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THESIS

STOCK FUND ASPECTS OF
DEFENSE BUSINESS OPERATIONS FUND

by

Sharon R. Chapman

September, 1992

Thesis Advisor:

Jerry L. McCaffery

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Stock Fund Aspects of
Defense Business Operations Fund

by

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Lieutenant, United States Navy
B.S., United States Naval Academy, 1986

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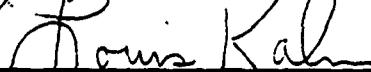
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ABSTRACT

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I. INTRODUCTION

A. BACKGROUND

The Navy Practical Comptrollership Course (PCC) is offered at the Naval Postgraduate School several times throughout the year. The course is designed for newly reporting Navy comptrollers and financial managers. The intent of the course is to familiarize these managers with existing regulations and management suggestions from experienced financial managers in the field. In the current budget environment, a financial manager must be informed in order to optimize his use of diminishing resources. Although the PCC focuses on a wide variety of topics, this thesis will concentrate on one specific segment of the current PCC manual, the Navy DBOF (Supply).

Recent changes initiated by Defense Management Report Decision (DMRD) 971 include the incorporation of the NSF into the Defense Business Operations Fund (DBOF). For the purpose of this thesis, however, we will continue to refer to the NSF segment of the Supply Management business area of DBOF as Navy DBOF (Supply).

To better understand the Navy DBOF (Supply), all financial managers must have a basic understanding of the revolving fund concept. A fund is defined as "a separate enterprise, having

assets, liabilities, net worth, income and expenditures of its own." In commercial practice, a fund is a device to limit the area of attention by defining the activities, or operations, with which a particular management group and set of records are concerned. In government practice, a fund is not tied to profit making, hence, the emphasis is not on maximizing income. The fund was created to isolate a particular area and allow management to focus on it as an entity.

A working capital fund is a revolving fund used as a source of financing for work (or services) that will be paid by the customer after completion of the job. The activity performing the work pays for costs incurred out of its working capital fund during job accomplishment. When the job is complete, the customer is billed and the fund is reimbursed. The goal of a DOD Working Capital fund is to recover all costs and work to a zero profit.

The Navy DBOF (Supply), a working capital fund, is used to purchase and hold inventories of supply items. Items purchased by the fund are held at stock points until they are needed by a customer. In effect, the final costing for the item is deferred until issued to the ultimate user. When items are issued from the Navy DBOF (Supply) to user activities, the user's financing appropriation reimburses the fund for items drawn, thus providing resources which can be used by the fund to purchase new items or to replace inventory that has been sold. The amount reimbursed to the Navy DBOF

(Supply) includes a surcharge to cover the cost of supply operations and several other costs incurred while the item was held at the stock point. (These factors that the surcharge is comprised of are discussed in detail in the following chapter.) Because of this last feature, DBOF is categorized within the government's accounting structure as a revolving and working capital fund.

Figure 1 provides an illustration of the above described revolving nature of the Navy DBOF (Supply). As illustrated in Figure 1, there are two major areas of the fund which complicate the above described model; the fund experiences some costs which must be recouped through surcharges and under certain circumstances, the fund may need an injection of resources from outside sources. These resources provide necessary financing to the fund during wartime or other expansion of the Navy.

The purpose of this thesis is to define this concept as it applies to the Navy DBOF (Supply) and explore the "need to know" areas (of the fund) for a financial manager at the field level.

B. RESEARCH QUESTION

The primary research question of this thesis is: What does a financial manager at the field level need to know to maintain strict accountability and control over his stock fund operation?

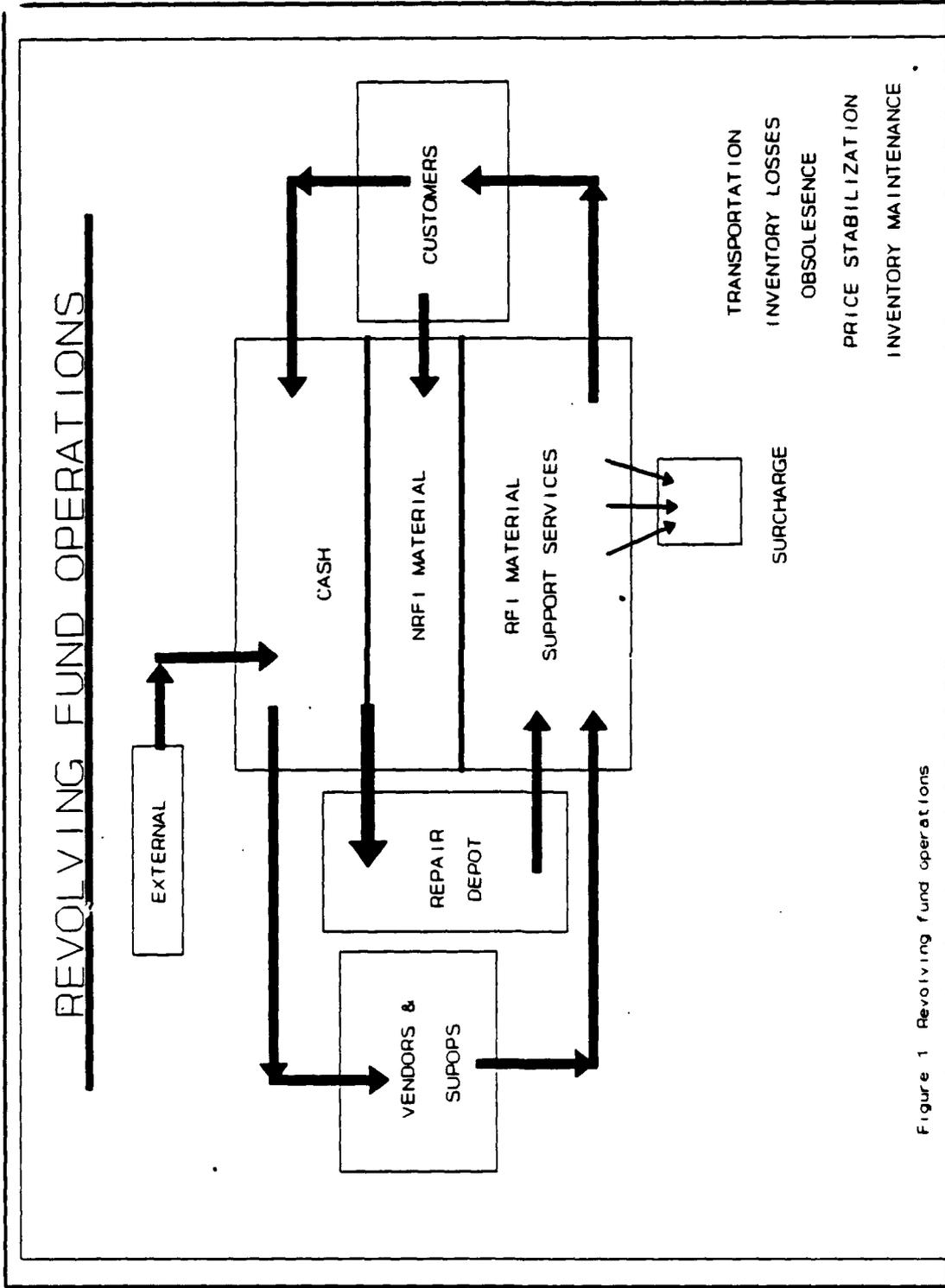


Figure 1 Revolving fund operations

C. SCOPE

This thesis focuses on the problem areas associated with the administration and management of the Navy DBOF (Supply). Existing regulations and management suggestions from experienced financial managers will also be included.

The information is intended for use by newly reporting Navy comptrollers and financial managers who have little experience with stock fund accounting and will be included in the manual used in the Navy PCC.

D. LITERATURE REVIEW AND METHODOLOGY

Information for this thesis was obtained by reviewing current Naval directives and instructions as well as memorandums (and guidance) from various commands. Personal interviews will be the method used to gather first-hand information from all levels of different field activities.

To gain different perspective on the current NSF regulations and accounting procedures, personnel from Defense Finance and Accounting Service (DFAS), Naval Supply Systems Command (NAVSUP), Navy Fleet Material Support Office (FMSO), and Navy Ships Parts Control Center (SPCC) were contacted.

E. THESIS ORGANIZATION

This thesis will be broken down into seven chapters.

These chapters go through:

- development and structure of Navy DBOF (Supply)
- supply system structure
- DBOF budgeting
- Navy DBOF (Supply) reporting
- DMRD's

F. A NOTE ON STYLE

Since certain portions of this thesis will be used as a supplement to the Navy PCC manual the normal thesis format has not been strictly observed. To make the text more readable to students third person pronouns are used. The usage of the terms "he" or "she" is intended generically as is the possessive "his" or "hers." It should be understood that either term is equally applicable to all such usages.

II. DEVELOPMENT AND STRUCTURE OF NAVY DBOF (SUPPLY)

A. EVOLUTION OF NAVY DBOF (SUPPLY)

The Department of the Navy Stock Fund (DONSF) operated under a management concept which evolved over a period of over 100 years and was by far the oldest stock fund in the Department of Defense. Prior to 1878, all supply inventories were maintained and distributed on a free issue basis. The forerunner of the NSF was born in the creation of that year of a "general account of advances" which was a simple annually appropriated revolving fund that varied in size from year to year. In the year 1893 the Navy Supply Fund Act was passed, the pertinent portion of which follows:

"And the Secretary of the Treasury is hereby authorized and directed to cause the general account to be charged with the sum of two hundred thousand dollars, which amount shall be carried to the credit of a permanent naval supply fund to be used under the direction of the Secretary of the Navy in the purchase of ordinary commercial supplies for the naval service, and to be reimbursed from the proper naval appropriations whenever the supplies purchased under said fund are issued for use."

The act established the basic concept of the stock fund in its formation of a "corpus" or body of capital which is reimbursed by the customer at the time of issue of material. In 1942, the corpus was increased in size to accommodate the

increased needs of the wartime Navy and it acquired the name "Navy Stock Fund."

In 1949, when Congress amended the National Security Act of 1947 establishing the Department of Defense, the need to promote "efficiency and economy" through use of uniform budgetary and fiscal procedures was recognized. Among the features of the National Security Act was authorization (10 U.S.C. 2208) for the Secretary of Defense to establish working capital funds for the purpose of financing supply inventories and the capitalization of industrial type activities.

In 1955, the Commander, Naval Supply Systems Command (then the Bureau of Supplies and Accounts) was tasked with the responsibility of administration and management of the NSF. Finally, in 1961, the Defense Supply Agency was established which had a profound effect on DONSF management, both financially and operationally. The Defense Supply Agency (later named the Defense Logistics Agency) was to assume procurement and supply management responsibility for a considerable number of high demand type items which had previously been managed by the Navy and held in the Navy Stock Account of the stock fund. The DONSF was operated in accordance with Department of Defense Directive 7420.13R "Stock Fund Operations."

In 1987, the NSF and the Marine Corps Stock Fund merged into the DONSF. Even though they were part of the same fund, the allotment and inventory accounting systems were maintained

separately at the operating level, the budget project level, and at the administering office levels (Naval Supply Systems Command and Commandant of the Marine Corps) . The two portions of the DONSF were combined at the Department level for reporting to higher levels.

In fiscal year 1992, two types of revolving funds, industrial funds (which operated under Department of Defense Regulation 7410.4) and stock funds were incorporated into the Defense Business Operations Fund (DBOF). A few additional Defense Agency activities that lend themselves to a business management mechanism are also included in the Fund. The primary goal of implementing the DBOF is to provide a business management structure that encourages managers and employees of Department of Defense (DOD) support organizations to provide their products or services at the lowest cost. The DBOF essentially combines existing commercial or business operations that were previously managed as individual revolving funds into a single revolving or business management fund.

The establishment of the Fund does not change any previous organizational reporting structure or command authority relationship. Combining business activities under a single Treasury Code allows consolidation of cash management, while functional and cost management responsibilities remain with the Military Departments and Defense Agencies.

The Office of the Department of Defense Comptroller DOD(C) has stressed that in this period of declining resources, all financial managers need to associate support costs to specific missions while optimizing these resources to provide quality support. To meet these challenges such objectives as:

- streamlining departmental operations
- cutting costs without cutting capability
- cutting overhead

have been implemented by the DOD(C) through Defense Management Report Decisions (DMRD's). DMRD 971 (discussed in more detail in Chapter VI) introduced the theory of applying business-like practices to Department of Defense financial management. "The goals of DMRD 971, as outlined by the Office of the Secretary of Defense (OSD), are based on creating a business environment in DOD operations. As with all businesses, it is essential that operations put a premium on quality and encourage managers at all levels to reduce costs." [Ref. 1]

"Managers and employees will be provided with the tools and financial information needed to evaluate productivity of the sustaining base in terms of costs and outputs. Eventually, all functions of the sustaining base will be moved into the DBOF and those support functions will be operated on a revolving fund basis. Simply put, OSD is attempting to turn the support structure of the services into business activities that must sell their products in order to continue to exist.

The idea is that the funds expended in those support functions should be tied directly to the "demands of the mission elements" of defense - those war-fighting units that represent the real output of the Defense funding appropriated by Congress. In short, that means giving the funds to the mission customers and letting them buy the support they require. If support functions are to survive, providers must be able to sell the goods and services they produce to their mission force customers at a price the customers are willing to pay in an austere fiscal environment." [Ref. 1]

B. PURPOSE OF DBOF

As mentioned above, a major feature of the business management structure in DBOF is the increased emphasis on business operations. This business operations structure identifies each business area, the products or services, and the total cost of operations within that business area. Under this structure, customers establish requirements and are charged, through the rate structure, for the cost of industrial and commercial-type services and products provided. Providers, in turn, produce quality goods and services which satisfy customer requirements at the lowest cost. In other words, support organizations incur costs based on customer orders.

The linkage of support costs to customer funding ensures better communication between the customer and the provider.

By making the producing organization responsible for managing all costs associated with delivering the goods or services, those managers will identify cost drivers and can focus their management improvement efforts accordingly. Better cost visibility enables managers at all levels to make informed decisions.

C. DBOF PRICING POLICY

Under DBOF, all direct, indirect and general and administrative costs incurred will be collected and identified to the product or service benefitting from the costs. DBOF and non-DBOF customers will be billed the total, all inclusive, cost for goods and services provided, based on the price structure approved in the President's budget. Cost per output or "unit cost" has the advantage of giving all levels of management a focus on the cost of doing business, or production of specific outputs. The result is a better tool to manage DOD's business and a basis for charging customers for the products of each supporting organization.

Although operations of the DBOF are based on policies and procedures that have been in effect for the stock and industrial funds, a number of management, accounting, policy, and procedural changes have been implemented. One key change that relates specifically to the Navy DBOF (Supply) is the initiative for the full recovery of costs. Pricing guidance is consistent with long standing DOD policy calling for break-

even operation of certain business functions within the Department. Previous stock fund operations were expected to break-even over the long term. In actuality, prior year operations have at times resulted in substantial losses remaining on the financial records over a number of years. Management philosophy and focus under the Fund has reaffirmed the Department's policy for budgeting on a break-even basis. As a result, prices in future budget submissions will be uniformly established to recover the full cost of operations, including recovery of prior year losses or return of prior year gains, by the end of the budget year.

All businesses in the Fund are required to set their prices based upon full cost recovery. Prices or rates, as appropriate, are fixed during the year; actual costs are evaluated against established prices; and the financial condition assessed accordingly. Profits or losses will be determined at the end of the year and reflected in price adjustments to the customer in a subsequent year. Establishing rates based on costs assists individual program managers (customers) in making cost effective program decisions. Such decisions may involve selecting among alternative goods or services, choosing from competitive sources providing similar goods or services, or determining whether to replace or to repair an item. Assessing the financial health of the Fund through the evaluation of financial results will improve the emphasis on the cost of

doing business and ultimately reduce the prices charged to the operating forces, and the cost of those forces.

D. PRICE COMPOSITION

In terms of cost recovery, there are six items which must be countered through surcharges in order to allow the Fund to revolve and maintain approximately the same real worth. These are:

- Cost of Supply Operations
- Transportation
- Inventory Losses
- Obsolescence
- Price Stabilization/Inflation
- Inventory Maintenance

These surcharges are included in both the standard and net prices. There are, however, two additional factors included only in the net price: depot washout factor (accounts for depot level repairables which do not survive the depot repair process) and carcass loss factor (accounts for unserviceable depot level repairables turned in but lost in the cycle). Below is a brief explanation of each surcharge and why it is applied to the price of Navy DBOF (Supply) material.

1. Supply Operations

This category includes the costs of supporting the mission of Supply Depots and ICP's, service wide transportation and base operating support.

2. Transportation

Normally the cost of material purchased by the fund includes the cost of initial transportation from source of manufacture or purchase to a stock point. Additionally, if this material is relocated within the supply system, from one stock point to another, the fund must bear the cost of this transportation.

3. Inventory Losses

Since the fund holds inventory until it is issued to a customer, it experiences a measure of damage or loss of the inventory in the process.

4. Obsolescence

Because the supply system and the fund support Navy customers and their methods of operation are through the issuance of material from inventory (as opposed to simply ordering it from commercial sources upon customer request), the fund buys most material for stock in anticipation of a level of customer demand. Due to erroneous anticipation of demand, technological advances or system deactivations, however, inventory often becomes "unsalable".

5. Price Stabilization/Inflation

The price stabilization factor is the cash tool used to effect the budgeted rate change across all material categories and to achieve the approved level of fund with the Treasury. It is a buffer that compensates for the difference

between pricing assumptions made in the budget and actual costs experienced during the preceding twelve months. Inflation is also included in this category as this is the anticipated price escalation in the market as established by the Office of the Secretary of Defense.

6. Inventory Maintenance

This is simply the costs incurred by inventory growth due to increased demand.

These six aspects are illustrated in Figure 2 as components in the prices charged to customers for inventory issued by the stock fund.

Navy Price Composition

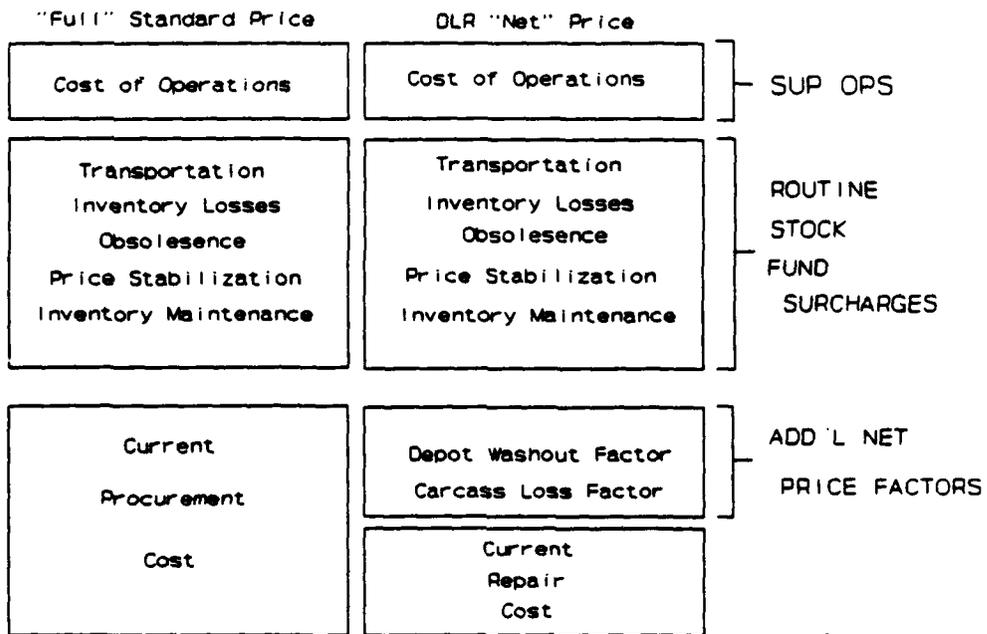


Figure 2. Navy price composition

III. THE STRUCTURE OF THE SUPPLY SYSTEM

A. NAVY DBOF (SUPPLY) LEVELS

Navy DBOF (Supply) operates on at least two levels; wholesale (in support of world-wide requirements) and retail (in support of local or area customer requirements). Every item in the National supply system has been assigned to one of the services, DLA or GSA for world wide management. Within the service which is assigned wholesale management responsibility for a particular line item of supply, each item is assigned to an Inventory Control Point (ICP) for management. These ICP's are responsible for predicting/obtaining world-wide demand, buying appropriate quantities of stock and directing the issuance of that stock to various customers in DOD or the federal government as required.

Within the Navy, ICP's do not actually hold inventories on their premises, but rather consign deliveries of incoming wholesale material to warehouses at Navy stock points such as the Naval Supply Center (NSC) San Diego. NSC San Diego, in the wholesale arena, acts as a warehouse for ICP owned material and receives wholesale stock as it is "pushed" to NSC by the ICP's. Similarly, the ICP's may refer requisitions for wholesale material to NSC San Diego (as a warehouse) to issue

to customers or other stock points. As the reader might imagine, ICP's execute various location strategies for wholesale material, sometimes concentrating all stocks of a particular line item in one warehouse or spreading stocks of a particular line item to many different (wholesale) stock points.

NSC San Diego (for example), in addition to acting as a wholesale stock point, has a specific regional area for which it is responsible for providing supply support. NSC maintains an inventory of supplies for the purpose of supporting its local customers. In supporting its local customers, the NSC is executing a retail, rather than wholesale function. NSC San Diego (for example), orders line items of supply into stock which it anticipates will be necessary to support its local customers. The normal source of these line items is to order them (for retail stocks) from the ICP which exercises wholesale inventory management responsibility. Thus retail stocks are "pulled" to the retail stock point as opposed to wholesale stocks which are "pushed" to a stock point by an ICP.

Wholesale managers, ICP's, obligate Navy DBOF (Supply) resources when they procure wholesale material from commercial sources. Navy retail stock points may obligate Navy DBOF (Supply) resources when they pull retail material from ICP's which operate in other than the Navy portion of DBOF or when they buy quantities of retail material on the local commercial

market. Navy DBOF (Supply) resources are not obligated when material is moved between stock points (on a push or pull basis) which carry the material in the same business area of the fund. Such transfers of material between Navy stock points are called Other Supply Officer (OSO) transfers.

Within a stock point, material may be carried for different purposes and at different locations. As illustrated in Figure 3, material carried at a stock point may be categorized as to its source (Navy, DLA or other ICP Management), purpose (wholesale, retail) or its location (Main Store, Ready Supply Store, ServMart). The material may be held in the Appropriation Purchases Account (APA) or Navy Stock Account (NSA).

B. RESALE INVENTORY

There is a segment of retail inventory different from the retail inventory described above in that it is destined for sale to individuals. This is sometimes called "resale" inventory. Ships stores carry resale material. Ships stores carry health and comfort items, some food items and certain uniform items for sale to shipboard personnel.

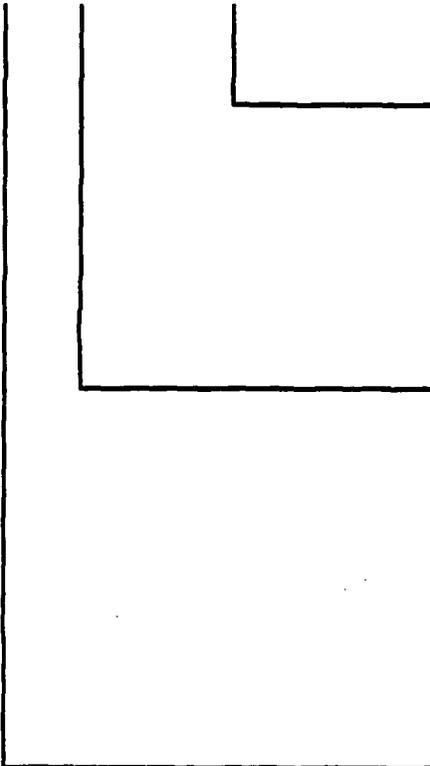
C. MATERIAL/FINANCIAL IDENTIFICATION

Item management and ownership are codified into a Material Cognizance Symbol (called COG) for every line item in the Navy supply system. The Navy COG symbol contains two digits and

precedes the National Stock Number (NSN) which has been assigned to each item of supply. A typical COG and NSN would be 9G-7520-00-904-1265. This NSN would reveal the information shown in Figure 3.

NAVY COG AND NATIONAL STOCK NUMBER

9G-7520-00-904-1265



National Item Identification Number (NIIN): the first two digits (00) indicate the NATO Source Country (USA), the remaining digits are a unique number which has been randomly assigned to this line item within the Federal Supply System.

Group and Classification: a four digit number which categorizes the item by its individual characteristics. (7520) would indicate office supplies, writing material and could be used by a stock point or ICP to assign management of storage for similar types of items.

Material Cognizance Code (COG): the first digit indicates basic ownership. Odd numbers (1-3-5-7-9) are assigned to stock fund items and even numbers to APA items. The presence of a number in the first digit indicates Navy ownership; items owned by DLA are coded with an alpha character to indicate DLA wholesale ownership.

Figure 3. Navy COG and NSN.

IV: DBOF BUDGETING, FLOW OF FUNDS AND ACCOUNTING

A. OVERVIEW OF NAVY DBOF (SUPPLY) FINANCING

DBOF's financial procedures provide increased flexibility to enhance management discretion. The annual budget documents for each business area in the Fund provide clear guidance as to DOD's expectation of financial performance. Each business area receives both an operating and a capital budget. During FY 1992, a major effort has taken place in each business area (such as Navy DBOF (Supply)) to improve the delineation between capital investments and operating costs.

Requirements for Navy DBOF (Supply) assets are generally for two basic purposes: to support peacetime operations (called Peacetime Operating Stocks or POS) and to support mobilization and war requirements (called War Reserve Requirements). While War Reserve Requirements are generally stated in terms of fixed levels of assets to support contingency plans, much of the POS requirements are based on the level of business which has been forecasted for the next year. The remainder of the POS requirement is stated in terms of fixed levels of supplies for insurance purposes or to support new equipment.

Another facet of the peacetime Navy DBOF (Supply) procurement program is linked to buy-out accounts within the annually appropriated procurement funds. Depot Level

Repairable procurement buy-in to support planned outfittings for ships and aircraft are tied to the funding in these accounts. The buy-out funds available relieve the burden from the Navy DBOF (Supply) of having to invest large scale turnovers of material involved in, for instance, aircraft carrier re-outfittings.

A change in pricing policy reflected in the FY 1993 budget changes the way costs related to mobilization and excess surge capacity for wartime requirements will be funded, as they are identified. This policy applies to those costs incurred at an activity that will insure that the activity will meet the mobilization/surge requirements that it has been given, in other words, costs which would not be incurred to satisfy customer peacetime requirements. Examples of costs included in this category are: maintenance of facilities, when those facilities are in excess of peacetime requirements; purchase of war reserve material; and purchase of material in excess of peacetime requirements to maintain an industrial base.

These mobilization costs will be funded through direct appropriations to the Operations and Maintenance account of the Navy. The prices of outputs of these activities are to reflect peacetime operating costs only. Customers of the Navy DBOF (Supply) will pay the cost of the items being procured (including overhead), and thus should be faced with more consistent pricing between competing activities. Similarly, there will be better visibility, to decision makers at every

level, of those costs included in the DOD budget for surge or readiness requirements.

Military personnel costs have been included in revolving funds since FY 1991. This change was made to ensure that the total costs of the business were being captured. The cost of the military personnel included in the Fund (DBOF) is reimbursed to the Military Personnel appropriations, and the budget request for those appropriations reduced accordingly. It is understood, however, that some military personnel may be working in business areas of the Department for a variety of reasons not directly related to peacetime missions. These include military assigned for career progression or sea/shore rotational assignments. If it were not for these requirements, some positions now staffed by military personnel would be staffed with civilians at a lower cost than military members.

Fund policy provides for "costing" at civilian rates those military personnel that are in Fund activities only for career progression and rotational assignments. The additional costs of these military personnel are financed separately in the Military Personnel Appropriations. By identifying the reasons military are assigned, this policy should contribute to the emphasis on improving visibility of costs to decision makers at all levels. This improved identification will also provide better information about military personnel requirements so that they can be adequately considered. Complete

justification must be provided in budget justification materials to support each military billet proposed for civilian equivalent costing.

Another cost to DBOF is that of assets from the industrial and stock funds. (These costs were transferred to the Defense Business Operations Fund.) Accountability of these assets is in accordance with current DOD regulations that governed the stock and industrial funds. All capital assets used by Fund activities are depreciated or amortized in accordance with generally accepted accounting standards. Full recovery of costs is essential for DBOF operations. All business areas in the Fund are required to set their prices based upon this full cost recovery. Prices are established through the budget process and remain fixed during the year of execution; actual costs are evaluated against revenue generated by workload at established prices; and the financial conditions is assessed accordingly. Profits or losses will be determined at the end of the year and will be employed as a basis for evaluating operating efficiency.

Prices for every Defense Component business activity are established for each fiscal year. Once established, these prices are held constant (stabilized) through program execution. This stabilized rate policy serves to protect customers from unforeseen inflationary increases and other cost uncertainties and better assures customers that they will not have to reduce programs to pay for potentially higher-

than-anticipated prices. In turn, this policy aids in stabilizing Fund workload levels and permits a more effective utilization of Fund resources.

Prices for the budget year(s) will be set to recover costs on a period-by-period basis. This means that Net Operating Result in the budget year will be zero. During budget execution, business areas will record either a positive or negative Net Operating Result. The treatment of these profits or losses will be determined during the budget review and should not be addressed in the setting of budget year prices by Components. (In the supply management businesses, the price setting process will be consistent with the rate changes approved during the budget review.)

To ensure consistency in the revenue recognition policy for end-product type orders within DOD and to guarantee the operating results reported in the financial statements are comparable between business areas, the percentage-of-completion method will be followed.

The percentage-of-completion method of revenue recognition is used for all end-product type orders that are expected to be completed in a fiscal year other than the fiscal year in which the order is started. Revenue, under the percentage-of-completion method, may be recognized on a percentage of physical completion based on visual observation or judgment of qualified personnel. Alternatively, when costs are incurred on a relatively uniform basis over the life of an order,

revenue may be recognized as a percentage of incurred costs to total projected costs. In all instances, the portion of work in process associated with the revenue recognition shall be transferred to cost of goods sold. The customer funding the order shall be billed for the revenue recognized, or when progress payments have been previously billed, those progress payments shall be recorded to the appropriate revenue account. At a minimum, the customer shall be billed and revenue recognized at the end of each fiscal year quarter. In no case shall the total amount of revenue recognized and billed exceed the amount of the order.

Defense Business Operations Fund business areas, not currently using the percentage-of-completion method to recognize revenue will begin immediately to conform to this policy. (DBOF activities will prepare their June 1992 financial statements using the percentage-of-completion method.) For service-type orders, revenue shall continue to be recognized at least monthly and considered as completed services rendered. Component revenue and expenses estimates will be consistent with this revenue recognition policy.

B. BUDGETARY POLICY

A critical aspect of Navy DBOF (Supply) is the budgetary policy and procedures for the financing of supply operations costs. This financing, which began on 1 October 1990, gave the NSF (as it was then called) responsibility for financing

traditional Operation & Maintenance (O&M) costs associated with ICP Operations and Supply Depot Operations, both previously budgeted for via the NAVSUP claimancy in its O&M, Navy appropriations.

During the development of the FY 1991 President's Budget, Defense Management Report Decision (DMRD) number 901 (Reducing Supply System Costs) removed all funding in the above categories from the NAVSUP claimancy, moved these costs into the Navy DBOF (Supply), provided FY 1991 DONSF obligational authority to meet the projected costs of supply operations, provided for increased NSF pricing to recoup these costs in its FY 1991 sales base, and provided financing in stock fund customer accounts to meet the expected pricing increase. In theory, Navy DBOF (Supply) pricing will reflect the total cost of both material procurement and all management overhead costs associated with operation of the Navy logistics network.

The major thrust of this initiative, i.e., to finance Supply Operations costs in the Navy DBOF (Supply), as well as the other initiatives proposed by DMRD 901 is to reduce costs and improve management in the DOD. The financing of Supply Operations in the Fund is not itself a cost savings feature but rather provides the inherent flexibility of management in the Fund to the O&M accounts. This financing change removes the appropriation "barrier" which has thwarted innovative changes by either fiscal regulation or financial shortfalls in "authorized" accounts. With both operations and material

costs in Navy DBOF (Supply), managers will have the flexibility to make better investment decisions between labor and material costs which will result in lower overall costs to Navy and DOD.

1. EXISTING BUDGETARY STRUCTURE

The existing budgetary structure for development, review, and execution of Navy DBOF (Supply) requirements will be utilized for all obligational requirements supporting costs of Supply Operations (SUPOPS). SUPOPS costs will be considered as a single, separate budget project for both budgeting and execution purposes. As in its Navy DBOF (Supply) material budgets, the claimant (NAVSUP) will review all SUPOPS financing requirements for all of its activities resourced through the Fund and will submit a consolidated request for obligational authority. Activity level data may be requested during budgetary reviews; however, no activity level data is anticipated to be provided in support of the Department of the Navy (DON) request to the Office of the Secretary of Defense (OSD).

Once approved by OSD, NAVSUP will be provided a single SUPOPS allocation of obligational authority for the year. Provided with this allocation will be the flexibility to move obligational authority between the material and SUPOPS Budget Projects (BP's) in an amount not to exceed 5% of the projected SUPOPS requirement. This flexibility will be used at the

discretion of NAVSUP to finance initiatives identified between budget reviews. A portion of the documented savings from these initiatives will be used to reconstitute the 5% flexibility level.

Execution of the 5% flexibility level must give consideration to more than the movement of obligational authority between material and SUPOPS BP's and the accrual of savings therefrom. A third consideration which must necessarily be met to effect this flexibility is the cash solvency of Navy DBOF (Supply). Movement of obligational authority to SUPOPS to produce savings will likely generate an earlier outlay of Navy DBOF (Supply) cash since labor costs expend at a much faster rate than the costs of acquiring material. The ability of the Fund cash balance to accommodate this earlier outlay must be analyzed in relation to the time periods in which savings (i.e., reduced outlays) will accrue to insure Fund solvency.

2. ALLOCATION OF SUPPLY OPERATIONS OBLIGATIONAL AUTHORITY

The procedures in place for material BP's, i.e., NAVSUP controls activity level distribution and execution, are identical for the allocation of SUPOPS obligational authority. Activities holding allotments of SUPOPS obligational authority will have a limited level of flexibility to make direct tradeoffs between material and SUPOPS BP's. With NAVSUP approval these activities may move obligational authority

between BP's up to an amount not to exceed 5% of their SUPOPS allotment to execute new savings initiatives. The movement of obligational authority will result from cost/benefit analyses or realized savings. Execution of this flexibility will be controlled and monitored by NAVSUP with Navy DBOF (Supply) BP managers through activity level reporting and demonstrated success on prior savings initiatives. A portion of the documented savings from these initiatives will be used to reconstitute the 5% flexibility level.

As unit costing is implemented at ICP and Supply Depot activities, allocation of SUPOPS obligational authority will become a product of the expected level of outputs. Income to finance SUPOPS costs will result from the SUPOPS surcharge included in each item sold by the Navy DBOF (Supply). Given that SUPOPS costs are relatively fixed in the short term, any reductions in the anticipated level of the Fund's sales will affect the financing of SUPOPS. If the budgeted sales or receipts/issues (assumed output measures for ICP's and Supply Depots, respectively) do not accrue, the level of obligational authority and outlays for both material and SUPOPS will be subject to review. NAVSUP will have the authority within the 5% flexibility levels noted above to move obligational authority between material and SUPOPS BP's to execute short term imbalances. Also, similar to the procedures under O&M,N funding, obligational authority for SUPOPS will be allotted by NAVSUP on a quarterly basis.

3. SUPOPS FINANCING REQUIREMENTS

The Navy DBOF (Supply) pricing mechanism will be employed to generate requisite income necessary to meet all SUPOPS financing requirements. As an integral portion of the budgetary review process, projected Fund expenditures will be expected revenues from sales of Fund material. The fund pricing will be revised as necessary to achieve the requisite level of cash at the end of the budget period. Fund customer pricing will recoup total SUPOPS costs through the sale of wholesale material. No separate surcharge for premium shipment was applied in FY 1991 but may be considered in the future.

V: NAVY DBOF (SUPPLY) REPORTS

A. FINANCIAL INVENTORY (STORES) ACCOUNTING

The Financial Inventory Report (FIR) is derived from Financial Inventory Control Ledgers (FICL) which are maintained by the Authorized Accounting Activities (AAA) for the stock points and ICP's which are accountable for this inventory. The structure of these FICL's and their FIR's is quite complex as they attempt to provide financial information about many different segments of the inventory held. The most basic structure of the FICL's can be viewed as a matrix of information (for material held at one stock point) which classifies the material as to its item manager and ownership and storage echelon of stock involved. Item management and ownership can be determined by material cognizance (known as the COG) as explained in Chapter III. Groupings of specific categories of material cognizance equate to the Budget Projects.

The second level of the matrix, storage echelon, is categorized by a three digit code structure which is called Special Accounting Class (SAC). A few examples of SAC's are as follows:

- SAC 200: material in main store
- SAC 203: material in shop/ready supply stores

- SAC 207: material in stock funded ships and units
- SAC 224: material in fleet issue loads
- SAC 260: material in ServMart

Thus the most basic structure of the FICL's is a matrix of material values by SAC and COG within SAC. Further basic subdivisions of COG are made by amplifying this information matrix to include Material Condition Code (MCC) categories (A, F, G and M only) to identify Ready for Issue (RFI), Not Ready for Issue (NRFI), etc., and MCC E, L, and O to identify field/depot level repairables, etc.

Within this basic matrix then, the AAA and ICP's categorize and summarize all material transactions which have occurred during the accounting period, fiscal year to date and the current month. The basic transactions categorization is as follows:

- Beginning inventory
- Receipts/gains/increases
- Issues/losses/decreases
- Ending inventory

Within the groupings identified above there are also several "sub-groupings" which contribute to the complexity of both the FIR and the FICL. Figure 4 is a sample FIR that shows the quantity of information about inventory changes

	FIR CAPTION	OPEN. INV.	RECEIPTS	EXPENDITURES	CLOSING INV.
H1	OPENING INV.	25,000			
A1	COMMERCIAL PROC.		5,000		
A3	DOD AGENCY PROC.		2,000		
B1	RET. FROM USERS		100		
D4	INV. GAIN		200		
E1	PURCH. VARIANCE		300		
E2	STD. PRICE ADJ.		1,025		
F4	OSO TRANSFERS		500		
J1	SERVICE USE			10,000	
K5	DECAPITALIZATION			200	
L1	TRANS TO DISPOSAL			300	
M4	INV. LOSS			400	
M5	INV. SHIPMENT LOSS			350	
N2	STD. PRICE ADJ.			174	
P4	OSO TRANSFERS			1,000	
R1	CLOSING INV.				21,701
	TOTALS	25,000	9,125	12,424	21,701

Figure 4. Sample Financial Inventory Report (FIR).

during the period as well as inventory values at the end of an accounting period. This flow of information is useful in budget development at the Budget Project level. (The reports are complicated somewhat by the fact that some material will be in transit between stock points.) This material is accounted for by matching material receipts with OSO Summarized Invoices.

B. DBOF REPORTING

The new FY 1992 DBOF Financial Management Guidance provides for a "Flash Report on DBOF Fund Status", designated Account Report 1445.1. The report will reflect disbursements and collections incurred in the DBOF revolving fund of the Department of Defense. These reports are a valuable tool in monitoring the planned weekly execution of the approved DOD program. FLASH reporting applies to all applicable DOD components and DFAS, as the departmental-level accounting entity for the Defense Agencies, with respect to disbursements and collections incurred for all military functions including the related allocation and transfer appropriation accounts.

Reports are submitted weekly to the Director for Revolving Funds on the third workday of the week immediately following the reporting week. DOD activities shall submit feeder reports to the responsible consolidating DOD component in order to meet the required due date to the Office of the DOD

Comptroller. (The Defense Finance and Accounting Service (DFAS) in Washington supports the Navy and Marine Corps.) Actual execution results should be readily available for inclusion in this report, however, estimated disbursements and collections may be substituted when actual results are delayed by unforeseen events. The DFAS-Washington Center is also responsible for consolidation of Component/Agency level DBOF reports prepared at each DFAS for the Army, Air Force and Defense Agencies.

The reports structure is relatively simple. It contains three columns, one for collections, one for disbursements, and a third which is the net of the two amounts. Separate amounts are required for each component for each business area, with totals for each component. Figure 5 is a sample of the Navy portion of the "Weekly Flash Report on Fund Status". The report is actually broken down into sections for Army, Navy, Air Force, Marine Corps, and Defense Agencies.

DEFENSE BUSINESS OPERATIONS FUND
WEEKLY FLASH REPORT ON FUND STATUS
(ACCT RPT (W) 1445.1)
(IN THOUSANDS OF DOLLARS)

REPORTING COMPONENT

WEEK ENDING

COMPONENT BUSINESS AREA	ID	ID	DISBURSEMENTS	COLLECTIONS	NET OUTLAY
NAVY		N			
DEPOT MAINT.	A		\$ _____	\$ _____	\$ _____
DIST. DEPOTS	B		\$ _____	\$ _____	\$ _____
SUPPLY MGMT.	C		\$ _____	\$ _____	\$ _____
TRANSPORTAT.	D		\$ _____	\$ _____	\$ _____
BASE SUPPORT	E		\$ _____	\$ _____	\$ _____
INFO. SVCS.	F		\$ _____	\$ _____	\$ _____
PRINT & PUB.	G		\$ _____	\$ _____	\$ _____
R & D		H	\$ _____	\$ _____	\$ _____
COMPONENT TOTAL			\$ _____	\$ _____	\$ _____

Figure 5. DBOF FLASH Report.

VI. DMRD'S AND NAVY DBOF (SUPPLY)

A. DMRD 901

It is critical that financial managers understand DMRD's in general and specifically the DMRD's that will impact Navy DBOF (Supply). OSD has approved a series of Defense Management Review (DMR) cost-reduction initiatives to accommodate a declining defense budget. DMR Decision (DMRD) 901 accounts for a total Navy savings of \$4.5 billion from FY91 through FY97.

The major thrust of DMRD 901 is to reduce supply system costs through several savings initiatives, including financing of supply operations costs in the Services or DLA stock funds. This financing concept commenced in FY91, at which time the DONSF assumed responsibility for funding traditional supply related O & M, Navy costs primarily associated with ICP's , Naval Supply Centers, and Service Wide Transportation. To support these costs, the FY91 prices for NSF managed material increased by 14.9% over FY90 prices. These higher prices include incorporation of approximately \$750 million of former O & M, Navy costs into the DONSF in FY91. In turn, the O & M, Navy funds formerly supporting these costs were distributed to customer accounts to finance the stock fund price increase. This process is similar to the approach taken in the 1980's when Depot Level Repairables were converted to stock funding

and the customer accounts were increased. In the future, through the normal budgetary review process, the annual stock fund customer price changes and customer account funding will continue to be adjusted each year to maintain a proper balance.

The benefit of this new financing process is that with both operations and material costs financed in what is now Navy DBOF (Supply), ICP and Supply Center managers will have the flexibility to make better investment decisions between management and material costs. These decisions will ultimately result in lower overall costs to the Navy. Other DMRD 901 initiatives to reduce costs (and result in lower DBOF pricing in the future) include actions to:

- reduce inventory level investments
- reduce procurement leadtimes
- reduce prices for spare parts
- position material more economically
- improve visibility of material

B. DMRD 902

DMRD 902, dated 9 November 1989, addresses DOD's need to reduce overhead costs by revisiting the concept of a single depot system. Currently there are 33 supply depots in the DOD system. Each of the four Services and DLA manage "their own" depots. A number of these depots are located within 50 miles

of each other. A small number are within 10 miles of another depot.

Currently under NAVSUP there are two ICP's, Ships Parts Control Center (SPCC) and Aviation Supply Office (ASO), which have overall supply management responsibility for nearly all of the items assigned to the Navy for management. The Navy system is based upon a combination of both centralized and decentralized management control. Each ICP exercises control over the items for which it has management responsibility, deciding what items to stock, where to stock them and how much to stock. The Navy maintains its accountable records at the stock point rather than at the ICP. If the customer point-of-entry for requisitions is one of the wholesale stock points, the stock point is generally permitted to make a decentralized issue and report it to the ICP after the fact. For those customers who transmit requisitions directly to the ICP, or for requisitions which are referred to the ICP from a stock point, the ICP will determine which stock point will issue the item.

The majority of Navy customers are located or homeported in the local area of the Supply Centers and Air Stations. Norfolk and Oakland are the major CONUS points of support for overseas activities and fleet units when deployed. They account for over half of the total wholesale issues made by the eight Navy depots. Navy customers have assigned

requisition channels which, for various classes of items, may lead to either stock points or ICP's.

Consolidation of the management of all supply depots in a single Service or agency would result in significant reductions in: base and headquarters level overhead costs, systems developments costs, and significantly better utilization of the existing capacity, with a resulting increase in efficiency. Significant savings in transportation costs would also be realized because of the ability to improve the consolidation of shipments. The Service depots should be transferred to the DLA. This action would be consistent with the original purpose of establishment of that agency. The management infrastructure is in place, and because of the rotation of military officers through, DLA they are already familiar with the operation of the Service depots and the Service systems.

C. DMRD 926 AND 971

DMRD 926 incorporates several ideas from DMRD 902 but it also includes a phased implementation plan for consolidating ICP's. Phase I is of particular interest to financial managers who work with Navy DBOF (Supply) as it explains the transfer of all consumables to DLA, one third each year, over fiscal years 1991, 1992, and 1993. DLA will be unable to absorb one million new items immediately and induction of one third of the items a year will smooth the transition of

management without jeopardizing support. An adjustment has been made to enable DLA to absorb this additional workload. Because of improvements in information management and practices, it is expected that DLA can absorb this workload with fewer work years than being expended now by the Services. As items are transferred from the Services, reductions will be made to reflect the change in workload. This should result in further downsizing in headquarters and field work years to position for consolidation.

DMRD 971 is another form of consolidation within DOD. This DMRD establishes a new revolving fund, the Defense Business Operations Fund, as discussed throughout this thesis. DBOF incorporates all the Services' Stock funds and industrial funds. Under DBOF, all direct, indirect and general and administrative costs incurred will be collected and identified to the product or service benefitting from the costs. DBOF and non-DBOF customers will be billed the total, all inclusive, costs for goods and services provided, based on the price structure approved by the President's budget. Cost per output or "unit cost" has the advantage of giving all levels of management a focus on the cost of doing business, or production of specific outputs. The result is a better tool to manage DOD's "business" and a basis for charging customers for the products of each supporting organization.

VII. RECOMMENDATIONS AND CONCLUSIONS

A. RECOMMENDATIONS

The objective of this thesis was to provide the essential facts about Navy DBOF (Supply) to newly reporting financial managers and comptrollers. In the current budget environment, maintaining accountability as well as running an efficient operation are of paramount importance. During the course of the research, however, it became apparent that not only is information difficult to obtain but a great deal of misinformation is circulating. The following areas, though still in the development phase, must be studied as new information becomes available:

- Intrafund Transactions
- Common Costs
- DOD Financial Management Policy

Intrafund Transactions: Purchases and sales of goods and/or services between business areas within DBOF will be recorded as expenses by the receiver and revenue by the provider of those goods and/or services without the exchange of cash or the recording of obligations. Cost incurred through an intrafund transaction will be recorded and reported in the financial records, included in the cost of operations,

and used in the measurement of performance against cost authority and goals. Detailed policies and procedures will be developed for intrafund transactions, and specific business applications will be identified where use of the transaction will derive maximum benefit. Until those policies and procedures are developed, transactions will continue to be on an obligation/payment basis. The final systems implementation plan should be completed by January 1993.

Common Costs: A consolidated DBOF payment is the preferred method for paying common costs incurred by multiple business areas. An example is reimbursement to the Military Personnel appropriation for the cost of military personnel assigned to DBOF business areas. These costs will be accumulated at the activity level, and paid at the Component level. Each activity will record in their financial records expenses incurred for the military assigned and working at the activity and include them in their cost of operations. The obligation and payment for the aggregate cost of military in all activities within the Component will be consolidated, managed, and maintained in one Component corporate account. Until detailed policies and procedures are developed and issued for application to specific categories of cost, obligations and payments will continue to be made at the business area and Component level. The final systems implementation plan should be completed by September 1992.

DOD Financial Management Policy: DOD plans to incorporate applicable financial management policies into a single DOD publication. DBOF financial management guidance and procedures that have been issued by the DOD Comptroller, and all industrial and stock fund financial policies will be consolidated in this publication. It is envisioned that most of the existing DOD Comptroller directives, instructions and other financial management policy issuances and guidance will be merged into this publication. The publication will serve as the single source for all DOD Comptroller financial management guidance. The publication is expected to be completed and to the publisher by June 1993.

B. CONCLUSIONS

As the objective of this thesis was to provide the essential facts about the Navy DBOF (Supply) to newly reporting financial managers, it is critical to understand what the DOD Comptroller has set as the goal for all financial managers: provide the best support at the lowest price with the best value. Obtaining this goal requires a supportive financial system, focus on performance and cost, and increased emphasis on business operations.

Financial managers must thoroughly understand the basic business concepts of DBOF. These concepts include:

- existence of a customer-provider relationship

- customer determines requirement and justifies funding
- provider is reimbursed for product
- provider manages under unit cost

The standard DBOF policies, including intrafund transactions to be executed without cash and common costs to be consolidated for payment, along with the benefits of a revolving fund are all critical concepts for today's financial managers. Such benefits as:

- rates approximating cost
- stabilized rates/fixed prices
- break-even basis over long-term

are the qualities that allow a revolving fund to provide the best financial management system.

DBOF is taking the revolving fund in a new direction by creating a business environment for Department of Defense. By creating a market relationship between the operating forces (customers) and support organizations (providers), requirements are defined and satisfied in the most direct manner. The customers use appropriated dollars to buy support and the providers obtain financing from customer reimbursements.

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