectives. Two aspects of control are relevant in contrasting private sector commercial operations and the Federal government: the source of control and the means of control. The source of control relates to the forces that establish the rules for operation. The source of control influences how activities are conducted.

The means of control relates to; the mechanisms that exist to direct the flow of resources.

1. Private Sector Controls

For private sector commercial organizations the market is the primary source of control. The profit motive and pricing mechanism are the primary means of control. Capital markets direct financial resources in search of a return on

investment. Labor markets direct labor resources in search of a return on effort. Product markets direct producer products and customer dollars in search of a fair exchange. The use and exchange of resources are guided by opportunities to maximize returns in markets, hence markets provide an automatic allocating and regulating device. In this context, financial reporting has evolved to provide measures of the success of organizations in generating profit and providing a return on resources.

2. Federal Government Controls

For government organizations, a market analogous to private sector commercial markets generally does not exist. For government organizations the primary source of control is the political process. Key decisions regulating the allocation of resources for governmental agencies or departments are made by political and bureaucratic leaders. As detailed in chapter II, the Congressional and Executive leaders direct the agenda of Departments. For instance, the DON can not decide on its own to build aircraft carriers, or outfit the Marine Corps with an additional force of 50,000 Marines. Those initiatives require congressional and executive approval and funding.

The means of control is primarily bureaucratic, with resources directed through laws, rules, and regulations enacted by both the legislative and executive branches. For

example, the means of control can be examined by reviewing the fiscal constraints imposed on the DOD and the DON by the Federal government. As discussed earlier, DOD is constrained in how much money it can spend by the amount authorized and appropriated by Congress (Budget limits). Additionally, within the amount appropriated, the funds are segregated into different categories, e.g., Operations & Maintenance (O&M), Military Personnel (Milpers), Military Construction (Milcon), Procurement, Research Development Test & Evaluation (RDT&E). These categories, the "color of money", provide boundaries restricting how much money can be spent for each purpose. Furthermore, within each category there are specific rules and regulations limiting when each of the amounts must be obligated and expended; this is known as the "life of funds". Lastly, the DON must further subdivide the funds, as legislation directs, between the Navy and the Marine Corps, while adhering to all requirements. So the uses of financial resources are guided by the constraints of budget limits, color of money, and life of money. All are means of control imposed on DOD and DON activities by the political and bureaucratic process. In this context, financial statements and financial reporting have evolved into reporting on compliance with the spending limitations and requirements imposed by the political and bureaucratic process. Table 3.3 displays contrasts between commercial and governmental control of activities.

| TABLE 3.3 CONTRASTS: CONTROL OF ACTIVITIES | | |
|--|--|---|
| | <u>COMMERCIAL</u> | <u>GOVERNMENTAL</u> |
| SOURCE OF CONTROL: | *Market *Stockholders | *Political and Bureaucratic |
| MEANS OF CONTROL: | *Profit Mechanism *Profit motive provides an automatic allocating and regulating device | *Laws/Rules/Regs *Budget limits "Color of money" "Life of funds" |

E. USERS AND USES OF FINANCIAL REPORTS

The primary purpose of producing financial reports is to provide users of those reports with the financial information necessary for decision making. The private and governmental sectors differ with respect to the intended primary uses of financial report information and the particular purposes for which the information is used.

1. Private Sector Users

In the private sector the primary intended users of the financial reports are investors and creditors. User concerns normally involve investment and credit decisions. These decision makers review the reports to insure the entity is moving to accomplish their individual objectives. In the case of investors it may be to achieve an adequate level of return on their investment in the future. Creditors may wish

to see that the company is not accruing a large amount of debt which would encumber the entity from being able to meet existing obligations. Other users of financial reports include management. The manager's focus is geared toward insuring sustained effective and efficient operations. The primary focus of financial reporting for an entity is to present a report of the company's ability to operate profitably and generate cash. The conventional view is that financial statements report on past events and current financial position but that the information is used to assess future prospects. Hence the perspective of the user is forward-looking.

2. Federal Government Users

In the Federal government sector, the primary intended users of financial reports are those, at higher levels in the chain of command, who have imposed restrictions on the use of appropriated funds. These include the legislative and executive leaders, and civilian and military superiors. Their concern is that appropriated funds have been expended in the manner directed. Thus the primary focus of governmental financial reporting has traditionally been on the control and accountability of organizations for expendable financial resources. Hence the perspective of the users tends to be backward-looking. The central concern is with management's stewardship of funds provided.

Proprietary financial reporting as viewed through the users of reports is summarized in Table 3.4.

| TABLE 3.4 CONTRASTS: FINANCIAL REPORTING | | |
|---|--|---|
| | <u>COMMERCIAL</u> | <u>GOVERNMENTAL</u> |
| COMMON USERS: | *Investors Creditors (Managers) | *Legislators (Managers) |
| USERS PERSPECTIVE: | *Forward-looking | *Backward-looking |
| USERS CONCERNS: | *Investment and credit decisions | *Stewardship |
| FOCUS: | *Ability to operate profitably and generate cash | *Control and accountability for expendable financial resources |

F. CONCEPTUAL MODELS

In chapter II the basic models for the private and government sector were briefly discussed. The private sector and government sector models differed by the use of Owners Equity in the private model and Net Position in the government model. The following discussion will provide further basic differences between the two models.

1. Private Sector Model

The basic formula for private sector proprietary reporting is:

$$\begin{aligned} \text{Assets (A)} &= \text{Liabilities (L)} + \text{Owners Equity (OE)} \\ (A) &= (L + OE) \end{aligned}$$

The accounting model can also be thought of as:

$$\text{Resources} = \text{Sources of Resources}$$

The assets of a business are its resources, which must be supplied by someone. The liabilities and owners equity represent the sources of the assets. Owners Equity includes both Contributed Capital (CC) and Retained Earnings (RE). The accounting model is an algebraic model, and can also be rearranged in various ways, such as Assets - Liabilities = Owners' Equity. It also expresses a basic truism: "What I own, less what I owe, equals my equity in my business". [Ref.6]

2. Federal Government Model

The basic formula for proprietary reporting is:

$$\text{Assets (A)} = \text{Liabilities (L)} + \text{Net Position (NP)}$$

As was previously stated, the two primary objectives of proprietary accounting are to provide information useful in: (1) allocating resources and (2) assessing management's performance and stewardship. In order to accomplish those objectives, net position is used in the Federal government basic formula. The components of net position are Invested Capital (IC), Cumulative Results of Operations (CRO), and Unexpended Appropriations (UA).

Invested Capital is the portion of an agency's net position representing (1) the book value of agency fixed assets, inventory, loans made, and other capital assets that were financed with appropriations provided by other agencies without reimbursement, and (2) investments (contributed capital) in the agency's revolving funds and business-type activities made to provide initial financing for those operations or to finance expansion of the services offered. [Ref. 6]

Unexpended Appropriations (results from appropriation financed activities) represent valid unused appropriation authority that carries over to the next fiscal year or other reporting period. [Ref. 6]

Cumulative results of operations (results primarily from business type activities) are cumulative excess revenues, gains, financing sources, etc., over expenses, and losses from the inception of an agency. [Ref. 6]

All agencies within the Federal government have capital investments. However, agencies may have either none, one, or both of appropriated capital and cumulative results of operations. Table 3.5 illustrates the basic accounting models.

| TABLE 3.5 BASIC ACCOUNTING MODELS | | |
|-----------------------------------|--|---------------------------|
| Private | | Federal Government |
| Sector Model: | | Model: |
| $A = L + OE$ | | $A = L + NP$ |
| $A = L + (CC + RE)$ | | $A = L + (IC + CRO + UA)$ |
| | | |

In the following chapter, the laws, rules and regulations which mandate Federal proprietary financial reporting will be examined. In chapter V, an examination of an expanded view of the Federal government conceptual model and its form and content will be conducted.

IV. REQUIREMENT FOR PROPRIETARY FINANCIAL REPORTING

A. OVERVIEW

As stated previously in this thesis, GAO has documented major weaknesses in our financial management system. In an effort to correct the deficiencies in the Federal government, several laws, statutes, and regulations were enacted. In this chapter the major laws enacted, as well as the agencies responsible for monitoring and implementing policies for proprietary financial reporting will be discussed.

B. MAJOR LAWS

Chapter II mentioned current initiatives instituted in an effort to overcome some major short-comings of the Federal financial management system. Specifically mentioned in chapter II were the Chief Financial Officer (CFO) Act of 1990, the Government Performance Results Act of 1993 (GPRA), and the Government Management Reform Act of 1994 (GMRA).

1. CFO Act of 1990

For this thesis the most important law enacted was the CFO Act of 1990 (Public Law 101-576). The CFO Act was passed to improve the general and financial management of the Federal government. The CFO Act established a position for OMB Deputy Director for Management to be the chief official responsible for financial management in the Federal government, and an OMB Office of Federal Financial Management to be headed by a

Controller. The CFO ACT established chief financial officers within numerous Federal departments and agencies. The CFO Act also requires OMB and other Federal agencies to develop plans to improve Federal financial management systems and prepare financial statements and audits of various Federal agencies activities, including trust funds, revolving funds, and commercial activities. One initiative of the CFO Act is the preparation of auditable consolidated financial statements for departments, agencies, and the Federal government as a whole. Ten departments and agencies were tasked to have their fiscal year 1996 financial statements audited. With the enactment of the CFO Act, Congress called for the production of financial statements that fully disclose a Federal entity's financial position and results of operations, and provide information not just for the effective allocation of resources, but also information with which Congress, agency managers, the public, and others can assess management performance and stewardship. [Ref. 7] The main purpose of the CFO Act is to improve federal financial management and prevent fraud, waste, and mismanagement.

2. GPRA of 1993

To complement the CFO Act, GPRA 1993 was enacted. GPRA expressed the congressional will that performance measurement and reporting be introduced throughout the government, and authorized experimentation with performance budgeting to tie

performance measures or standards to costs. The CFO Act provides audited financial reports from which the performance measurements of GPRA are to be developed. Similar to the private sector where financial ratios are utilized to analyze the relative financial condition of an entity, performance measures for the Federal government are intended to be developed to analyze the relative financial condition of Federal government entities. By using the information obtained through the CFO Act, GPRA's main features are:

- A requirement that Federal departments and agencies prepare annual performance plans, setting out specific performance goals for a fiscal year, starting with a performance plan for fiscal year 1999.
- A requirement that Federal departments and agencies submit an annual program performance report to the President and Congress, which compares actual performance with the goal levels that were set in the annual performance plan. The first report, covering fiscal year 1999, is to be submitted by March 31, 2000.
- Provisions giving managers greater flexibility in managing by allowing the waiver of various administrative controls and limitations. In return, managers are expected to be more accountable for the performance of their programs and operations.

Currently, federal officials are mainly evaluated not on what their programs accomplish, but on whether they follow the administrative rules and internal practices that govern their conduct as managers. Under GPRA, this adherence still matters, but one's role and responsibility for a successful or

failing program should be of greater importance. [Ref. 8] GPRA provides a means to enable the Federal government to achieve the goals of the CFO Act which is to improve financial management within the Federal government.

3. GMRA of 1994

Under the CFO Act, auditable financial statements have been prepared for selected departments and agencies. The GMRA extended the audit requirement from 10 to 24 CFO departments and agencies. This expansion of the audit requirement has quickened the pace at which departments and agencies need to access their adherence to both the CFO Act and the GPRA. GMRA also requires that the statements be audited within five months of the close of the fiscal year to make the data more timely for the budget process. It also directed that an audit of the government-wide financial statement for fiscal year 1997 be produced [Ref. 9].

C. AGENCIES RESPONSIBLE

1. The Overseers

The responsibility for overseeing the Federal government financial accounting and financial reporting, falls primarily to four agencies: the Department of the Treasury, Federal Accounting Standards Advisory Board (FASAB), GAO, and OMB.

a. The Department of the Treasury

The Department of the Treasury, in the executive branch, is headed by the Secretary of the Treasury. The

Department of the Treasury acts as both chief accountant and banker for the Federal government. The Department of the Treasury is responsible for the central accounting and reporting for the Federal government as a whole, including development of government wide consolidated financial statements. The Treasury also maintains the government wide Standard General Ledger (SGL).

b. Federal Accounting Standards Advisory Board

FASAB was created by a joint agreement between the Treasury, OMB, and GAO to establish accounting and audit standards for the Federal government. The FASAB is a nine member board with representatives from the Treasury, OMB, GAO, the Congressional Budget Office, civil agencies, and defense and international agencies, and three representatives from outside the federal government [Ref. 5]. FASAB is responsible for developing the principles and standards and related requirements to be used for the government-wide proprietary financial reports. Three statements which were developed by FASAB, and will be utilized to achieve CFO Act requirements are:

1. Statement of Financial Position
2. Statement of Operations and Change in Net Position
3. Statement of Cash Flows (Revolving funds only)

c. General Accounting Office

The GAO has been headed by the Comptroller General

of the United States since its inception in 1921. The GAO has a multitude of responsibilities. The primary ones are assisting the Congress in the general oversight of the executive branch and serving as the independent auditor of the Federal government. The two primary responsibilities related to accounting and financial reporting are:

- Prescribing principles and standards for Federal agency accounting and financial reporting, internal control, accounting systems, and auditing.
- Auditing the financial statements of Federal agencies. [Ref. 5]

d. Office of Management and Budget

An agency within the Executive Office of the President, the OMB has broad financial management powers as well as the responsibility of preparing the executive budget. The CFO ACT gives the OMB responsibility for directing federal financial management, modernizing financial management systems, and strengthening financial reporting. The Deputy Director for Management at OMB is the government's CFO responsible for financial management. The responsibility for carrying out OMB's financial management policies is coordinated through Agency CFO's in 24 major agencies. Some of OMB's other responsibilities include establishing the requirements for accounting and reporting, and prescribing the form and content of financial statements consistent with

applicable accounting principles, standards, and requirements as set by FASAB.

The overall objective of OMB, with regard to proprietary financial reporting, is to provide information that can be used to determine budgets for operations more on a performance and outcome related basis. OMB has issued a five year plan and is trying to integrate the tasks required by each of the individual Acts. Figure 4.1 illustrates the relationship of the overseers.

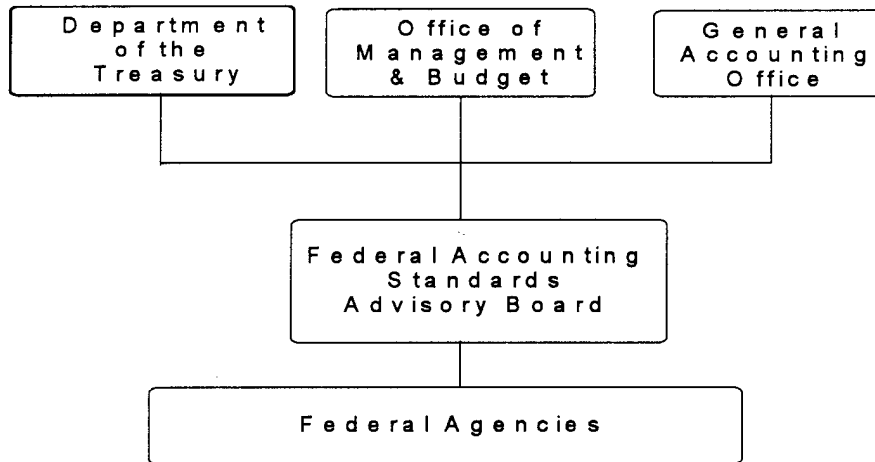


Figure 4.1 The Overseers

2. Within the Department of Defense

Financial responsibility for the DOD is the primary duty of the Under Secretary of Defense (USD) Comptroller, who reports to the Secretary of Defense (SECDEF). The Secretaries for the services likewise have Assistant Secretaries for the

respective services (e.g. Assistant Secretary of the Navy (ASN)) for Financial Management & Comptroller (FM&C). The organizational structure is displayed in Figure 4.2.

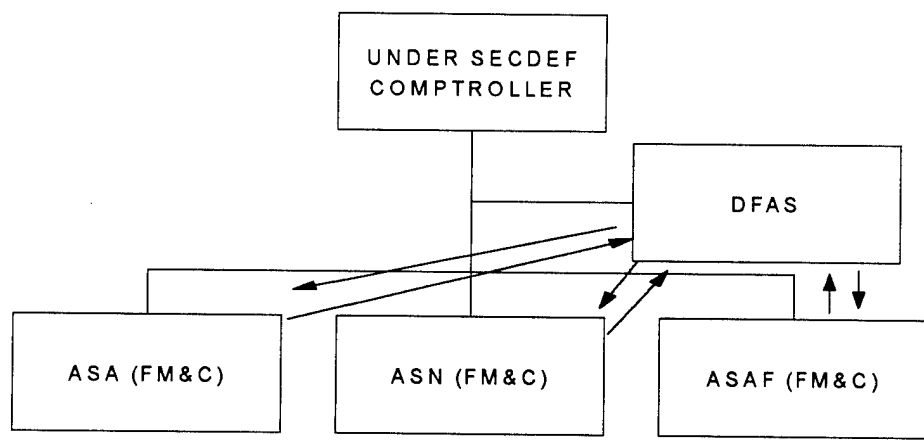


Figure 4.2 DOD Financial Organizational Structure

As stated earlier the CFO ACT amended by the GMRA has designated 24 CFO agencies to be audited. Those agencies are required to have annually prepared and audited, financial statements beginning with those for fiscal year 1996. The DOD is included under that requirement.

Prior to 1991, the services each had a finance and accounting office which handled their service's financial accounting requirements. The offices were responsible to the services for what was accomplished. As a result of the CFO ACT, the Defense Finance and Accounting Service (DFAS) was activated on January 15, 1991 to improve the overall

effectiveness of DOD financial management through consolidation, standardization, and integration of finance and accounting procedures, operations, and systems. With that consolidation the services lost direct control. The DFAS reports to the Under Secretary of Defense (Comptroller). It must be noted that DFAS was initiated by the Office of the Secretary of Defense with little enthusiasm from the services. The lack of support for DFAS stemmed principally from the military services not being able to have the control over the accounting and finance functions they once enjoyed. Also, the consolidation mandated a twenty percent reduction in force for the DFAS from the manning level the finance and accounting sections were at prior to consolidation. With respect to the Navy, not only was their accounting branch closed down and a twenty percent reduction in force imposed, but their office which was in Washington D.C. was relocated to Cleveland, Ohio. A large number of employees did not move to the new location in Cleveland where the DFAS center for the Navy was installed.

Thus a substantial amount of corporate knowledge within finance and accounting has been lost by the DON. DFAS has specific centers which support each of the services, those being:

1. DFAS Indianapolis for the Army
2. DFAS Denver for the Air Force
3. DFAS Cleveland for the Navy
4. DFAS Kansas City for the Marine Corps

For proprietary (CFO) financial reporting purposes the DOD has nine reporting entities. Each has a program manager with lead responsibility for submitting audited financial statements for fiscal year 1996, as depicted in Table 4.1 [Ref. 12]. DFAS responsibilities are to perform related accounting functions and generate financial reports for the services and DOD as a whole. [Ref. 10] The responsibility for what condition the reports depict remains with the services.

| TABLE 4.1 REPORTING ENTITIES AND PROGRAM MANAGERS | |
|--|--|
| Reporting Entities | Program Manager |
| Department of the Army | Assistant Secretary of the Army (Financial Management and Comptroller) |
| Department of the Navy | Assistant Secretary of the Navy (Financial Management and Comptroller) |
| Department of the Air Force | Assistant Secretary of the Air Force (Financial Management and Comptroller) |
| Defense Business Operations Fund | Chief Financial Officer, DOD |
| DOD Military Retirement Trust Fund | Under Secretary of Defense (P&R) |
| National Defense Stockpile Transaction Fund | Comptroller, Defense Logistics Agency (DLA) |
| Other Defense Organizations | Chief Financial Officer, DOD |
| Army Corps of Engineers | Assistant Secretary of the Army (Financial Management and Comptroller) |
| Defense Security Assistance Agency (DSAA) | Comptroller, DSAA |
| Total DOD | Chief Financial Officer (CFO), DOD |
| [Ref. 11] | |

The responsibility for preparation and submission of stand-alone financial statements within the DOD rests with the CFO for DOD, DFAS, and the nine program managers of the

reporting entities. Table 4.2 displays the responsibilities of the primary players within the DOD to produce CFO financial reports [Ref. 11]. Figure 4.3 is an example of the DOD consolidated financial statement, incorporating the separate reporting entities.

| TABLE 4.2 FUNCTIONAL RESPONSIBILITY | | | |
|---|----------------|----------------------------------|------------------------|
| Responsibility for Preparation of Stand Alone Financial Statements | CFO DOD | DFAS/ Accounting Activity | Program Manager |
| Overview of the Reporting Entity | | | * |
| Preparation of Financial Statements | | * | |
| Note 1 to the Principal Statements | | * | |
| Remaining Notes to the Principal Statements | | | * |
| Consolidating Statements | | * | |
| Supplemental Financial and Management Information | | | * |
| Supplemental Schedules | | | * |
| Submission of Unaudited Financial Statements to CFO, DOD | | | * |
| Submission of Unaudited Financial Statements to Inspector General (IG), DOD for Audit | * | | |
| Submission of Audited Financial Statements to OMB | * | | |
| * Organization to take leadership role in the preparation of specified part of the financial statement. [Ref. 11] | | | |

DEPARTMENT OF DEFENSE CONSOLIDATING FINANCIAL STATEMENT

| Statement of Financial Position | Department of the Army (1) | Department of the Navy (1) | Department of the Air Force (1) | Defense Business Operations Fund | DoD Military Retirement Trust Fund | National Defense Stockpile Transaction Fund | Other Defense Organizations | U.S. Army Corps of Engineers | Defense Security Assistance Agency | Eliminating Entries | Total Department of Defense |
|---|----------------------------|----------------------------|---------------------------------|----------------------------------|------------------------------------|---|-----------------------------|------------------------------|------------------------------------|---------------------|-----------------------------|
| Assets: | | | | | | | | | | | |
| 1. Entity Assets | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX |
| 2. Non-Entity Assets | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX |
| 3. Total Assets | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX |
| Liabilities: | | | | | | | | | | | |
| 4. Liabilities Covered by Budgetary Resources | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX |
| 5. Liabilities Not Covered by Budgetary Resources | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX |
| 6. Total Liabilities | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX |
| Net Position: | | | | | | | | | | | |
| 7. Balances | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX |
| 8. Total Liabilities and Net Position | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX | XXXXXX |

① Excluded amounts appropriated to Defense-wide (so-called "97" accounts) entrusted to the Military Departments for execution. Such amounts should be included in the "Other Defense Organizations" category.

② Reporting sub-entities for the "Other Defense Organizations" category are shown in Appendix I-B

Note: This is a sample - actual Consolidating report will show all required form and content lines.

Figure 4.3 Consolidated Financial Statement

3. Within the Department of the Navy

The DON accounts for 31%, or \$78 billion, of DOD's fiscal year 1996 gross budget authority. It controls about 50%, or half a trillion dollars in DOD assets, including 361 ships and over 4,200 aircraft; and employs nearly one million civilian and military personnel. The DON has a significant portion of the DOD pie. Within the office of the Secretary of the Navy (SECNAV), is the ASN(FM&C), who is primarily responsible for the financial management of the DON. The ASN(FM&C) office is divided into four branches. They are:

1. Administrative & Fiscal (FMA)
2. Office of Counsel (FMC)
3. Office of Financial Operations (FMO)
4. Office of Budget/ (FMB)

The FMO branch has responsibility for financial policy, including budget and accounting aspects. FMO is also responsible for funds control at the DON level, closing the fiscal books at year's end, closing appropriation accounts, and developing / reviewing CFO financial statements.

The DON is comprised of the Navy and the Marine Corps. The heads of the Navy and Marine Corps are the Chief of Naval Operations (CNO) and the Commandant of the Marine Corps (CMC) respectively. The Marine Corps reports to the ASN (FM&C) with respect to financial reporting. Within the office of the CMC is the Programs and Resources Department (P&R). The P&R department has within it the Fiscal Division (FD), and one of

FD's branches is Resource Financial Liaison (RFL). The RFL branch is comprised of four sections, one being the report coordination section which has the primary responsibility for CFO reporting.

The office of the CNO, unlike the office of the CMC has no CFO reporting responsibility [Ref. 10]. There is a direct link between the FMO office within the DON and the major claimants (i.e., Operational commands and agencies in the Navy). An illustration of the DON financial structure for CFO reporting is displayed in Figure 4.4.

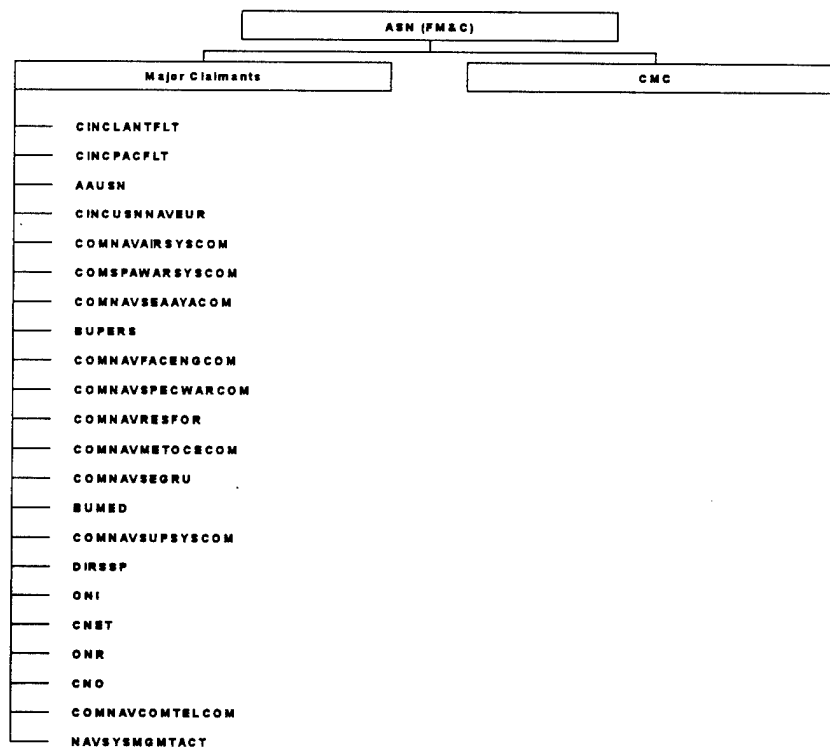


Figure 4.4 DON CFO Financial Reporting Structure

This chapter and the previous chapters have laid the foundation for proprietary financial reporting within the Federal government and the Navy. In the next Chapter, an examination of the form and content of the DON proprietary financial statements will be conducted.

V. THE FORM AND CONTENT OF DON FINANCIAL STATEMENTS

A. OVERVIEW

Beginning with fiscal year 1996, the Inspector General, DOD, (IG,DOD) will render opinions on the financial statements of the nine Departments within the DOD. The Treasury intends to consolidate all reported appropriations into a government-wide financial statement to be audited by the GAO. In order to provide consistency during these initial years of implementation, representatives of the Treasury Department (Financial Management Services) and the DOD (Office of the Deputy Chief Financial Officer) have agreed that the DOD will submit "Federal Agencies Centralized Trial Balance System" (FACTS) transmissions at the same reporting entity level as the Agency-wide CFO financial statements (Army, Navy, Air Force, etc.) vice reporting at the appropriation level. The objective is to produce financial statements that are accurate, consistent and meaningful; statements that can and will be used to improve the management of the Department.

[Ref. 11]

The Army and the Air Force have been in the pilot program for CFO reporting. Fiscal Year 1996 will be the first year that the DON is required to submit CFO statements. In this chapter, the form and content to be used by DON for the preparation of its financial statements for CFO reporting will be reviewed.

B. DBOF

The DBOF was established in fiscal year 1992 to consolidate a wide range of activities in the DOD that were previously funded through separate component revolving funds. Two types of revolving funds, industrial and stock, were incorporated into the DBOF. The DBOF is a business type financial system, and distinguishes between capital and operating costs using standard accounting principles. The basic tenet of its operations is to capture all costs of operating a business area and to reflect the total costs of doing business in stabilized prices charged to customers. It operates on a break-even basis over the long term. Profits, when they occur, are returned to customers through lower rates in subsequent years. Similarly, losses are recouped through an increase in rates. [Ref. 12]

Only the DBOF and all other revolving funds are required to submit the Statement of Cash Flows in addition to the Statement of Financial Position and the Statement of Operation and Change in Net Position. For the purposes of this thesis, an examination of general fund CFO reporting will be conducted emphasizing the Statement of Financial Position and the Statement of Operations and Changes in Net Position. An example of the DBOF statement of cash flows can be found in Appendix.

C. DON FORMAT FOR FINANCIAL STATEMENTS

The format which the DON will use for CFO reporting is prescribed by OMB and DOD. Each set of financial statements is comprised of, and presented in, the following sequence:

1. Overview of the Reporting Entity
2. Principal Statements and Related Notes
3. Consolidating Statements (CMC and Major Claimants)
4. Supplemental Financial and Management Information.

A review of the above list will be conducted to further understand the format of the CFO financial statements.

1. Overview of the Reporting Entity

The Overview of the reporting entity is the first part of the annual financial statement. Similar to a prospectus for a private sector firm, the overview is intended to provide readers with a clear and concise understanding of the reporting entity's activities, accomplishments, financial condition and results, problems and needs. [Ref. 11] The Overview shall contain sections which address:

- Mission and organization structure
- Performance measures: goals and results
- Limitations of the financial statements

a. *Mission and Organizational Structure*

The overview should contain a brief description of the mission(s) of the entity and its related organizational

structure. The mission statement must clearly articulate what the entity's major programs and activities are intended to accomplish. [Ref. 7]

b. *Performance Measures: Goals and Results*

The entity's program and financial results should be expressed in terms of relevant objective measures that disclose the extent to which its programs are achieving their intended objectives. Significant indicators of its financial performance and financial condition should be displayed by developing objective measures from the reports that, to the extent possible, provide information about the cost effectiveness of programs.

c. *Limitations of the Financial Statements*

The limitations section should clearly state that the report of financial position and results of operations have been prepared pursuant to the requirements of the CFO ACT and its amendments. It should acknowledge that the statements have been prepared as prescribed by OMB and they differ from financial reports used to monitor and control budgetary resources, which are prepared from the same books and records. Lastly, the limitations section should state that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation. [Ref. 11] That is a standard set of limitations which is required in each set of CFO financial reports.

2. Principal Statements and Related Notes

The principal financial statements are the Statement of Financial Position, Statement of Operations and Changes in Net Position, Statement of Cash Flows (DBOF and other revolving funds only). Those principal statements and related notes should summarize financial information for individual funds and accounts within reporting entities and sub-entities. The principal statements report general ledger account year end closing balances. The related notes will summarize the accounting principles and methods of applying those principles that management has concluded are the most appropriate for presenting the entity's significant assets, liabilities, net position, and results of operations. In cases where individual line items of the financial statement cannot be obtained or a substitution is made from the requirements, the deficiencies will be explained and the reason for noncompliance will be annotated. [Ref. 11]

3. Consolidating Statements

FASAB defines a consolidating statement as a financial statement in which the transactions and balances of component entities are presented in separate columns with inter-entity transactions and balances eliminated for the total column. Consolidating financial statements are required for the DOD-wide financial statement and for the DBOF. [Ref. 11]

4. Supplemental Financial and Management Information

Supplemental Financial and Management Information supports information presented in the Overview or which otherwise would enhance an understanding of the financial condition and operations of the reporting entity. Within the Department, such supplemental financial and management information shall consist of program and agency attributes quantified in terms of measures and indicators analyzed to produce an evaluation and interpretation of the program and agency financial attributes. [Ref. 11]

D. CONTENT OF THE FINANCIAL STATEMENTS

1. Statement of Financial Position

The purpose of the Statement of Financial Position, also known as the Balance Sheet in the private sector, is to report the position of an entity at a particular point in time. Financial position includes the amount of resources (i.e., assets) and liabilities (i.e., debts) of an entity. An examination of each major component (Assets = Liabilities + Net Position) of the Statement of Financial Position will be conducted. In this section a brief discussion of the private sector practice will be presented first, followed by the Federal government practice. The purpose is to illuminate items contained the Federal government statements by comparison and contrasting them with the better known private sector statements.

a. Assets

Assets are the resources owned by the entity. In the private sector, the major classifications of assets are current and non-current assets. Current assets are cash and other assets that may reasonably be expected to be realized in cash or sold or consumed, usually within a year or less through normal operations of the business. Non-current assets are assets used in the business that are of a permanent (useful life exceeds a year) or relatively fixed nature (e.g., equipment, machinery, buildings, and land). Assets are classified by duration of time and liquidity in the private sector. Figure 5.1 displays the classification of assets in the private sector model.

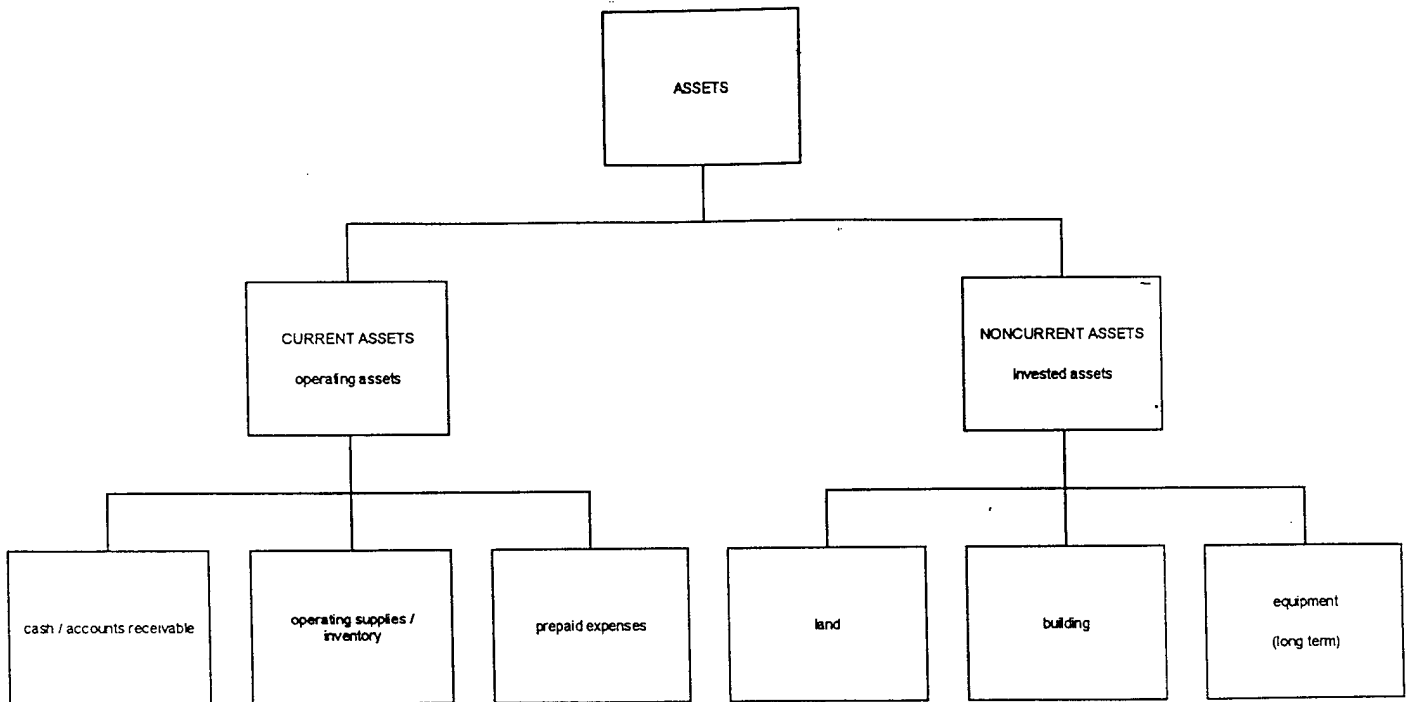


Figure 5.1 Classification of Private Sector Assets

In the Federal government, major classification of assets is not based on liquidity but instead indicates control. Assets are either entity or nonentity assets. Entity assets are assets which the reporting entity has authority to use in its operations. The authority to use funds in an entity's operation means that the entity's management has the authority to decide how funds are used.[Ref. 11] Entity assets are further divided into distinctive groups (i.e., transactions with Federal entities, transactions with non-Federal entities, cash, inventory, plant, property and equipment). Transactions with Federal entities are assets, such as accounts receivable, that arise as a result of transactions between two Federal government entities. If an account receivable on the Statement of Financial Position of the DON was from a transaction with the Department of the Army (DOA), then the DOA would have a corresponding account payable of the same amount as DON's account receivable. When the accounts are rolled into one statement at the DOD level, there would be an eliminating entry to cancel the receivable against the payable, removing them from the DOD Statement of Financial Position. Transactions with non-Federal entities would not have this eliminating entry.

Nonentity assets are assets that are held by an entity but are not available to the entity for expenditure or

use. An example of this would be income tax receivable that the IRS collects for the United States government but has no authority to spend. Nonentity assets, similar to entity assets, are divided into distinct groups as well (i.e., transactions with Federal entities, transactions with non-Federal entities, cash and other monetary assets). Figure 5.2 illustrates the classification of assets for the Federal government.

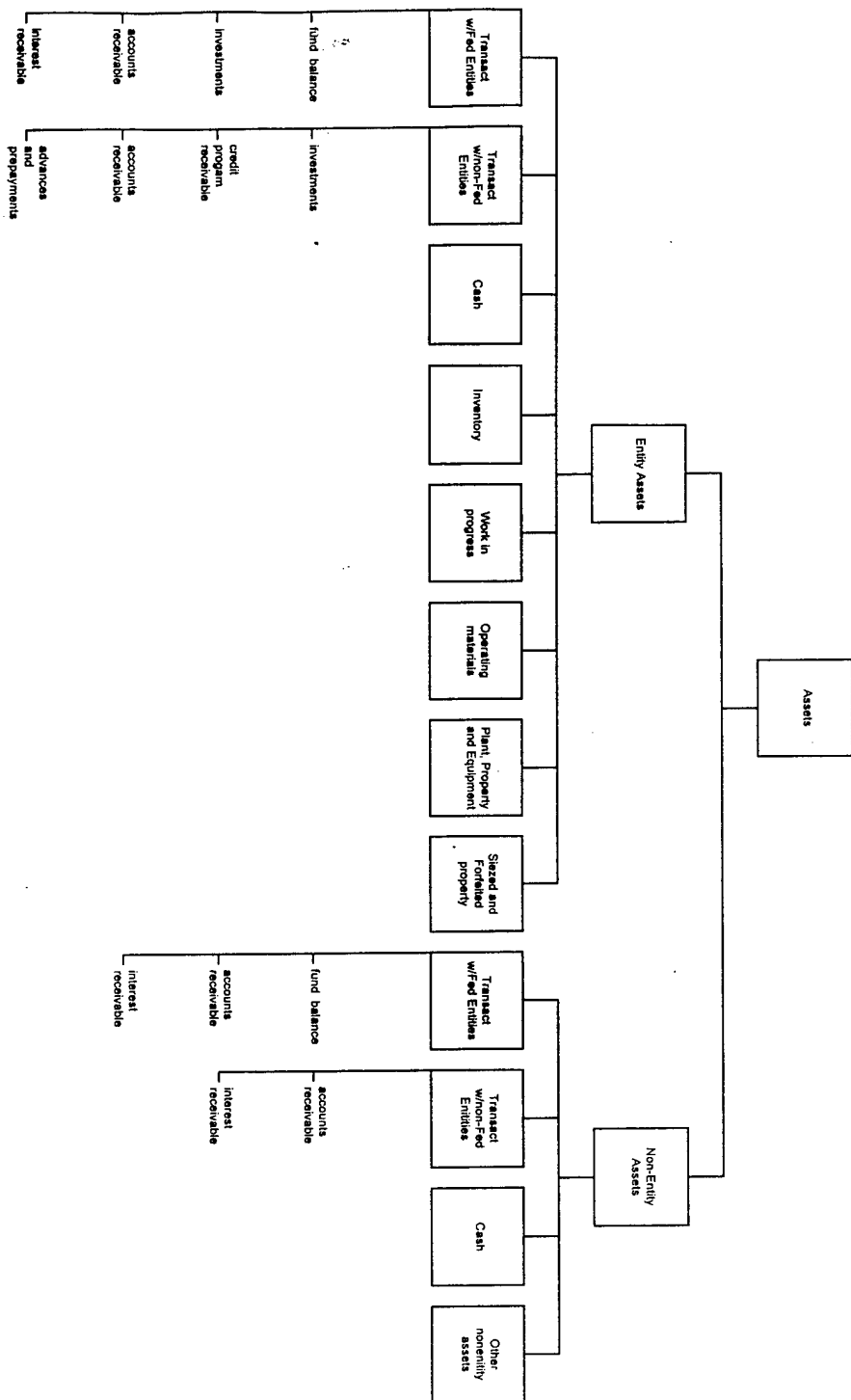


Figure 5.2 Classification of Federal Government Assets

b. Liabilities

In the private sector, liabilities are debts owed. Similar to the asset classification, liabilities are categorized in terms of their maturity, how soon they are due. Liabilities in the private sector are divided into current liabilities (i.e., notes payable, accounts payable) normally due within a year and long term liabilities (i.e., notes payable, bond payable) normally due after a year or more. Figure 5.3 depicts the classification of private sector liabilities.

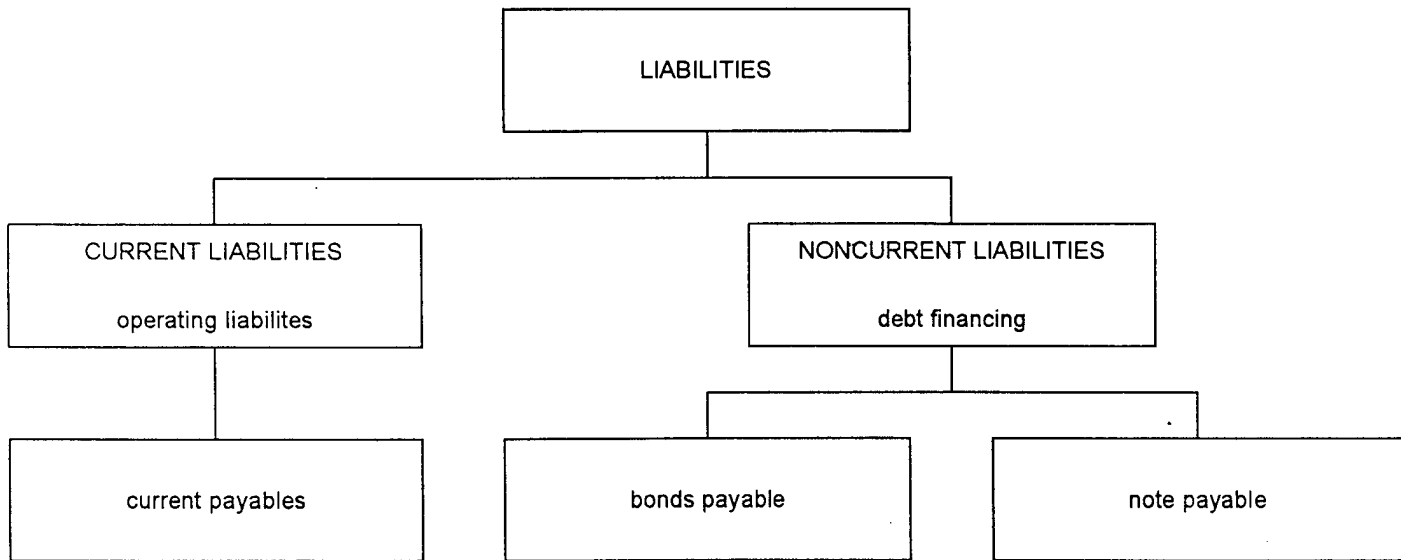


Figure 5.3 Classification of Private Sector Liabilities

Similar to the classification of assets in the Federal government, liabilities are not classified primarily in terms of maturity. Instead, liabilities are divided into two major classifications: those covered by budgetary resources and those which are not. Liabilities are to be recognized when they are incurred regardless of whether they are covered by available budgetary resources. Coverage means that the liability has budgetary resources available to financially satisfy the obligation or agreement entered into. Budgetary resources include: (1) new budget authority; (2) offsetting collections credited to an appropriation or fund account; (3) recoveries of unexpired budget authority through downward adjustments of prior year obligations; and (4) unobligated balances of such resources at the beginning of the year or transferred in during the year [Ref. 11]. Therefore, liabilities covered by budgetary resources are those obligations (i.e., payables, debts, notes) entered into that are covered by available resources or other resources available to cover liabilities for specified purposes in a given year.

Liabilities covered by budgetary resources are further divided into two sections: (1) Transactions with Federal entities (i.e., accounts payable, interest payable, and debt); (2) Transactions with non-Federal entities (i.e., accounts payable, accrued payroll and benefits, pensions and

other actuarial liabilities). Transactions with Federal entities are claims against the entity by other Federal entities, while transactions with non-Federal entities are claims against the entity by non-Federal entities, similar to the classification made with assets.

Those liabilities which are not covered by budgetary resources are liabilities which do not have available resources to cover the liabilities. Examples of this are liabilities which resulted from past transactions, government related events, government acknowledged events which are unpaid amounts due as of the reporting date. These liabilities are normally due to cancellation of budgetary authority after a liability was incurred. Liabilities not covered by budgetary resources are divided into two classifications similar to liabilities covered by budgetary resources, which are (1) Transactions with Federal entities and (2) Transactions with non-Federal entities. Figure 5.4 illustrates the classification of Federal government liabilities.

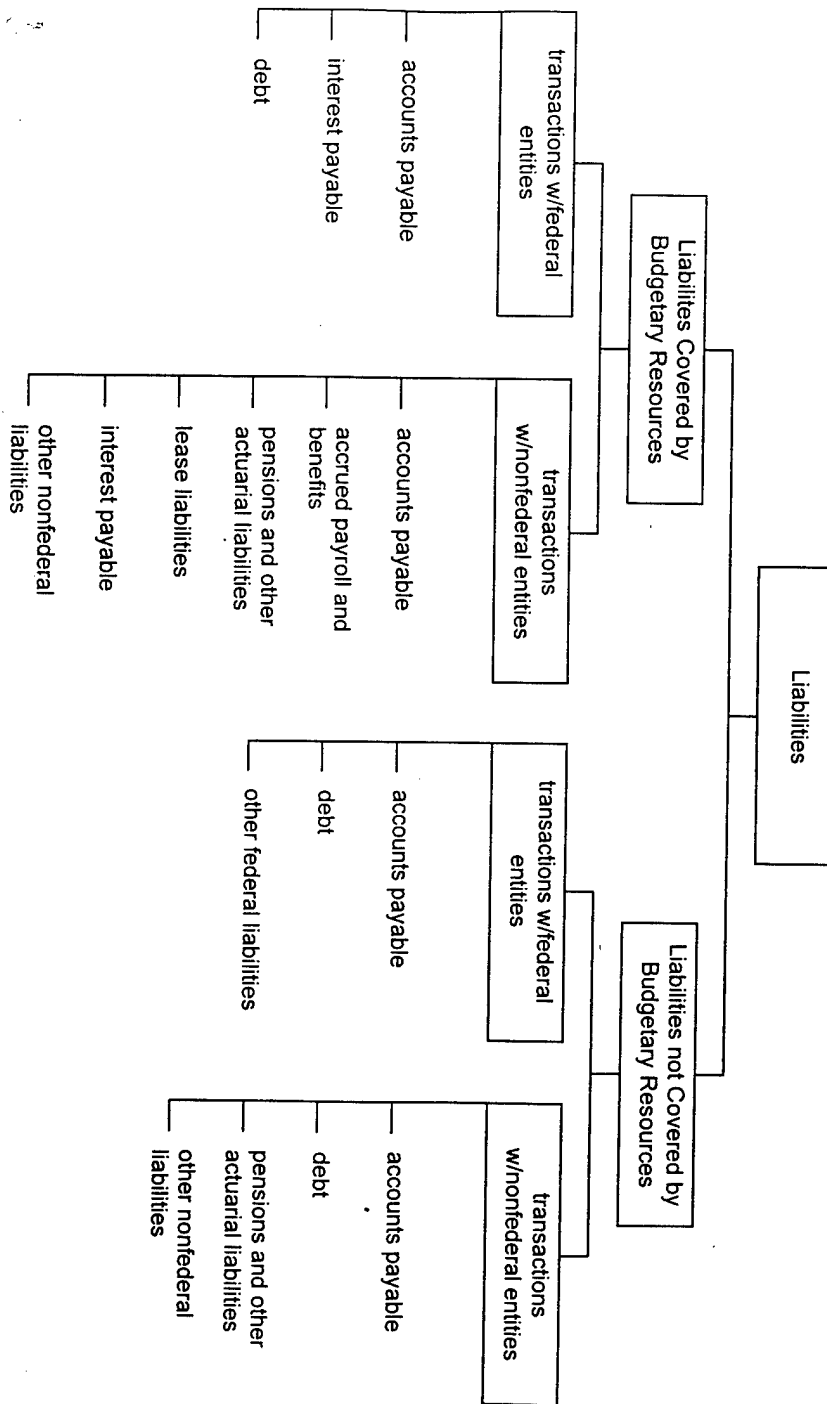


Figure 5.4 Classification of Federal Government Liabilities

c. Net Position

As discussed in chapter III the private sector owners equity section of the balance sheet is comprised of contributed capital and retained earnings. Contributed capital results from investments by owners or others. While retained earnings represent undistributed profits from operations. Both represent sources of capital for the entity. The distinction made is between the nature of the source: from investments or from operations.

Net position, as discussed earlier, is comprised primarily of the balances in unexpended appropriations, invested capital, and cumulative results of operations. Unexpended appropriations and invested capital represent a source of capital transferred in through appropriations, while cumulative results from operations represent results of entity operations for the period. In that sense, these Federal government classifications are analogous to the private sector. They measure capital provided from investment and operations sources. However, there are two other categories which form net position. They are "future funding requirements" and "other". Future funding requirements off set the liabilities reported in the statement of financial position which are not covered by available budgetary resources. Future funding requirements represent financing sources yet to be provided and thus would be negative. "Other"

represents other components of the net position not specifically identified in the previous categories which comprise net position (e.g., fair market value of donated assets accepted from state, local, or foreign governments). The five components of net position similar to the private sector components of owners equity represent the sources of capital for the entity. Figure 5.5 represents the owners equity for the private sector and Figure 5.6 represents net position for the Federal government.

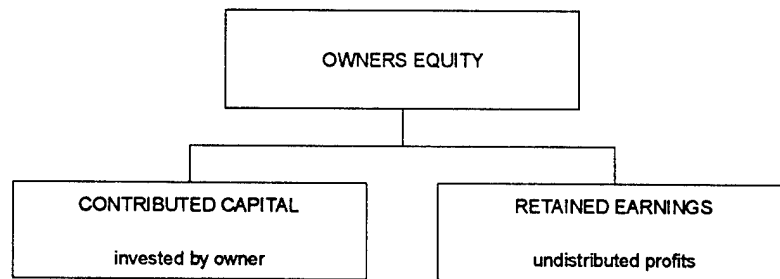


Figure 5.5 Classification of Owner's Equity

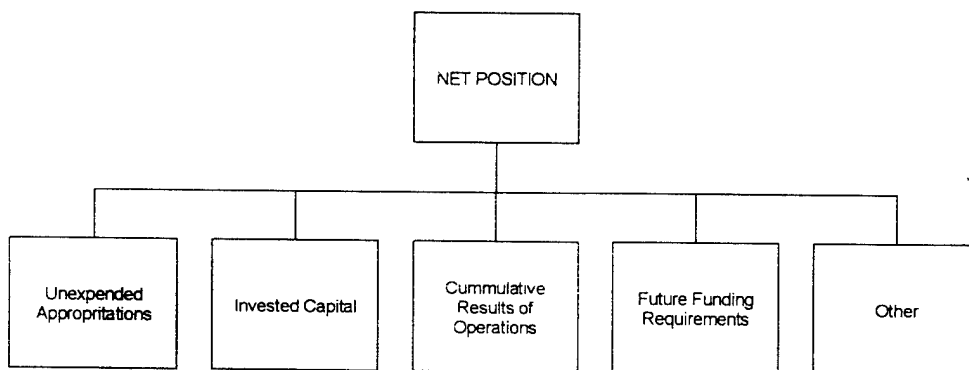


Figure 5.6 Classification of Net Position

d. *DON "Limited" Model*

The description of the Statement of Financial Position detailed previously represents the model for the Federal government. The DON's model incorporates only those elements which are relevant to it. For instance, the asset portion of the Statement of Financial Position does not include any non-entity assets. Also, the following assets which are found in the entity section of the Federal statement are not included on the DON statement:

1. Transactions with Federal entities (investments),
2. Transactions with Non Federal entities (investments),
3. Work in Progress,
4. Operating Materials, and
5. All non-entity assets.

Similarly, the liabilities section on the DON model does not include various elements which are present in the Federal model. The liabilities absent include every element in the liabilities not covered by budgetary resources section (except for "other" elements in both transactions with Federal entities and transactions with non-Federal entities). Liabilities covered by budgetary resources which are not present in the DON statement include the following:

1. Transactions with Federal entities (interest payable),
2. Transactions with Federal entities (debt),
3. Transactions with non-Federal entities (pensions and other actuarial liabilities),

4. Transactions with non-Federal entities (interest payable),
5. Transactions with non-Federal entities (lease Liabilities).

Net position on the DON statement unlike the assets and liabilities contain all the elements listed on the Federal statement. Figure 5.7 represents the DON statement.

| Department of the Navy STATEMENT OF FINANCIAL POSITION AS OF SEPTEMBER 30, 19XX (thousands) | | 1996/7 | 1995/6 |
|--|--|--------|--------|
| ASSETS | | | |
| 1. Entity Assets | | | |
| a. Transactions w/Fed Entities: | | | |
| (1) Fund Bal w/ Treasury | | | |
| (2) Accounts Receivable | | | |
| (3) Interest Receivable | | | |
| b. Transactions w/Non Fed Entities: | | | |
| (1) Accounts Receivable | | | |
| (2) Interest Receivable | | | |
| (3) Advances & Prepayments | | | |
| c. Cash | | | |
| d. Inventory | | | |
| e. Seized & Forfeited Property | | | |
| f. Plant, Property, & Equipment | | | |
| Total Entity Assets | | | |
| TOTAL ASSETS | | | |
| LIABILITIES | | | |
| 1. Liabilities Covered by Budgetary Resources | | | |
| a. Transactions w/Fed Entities: | | | |
| (1) Accounts Payable | | | |
| (2) Other Fed Liabilities | | | |
| b. Transactions w/Non Fed Entities: | | | |
| (1) Accounts Payables | | | |
| (2) Accrued Payroll Benefits | | | |
| (3) Other Non Fed liabilities | | | |
| Total Liabilities Covered by Budgetary Resources | | | |
| 2. Liabilities Not Covered By Budgetary Resources | | | |
| a. Transactions w/Fed Entities: | | | |
| (1) Other Fed Liabilities | | | |
| b. Transactions w/Non Fed Entities: | | | |
| (1) Other Non Fed Liabilities | | | |
| Total Liabilities Not Covered by Budget Resources | | | |
| TOTAL LIABILITIES | | | |
| NET POSITION | | | |
| 1. Balances | | | |
| a. Unexpected Appropriations | | | |
| b. Invested Capital | | | |
| c. Cumulative Results of Operations | | | |
| d. Other | | | |
| e. Future Funding Requirements | | | |
| Total Net Position | | | |
| TOTAL LIABILITIES & NET POSITION | | | |

Figure 5.7 DON Statement of Financial Position

2. Statement of Operations and Changes in Net Position

The purpose of the Statement of Operations and Changes in Net Position is to disclose the results of the reporting entity's operations for the reporting period, including the changes in the entity's net position from the beginning of the reporting period to the end. The Statement of Operations and Changes in Net Position is similar to the Income Statement of a private sector firm. They both measure the revenues and expenses over a given time period. Revenues measure the inflows of resources and expenses measure the outflows of resources.

a. Revenues

The private sector traditionally has only one broad source of revenue, that being revenue from sales of products or services. Revenues are inflows resulting from operations, specifically providing goods or services to customers. The Federal government has several inflow sources. Like the private sector, revenue may result from providing goods or services, but inflows may additionally occur as a result of the appropriations process or taxation. In the Statement of Operations and Changes in Net Position, the inflows are termed "revenues and financing sources", which are comprised of:

1. Appropriated Capital Used
2. Revenues from Sales of Goods and Services
3. Interest and Penalties, Non-Federal

4. Interest Federal
5. Taxes
6. Other Revenues and Financing Sources
7. Taxes and Receipts Transferred to the Treasury or Other Agencies.

The revenue and financing sources which have a significant impact on the financial statement will be discussed. Appropriated capital represents the main source of revenues for the DON during the period. Revenues from sales of goods and services normally would flow from the revenue generated by a DBOF business. A smaller portion of revenues from the sale of goods and services would be generated, for example, through sales of military equipment to foreign countries. Taxes and other collections result from the exercise of the Federal government's power to tax, such as, collecting and temporarily holding payroll taxes for military and civilian personnel (i.e., individual and corporate taxes, social security and medical contributions, customs duties and other miscellaneous taxes) [Ref. 11]. Other revenues and financing sources examples are, loan guarantee fees, cash donations, and rental income from seized, forfeited, or foreclosed property. The many sources of revenue and financing are quite different from the private sector.

b. Expenses

The expenses listed on the private sector Income Statement are divided into operating and nonoperating expenses. Also in the private sector the "cost of goods sold" is typically measured and reported separately. Cost of goods sold is subtracted from the revenues from sales to measure gross profit. In the Federal government operating expenses, program expenses, cost of goods sold, and other types of expenses are listed together under expenses. The expenses in the Federal government are comprised of the following:

1. Program or Operating Expense
2. Cost of Goods Sold
3. Depreciation and Amortization
4. Bad Debt and Writeoffs
5. Interest
6. Other Expenses

A brief discussion of significant DON expenses will follow. Program and operating expenses represent the largest expense for the DON. Program and operating expenses result from expenses incurred in conducting normal activities by a program. It is important to note that cost of goods sold are not included in program and operating expenses for items that were capitalized and are reported on the statement of Financial Position. "Costs of goods sold" reflects the amount of costs for goods sold to the public or other Federal entities (e.g., inventory equipment sold to the public, DBOF

costs charged). Depreciation and amortization will not be utilized by the DON for this first reporting year so the amount will be zero. Depreciation will be utilized in fiscal year 1997 statements. "Other expenses" reflect amount of expenses not reported previously dealing with losses on disposition of assets, and discounts lost.

In the private sector, expenses are subtracted from revenues to determine the "bottom line", net income. Analogously, for the Federal government, expenses are subtracted from revenues and financing sources to determine the result identified as "excess (shortage) of revenues and financing sources over total expenses". In both the private sector and Federal government these results may be reported both before and after inclusion of extraordinary items.

c. Change in Net Position

The net position balance at the end of a period is reported on the Federal government Statement of Financial Position. How net position changed during the period is reported on the Statement of Operations and Changes in Net Position. On that statement, determining the results of operation is not sufficient to explain fully the balance in net position. Further calculations must be made in order to verify the change in net position. To determine the change in the net position, the beginning balance of the net position must be obtained and any adjustment from the prior period must

included to determine the restated beginning balance of the net position. Once the restated net position is achieved, the result of operations for the period is combined with the net amount of non operating changes, such as unexpended appropriations, during the period. Finally, the Net position ending balance is achieved. The ending net position balance computed on the Statement of Operations and changes in Net Position should agree with the total amount of net position on the Statement of Financial Position. Figure 5.8 presents an illustration of the Federal government statement of Operations and Changes in Net Position.

| Department/ Agency Reporting Entity | 1996/7 | 1995/6 |
|---|--------|--------|
| STATEMENT OF OPERATIONS AND CHANGES IN NET POSITION FOR THE PERIOD ENDED SEPTEMBER 30, (thousands) | | |
| REVENUES AND FINANCING SOURCES | | |
| 1. Appropriated Capital Used | | |
| 2. Revenues from Sales of Goods and Services | | |
| a. To the Public | | |
| b. Intragovernmental | | |
| 3. Interest and Penalties, Non-Federal | | |
| 4. Interest, Federal | | |
| 5. Taxes | | |
| 6. Other Revenues and Financing Sources | | |
| 7. Less: Taxes and Receipts Transferred to the Treasury or Other Agencies | | |
| 8. Total Revenues and Financing Sources | | |
| EXPENSES | | |
| 9. Program or Operating Expenses | | |
| 10. Cost of Goods Sold | | |
| a. To the Public | | |
| b. Intragovernmental | | |
| 11. Depreciation and Amortization | | |
| 12. Bad Debts and Writeoffs | | |
| 13. Interest | | |
| a. Federal Financing Bank / Treasury Borrowing | | |
| b. Federal Securities | | |
| c. Other | | |
| 14. Other Expenses | | |
| 15. Total Expenses | | |
| 16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary | | |
| 17. Plus (Minus) Extraordinary Items | | |
| 18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | | |
| 19. Net Position, Beginning Balance, as Previously Stated | | |
| 20. Adjustments | | |
| 21. Net Position, Beginning Balance, as Restated | | |
| 22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | | |
| 23. Plus (Minus) Non Operating Changes | | |
| 24. Net Position, Ending Balance | | |

Figure 5.8 Statement of Operations and Changes in Net Position

d. DON "Limited" Model

Similar to the Statement of Financial Position, the Statement of Operations and Changes in Net Position has elements which are not relevant to the DON. Thus, those elements are absent from the financial statement of the DON. Those elements absent in the revenue and financing sources section are Federal interest and Taxes. The elements absent in the expenses section are interest for Federal financing and Federal securities (as noted in the previous section on expenses, depreciation and amortization will not be included for the fiscal year 1996 statements). Figure 5.9 represents the DON model for the Statement of Operations and Changes in Net Position.

| Department of the Navy STATEMENT OF OPERATIONS AND CHANGES IN NET POSITION FOR THE PERIOD ENDED SEPTEMBER 30, (thousands) | | |
|--|--------|--------|
| | 1996/7 | 1995/6 |
| REVENUES AND FINANCING SOURCES | | |
| 1. Appropriated Capital Used | | |
| 2. Revenue from Sales of Goods and Services | | |
| a. To the Public | | |
| b. Intragovernmental | | |
| 3. Interest and Penalties, Non-Federal | | |
| 4. Other Revenues and Financing Sources | | |
| 5. Less: Taxes and Receipts Transferred to the Treasury or Other Agencies | | |
| 6. Total Revenues and Financing Sources | | |
| EXPENSES | | |
| 7. Program or Operating Expenses | | |
| 8. Cost of Goods Sold | | |
| a. To the Public | | |
| b. Intragovernmental | | |
| 9. Bad Debts and Writeoffs | | |
| 10. Interest | | |
| c. Other | | |
| 11. Total Expenses | | |
| 12. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary | | |
| 13. Plus (Minus) Extraordinary Items | | |
| 14. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | | |
| 15. Net Position, Beginning Balance, as Previously Stated | | |
| 16. Adjustments | | |
| 17. Net Position, Beginning Balance, as Restated | | |
| 18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | | |
| 19. Plus (Minus) Non Operating Changes | | |
| 20. Net Position, Ending Balance | | |

Figure 5.9 DON Statement of Operations and Changes in Net Position

The financial statements which were discussed in this chapter provide a foundation for the analysis of the entities which they represent. In chapter VI, the information systems which support the financial statements will be reviewed.

VI. INFORMATION SYSTEMS AND PROPRIETARY FINANCIAL REPORTING

A. OVERVIEW

The Federal government depends largely on an automated accounting information system to compile data to meet the legislative and executive requirements. Therefore, a major component of proprietary financial reporting is the information systems which supports it. In order to obtain the proprietary financial reports (CFO statements), information must be collected and audited. This chapter will be organized into two sections. The first concentrates on the importance of accounting information systems. The second section focuses on how the DON will adhere to the requirements of the CFO Act with regard to its accounting information system.

B. IMPORTANCE OF ACCOUNTING INFORMATION SYSTEMS

A key to the success of any information system is the data available to the system. In the private sector, data is recognized as a resource and is as valuable as personnel and capital resources. The movement of the Federal government to require proprietary financial reporting via the CFO Act underscores the government's acknowledgment that such information is no less important to the successful operation of the Federal government than it is to large corporations.

The Federal government shares with business the need for financial information to monitor and control operations. Thus information must be provided to accomplish the following:

- predict economic conditions / events,
- establish budgets,
- monitor compliance with budgets,
- determine costs of operations, and
- compare expectations to actual performance.

Effective management of the Nation's resources requires comprehensive, consistent, and coordinated financial information. This implies the need for well-designed and integrated budgeting and accounting systems. The CFO Act calls for consolidated Federal financial statements. Financial information systems using consistent application of comprehensive accounting principles and standards by all agencies would help ensure comparability of financial data throughout the government.

C. DON'S EFFORTS TO IMPROVE ACCOUNTING INFORMATION SYSTEMS

1. The State of DON's Proprietary Accounting Systems

The DOD and DON have acknowledged that deficiencies in the accounting information systems exist that hamper their ability to effectively satisfy the requirements for accounting and financial reporting. DFAS-CL has reported that they were unable to prepare complete reliable, and accurate "mock" proprietary financial statements for fiscal year 1994 because

of systems deficiencies. DFAS-CL reported that the nonintegrated systems it used for the DON's CFO financial reporting:

- were designed prior to DOD's general ledger requirements, resulting in nonconformity to ledger requirements,
- did not use the standard data elements needed to ensure consistent definition of accounts, and
- required considerable manual intervention to summarize and interpret data from subordinate systems.

The absence of a fully integrated general ledger system necessitates reliance on labor intensive, error prone processes to determine required items, accounts, and amounts reported in the DON's financial statements. Without integrated systems operating under ledger control, there is no overall discipline to ensure the truthfulness and completeness for the amounts reported. [Ref. 12]

The DON can not derive all of the financial data to complete the financial reports from the existing financial systems structure. The information which is not resident in the integrated systems is primarily inventory, plant, property, and equipment. Therefore, the DON relies upon "data calls" to various DON commands and other organizations, which then rely on their logistics systems and databases to provide them with the requested information.

2. Primary Sources of Data

Previously discussed were the problems encountered by the DON in gathering accounting data which is critical in the preparation of the financial statements. There are two primary sources of data for the DON in compiling the financial statements: The integrated information system and the "data call".

a. *Integrated Systems Data*

The DON's integrated financial information system data are compiled by the Navy Computer Telecommunications System (NCTS) Washington. The Navy Headquarters Financial System (NHFS) is the financial computer system segment within NCTS Washington. DFAS-CL receives financial reports generated by NHFS, such as, the Report on Budget Execution (DD-1176) and the Treasury Trial Balance (TFS-2108). Those reports are an integral part in the efforts of DFAS-CL and the DON to collect data for the CFO statements. The DD-1176, as of the end of the fiscal year (September 30, 1996) is utilized to determine the validity of the financial statements at the appropriation level. The DD-1176 for September 30, 1995 is utilized to provide beginning balances to validate certain totals on the CFO statements. The TFS-2108 is derived directly from the September 30, 1996, DD-1176, and many of the amounts on the CFO statements must equal the amounts posted on the TFS-2108. Information collected by the reports are illustrated in Figure

6.1 by the notation of DFAS next to the element on both the Statement of Financial Position and the Statement of Operations and Changes in Net Position. DFAS-CL performs the reconciliation of the trial balances. If the trial balances can not be reconciled then NCTS Washington can quickly research and resolve discrepancies.

| Department of the Navy STATEMENT OF FINANCIAL POSITION AS OF SEPTEMBER 30, 19XX (thousands) | | | Source | Department of the Navy STATEMENT OF OPERATIONS AND CHANGES IN NET POSITION FOR THE PERIOD ENDED SEPTEMBER 30, (thousands) | | | Source |
|--|--|--|--------------|--|--|--|----------|
| ASSETS | | | | REVENUES AND FINANCING SOURCES | | | |
| 1. Entity Assets | | | | 1. Appropriated Capital Used | | | DFAS |
| a. Transactions w/Fed Entities: | | | | 2. Revenues from Sales of Goods and Services | | | |
| (1) Fund Bal w/ Treasury | | | DFAS | a. To the Public | | | DFAS |
| (2) Accounts Receivable | | | DFAS | b. Intragovernmental | | | DFAS |
| (3) Interest Receivable | | | DFAS | 3. Interest and Penalties, Non-Federal | | | DFAS |
| b. Transactions w/Non Fed Entities: | | | | 4. Other Revenues and Financing Sources | | | D. Call |
| (1) Accounts Receivable | | | D. Call/DFAS | 5. Less: Taxes and REceipts Transferred | | | |
| (2) Interest Receivable | | | DFAS | to the Treasury or Other Agencies | | | DFAS |
| (3) Advances & Prepayments | | | DFAS | 6. Total Revenues and Financing Sources | | | TOTAL |
| c. Cash | | | D. Call | | | | |
| d. Inventory | | | D. Call | EXPENSES | | | |
| e. Seized & Forfeited Property | | | D. Call | 7. Program or Operating Expenses | | | DFAS |
| f. Plant, Property, & Equipment | | | D. Call | 8. Cost of Goods Sold | | | |
| Total Entity Assets | | | | a. To the Public | | | DFAS |
| TOTAL ASSETS | | | TOTAL | b. Intragovernmental | | | DFAS |
| | | | | 9. Bad Debts and Writeoffs | | | DFAS/FMO |
| LIABILITIES | | | | 10. Interest | | | |
| 1. Liabilities Covered by Budgetary Resources | | | | c. Other | | | DFAS |
| a. Transactions w/Fed Entities: | | | | 11. Total Expenses | | | TOTAL |
| (1) Accounts Payable | | | DFAS | 12. Excess (Shortage) of Revenues and | | | |
| (2) Other Fed Liabilities | | | D. Call | Financing Sources Over Total Expenses | | | |
| b. Transactions w/Non Fed Entities: | | | | Before Extraordinary | | | TOTAL |
| (1) Accounts Payables | | | DFAS | 13. Plus (Minus) Extraordinary Items | | | D. Call |
| (2) Accrued Payroll Benefits | | | DFAS | 14. Excess (Shortage) of Revenues and | | | |
| (3) Other Non Fed liabilities | | | D. Call | Financing Sources Over Total Expenses | | | TOTAL |
| Total Liabilities Covered by Budgetary Resources | | | | 15. Net Position, Beginning Balance, as Previously Stated | | | TOTAL |
| | | | | 16. Adjustments | | | DFAS/FMO |
| 2. Liabilities Not Covered By Budgetary Resources | | | | 17. Net Position, Beginning Balance, as Restated | | | TOTAL |
| a. Transactions w/Fed Entities: | | | | 18. Excess (Shortage) of Revenues and Financing | | | |
| (1) Other Fed Liabilities | | | D. Call/FMO | Sources Over Total Expenses | | | TOTAL |
| b. Transactions w/Non Fed Entities: | | | | 19. Plus (Minus) Non Operating Changes | | | DFAS/FMO |
| (1) Other Non Fed Liabilities | | | D. Call/FMO | 20. Net Position, Ending Balance | | | TOTAL |
| Total Liabilities Not Covered by Budget Resources | | | | | | | |
| TOTAL LIABILITIES | | | TOTAL | | | | |
| | | | | | | | |
| NET POSITION | | | | | | | |
| 1. Balances | | | | | | | |
| a. Unexpected Appropriations | | | DFAS | | | | |
| b. Invested Capital | | | DFAS | | | | |
| c. Cumulative Results of Operations | | | DFAS | | | | |
| d. Other | | | DFAS | | | | |
| e. Future Funding Requirements | | | DFAS | | | | |
| Total Net Position | | | TOTAL | | | | |
| TOTAL LIABILITIES & NET POSITION | | | TOTAL | | | | |

Figure 6.1 Identification of Sources of Information for CFO Statements

b. Data Call Information

As stated earlier in the chapter the DON relies upon data calls to various commands and other organizations, which then utilize their logistic systems and databases to provide the information requested. A "data call" enables the DON to collect the data (e.g., plant, property, and equipment, and liabilities which are contingent) which are not resident on the integrated information systems. Unlike the integrated systems, where the data can easily be retrieved and traced to the source of input, the data call is a more complicated process for both retrieving and validating information. A data call has between one to all of the claimants playing a role in the collection of specific items of information. A discussion will follow on each element illustrating the claimants responsible for compiling the information for a data call and how they gather it. The information collected via a data call is annotated in Figure 6.1 by the term data call following the element on the two statements. For certain elements, claimants are responsible for compiling all the information for the DON because they are designated as the lead organization. The following list represents those elements which appear on the CFO financial statements which have primarily one claimant responsible for providing the financial data:

1. Inventory
2. Plant, Property, and Equipment to include; Land, Structures, Construction in progress
3. Military Equipment; Aircraft, Ships, Missiles, Satellites, Tanks
4. Other Federal liabilities covered by budgetary resource.

Inventory totals for DON will be collected and reported by Commander Navy Supply Systems Command (NAVSUP) utilizing the Supply System Inventory Report (SSIR). This account will include investment funded secondary items and principal items which are reported by other claimants.

The plant, property, and equipment that is listed is the responsibility of Commander Navy Facilities Command (NAVFAC). The information is gathered in its Navy Facility Assets Data Base Management System (NFADB MS). The property does not belong to NAVFAC but it is responsible for submitting the reports. Real property will be accounted for using the Defense Property Accounting System (DPAS). Military equipment, unlike that of plant, property and equipment, has a responsible claimant for each item.

Military equipment is handled differently, because asset values have not been maintained through any reports system. Hence, cost of equipment is recomputed based on historical figures. An analysis is made to determine the historical cost of military equipment (e.g., aircraft, by type) and then that cost is multiplied by the number of pieces

of equipment by type to determine the value depicted on the financial statements. Claimants who control military equipment are as follows: Aircraft is reported through Commander Naval Air Systems Command (NAVAIR); Ships are reported by Commander Naval Sea Systems Command (NAVSEA); Missiles are reported by Strategic System Programs; Satellites are reported by Commander Space and Naval Warfare Command; Tanks are reported through CMC. The accounting of historical military equipment, i.e., museum assets, are only listed by quantities not by the value on the CFO statements. This is because of the difficulty of assigning and determining a value of historical military equipment.

The last element for which there is primarily one source responsible for submitting information via the data call is other Federal liabilities covered by budgetary resources. The ASN(FM&C) holds the lead in gathering and reporting this information.

The following list represents those elements which most, if not all, the claimants must report financial information to the DON for data calls. These elements rely on various types of files and local programs which are used by the claimant to compile the required information:

1. Accounts receivable
2. Cash
3. Seized property
4. Forfeited property

5. Plant, Property, and Equipment to include: ADP software; Natural resources; Other assets
6. Other revenue and financing sources
7. Extraordinary items

Accounts receivable, from transactions with non-Federal entities, should be reported by any claimant who has accounts receivables which were not transmitted through the integrated system. The information is retrieved from the receivable records of the claimants.

Cash and other monetary assets should be reported by any claimant from a review of their bank records or by contacting their disbursing officers or imprest official for the cash values.

Seized and forfeited property will be reported by any claimant who is the custodial agent of the property. The legal counsel for the claimant is the source to provide the information on the seized property and the office of counsel should provide the information necessary for forfeited property.

Plant, property, and equipment (e.g., ADP software, natural resources, and other assets) along with other revenues and financing sources and extraordinary items require individual claimants to provide the requested information through their local property and financial accounting records.

c. Information Flow

With the understanding of what information comes from what source to produce the CFO financial statements, Figures 6.2 through 6.4 represent the flow of information from the claimant level to the auditors of the financial statements, the GAO and the Inspector General of the DOD. Figure 6.2 documents the flow of information from the integrated systems and in response to the data call. Figure 6.3 documents the process of validating the statements and Figure 6.4 documents the process of incorporating revisions of the statements.

It is important to note a few significant details on the flow diagrams:

- DFAS-KC is not depicted in the flow charts, however, they provide the same service to the Marine Corps that DFAS-CL provides to the Navy claimants.
- Note 1 summarizes the accounting principles and methods used of applying those principles that management has concluded are the most appropriate for presenting the entities significant elements on the financial statements.
- The Marine Corps financial statements will ultimately be incorporated into the DON statement upon certification of the final revision by the CMC by DFAS-KC transferring the certified statements to DFAS-CL.

By gathering financial information by means of the integrated financial systems of the DON and data calls, the DON has been able to produce the CFO statements. The following chapter will conclude this thesis by identifying several issues which were found in need of further study.

GENERAL FUND CFO STATEMENT
PROCESSING FLOW-CHART

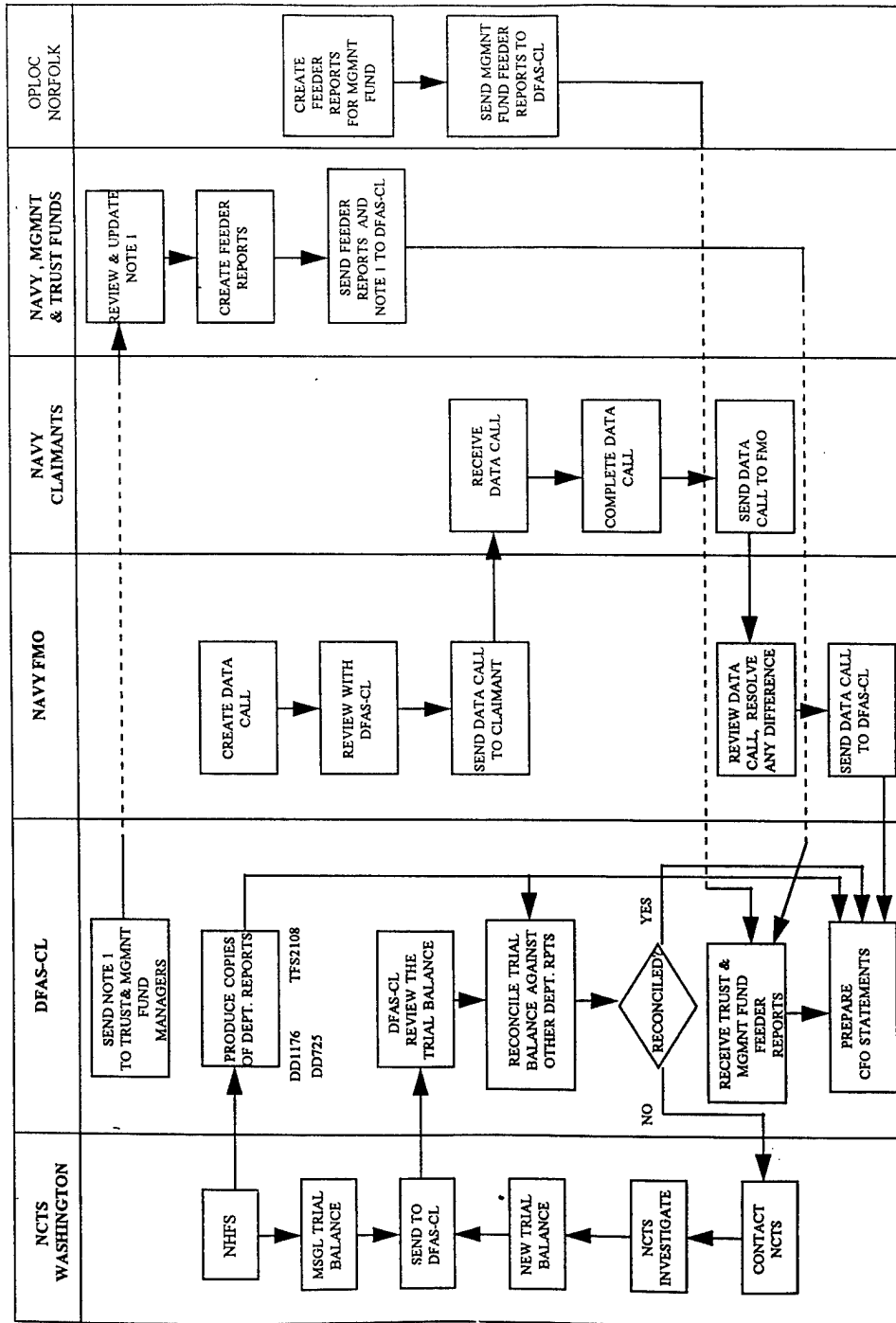


Figure 6.2 CFO Information Flow Chart #1

**GENERAL FUND CFO STATEMENTS
PROCESSING FLOW-CHART**

2

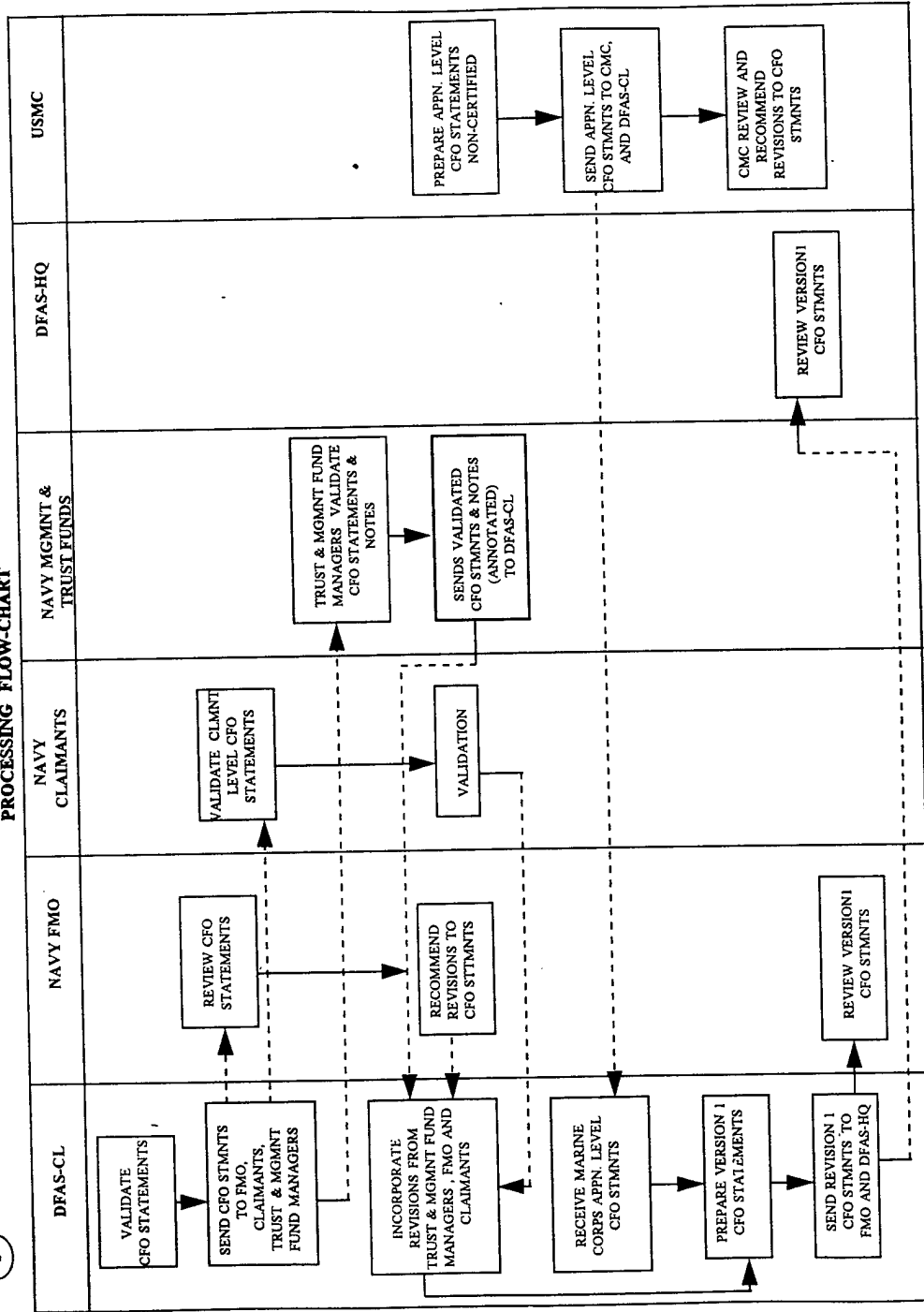


Figure 6.3 CFO Information Flow Chart #2

GENERAL FUND CFO STATEMENTS
PROCESSING FLOW-CHART

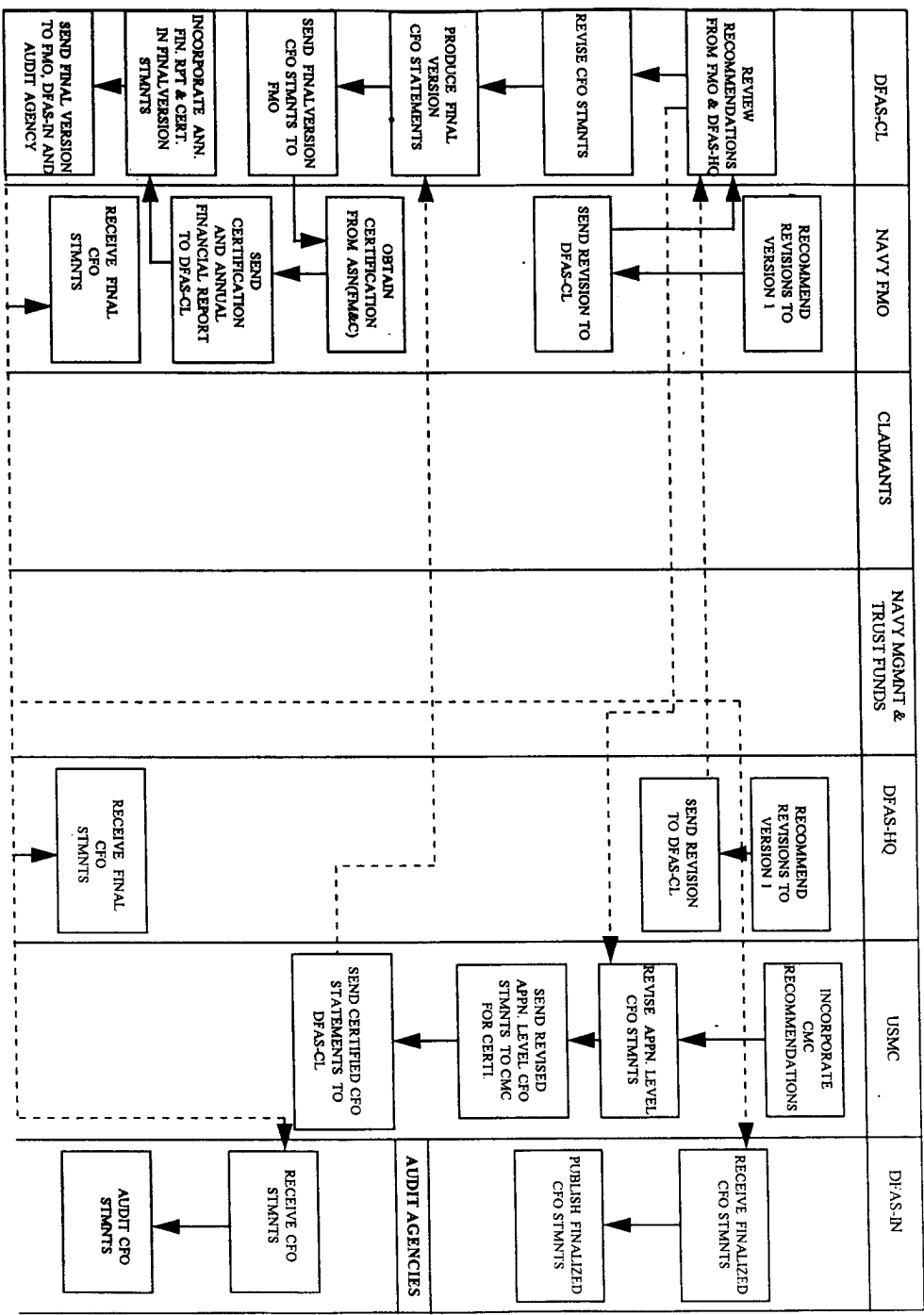


Figure 6.4 CFO Information Flow Chart #3

VII. SUMMARY AND CONCLUSION

A. SUMMARY

In an effort to show how the DON provides a comprehensive picture of its financial position and operations, this thesis has described the state of the art of proprietary financial reporting in the DON. Proprietary reporting includes reporting on the creation, management and use of all resources (assets) of an organization, not just expendable funds. The intent of proprietary reporting is to report on the financial condition and operations of the DON by measuring the assets, liabilities, and net position, and describing how assets, liabilities, and net position change over time.

To provide a point of reference, a comparison was made between proprietary reporting in the Federal government and in the private sector. This comparison was accomplished by discussing: the objectives, the nature of financial operations, the control of activities, the users of the financial reports, and the conceptual models on which reporting in the two sectors were based. The comparison of the Federal government and the private sector revealed differences in the financial objectives, differences in the information needs of financial statement users, and consequently, differences in the focus of financial reporting. More specifically, the objective of the entities for the

Federal government is to provide services to the constituents, while the private sector sought a return on investment, and a return of investment. The users of financial reports in the Federal government are concerned with control and accountability, while the private sector users are concerned with profitability. As a result the Federal government model of accounting focuses on reporting the obligation and expenditure of appropriated funds, while the private sector model focuses on reporting financial position and measuring performance in terms of income.

A review of the major laws, and the agencies responsible for carrying out financial reporting policies was conducted. Of significance was the CFO Act of 1990, this act called for the preparation of government-wide financial statements. The GPRA of 1993 is another significant law which requires Federal agencies to link performance measures to the financial statements.

To provide a closer view of how the DON is adhering to the CFO Act, an analysis of the statements was conducted. The form and content of the Statement of Financial Position and the Statement of Operations and Change in Net Position was reviewed. The elements which comprise the components of the model (assets, liabilities and net position) were discussed so that the reader would have an understanding of the composition of the financial statements. Two major findings were: (1) The

government categorized assets and liabilities by who exercises control over them, while the private sector categorized assets and liabilities by liquidity. (2) The Federal government provides a model for the financial statements, however, not all the elements which comprise the statements apply to the DON model.

In an effort to describe where and how the information for the reports are collected, a review of the information systems currently utilized was presented. It is important to note that a dual process is used to gather the information for the proprietary statements. The two processes are an integrated system and the data call. This situation exists because of the lack of an integrated system to capture all of the required data. This thesis illustrates the state of the art of proprietary financial reporting in the DON.

B. SIGNIFICANT ISSUES FOR FURTHER STUDY

The aim of thesis was to provide a broad view of the state of the art in proprietary financial reporting in the DON. While researching the topic several issues were found that require additional study. These issues could have a significant impact on the materiality, validity, and the accuracy of the proprietary financial statements. The significant issues which could effect the DON's proprietary financial statements are:

1. The capitalization of assets,
2. Expensing operating supplies and adjustments to prior year statements,
3. Performance Measures,
4. Data collection and validation of final statements.

1. Capitalization of Assets

In accounting for assets, the DOD Components capitalized and retained in their asset equipment accounts immaterial (low cost) items that were below the current capitalized threshold. Low-cost items were retained in the equipment accounts because the DOD accounting policy for capitalizing equipment requires that items formerly capitalized at lower or prior thresholds must be retained in the accounting records as a capital asset rather than be purged from the account when the threshold is changed by Congress. Specifically, since fiscal year 1984, the accounting policy has specified that the DOD Components should use six materiality thresholds, ranging from \$1,000, as established before 1985, to \$100,000, as established in 1996. As a result, the Defense Agency Equipment Account contains a mix of items, some material and some immaterial in value. [Ref. 13] This could lead to an assessment that the value of the Defense Agency Military Equipment Account is of limited utility for financial management purposes. Thus, the DON's value for equipment on the financial statements would be of limited use. Further detailed research is required to explain the degree of significance for the capitalization of assets and its effect on the utility of the statements.

2. Expensing Operating Supplies and Adjustments

DOD guidance has established that for the DON-wide accounts, operating supplies will be expensed and not reported as an asset. This treatment assumes that such supplies are consumed at the moment they are transferred from the supply system to the operating units. Thus, any supplies held by the operating units are not reported as assets. The value for these supplies on the Statement of Financial Position is presumed to be zero. This creates problems in accounting for supplies returned from operating units to supply centers. Supplies already expensed in a previous year may now be considered assets requiring some type of adjustment to prior year statements. Further research into the affect on adjustments to prior year statements is required to assure that accounts are properly adjusted.

3. Performance Measures

Previously mentioned was the GPRA. This act requires the Federal government to use performance measures to manage and monitor the success or failure of its operations. The CFO statements are intended to provide management with the information to establish performance measures. The link between the statements and the performance measures is supposed to be incorporated in the overview section of the financial statements. For instance, accounting for depreciation is not performed on military equipment. Measures

of depreciation have the potential to communicate the rate of consumption of assets, and hence, its remaining useful life. Providing performance measures for the depreciation of military equipment, such as aircraft, could communicate the need for replacement or the need to reinvest in upgrades. So, to ensure the return on the DON efforts are satisfactory, performance measurement requires further research.

4. Data Collection and Validation

As chapter VI discussed, effective management of the Nation's resources requires comprehensive, consistent, and coordinated financial information. The DON has understood this and is moving toward an integrated financial information system. Currently with the systems in place, the DON's 1996 statements will result in less than an unqualified opinion by the auditors. Relying on less than adequate information systems produces a ripple effect which hinders the ability to ascertain the financial condition of elements, claimants, and the DON overall. Therefore, additional research into data collection and ensuring the validation of the information is recommended.

C. CONCLUSION

Thomas Jefferson's statement introduced in Chapter II, is reproduced here:

I think it an object of great importance...to simplify our system of finance, and to bring it within

the comprehension of every member of Congress...the whole system [has been] involved in impenetrable fog. There is a point...on which I should wish to keep my eye...a simplification of the form of accounts...so as to bring everything to a single centre[;] we might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them to investigate abuses, and consequently to control them.

Thomas Jefferson
April, 1802

This represents the ideal in financial reporting, toward which the Federal government is moving. This thesis has examined and illustrated the state of the art of financial proprietary reporting in the DON. The DON has seen the twilight of an era in which the primary objective of financial management has been to manage and report on the obligation of appropriated funds. Now the DON is embarking on an adventure of heightened fiduciary responsibility. Performance measures, derived from the financial statements are to be developed to assist in monitoring the effective and efficient process of managing the Federal government's, DOD's, and DON's limited resources. With the arrival and the enforcement of the CFO Act, GPRA, and GMRA, proprietary financial management is rising to greater prominence in the DON business culture.

APPENDIX. CASH FLOW STATEMENT

Department/ Agency

| | 1996/7 | 1995/6 |
|---|--------|-------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| 1. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | | <hr/> |
| Adjustments affecting Cash Flow: | | |
| 2. Appropriated Capital Used | | |
| 3. Decrease (Increase) in Accounts Receivable | | |
| 4. Decrease (Increase) in Other Assets | | |
| 5. Increase (Decrease) in Accounts Payable | | |
| 6. Increase (Decrease) in Other Payable | | |
| 7. Depreciation and Amortization | | |
| 8. Other Unfunded Expenses | | |
| 9. Other Adjustments | | |
| 10. Total Adjustments | | <hr/> <hr/> |
| 11. Net Cash Provided (Used) by Operating Activities | | <hr/> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| 12. Sale of Property, Plant and Equipment | | |
| 13. Purchase of Property, Plant and Equipment | | |
| 14. Sale of Securities | | |
| 15. Purchase of Securities | | |
| 16. Collection of Loans Receivable | | |
| 17. Creation of Loans Receivable | | |
| 18. Other Investing Cash Provided (Used) | | <hr/> |
| 19. Net Cash Provided (Used) by Investing Activities | | <hr/> |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| 20. Appropriations (Current Warrants) | | |
| 21. Add: | | |
| a. Restorations | | |
| b. Transfers of Cash From Others | | |
| 22. Deduct: | | |
| a. Withdrawals | | |
| b. Transfers of Cash to Others | | |
| 23. Net Appropriations | | <hr/> <hr/> |
| 24. Borrowing from the Public | | |
| 25. Repayments on Loans to the Public | | |
| 26. Borrowing from the Treasury and the Federal Financing Bank | | |
| 27. Repayments on Loans from the Treasury and the Federal Financing Bank | | |
| 28. Other Borrowings and Repayments | | |
| 29. Net Cash Provided (Used) by Financing Activities | | <hr/> <hr/> |
| 30. Net Cash Provided (Used) by Operating, Investing and Financing Activities | | |
| 31. Fund Balances with Treasury, Cash, and Foreign Currency, Beginning | | <hr/> |
| 32. Fund Balances with Treasury, Cash, and Foreign Currency, Ending | | <hr/> <hr/> |

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