

# RAND Research Brief

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## Improving the DoD's Defense Finance and Accounting Service

As part of its ongoing improvement efforts, the Department of Defense (DoD) is exploring new ways to enhance the performance of its Defense Finance and Accounting Service (DFAS). Created in 1991, DFAS provides a variety of finance and accounting services, including payroll, bill payment, and budget tabulation, for the military services and other DoD entities. The establishment of DFAS has streamlined DoD finance and accounting operations by consolidating a multitude of service-specific facilities. DFAS handles an enormous volume of transactions. Virtually all of the DoD's annual budget flows through this agency.

Recently, DFAS asked RAND's National Defense Research Institute (NDRI) to identify opportunities for performance improvement. The results of this research are documented in two RAND reports, *Defense Working Capital Fund Pricing Policies: Insights from the Defense Finance and Accounting Service* and *Improving the Defense Finance and Accounting Service's Interactions with Its Customers*. These studies, led by RAND economist Edward Keating, found that DFAS's performance could be improved through changes in DFAS's pricing system and in the nature of many of its transactions with customers.

### DFAS'S PRICING POLICY

DFAS's pricing policy was the first area examined. As a Defense Working Capital Fund (DWCF) entity, DFAS is supposed to recover its operating costs through customer fees. But the research team found a disconnect between observed DFAS cost patterns and DWCF pricing rules. DFAS revenue is based on the number of "work units" performed (e.g., cutting a check to a civilian, processing a travel voucher), with prices per work unit typically established two years in advance. The prices are designed to take into account both fixed and more variable incremental costs and therefore should result in revenues equal to costs at expected demand levels.

However, the current system has two major shortcomings. First, when customer demand deviates from expected levels, the result is typically an imbalance between costs and revenue. When workload goes down, revenue proportionally decreases while DFAS's costs remain relatively unchanged. DFAS's cost rigidity is mostly likely the result of its large fixed costs, including the programming and maintenance of computer systems, and steadily increasing costs per civilian employee.

The divergence between price and incremental costs can lead customers to make inefficient purchasing decisions. Because the prices paid by DFAS customers are higher than DFAS's incremental costs, customers have a strong incentive not to purchase additional work units from DFAS even though it might be more efficient to do so.

### DFAS'S INTERACTIONS WITH CUSTOMERS

The analysis also focused on the need for improvement in DFAS's interactions with the customers of its finance and accounting services. DFAS's accounting services—the organization's single largest output—were found to be in particular need of management reform. DoD is required comply with the Chief Financial Officers (CFO) Act of 1990, which was intended to bring "real financial management" to the federal government. However, the analysts found that the CFO Act only mandates the "trappings" of financial management, such as the completion of auditable financial statements and other reports. It does not specifically require any broader management reforms that could improve the organization's decisionmaking process. From a customer service perspective, therefore, DFAS's efforts to comply with the CFO Act are not perceived as providing a large benefit.

Interviews with DFAS customers and other stakeholders suggested other problems with DFAS's services, including

- operational shortcomings, such as data entry errors and lost faxes;
- unacceptably high interest payment penalties due to DFAS and customer delays in processing commercial and contract invoices;
- incidents of delays in paying military personnel, particularly in response to major pay system adjustments; and
- challenges in acquiring and implementing new computer systems.

## CUSTOMERS' INFORMATION NEEDS

The research team also found that DFAS's accounting services are not providing customers all the data they want. "Warfighting" or appropriated fund customers want easy access to basic accounting information such as how much money has been spent and how much is left. Currently, such data are most easily extracted from DFAS through the use of software "overlays" added by customers. Working capital fund customers would like sophisticated "activity-based costing" information that can explain, for example, the incremental costs of producing a particular output. These customers noted that accounting data are frequently delayed relative to their management needs and that, even when the data are reported in a timely fashion, their accuracy is highly suspect. Particular concern was directed toward "problem disbursements," which occur when the accounting for a disbursement (e.g., money actually sent to a contractor) does not match up with the obligation (e.g., money set aside for a contractor) data.

## RECOMMENDATIONS

The RAND research team made six recommendations for improving DFAS's performance:

- Adopt a "nonlinear" pricing structure that better reflects the costs of DFAS's services. Such a pricing structure would involve some sort of up-front fee to "open the door" for services, followed by lower incremental charges for additional units. Customers facing a nonlinear pricing schedule can get a considerable

quantity discount. A change of this sort would not be easy to implement, but could be achieved through careful analysis to determine how best to divide DFAS's fixed costs among its customers and to set appropriate incremental fees. The analysts also suggest that CFO Act efforts should be funded by a direct appropriation to DFAS because this initiative has been mandated by Congress rather than by DFAS customers.

- Seek broader improvements in management accounting capabilities to provide real financial management reform. Compliance with the financial reporting provisions of the CFO Act could ultimately benefit customers by helping rectify various data problems. And to the extent that DFAS can use its mandated compliance to develop more far-reaching improvements in its management capabilities, the DoD will also benefit from enhanced decisionmaking processes.
- Develop the capability to respond to crises such as military pay system changes. More cross-training of workers will improve DFAS's ability to "fight fires." Contractors could also provide surge workforce in times of need.
- Attempt to acquire new software commercially. The use of proven, debugged commercial software could help alleviate DFAS's system problems and may expedite efforts to comply with the CFO Act. Having fewer systems would also make cross-training more feasible.
- Make greater use of the Web to communicate with customers. Rapid posting of information would make accounting data more timely and would expedite efforts to fix errors. It would also reduce the organization's dependence on paper transactions.
- Consider allowing customers to buy finance and accounting services from other sources. It may be that some current DFAS customers could be better served by other sources. Their departure could be mutually beneficial since customers that DFAS has had the most trouble serving would seem most likely to leave.

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*RAND research briefs summarize research that has been more fully documented elsewhere. This research brief describes work prepared for the Defense Finance and Accounting Service by RAND's National Defense Research Institute; it is documented in Defense Working Capital Fund Pricing Policies: Insights from the Defense Finance and Accounting Service by Edward G. Keating and Susan M. Gates (RAND MR-1066-DFAS) and Improving the Defense Finance and Accounting Service's Interactions with Its Customers by Edward G. Keating, Susan M. Gates, Jennifer E. Pace, Christopher Paul, and Michael G. Alles (RAND MR-1261-DFAS). Available from RAND Distribution Services (Telephone: toll free 877-584-8642; Fax: 310-451-6915; or E-mail: order@rand.org). Abstracts of all RAND documents may be viewed on the World Wide Web (<http://www.rand.org>). Publications are distributed to the trade by NBN. RAND® is a registered trademark. RAND is a nonprofit institution that helps improve policy and decisionmaking through research and analysis; its publications do not necessarily reflect the opinions or policies of its research sponsors.*

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