

GAO

Report to the Subcommittee on
Readiness and Management Support,
Committee on Armed Services, U.S.
Senate

June 2010

ARMY WORKING CAPITAL FUND

Army Faces
Challenges in
Managing Working
Capital Fund Cash
Balance during
Wartime Environment



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Report Documentation Page

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Highlights

Highlights of [GAO-10-480](#), a report to the Subcommittee on Readiness and Management Support, Committee on Armed Services, U.S. Senate

Why GAO Did This Study

The Army Working Capital Fund (AWCF) collected over \$16 billion for goods and services provided to customers in fiscal year 2009. Cash generated from sales is used by AWCF to cover its expenses such as paying employees. In light of the Army's changing role in the Middle East, GAO was asked to determine whether (1) AWCF's monthly cash balances fell within the Department of Defense's (DOD) cash requirements for fiscal years 2000 through 2009, (2) the cash transfers resulted in AWCF's monthly cash balances falling below the minimum amount required by DOD, and (3) the AWCF's projected monthly cash balances are expected to fall below DOD's minimum cash requirement for fiscal years 2010 and 2011 and actions the Army can take to manage those balances. To address these objectives, GAO (1) reviewed relevant DOD guidance, (2) obtained and analyzed AWCF budget and accounting reports containing cash information, and (3) interviewed DOD and Army officials.

What GAO Recommends

GAO is making four recommendations to DOD aimed at improving the management of AWCF's cash balances and clarifying the DOD's Financial Management Regulation that contains guidance on inventory levels. DOD concurred with our recommendations and has taken or plans to take action to implement them.

View [GAO-10-480](#) or [key components](#). For more information, contact Asif A. Khan at (202) 512-9095 or khana@gao.gov.

ARMY WORKING CAPITAL FUND

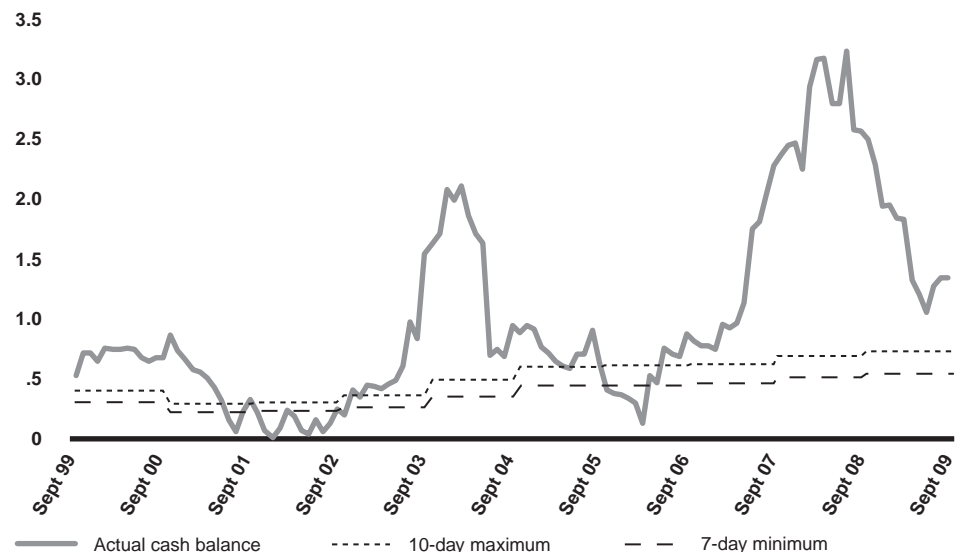
Army Faces Challenges in Managing Working Capital Fund Cash Balance during Wartime Environment

What GAO Found

GAO analysis showed that the AWCF monthly cash balance fluctuated significantly between fiscal years 2000 and 2009 and exceeded the maximum cash requirement prescribed by DOD regulation for 94 out of 120 months. The fluctuations were due to differences between receipts and disbursements, including the (1) receipt of collections from AWCF operations, (2) appropriations received in support of the wars, (3) disbursements made to pay for AWCF expenses, and (4) transfers made to fund other Army requirements.

AWCF Monthly Cash Balance Compared with Minimum and Maximum Cash Requirements

Dollars in billions



Source: GAO analysis of AWCF data.

The Army transferred \$4.8 billion out of AWCF from fiscal years 2004 through 2009. Most of the transfers funded requirements of Operation Iraqi Freedom, Operation Enduring Freedom, or military personnel costs. These transfers helped to reduce the cash balance, but also resulted in the AWCF cash falling below the minimum cash requirement for a 6-month period in fiscal year 2006.

GAO analysis of the AWCF fiscal year 2011 budget and cash plan showed that the projected monthly cash balances for fiscal years 2010 and 2011 would exceed DOD's minimum cash requirement for 22 out of 24 months. While the Army does not expect a cash shortfall due primarily to an increase in military build-up activities in Afghanistan, a cash shortfall may occur if certain Army actions are not implemented and monitored effectively. These actions include (1) reducing AWCF obligations to less than the amount of inventory sold, (2) collecting funds from Defense Logistics Agency (DLA) for inventory items transferred from AWCF to DLA, and (3) reducing the amount of inventory at industrial operations activities. Further, the relevant DOD Financial Management Regulation lacks sufficient clarity to determine the appropriate level of inventory to be held at these activities.

Contents

Letter		1
	Background	3
	AWCF Monthly Cash Balance Fluctuated Significantly but Generally Remained above the Maximum Cash Requirement	6
	Billions of Dollars Transferred out of AWCF Did Not Result in a Cash Balance below the Minimum Cash Requirement Except for a 6-Month Period	10
	For Fiscal Years 2010 and 2011, AWCF- Projected Monthly Cash Balances Generally Exceed the Minimum Cash Requirement	12
	Conclusions	18
	Recommendations for Executive Action	19
	Agency Comments and Our Evaluation	20
Appendix I	Scope and Methodology	21
Appendix II	Comments from the Department of Defense	23
Appendix III	GAO Contact and Acknowledgments	26
Table		
	Table 1: AWCF Cash Transfers from Fiscal Year 2004 through Fiscal Year 2009	11
Figures		
	Figure 1: AWCF Industrial Operations Process	4
	Figure 2: AWCF Supply Management Process	5
	Figure 3: AWCF Monthly Cash Balance Compared with Minimum and Maximum Cash Requirements	7
	Figure 4: The AWCF Projected Monthly Cash Balances Compared with Minimum Cash Requirements According to the Fiscal Year 2011 AWCF Budget and Current DOD Regulation	13

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United States Government Accountability Office
Washington, DC 20548

June 22, 2010

The Honorable Evan Bayh
Chairman
The Honorable Richard Burr
Ranking Member
Subcommittee on Readiness and Management Support
Committee on Armed Services
United States Senate

The Army Working Capital Fund (AWCF) collected over \$16 billion in fiscal year 2009 through (1) selling spare and repair parts needed by its customers, primarily Army operating units and depots; (2) repairing and upgrading equipment such as the Army's Apache helicopter and M1 Abrams tank; and (3) producing weapons and munitions. AWCF supports the combat readiness of Army units operating worldwide, especially in Iraq and Afghanistan. AWCF generates revenue by billing customers at predetermined, fixed prices as AWCF performs specifically agreed-upon work for those customers. AWCF customers primarily use their appropriated funds to pay for the work, and AWCF's income from the sale of the goods and services is then used to fund continuing operations. Cash generated from the sale of goods and services is the primary means by which AWCF meets its financial obligations, such as paying its civilian employees and purchasing needed materiel to sustain continued operations.

The availability of sufficient cash in AWCF¹ depends on the outcome of many decisions made during the Department of Defense's (DOD) budget process with regard to (1) projecting workloads, (2) estimating costs, and (3) setting prices to recover the estimated full cost of goods and services. The cash account balances are directly affected by collections from the sale of goods and services; disbursements (such as salaries and purchases of inventory); appropriations from Congress; and transfers in and out of the AWCF. According to the DOD Financial Management Regulation,²

¹The AWCF cash balance is the Fund Balance with Treasury. According to DOD Financial Management Regulation 7000.14-R, vol. 4, ch. 2, p. 2-3, the Fund Balance with Treasury is an asset account that reflects the available budget spending authority of federal agencies. For the purpose of this report, we will refer to the Fund Balance with Treasury as cash.

²DOD Financial Management Regulation 7000.14-R, vol. 2B, ch. 9, p. 9-5, dated November 2009.

“cash levels should be maintained at 7 to 10 days of operational cost and six months of capital disbursements,” (hereafter, referred to as the cash requirement). If the cash balance becomes negative, the Army could incur an Antideficiency Act violation.³ If AWCF builds excess cash balances, it is subject to either budget cuts from DOD or Congress or transfers from AWCF to other Army activities.

As requested and agreed to with your office, our objectives were to determine whether (1) AWCF monthly cash balances fell within DOD’s cash requirements for fiscal years 2000 through 2009, (2) the cash transfers for fiscal years 2000 through 2009 resulted in the AWCF’s monthly cash balances falling below the minimum cash requirement, and (3) AWCF’s projected monthly cash balances are expected to fall below the minimum cash requirement for fiscal years 2010 and 2011, and actions the Army can take to manage those balances.

Financial information in this report was obtained from official Army budget documents and accounting reports. To assess the reliability of the data, we (1) obtained and analyzed reports containing detailed data on transactions affecting the AWCF cash balance including collections, disbursements, direct appropriations to the AWCF, and funds transferred in or out of the AWCF; (2) obtained an understanding of the process used by the Defense Finance and Accounting Service to reconcile Army cash balances with Department of the Treasury records; (3) reconciled year-end cash balances between Army reports and Treasury records; and (4) obtained and analyzed documentation supporting the amount of funds transferred out of the AWCF. On the basis of procedures performed, we have concluded that these data were sufficiently reliable for the purposes of this report.

Further details on our scope and methodology are provided in appendix I. We conducted this performance audit from June 2009 through June 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions

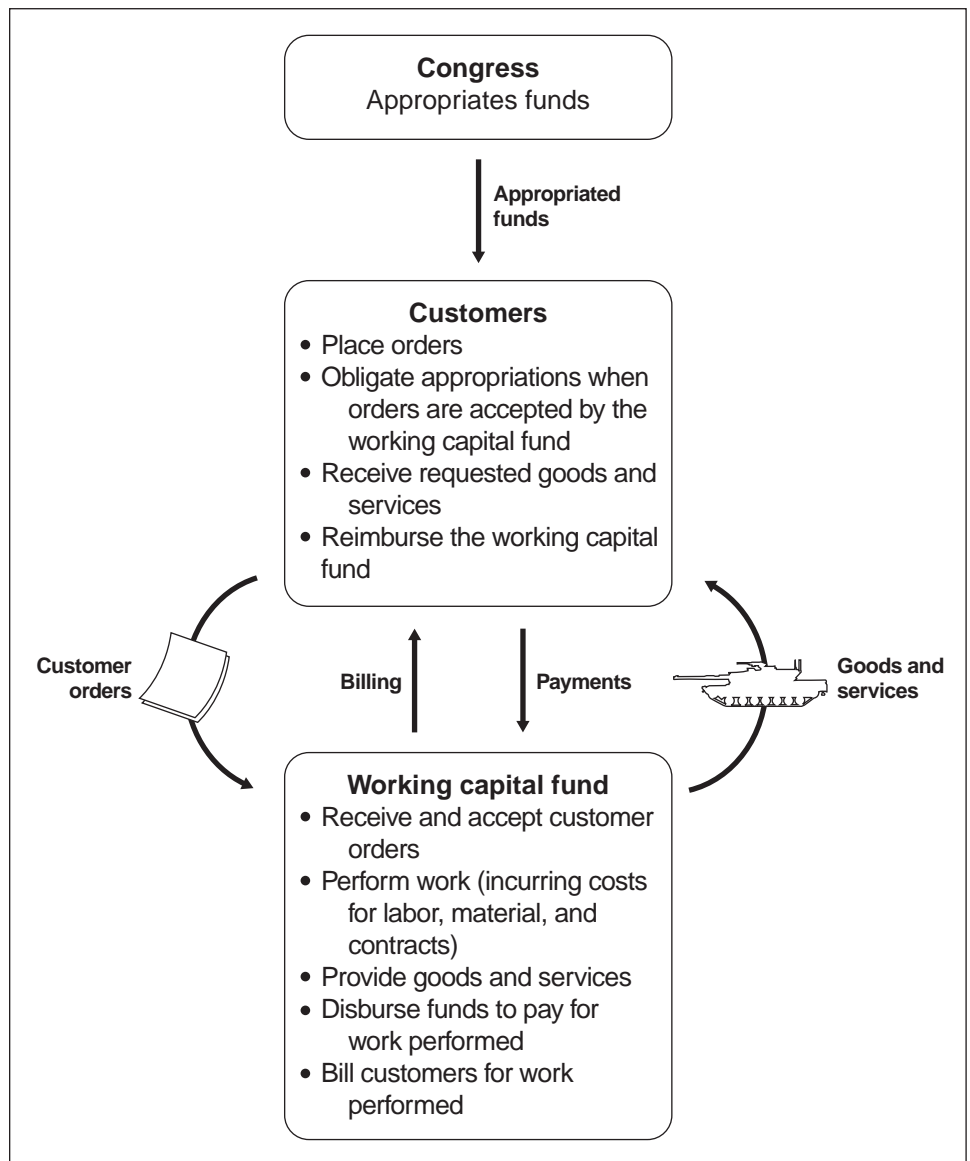
³The Antideficiency Act, 31 U.S.C. 1341 (a) (1), 1517, provides that no officer or employee of the government shall make or authorize an expenditure or obligation exceeding the amount of an appropriation, fund, or apportionment available for expenditure or obligation.

based on our audit objectives. We requested comments on a draft of this report from the Secretary of Defense or his designee. Written comments from the Office of the Under Secretary of Defense (Comptroller) are reprinted in appendix II.

Background

AWCF consists of two activity groups: industrial operations and supply management. The Army industrial operations activity group provides the Army with the in-house capability to conduct depot-level maintenance, repair, and upgrade; produce quality munitions and large-caliber weapons; and store, maintain, and demilitarize materiel (equipment and supplies) for all branches of DOD. To perform its mission, the industrial operations activity group employed 26,200 civilian personnel who, according to the AWCF budget, performed approximately 31.1 million hours of direct labor in fiscal year 2009. As figure 1 illustrates, the industrial operations activities receive orders from customers to perform work. Customers primarily use appropriated funds to finance orders placed with the industrial operations activities. When industrial operations activities accept customer orders, the customers' appropriations are obligated by the amount of the orders. The industrial operations activities then incur costs, such as materiel and labor costs as the work is performed, and disburse funds to cover those costs. The industrial operation activities then bill the customers for the work performed.

Figure 1: AWCF Industrial Operations Process

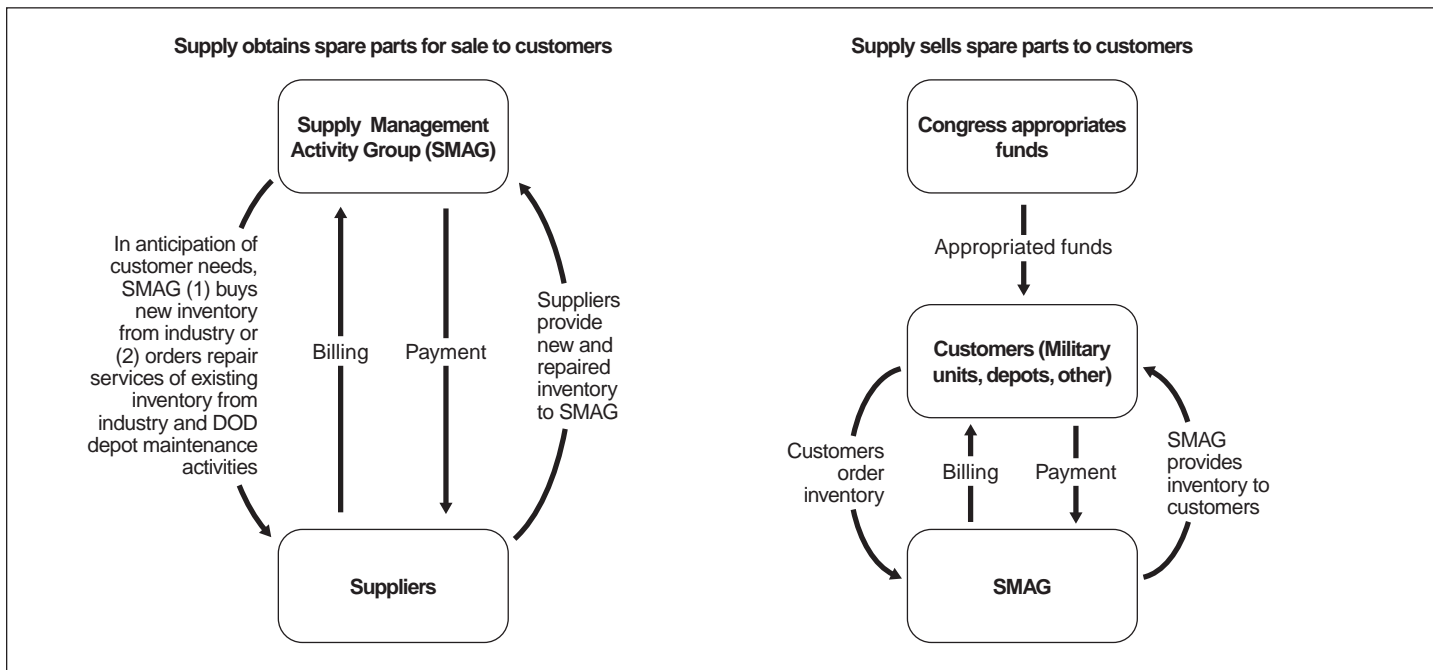


Source: GAO analysis of AWCF industrial operations process.

The Supply Management Activity Group buys and manages spare and repair parts for sale primarily to Army operating units located worldwide and the Army industrial operations activity group. According to AWCF's fiscal year 2011 budget, the supply group employed 3,000 civilian personnel and managed 119,000 inventory items, received 1.1 million

requisitions from customers, and awarded 13,550 contracts in fiscal year 2009. As illustrated in figure 2, in anticipation of customer needs, supply (1) buys new inventory items or (2) places orders with contractors and DOD depot maintenance activities to repair existing inventory items. In some cases, supply enters into contracts over a year in advance because of the lead time required to obtain the inventory items. When supply receives the items, it pays the vendors for those items. Customers primarily use appropriated funds to finance the purchases of the inventory items from supply. Supply provides the inventory items to the customers and bills the customers for the items. Supply uses the payments from customers to replenish the inventory sold to customers.

Figure 2: AWCF Supply Management Process



Source: GAO analysis of AWCF supply management process.

A critical function for AWCF is cash management. Effective cash management is largely dependent on Army managers receiving accurate and timely data on AWCF cash balances, collections, disbursements, and projections of anticipated activity. According to DOD's Financial Management Regulation, Volume 2B, chapter 9, AWCF is to maintain the minimum cash balance necessary to meet both operational and disbursement requirements in support of the capital asset program. AWCF

is to maintain a minimum cash balance sufficient to cover expenses, such as paying (1) employees for repairing aircraft, weapon systems, and equipment; and (2) vendors for inventory items. Currently, DOD's regulation states that "cash levels should be maintained at 7 to 10 days of operational cost and cash adequate to meet six months of capital disbursements." Thus, the minimum cash requirement consists of cash that is sufficient to meet 6 months of capital requirements plus 7 days of operational costs. The maximum cash requirement consists of 6 months of capital requirements plus 10 days of operational costs. The regulation further provides that a goal of AWCF is to minimize the use of advance billing of customers to maintain cash solvency unless required to avoid Antideficiency Act violations.

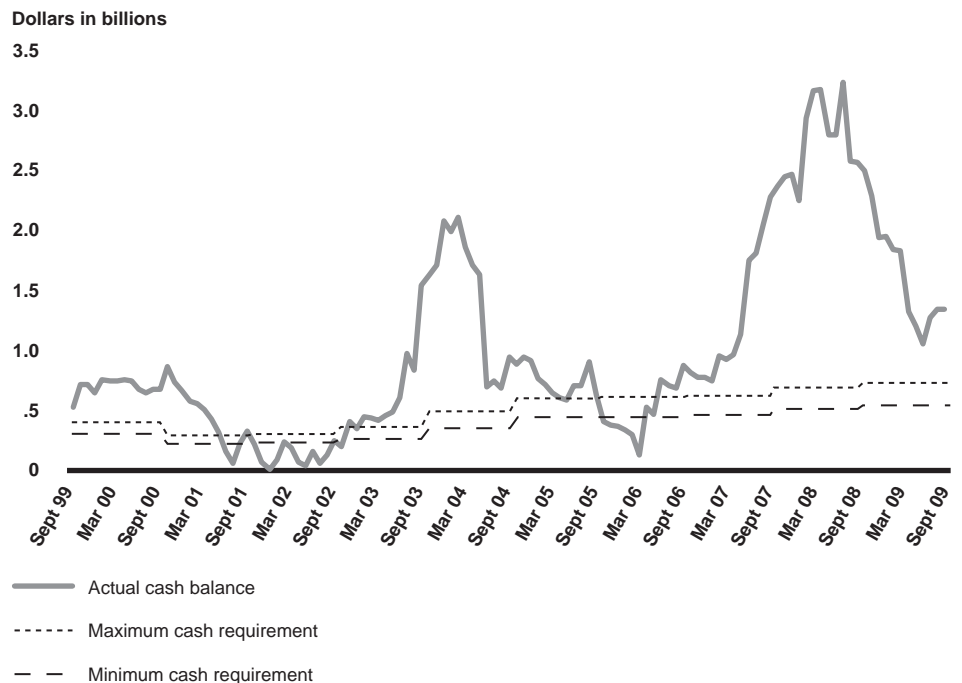
Cash generated from the sale of goods and services is AWCF's primary means of maintaining an adequate level of cash to sustain its operations. The ability to generate cash consistent with DOD's regulation is dependent on (1) accurately setting prices to recover the full costs of producing goods and services; (2) accurately projecting workload, such as the number of tanks, missiles, and helicopters to be repaired during the year; and (3) meeting established operational goals. If projections of cash disbursements and collections indicate that cash balances will drop below prescribed levels, AWCF can generate cash by adding a surcharge to one or more of its activity groups' sales prices. In addition, if the cash balance becomes too low and there is a possibility of an Antideficiency Act violation, AWCF can raise additional cash by advance billing customers for work not yet performed. Conversely, if the cash balances are too high, DOD or the Secretary of Defense, under specific statutory authority, or Congress can transfer the unneeded funds to other appropriations to either reduce budget requests or finance additional requirements.

AWCF Monthly Cash Balance Fluctuated Significantly but Generally Remained above the Maximum Cash Requirement

Our analysis of AWCF cash data showed that the AWCF monthly cash balance fluctuated significantly between fiscal years 2000 and 2009, but that it has generally remained above the maximum cash requirement. Over the 10-year period, the fluctuations were due to AWCF (1) collecting \$1.7 billion more than it disbursed for several reasons, including experiencing significantly higher sales volume at the beginning of the war in Iraq, (2) receiving \$3.9 billion in appropriations primarily to cover war-related expenses, and (3) transferring \$4.8 billion out of AWCF to pay for other requirements such as Operation Iraqi Freedom (OIF). AWCF was over the maximum cash requirement for 94 of the 120 months, between the minimum and maximum cash requirements for 7 of the 120 months, and under the minimum cash requirement for 19 of the 120 months. Figure

3 shows the AWCF monthly cash balance compared with the minimum and maximum cash requirements for the 10-year period.

Figure 3: AWCF Monthly Cash Balance Compared with Minimum and Maximum Cash Requirements



Source: GAO analysis of AWCF data.

Following is a chronological analysis of the fluctuations in the cash balances from September 30, 1999, through September 30, 2009, and the reasons for the changes.

Cash Balance Declined from September 1999 through September 2002, Driving the Cash Balance below the Minimum Cash Requirement

The Army's cash balance fell below the minimum cash requirement during fiscal years 2001 and 2002, as illustrated in figure 3. During this period, the Army had difficulty maintaining cash balances because of diminished cash flows. The cash balance fell from \$533 million on September 30, 1999, to its lowest point on December 31, 2001, at \$14 million. AWCF officials and financial documentation attributed the reduction to two factors. First, to return accumulated operating results (gains) to its customers, the Army lowered the Supply Management Activity Group's prices by 4.2 percent in fiscal year 2001 and 2.5 percent in fiscal year 2002. This action reduced AWCF collections for the 2-year period. Second, AWCF paid a \$92 million

settlement for back pay (for asbestos environmental differential pay) at the Corpus Christi Army Depot. This action increased AWCF disbursements. As a result, the Army advanced billed its depot maintenance and ordnance activity groups' customers \$200 million in fiscal year 2002 to increase the cash balance of the AWCF.

Cash Balance Increased Significantly from September 2002 through February 2004, Causing Cash Balance to Exceed Maximum Cash Requirement

Beginning in fiscal year 2003, the cash balance in AWCF changed dramatically with the build-up and execution of the war in Iraq. Between September 30, 2002, and February 29, 2004, (17 months), the cash balance increased from \$251 million to \$2.1 billion—exceeding the maximum cash requirement. AWCF officials and financial documentation pointed to two primary factors as causes of the increase in the cash balance. First, Congress appropriated \$468 million to AWCF to (1) increase the Supply Management Activity Group's inventory, such as war reserve inventory; and (2) pay for ordnance and the depot maintenance activity group's fixed overhead costs for maintaining plant and equipment required by the Army to meet mobilization and wartime surge capability. Second, collections exceeded disbursements by \$1.4 billion. AWCF officials and Army documentation provided three reasons for collections exceeding disbursements.

- The Supply Management Activity Group experienced significantly higher sales volume during fiscal years 2003 and 2004 to support OIF, which began in March 2003. According to the Army, collections from sales are generally higher than disbursements for materiel deliveries during a time of war. This occurred due to a timing difference between the delivery and payment for long-lead-time materiel (up to 24 months). As a result, higher sales volume increased receipts, but the corresponding disbursements for the items being sold were made in prior periods.
- The Supply Management Activity Group implemented a policy of not providing cash to customers for the value of broken inventory items returning from Iraq due to higher repair costs associated with (1) the impact of the desert environment on Army equipment and inventory, (2) increased wear on components from the high operational tempo,⁴ (3) battle damage sustained in ongoing operations, and (4) longer times needed to repair damaged or worn out equipment and inventory.

⁴Operational tempo refers to the pace of operations and training that units need in order to achieve a prescribed level of readiness.

-
- The Supply Management Activity Group increased its prices by 9.2 percent in fiscal year 2003 to recover prior years' losses. This action increased collections which in turn increased the AWCF cash balance.

Cash Balance Declined Significantly from February 2004 through March 2006, Driving Cash Balance below the Minimum Cash Requirement for a 6-Month Period

From February 29, 2004, to March 31, 2006, (25 months), the AWCF cash balance fell from \$2.1 billion to \$130 million due primarily to the Army transferring funds out of AWCF. These transfers caused the AWCF cash balance to fall below the minimum cash requirement for a 6-month period in fiscal year 2006. The Army transferred \$2.1 billion out of AWCF during the 25 months to pay for unfunded operational expenses associated with Operation Iraqi Freedom/Operation Enduring Freedom. Approximately \$107 million of the amount transferred was directed by Congress. Further details are presented in the transfer section of this report.

Cash Balance Increased Significantly from March 2006 through July 2008, Driving Cash Balance above Maximum Cash Requirement for Most of the Period

From March 31, 2006, to July 31, 2008, (28 months), the AWCF cash balance increased from \$130 million to \$3.2 billion. This period represented the largest increase in the cash balance during the 10-year period of our review. This increase occurred despite a \$596 million transfer out of AWCF to cover other priority programs. According to AWCF officials and documentation, the increase was due to (1) a series of appropriations to AWCF (\$2.3 billion) to fund the "Global War on Terror" and other purposes,⁵ and (2) AWCF collections exceeded disbursements by \$1.4 billion. AWCF officials and financial documentation pointed to two factors for the collections exceeding disbursements. First was the Supply Management Activity Group's policy of not paying customers for returning broken inventory items from Afghanistan beginning in fiscal year 2006. Second, the Supply Management Activity Group experienced higher sales volume in fiscal years 2007 and 2008 to support surge operations in Iraq needed to stabilize the country. As was the case in fiscal year 2003, when the war in Iraq began, cash was generated from a higher sales volume due to increased wartime operations. This occurred because of the timing difference between the delivery and payment of its suppliers for long-lead-time materiel needed to replace depleted inventories (up to 24 months) and collections to support immediate operational demands from on-hand inventories.

⁵The other purposes are hurricane recovery, emergency supplemental requests to support the wars in Iraq and Afghanistan, Supply Management Activity Group's inventory (e.g., war reserve inventory), and the industrial operations activity group's increased fuel costs.

Cash Balance Declined from July 2008 through September 2009 but Remained above Maximum Cash Requirement

The AWCF's cash balance declined by over 50 percent from July 31, 2008, to September 30, 2009, but the monthly cash balance remained above the maximum cash requirement. The cash balance decreased from \$3.2 billion to \$1.3 billion over the 14-month period. Our analysis of financial documentation showed that two factors primarily caused the decrease. First, the Army transferred over \$2 billion from the AWCF to pay for (1) unfunded expenses to support Operation Iraqi Freedom/Operation Enduring Freedom (\$800 million), (2) shortfalls in Army personnel accounts (\$400 million), and (3) a shortfall in the fiscal year 2009 Army operation and maintenance account needed to cover normal operating expenses (\$823 million).⁶ Second, AWCF disbursed \$409 million more than it collected during the 14-month period.

Billions of Dollars Transferred out of AWCF Did Not Result in a Cash Balance below the Minimum Cash Requirement Except for a 6-Month Period

To fund other critical Army requirements, or as directed by Congress, the Army transferred \$4.8 billion out of AWCF from fiscal year 2004 through fiscal year 2009.⁷ Our analysis of Army documentation and financial reports for the 6 years determined that the transfers did not result in the AWCF's cash balance falling below the minimum cash requirement except for a 6-month period in fiscal year 2006. In fact, for 63 months of the 72-month period the AWCF cash balance was higher than the maximum cash requirement even though the Army transferred out billions of dollars. At no time during the 6-year period was AWCF unable to pay its bills timely due to insufficient cash or required other means to increase the cash account, such as advance billing of customers for goods or services ordered. Table 1 provides the amounts and purposes/intended uses of AWCF cash transfers for the period.

⁶Budget documentation showed that Congress appropriated \$823 million less for fiscal year 2009 than the Army requested due to excess cash in the AWCF. The Army replaced the shortfall with cash transferred from the AWCF.

⁷The Army did not transfer any amounts out of AWCF for fiscal years 2000 through 2003.

Table 1: AWCF Cash Transfers from Fiscal Year 2004 through Fiscal Year 2009

Fiscal year	Amount	Purposes/intended uses
2004	\$41,600,000	Defense Commissary Agency expenses
2004	107,000,000	Replace congressionally directed reductions in Army Operations and Maintenance (O&M) funding due to excess cash in AWCF
2004	1,300,000,000	Operation Iraqi Freedom (OIF)/Operation Enduring Freedom (OEF)
2004	\$1,448,600,000	Total
2005	\$250,000,000	OIF/OEF
2005	450,000,000	OIF/OEF
2005	\$700,000,000	Total
2006	0	Not applicable
2007	\$38,700,000	Development of the Army's General Fund Enterprise Business System
2007	107,000,000	Procurement of Mine Resistant Ambush Protected Vehicles
2007	\$145,700,000	Total
2008	\$420,000,000	Replace congressionally directed reductions in Army O&M funding due to excess cash in AWCF
2008	30,000,000	Military personnel costs associated with Army permanent change of station
2008	658,738,000	OIF
2008	141,423,000	OIF/OEF
2008	154,300,000	Army National Guard personnel costs
2008	45,539,000	Army military personnel payroll
2008	\$1,450,000,000	Total
2009	\$200,000,000	Army military personnel payroll and permanent change of station requests
2009	493,000,000	Replace congressionally directed reductions in Army O&M funding due to excess cash in AWCF
2009	237,000,000	Replace congressionally directed reductions in Army O&M funding due to excess cash in AWCF
2009	93,000,000	Replace congressionally directed reductions in Army O&M funding due to excess cash in AWCF
2009	\$1,023,000,000	Total
	\$4,767,300,000	Grand total

Source: GAO analysis of AWCF data.

The transfers in fiscal year 2004 and the first transfer in fiscal year 2005 did not reduce the Army's cash balance below the maximum cash requirement (see fig. 3). However, in September 2005, the Army transferred \$450 million, which resulted in the AWCF cash balance falling below the minimum cash requirement during the first 6 months of fiscal year 2006. Since that time, the AWCF cash balance steadily increased through July 31, 2008, when the cash balance reached \$3.2 billion. From

July 31, 2008, through September 30, 2009, the Army made eight transfers totaling \$2 billion, which contributed to the sharp decline in the cash balance from \$3.2 billion to \$1.3 billion at the end of fiscal year 2009 (see fig. 3). Despite these transfers, the AWCF cash balance remained above the maximum cash requirement at the end of fiscal year 2009.

According to the AWCF fiscal year 2010 budget, the \$4.8 billion in transfers was used to fund other Army programs. The budget document noted that the Army considered emerging requirements, the current cash balance, the collections and disbursements projection, the accumulated operating results, the size of undelivered orders, and previous transfer amounts before making the decision to transfer the funds. Army officials told us that during the 6-year period during which the transfers occurred, the AWCF cash balance was generally much higher than normal, allowing the Army to transfer cash from AWCF to cover critical Army requirements.

For Fiscal Years 2010 and 2011, AWCF-Projected Monthly Cash Balances Generally Exceed the Minimum Cash Requirement

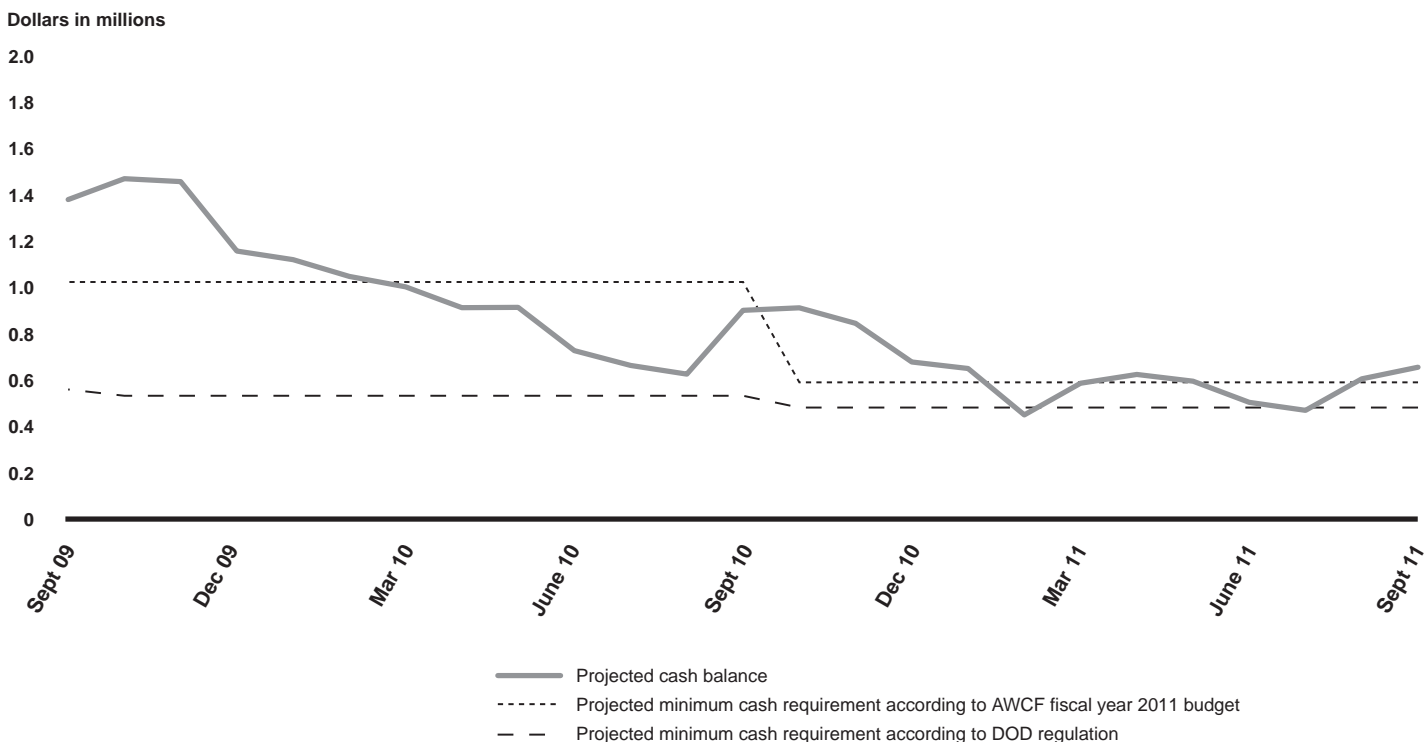
Our analysis of the AWCF fiscal year 2011 budget and cash plan showed that the projected monthly cash balances are expected to generally exceed the minimum cash requirement for fiscal years 2010 and 2011 under the Army's assumptions. The cash projections differ from those in the fiscal year 2010 budget, when the Army's projections indicated a cash shortfall during fiscal year 2010. The primary reasons for the higher projected cash balances in the fiscal year 2011 budget were (1) the decision to increase the size of U.S. forces in Afghanistan by 30,000 troops will likely increase AWCF sales and cash collections, and (2) the Army has planned actions that are expected to increase AWCF collections and decrease disbursements. These actions include improved inventory management practices and the Army's decision not to return gains to customers through reduced prices.

The Army Expects the AWCF Will Have Sufficient Cash in Fiscal Years 2010 and 2011 Due to Higher Sales Supporting Operations in Afghanistan

The Army expects that the AWCF will have sufficient cash in fiscal years 2010 and 2011 due to higher AWCF sales supporting operations in Afghanistan without resorting to cash surcharges or advance billing customers for work yet to be performed. The AWCF's fiscal year 2011 budget and cash plan show that projected monthly cash balances for fiscal years 2010 and 2011 are expected to be above the minimum cash requirement for 13 of the 24 months. However, using the current DOD guidance, our analysis shows that the Army's projected cash balance is expected to be above the minimum cash requirement for 22 out of 24 months. Army officials informed us that they did not use current DOD guidance to calculate the minimum and maximum cash requirements for

presentation in the fiscal year 2011 budget. Instead, they used a proposed methodology identified during a study DOD is performing to address congressional concerns regarding the cash requirement.⁸ This study is not yet completed. Figure 4 shows the AWCF's projected monthly cash balances for fiscal years 2010 and 2011 and the minimum cash requirements according to the fiscal year 2011 AWCF budget and current DOD regulation.

Figure 4: The AWCF Projected Monthly Cash Balances Compared with Minimum Cash Requirements According to the Fiscal Year 2011 AWCF Budget and Current DOD Regulation



Source: GAO analysis of AWCF data.

⁸In the Report of the House Committee on Armed Services (H.R. 2647, H.R. Rep. No. 111-166 (June 18, 2009), p. 430), the House Armed Services Committee raised concerns about the effect that the DOD cash requirement has on working capital fund prices and rates. In response, DOD formed a working group to identify alternatives to the current cash requirement. DOD presented those alternatives to the congressional defense committees for review in January 2010. The working group is currently developing the calculation methodology for implementation in the fiscal year 2012 budget submission.

The Army's cash projections in the fiscal year 2011 budget are significantly different than the cash projections in the fiscal year 2010 budget. The AWCF's year-end projected cash balances for fiscal years 2010 and 2011 are expected to be \$876 million and \$632 million, respectively (see fig. 4). The \$876 million projected cash balance for fiscal year 2010 in the fiscal year 2011 budget is \$362 million higher than the previously projected \$514 million balance for fiscal year 2010 in the fiscal year 2010 budget.

The AWCF's projected cash balance increased for fiscal year 2010 because the current administration decided to increase troop levels by about 30,000 in Afghanistan.⁹ The increase in troop level is expected to result in additional sales and thus collections by the AWCF Supply Management Activity Group through fiscal year 2011. AWCF assumptions contained in the fiscal year 2011 budget for fiscal years 2010 and 2011 follow:

- The fiscal year 2011 budget assumes reduced troop strength and lower operational levels for OIF. The Army estimates that OIF's operational tempo for fiscal years 2010 and 2011 at 33 percent of fiscal year 2009 levels. This decrease in tempo is expected to result in reduced sales and collections by the AWCF Supply Management Activity Group.
- The fiscal year 2011 budget assumes increased troop strength and higher operational levels for OEF. The Army estimates that OEF's operational tempo will increase by 50 percent for fiscal years 2010 and 2011 over the fiscal year 2009 level. The increase in the AWCF Supply Management Activity Group sales supporting OEF should partially offset the reduction in sales supporting OIF.
- The fiscal year 2011 budget assumes the AWCF industrial operations activity group will continue to operate at historically high levels of production in order to reset¹⁰ equipment returning from the current conflicts. The fiscal year 2011 budget projects total direct labor hours to remain about 31 million for work performed by AWCF industrial operations activities.

⁹On December 1, 2009, the President announced that the administration plans to send 30,000 additional troops to Afghanistan beginning in the first part of 2010. Eighteen months later (July 2011) the administration plans to begin bringing troops home.

¹⁰The Army's reset program ensures Army equipment is restored to a level of combat capability commensurate with a unit's future mission. The reset program is expected to continue through the current conflicts and an additional 3 years afterward.

Army Actions Are Aimed at Increasing the AWCF Cash Balance to Avoid Potential Shortfalls

Army headquarters officials informed us that they do not anticipate an AWCF cash shortage in fiscal years 2010 and 2011 due to increased troop levels in Afghanistan and four management actions under way that are aimed at increasing collections or decreasing disbursements. The actions are (1) limiting the AWCF Supply Management Activity Group's obligations to less than the total amount of inventory sold to customers, (2) reducing the AWCF industrial operations' inventory, (3) collecting funds from the Defense Logistics Agency (DLA) for consumable inventory items¹¹ transferred from AWCF to DLA, and (4) retaining the AWCF's accumulated gains instead of returning the amounts to customers. While Army officials expect the management actions to help AWCF avert potential shortfalls in fiscal year 2010 and beyond, the success of these actions will largely depend on how well the actions are implemented and monitored. These actions are discussed below.

Limiting the Supply Management Activity Group's Obligations to Less Than the Total Amount Sold Generates Cash

In the AWCF fiscal year 2010 budget, the Army projected a unit cost ratio (obligations to sales)¹² of 1.0 for fiscal years 2009 and 2010. After the fiscal year 2010 budget was issued in May 2009, we discussed with Army headquarters officials the unit cost ratio of 1.0 and the effect that it has on inventory and disbursements that affect future cash balances. During these discussions, an Army official acknowledged that the unit cost ratio for these fiscal years needed to be adjusted. In response to the announcement that U.S. troops would be out of Iraq by December 2011, resulting in reduced future inventory sales, the Army lowered the unit cost ratio to 0.88, 0.90, and 0.89 for fiscal years 2009, 2010, and 2011, respectively, in its AWCF fiscal year 2011 budget. By lowering the unit cost ratio, the AWCF Supply Management Activity Group (1) obligates fewer funds to buy or repair inventory than the dollar amount of inventory sold to its customers, and (2) reduces its disbursements. On the basis of the reduced unit cost ratio, AWCF expects to reduce disbursements by \$970 million over fiscal years 2009 and 2010. Lowering the unit cost ratio indicates a consistent goal by the Army to manage inventory in relation to the projected declining sales volume. Army officials informed us that as leadership decisions unfold in a wartime environment, the projections for AWCF can

¹¹Consumable items are those supply items that are consumed in use or discarded when worn out or broken because they cannot be repaired economically. Consumable items include not only common usage, low-cost items such as fasteners and gasket materiel, but also high-priced, sophisticated spare parts such as micro switches and precision valves.

¹²Unit cost ratio is the percentage of sales that the Army can use to pay its bills and spend on repairing and buying new inventory. The unit cost ratio is calculated by dividing the total operating costs (total obligations, credits, and depreciation expense) by gross sales.

change significantly. With the increase in troops in Afghanistan and eventual drawdown, it is critical that the Army monitors the unit cost ratio in order to help ensure that inventory purchases are in line with AWCF sales and its overall unit cost goal.

Reducing Industrial Operations’
Inventory Defers Cash
Disbursements

At the end of fiscal year 2009, the 13 industrial operations depot maintenance and ordnance activities had \$650 million in inventory. Of that amount, one activity—the Corpus Christi Army Depot—had \$365 million (56 percent) of the inventory. Our analysis of the Army’s accounting reports showed that Corpus Christi had about 9.5 months of inventory on hand at the end of fiscal year 2009. By comparison, the reported inventory for the remaining 12 industrial operations activities represented about 2 months of inventory on hand for the same period. Maintaining high levels of inventory at Corpus Christi or any industrial operations activity affects the AWCF cash balances, since AWCF uses cash to purchase the inventory. The cash is not returned to AWCF until the industrial operations activities use the inventory in their operations (such as repairing a tank), and then bill the customers for the work performed. This point is discussed in AWCF guidance for the *FY 2010/2011 Budget Estimate Submission*. Accordingly, the guidance states, “inventory continues to get high level attention not only because it impacts the cash corpus, but because the industrial operations installations should not be in the inventory business.”

The AWCF fiscal year 2011 budget provides for industrial operations activities’ inventories to be reduced from \$650 million in 2009 to \$406 million in fiscal year 2011—a reduction of \$244 million (38 percent). This reduction will generate cash as the industrial operations activities use up existing inventories in performing their work. The high level of industrial operations inventories were identified when the Army implemented the Logistics Modernization Program (LMP) system at the Corpus Christi and Letterkenny Army depots in May 2009. LMP improved visibility over inventory balances. Since LMP is scheduled to replace existing systems at 10 industrial operations activities in October 2010, additional inventory amounts could be identified on these activities’ financial reports once the system is implemented. The Army will need to monitor its inventory levels at the 13 activities to ensure that inventory is reduced to \$406 million as specified in the budget.

Collecting Funds from DLA for Consumable Inventory Items Transferred to DLA Reimburses AWCF for Funds Already Disbursed

The current DOD guidance¹³ on the amount of inventory to be maintained by the industrial operations activities is ambiguous. The previous guidance stated that “inventory items classified as operating materials and supplies held for use, shall not exceed the amount expected to be used within 30 days unless justifying documentation supporting a supply in excess of 30 days is developed and maintained for review.” The revised guidance requires that materials and supplies should not exceed the amount expected to be used within normal business operations unless documentation justifying an excess supply is developed and maintained for review. However, the term normal business operations was not defined. In discussing the regulations on inventory limits, Army officials stated that the current policy of using “normal business operations” was ambiguous. We agree with Army officials and believe that the regulation needs to be clarified.

Base Realignment and Closure 2005 initiatives directed the Army to transfer the management of consumable items to DLA. The Army is transferring management responsibility for about 26,000 different types of consumable items (known as national stock numbers), and it plans to complete the transfers by August 2010. The Army estimates that DLA will reimburse AWCF \$383 million and \$176 million in fiscal years 2010 and 2011, respectively, for the items transferred to DLA. These amounts are included in the AWCF fiscal years 2010 and 2011 projected cash balances.

When items are transferred from one activity to another, the gaining activity generally receives a cash benefit and the losing activity incurs a cash loss. Specifically, the AWCF Supply Management Activity Group continues to pay for items on order at the time of the transfer even though the items are delivered to and sold by DLA. Thus, the AWCF cash balance decreases when the Army pays the suppliers for items delivered to DLA and DLA’s working capital fund cash balance increases when the items are sold by DLA to its customers. To ensure cash neutrality, DLA is expected to reimburse AWCF for the funds spent by AWCF for the inventory items on order and purchased by AWCF at the time of the transfer. Army headquarters officials informed us that the Army and DLA have formed a team to determine (1) the quantities of each type of item to be transferred from AWCF to DLA, and (2) the amount of the reimbursement. The team is expected to complete its work by August 2010.

¹³DOD Financial Management Regulation 7000.14-R, vol. 4, ch. 4, p. 4-10, dated May 2009.

Retaining Accumulated
Operating Results Increases
AWCF Cash Balance

Since the AWCF's projected monthly cash balances for fiscal years 2010 and 2011 are based on the reimbursement of the transferred items, it is important that the Under Secretary of Defense (Comptroller) monitor this effort, because the AWCF expects to receive the \$383 million in September 2010, but the Army and DLA do not expect to complete their work on the amount of reimbursement until August 2010. In the past, delays in transfers have occurred when the military services and DLA were unable to agree on the reimbursement amounts.¹⁴ Delays in transferring could result in a lower cash balance by hundreds of millions of dollars in fiscal year 2010 than the projected amount in the AWCF cash plan.

The DOD Financial Management Regulation, Volume 3, Chapter 19, dated October 2008, states that the goal of working capital funds is to achieve zero accumulated operating results¹⁵ over time. The stabilized prices that customers are charged by working capital funds for goods and services are set to achieve this result. Thus, the stabilized prices are adjusted annually to either return gains or recoup losses. However, the Army did not return \$491 million in accumulated operating gains to its customers in fiscal years 2010 and 2011. According to the AWCF's fiscal year 2011 budget and Army headquarters officials, the Army decided to retain the \$491 million for three reasons. First, if the Army returned the entire positive accumulated operating results balance in one year, customer prices would decrease significantly in that year and increase significantly in the following year. Second, the Army reviewed the AWCF cash balance and projected cash balance and determined that AWCF did not have sufficient cash to return the entire accumulated gains to their customers. Third, AWCF retained \$491 million to partially offset prior-year cash transfers, as discussed earlier in this report. The Army noted that it will evaluate its revised accumulated operating results projections, cash position, and impact on fiscal year 2012 rates in determining the amount of accumulated operating results to retain in the next budget cycle.

Conclusions

While the trend of the AWCF cash balance has varied greatly over the last 10 years, the Army's ability to maintain the AWCF's cash balance above the minimum cash requirement will largely depend on the actions the

¹⁴Department of Defense, Office of Inspector General, *Audit Report: Consumable Item Transfer, Phase II, Cash Imbalance Issue*, Report No. 97-106, (Arlington, Va., Mar. 5, 1997).

¹⁵The accumulated operating results represent the cumulative impact of gains and losses on total operations of the activity group since the inception of the fund.

Army takes now and in the future in relation to increases and decreases in military build-up activities. While the Army does not expect a cash shortfall in fiscal years 2010 and 2011 due primarily to an increase in military build-up activities (sending more troops to Afghanistan), a cash shortfall may occur if (1) the Supply Management Activity Group's sales are significantly lower than the wartime assumptions, or (2) the Army's management actions to improve the AWCF cash position are not implemented and monitored effectively. Most notably, the Army reduced its unit cost ratio at the AWCF supply management activities to less than 100 percent replacement. This action is expected to reduce inventory and increase cash for AWCF in fiscal year 2010 and future years. In addition, the Army is (1) collecting funds from DLA for consumable item transfers, (2) retaining positive accumulated gains by not reducing its prices to customers, and (3) reducing inventory by 38 percent at industrial operations activities that should increase AWCF cash. Further, the relevant DOD Financial Management Regulation lacks sufficient clarity to determine the appropriate level of inventory to be held at industrial operations activities. Continued monitoring of these actions and the related impact on cash balances is needed as AWCF supports the additional 30,000 troops in Afghanistan and the eventual drawdown.

Recommendations for Executive Action

We are making four recommendations to the Secretary of Defense to (1) improve the management of the AWCF's cash balances, and (2) clarify the DOD Financial Management Regulation that contains guidance on inventory levels to be maintained by the industrial operations activities.

We recommend that the Secretary of Defense direct the Secretary of the Army to take the following actions:

- Evaluate periodically the unit cost ratio (obligations to sales) and take action to adjust the ratio as necessary, to support the war effort in Iraq and Afghanistan and the eventual drawdown of troops.
- Take action if the industrial operations activities do not reduce their inventory levels to the specified amount in the fiscal year 2011 budget.

We recommend that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to take the following actions:

- Clarify the term normal business operations in the DOD Financial Management Regulation as it pertains to the amount of inventory items to be held for use by the industrial operations activities.

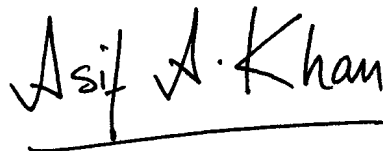
-
- Oversee Army and DLA efforts to reach agreement on the amount that DLA will reimburse AWCF for the consumable items transferred to DLA and ensure that DLA reimburses AWCF for the items transferred in a timely manner.

Agency Comments and Our Evaluation

DOD provided written comments on a draft of this report. In its comments, DOD concurred with the four recommendations and cited actions taken, under way, or planned to address them. For example, DOD stated that the Under Secretary of Defense (Comptroller) will coordinate with the Under Secretary of Defense (Acquisition, Technology and Logistics) to clarify the term normal business operations and that the Under Secretary of Defense (Comptroller) will update the Financial Management Regulation. DOD stated that this is a cause for concern and will act to implement this recommendation in the fiscal year 2012 President's budget. DOD also stated that it has actions under way in the areas of evaluating unit costs and inventory levels, and monitoring the funding associated with the consumable items transferred.

We are sending copies of this report to the Senate Committee on Armed Services; the Subcommittee on Defense, Senate Committee on Appropriations; the House Committee on Armed Services; the Subcommittee on Readiness, House Committee on Armed Services; the House Committee on Appropriations; and the Subcommittee on Defense, House Committee on Appropriations. We are also sending copies to the Secretary of Defense and the Secretary of the Army. The report also is available at no charge on the GAO Web site at <http://www.gao.gov>.

Should you or your staff have any questions concerning this report, please contact Asif A. Khan at (202) 512-9095 or khana@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.



Asif A. Khan
Director, Financial Management and Assurance

Appendix I: Scope and Methodology

To determine whether the Army Working Capital Fund (AWCF) monthly cash balances fell within Department of Defense's (DOD) cash requirements for fiscal year 2000 through fiscal year 2009, we (1) obtained the DOD regulation on calculating the minimum and maximum cash requirements, (2) calculated the cash requirements for the period based on the regulation, and (3) obtained monthly cash balances for the period. We compared the minimum and maximum cash requirements to the month-ending reported cash balances. If the cash balances either exceeded the maximum amount or were under the minimum amount, we reviewed AWCF financial statements, budget justification books, and other reports to ascertain the reasons for the surpluses or deficiencies, and we discussed with Army officials the reasons for the variances. In addition, we performed a walk-through of the Defense Finance and Accounting Service's processes for reconciling the Department of the Treasury trial balance monthly cash amounts for AWCF to the balances reported on the AWCF cash management reports. To test the reconciliations, we reconciled the year-end cash balances between the Treasury trial balance and the Army cash management reports for fiscal years 2000 through 2009.

To determine whether the cash transfers for fiscal years 2000 through 2009 resulted in the AWCF's monthly cash balances falling below the minimum cash requirement, we (1) analyzed DOD budget and accounting reports to determine the dollar amount of transfers made for the period, and (2) obtained journal vouchers from the Defense Finance and Accounting Service that documented the dollar amount of the cash transfers. We analyzed cash transfers to determine if any of the transfers resulted in cash balances falling below the minimum cash requirement, and if so, the amount below the minimum. We also obtained and analyzed reprogramming documents and journal vouchers and interviewed key Army officials to determine the reasons for the transfers.

To determine whether the AWCF projected monthly cash balances are expected to fall below the minimum cash requirement for fiscal years 2010 and 2011 and actions the Army can take to manage those balances, we obtained and analyzed AWCF budget documents and cash plans for the 2 years. We used the DOD regulation to calculate the minimum cash requirement for those years and compared it to the projected cash balances. We also compared the minimum cash requirement according to DOD regulation to the minimum cash requirement in the fiscal year 2011 AWCF budget document. We discussed with Army headquarters officials any differences. In addition, we met with Army headquarters officials to discuss the impact that increased troop levels to Afghanistan will have on the AWCF projected cash balance. We also met with officials from Army

headquarters, the Supply Management Activity Group, and the industrial operations activity group to discuss issues that can affect AWCF projected cash balances. We also interviewed Army headquarters officials to determine what actions the Army is taking or can take to increase collections or decrease disbursements to avoid potential AWCF cash shortages. In addition, we interviewed DOD officials and reviewed the DOD Financial Management Regulation to determine the criteria for maintaining inventory levels for industrial operation activities.

We performed our work at the headquarters of the Office of the Under Secretary of Defense (Comptroller) and Office of the Secretary of the Army, Washington, D.C.; Army Materiel Command, Fort Belvoir, Virginia; Aviation and Missile Command, Redstone Arsenal, Alabama; TACOM (formerly known as Tank-automotive Armament Command), Warren, Michigan; Communications-Electronics Command, Fort Monmouth, New Jersey; and Defense Finance and Accounting Service, Indianapolis, Indiana.

Most of the financial information in this report was obtained from official Army budget documents and accounting reports. To assess the reliability of the data, we (1) obtained and analyzed reports containing detailed data on transactions affecting the AWCF cash balance including collections, disbursements, direct appropriations to the AWCF, and funds transferred in or out of the AWCF, (2) obtained an understanding of the process used by the Defense Finance and Accounting Service to reconcile Army cash balances with Treasury records, (3) reconciled year-end cash balances between Army reports and Treasury records, and (4) obtained and analyzed documentation supporting the amount of funds transferred out of the AWCF. On the basis of procedures performed, we have concluded that these data were sufficiently reliable for the purposes of this report. We conducted this performance audit from June 2009 through June 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Department of Defense



COMPTROLLER

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

MAY 26 2010

Mr. Asif A. Khan
Director
Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Khan:

This is the Department of Defense (DoD) response to the GAO draft report (GAO-10-480), "ARMY WORKING CAPITAL FUND: Army Faces Challenges in Managing Working Capital Fund Cash Balance during Wartime Environment, dated April 28, 2010, (GAO Code 197088).

Sincerely,

A handwritten signature in cursive script that reads "Robert F. Hale".

Robert F. Hale



GAO DRAFT REPORT DATED APRIL 28, 2010
GAO-10-480 (GAO CODE 197088)

“ARMY WORKING CAPITAL FUND: ARMY FACES CHALLENGES IN
MANAGING WORKING CAPITAL FUND CASH BALANCE DURING
WARTIME ENVIRONMENT”

DEPARTMENT OF DEFENSE COMMENTS
TO THE GAO RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommends that the Secretary of Defense direct the Secretary of the Army to evaluate periodically the unit cost ratio (obligations to sales) and take action to adjust the ratio as necessary, to support the war effort in Iraq and Afghanistan and the eventual drawdown of troops. (p. 26/GAO Draft Report)

DOD RESPONSE: Concur. The Office of the Under Secretary of Defense (Comptroller) and the Office of the Assistant Secretary of the Army (Financial Management & Comptroller) evaluate unit cost goals during the annual budget review. The Department manages inventory in relation to projected sales volume. The FY 2011 President’s Budget established unit cost ratios for the Army’s Supply Management business area at 0.903 for FY 2010 and 0.887 for FY 2011, which is consistent with projected sales volume declines.

RECOMMENDATION 2: The GAO recommends that the Secretary of Defense direct the Secretary of the Army to take action if the industrial operations activities do not reduce their inventory levels to the specified amount in the fiscal year 2011 budget. (p. 26/GAO Draft Report)

DOD RESPONSE: Concur. The Office of the Under Secretary of Defense (Comptroller) and the Office of the Assistant Secretary of the Army (Financial Management & Comptroller), evaluate inventory levels during the annual budget review process. We anticipate the value of Army’s inventory to decline after first quarter FY 2011.

RECOMMENDATION 3: The GAO recommends that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to clarify the term “normal business operations” in the DoD Financial Management Regulation as it pertains to the amount of inventory items to be held for use by the industrial operations activities. (p. 27/GAO Draft Report)

DOD RESPONSE: Concur with comment. The Department accepts that this is a cause for concern and will act accordingly for implementation in the fiscal year 2012 President’s Budget. The Under Secretary of Defense (Comptroller) will coordinate with the Under Secretary of Defense (Acquisition Technology and Logistics), which regulates business operations for industrial operations, to clarify the term “normal business operations”. The Under Secretary of Defense (Comptroller) will update the Financial Management Regulation based on the definitional changes.

RECOMMENDATION 4: The GAO recommends that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to oversee Army and Defense Logistics Agency (DLA) efforts to reach agreement on the amount that DLA will reimburse Army Working Capital Fund (AWCF) for the consumable items transferred to DLA and ensure that DLA reimburses AWCF for the items transferred in a timely manner. (p. 27/GAO Draft Report)

DOD RESPONSE: Concur. The Under Secretary of Defense (Comptroller) has provided guidance in Volume 11B, Chapter 2, Section 0205 of the Financial Management Regulation and will continue to monitor the funding associated with the transfer of consumable items.

Appendix III: GAO Contact and Acknowledgments

GAO Contact

Asif A. Khan, (202) 512-9095 or khana@gao.gov

Acknowledgments

In addition to the contact named above, Greg Pugnetti, Assistant Director; Richard Cambosos; Steve Donahue; Keith McDaniel; and Hal Santarelli made key contributions to this report.

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