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GAO

Report to the Honorable David H. Pryor
United States Senate

July 1986

DOD FINANCIAL MANAGEMENT

Improper Use of Foreign Currency Fluctuations Account

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National Security and
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The Honorable David H. Pryor
United States Senate

Dear Senator Pryor:

On February 3, 1986, you requested that we undertake a study of the Department of Defense (DOD) Foreign Currency Fluctuations, Defense (FCF,D) account. Specifically, you requested that we review the account's history, analyze the need for and justifications of transactions involving this account, and determine the source and type of funds being transferred into the account. Your staff also asked us to determine the impact of the Gramm-Rudman-Hollings act on the FCF,D account.

In summary, we found that, because DOD used budgeting records rather than the services' accounting records as a basis for managing and reporting on the FCF,D account and because of DOD's interpretation of Public Law 96-38, it (1) was able to retain the use of $659.7 million of funds that appropriately should have been returned to the Treasury, and (2) in effect circumvented a congressionally imposed ceiling on the FCF,D account. We believe that DOD's handling of the FCF,D account exemplifies the problems with federal financial management that we previously reported in our Managing the Cost of Government (GAO/AFMD-85-35, 35A, February 1985.)

For fiscal year 1986, the Congress recognized the substantial amount of funds—$1.32 billion—that DOD had accumulated in the FCF,D account and took action to reduce it. The Congress may wish to further clarify how it wants the FCF,D account to be used.

Background

The FCF,D account was established by Public Law 95-457, dated October 13, 1978. This law gave the Secretary of Defense authority to make transfers from the account to the services' Operations and Maintenance (O&M) and Military Personnel accounts.[1] The purpose of the FCF,D account is to provide a mechanism for stabilizing that portion of the O&M appropriation used for purchasing foreign goods and services by providing funds to the O&M account when foreign exchange rates are unfavorable (when losses occur), and by receiving funds from the O&M account when

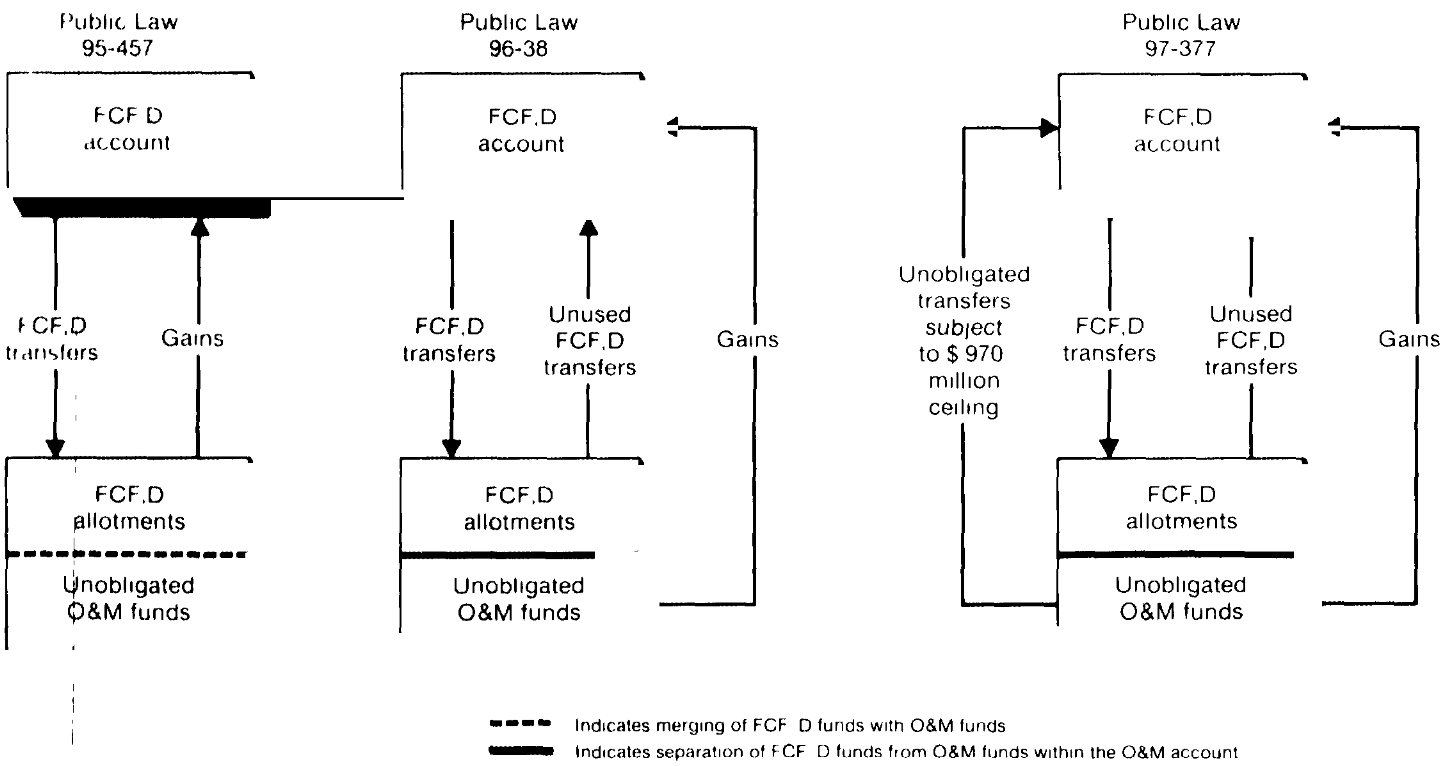
[1] Public Law 95-457 included the Military Personnel account, but the Congress eliminated it at the end of fiscal year 1980. Thus, this report, unless otherwise specified, addresses only the O&M account.

the rates are favorable (when gains occur). The basic intent is to ensure that any given O&M appropriation for the purchase of foreign goods and services will purchase the budgeted amount of goods and services, regardless of the gains and losses of the dollar caused by currency fluctuations. To date, the Congress has appropriated $970 million to the FCF,D account.

FCF,D funds differ from O&M funds in two ways First, while O&M funds are used to purchase goods and services, FCF,D funds can be used only to pay for the increased cost of those purchases caused by unfavorable foreign currency exchange rates. Second, FCF,D funds are no-year funds (available until used), while O&M funds are 1-year funds. That is, O&M funds expire at the end of the fiscal year in which they are appropriated if they are not obligated. Expired funds remain in the O&M account for 2 additional years and can be used to pay existing obligations and liabilities previously incurred but cannot be used to incur new obligations. At the end of the 2-year period, unused expired funds flow to a surplus account within the Treasury's general fund.

The original operations of the FCF,D account as established by Public Law 95-457 have been amended twice First, Public Law 96-38, dated July 25, 1979, authorizes the transfer back of unused FCF,D funds that the Office of the Secretary of Defense (OSD) allots to the services' O&M accounts. Second, Public Law 97-377, dated December 21, 1982, authorizes the direct transfer of unobligated O&M funds to the FCF,D account as long as the direct transfer does not cause the balance in the FCF,D account to exceed $970 million. (It is to be noted that this law imposes no ceiling on the amount of allotted FCF,D funds or gains that can be transferred to the FCF,D account.) Figure 1 illustrates these changes.

Figure 1: Legislated Changes in Transfer Authority Between FCP,D and O&M Accounts



While Public Law 95-457 authorized FCF,D funds to be merged with O&M funds, the later laws, in our opinion, require that the two types of funds be kept separate. By authorizing unused allotments of FCF,D funds to be returned to the FCF,D account, Public Law 96-38 requires, in effect, that allotments be segregated from O&M funds in order to determine the unused portions of the amount allotted. By authorizing the transfer of unobligated O&M funds into the FCF,D account subject to a $970-million ceiling in that account, Public Law 97-377 also requires this segregation in order to distinguish O&M funds from FCF,D allotments since allotments are not subject to the ceiling.

Relationship Between FCF,D and O&M Appropriations

Before the FCF,D appropriation was established, foreign purchases were obligated at the foreign exchange rates in existence at the time of the obligation. If the value of the U.S. dollar weakened before that obligation was liquidated, the additional funds needed came from the O&M account. On the other hand, if the U.S. dollar became stronger, causing the amount spent to be less than the amount obligated, the excess funds allowed additional purchases to be made from the O&M account

With the establishment of the FCF,D appropriation, foreign purchases are obligated at the foreign exchange rates as determined in the annual budget process. In other words, O&M funds appropriated for foreign purchases are based on stated foreign exchange rates. Additional costs resulting from a subsequent unfavorable exchange rate are to be paid with funds from the FCF,D account, and any gain resulting from a favorable exchange rate is to be transferred to the FCF,D account.

The transactions of fiscal year 1979, when the exchange rate was unfavorable, and those of fiscal year 1981, when the exchange rate was favorable, illustrate the relationship between the FCF,D and O&M accounts. In fiscal year 1979, DOD obligated $2.1 billion of O&M funds to purchase foreign goods and services. These funds were obligated at the same foreign exchange rates used in preparing the budget. As these obligations were liquidated, an additional $251.5 million was needed because the dollar had become weaker than it was when the budget was submitted. DOD used FCF,D funds to pay these costs.

During fiscal year 1981, DOD obligated $2.5 billion of O&M funds and liquidated $1,842 million of this amount. However, since the dollar was stronger at the time of the liquidations than at the time of the obligations, DOD spent only $1,593 million. The excess amount (about $250 million) was a gain. After adjusting this gain for losses on the 1979 and 1980 obligations liquidated in 1981, a net gain of $187 million was included in the amount that was transferred from the services to the FCF,D account.

Budget Transfers Used for Accounting

Using budget transfers for reporting rather than actual gains and losses allowed DOD, based on its interpretation of the law, to retain FCF,D funds for future use by spending O&M funds that it would otherwise have lost. In addition, the use of this budget-transfer procedure in fiscal year 1985 made it possible for DOD to, in effect, circumvent the congressional ceiling on direct transfers of unobligated O&M funds. Since budget transfers rather than the services' accounting records are used for reporting on the FCF,D appropriation, DOD, in our opinion, has consistently incorrectly reported the balance in the FCF,D account.

At the beginning of each fiscal year in which the dollar's value has decreased from that used in the budget process, OSD transfers funds from the FCF,D account to the services' O&M accounts. The amount transferred is based on estimates of what will be needed and is determined by using the then-current exchange rates. If estimates later in the year show that not enough funds were transferred, OSD makes additional transfers. If funds transferred to the services are not needed, the unneeded amounts—as well as net gains—are transferred back to the FCF,D account. These transfers are the basis on which OSD accounts for the FCF,D appropriation and reports year-end balances for FCF,D funds. For example, in fiscal year 1979, OSD transferred $483.5 million of the $500 million appropriated for the FCF,D account to the services' O&M and Military Personnel accounts DOD reported these transfers to the Treasury and reported the balance in the FCF,D account as $16.5 million.

Budget transfers, however, fail to show what actually happened to the no-year FCF,D funds, i.e., how much was spent or gained in a given fiscal year. For example, of the $483.5 million OSD transferred to the services in fiscal year 1979, only $368.6 million was spent.[2] Consequently, the balance of no-year funds that should have been available in the FCF,D account was $131.4 million, not the $16 5 million OSD reported. Had the actual amount of no-year funds been reported, the Congress might have appropriated less for fiscal year 1980 than the $470 million it did appropriate.

Substitution of Expired O&M Funds for Spent FCF,D Funds

Since budget transfers are used to account for FCF,D funds, DOD is able to substitute expired O&M funds that are about to flow into the Treasury's general fund for FCF,D funds that have already been spent. In 1979, 1980, and 1983, as O&M obligations to purchase foreign goods and services were liquidated, DOD used FCF,D funds to cover additional costs due to unfavorable foreign currency fluctuations. However, in 1981, 1982, and 1985, DOD changed its budget records but not its accounting records to indicate that O&M expired funds[3] had been spent to cover much of these additional costs which were originally paid for with FCF,D funds.

[2]The $368 6 million includes $251 5 million from the O&M account and $117 1 million from the Military Personnel account

[3]We could not determine the source for all the expired O&M funds substituted for spent FCF,D funds However, we did establish that some of the funds had expired for reasons unrelated to foreign purchases or foreign currency fluctuations For example, most of the 1983 expired O&M funds that the Navy substituted in 1985 for spent FCF,D funds were deobligated O&M program funds, and some of the deobligated funds came from budgets of U S -based commands which do not make foreign purchases

For example, in 1985, when it became evident that the O&M account would have at least $340 million of excess 1983 funds, OSD told the services (1) to report that they had used O&M funds to finance their 1983 losses due to foreign currency fluctuations even though they had already paid for these losses with FCF,D funds, and (2) to return the FCF,D allotted funds to the FCF,D account. This procedure mischaracterizes what actually happened. OSD, in effect, transferred $340 million from the services' O&M appropriations to its FCF,D account. As shown in table 1, this procedure, since the inception of the FCF,D account, has allowed DOD to gain use of $659.7 million that it otherwise would have had to return to the Treasury.

Table 1: Use of Funds Gained by DOD

Dollars in Millions

Fiscal year in which substitution recorded	Fiscal year in which O&M funds appropriated	Spent funds restored to FCF,D no-year account
1981	1979	$144 7
1982	1980, 1981	175 0
1985	1983	340 0
		$659.7

Unauthorized Retention of Appropriated Funds

OSD officials state that Public Law 96-38 authorizes the after-the-fact substitution because it contains a clause saying that funds other than FCF,D funds can be used to liquidate obligations incurred due to fluctuations in currency exchange rates if these "other funds are, or become, available." OSD officials interpret this clause to mean that O&M funds can be used to cover unfavorable foreign currency fluctuations that occurred before the funds became available. We do not believe that Public Law 96-38 means that other funds (O&M funds) can be used to cover unfavorable foreign currency fluctuations which occurred and were paid for with FCF,D funds before the O&M funds became available. Consequently, the after-the-fact substitutions, in our opinion, are unauthorized.

Since the substitutions are unauthorized, the funds OSD transferred were, in effect, O&M funds. However, Public Law 96-38, dated July 25, 1979, provides no authority to transfer O&M funds into the FCF,D account. Consequently, the transfers of $319.7 million of unobligated O&M funds in 1981 and 1982 are unauthorized and should have been returned to the Treasury. The transfers of $340 million in 1985 are also unauthorized since they caused the FCF,D account balance to exceed the congressionally imposed ceiling for such transfers.

1985 Substitution Circumvents Congressional Ceiling

While substitutions took place in 1981, 1982, and 1985 to spend expired O&M funds, the 1985 substitution also had the effect of circumventing the legislated ceiling imposed by Public Law 97-377. In December 1982, Public Law 97-377 granted DOD authority to transfer expired O&M funds directly to the no-year FCF,D appropriation. However, the legislation granting the authority also established a $970-million ceiling when making such transfers. In 1984, DOD used this authority to transfer $404 million of 1-year O&M-program funds into the no-year FCF,D account, bringing its balance to $970 million. Consequently, in 1985, when DOD found that it had $340 million of expired O&M funds that it would have liked to transfer, it could not because the ceiling had been reached. DOD then substituted the $340 million of O&M funds for a like amount of FCF,D funds that had already been spent. As previously stated, this procedure, in effect, transferred unobligated O&M funds to the FCF,D account. Thus, the substitution accomplished the same result that a direct transfer would have; that is, it increased no-year FCF,D funds by $340 million.

Year-End FCF,D Balances

Using the services' "Foreign Currency Fluctuations" reports, which are based on their accounting records, we calculated what we believe the fiscal year-end FCF,D balances should have been (see table 2) and compared them with what DOD reported to the Treasury Department based on budget transfers (see table 3).

Table 2: Year-End Balances Based on Services' Accounting Records

Dollars in Millions

Fiscal year	Beginning balance	Appropriated funds	Fluctuation gains/ (losses)	Transfers unrelated to foreign purchases in/(out)	Year-end balances per accounting records
1979	$ 0	$500 0	$(368 6)	$ 0	$131 4
1980	131 4	470 0	(446 3)	0	155 0
1981	155 0	0	187 4	0	342 4
1982	342 4	0	325 3	0	667 7
1983	667 7	0	(146 3)	(174 6)	346 8
1984	346 8	0	(56 7)	404 0	694 1
1985	694 1	0	(34 0)	309 9[a]	970 0

[a]Amount that could have been transferred directly from O&M account to FCF,D account, according to Public Law 97-377

Table 3: Comparison of Balances Based on Services' Accounting Records With DOD-Reported Balances

Dollars in Millions

Fiscal Year	DOD	Services
1979	$ 16 5	$131 4
1980	57 6	155 0
1981	487 1	342 4
1982	987 4	667 7
1983	506 1	346 8
1984	970 0	694 1
1985	1,319 9	970 0

Impact of Congressional Actions

For fiscal year 1986, the Congress recognized the large amount of funds available in the FCF,D account—$1 32 billion—and made three adjustments to reduce the amount of no-year funds available. First, the Congress, by basing the O&M budget on higher foreign exchange rates, caused a $400-million reduction in the O&M appropriation for purchasing foreign goods and services. DOD requested $2,751.4 million, and the Congress increased the budgeted foreign exchange rates per U.S dollar to reduce the O&M appropriations to $2,351.4 million. The adjustment, in turn, will require the $400 million to be funded from the FCF,D account if DOD purchases the budgeted amount of foreign goods and services

Second, the Congress reduced the O&M appropriation another $468 million and included a general provision allowing DOD to transfer a like amount from the FCF,D account to the O&M operating accounts. This transfer allows DOD to buy $468 million of goods that it budgeted for in the O&M account but reduces the FCF,D account to pay for those goods.

Third, the Gramm-Rudman-Hollings act required a reduction of $64.7 million from the FCF,D account.[4] Table 4 shows the three budget reductions.

Table 4: Congressional Reductions to FCF,D Account After September 30, 1985

Balance as of September 30, 1985		$1,319,928,000
Reductions per 1986 appropriation		
Foreign exchange rate adjustment	$400,000,000	
Transfer authority	468,000,000	868,000,000
Subtotal		**$451,928,000**
Gramm-Rudman-Hollings reduction		64,680,000
Balance after congressional reductions		**$387,248,000**

Source and Type of Unobligated Funds Transferred Into the FCF,D Account Cannot Be Determined

Transfers of unobligated O&M funds into the FCF,D account have been either deobligated funds (gains), which resulted from the dollar's becoming stronger, or expired O&M program funds which either were never obligated or were deobligated for some reason other than foreign currency fluctuations. Since the services' headquarters do not maintain records on the source (from where within the services the funds came) and type (why the funds became expired), but rather recognize the total amount as a single pool of funds, we were unable to determine specifically why expired funds existed without doing extensive work—i.e., contract audits at the user commands.

Conclusions

In our report, Managing the Cost of Government, we discuss what we believe are some major problems in federal financial management today, and outline some basic financial management principles that could serve as the basis for financial management improvements. That report defines financial management as encompassing the processes and functions of (1) planning and programming, (2) budgeting, (3) budget execution and accounting, and (4) audit and evaluation. It views sound financial management as four distinct but interrelated phases, supported and linked by useful program and cost data.

[4] On July 7, 1986, the Supreme Court of the United States held unconstitutional the process by which spending reductions were to be instituted pursuant to calculations made by the Comptroller General However, the Act has a fallback deficit reduction process under which spending reductions may be made At this time it is unclear if similar or different reductions will be made under this process

To be useful for daily program management, and congressional and executive branch decision-making, that information must be reliable, consistent over time, and comparable among similar activities, so that it presents an accurate picture of program activities and costs. In our view, DOD reports regarding the FCF,D and O&M accounts do not meet these criteria Information gaps and weak links can occur when the budget execution and accounting phase is not integrated with the budgeting phase.

DOD used budgeting records rather than accounting records to report on its FCF,D funds and substituted O&M funds for FCF,D funds which had already been appropriately spent to cover currency fluctuations Both actions are contrary to sound financial management practices and resulted in DOD's

- retaining $659 7 million of previously spent no-year FCF,D funds for future use by using $659.7 million of expired O&M funds that should have been returned to a merged surplus account within the Treasury's general fund, and
- circumventing the congressionally imposed ceiling for direct transfer of unobligated O&M funds to the FCF,D account.

DOD officials believe that Public Law 96-38, which amended the law originally establishing the FCF,D account, authorizes after-the-fact substitution of funds because the law says that "other funds" can be used to liquidate obligations incurred due to fluctuations in currency exchange rates if these funds "are, or become, available." We do not believe that this law meant that such funds can be used to cover unfavorable foreign currency fluctuations which occurred and were disposed of before those funds became available. Consequently, we consider the after-the-fact substitutions unauthorized. Moreover, the transfers in 1985 exceeded the ceiling imposed by Public Law 97-377

Matters for Congressional Consideration

Because DOD, in our opinion, has used unauthorized transfers as a result of its interpretation of Public Law 96-38, the Congress may wish to clarify the use of the FCF,D appropriation and include a reporting requirement which would show the actual amounts of FCF,D funds being spent as well as the source of funds flowing into the account. In our view, sound financial management practices require that DOD report separately each fiscal year all sources of funds—annual appropriations, unobligated O&M funds, and gains from foreign currency fluctuations—flowing into the FCF,D account and actual expenditures from the account.

Accurate accounting-based reports on what actually happened provides both DOD managers and the Congress the information they need to assess the effects of both foreign currency fluctuations and O&M purchases of foreign goods and services

Objective, Scope, and Methodology

Our objective was to analyze the FCF,D appropriation to determine how the account operates and is used. We researched the legislative history to determine its intended purpose and operating procedures. We also examined all budget transfers in and out of the FCF,D account and DOD reports of gains and losses occurring due to fluctuations in foreign currency exchange rates. The records reviewed covered the period from fiscal year 1979 through January 1986.

Our review was conducted in the Washington, D.C., vicinity and included contacting the following organizations:

- Office of the Secretary of Defense,
- Washington Headquarters Services,
- Office of the Comptroller of the Navy,
- Office of the Comptroller of the Air Force, and
- Office of the Comptroller of the Army.

At each organization, we interviewed responsible officials and obtained pertinent documents. Our review was conducted from February through June 1986 in accordance with generally accepted government auditing standards.

As requested by your office, we did not obtain formal agency comments on this report. However, we did discuss it with officials in the office of the Assistant Secretary of Defense, Comptroller and have included their comments as appropriate.

As planned with your office, we plan no further distribution of this report until 10 days from the date of this report. Then, we will send copies of this report to the Chairmen of the Appropriations, Armed Services, Government Operations, and Government Affairs Committees; the Secretaries of Defense, the Army, the Navy, and the Air Force; and other interested parties If you have any questions, please call Martin M Ferber, Associate Director for Manpower, Reserve Affairs and Logistics at 275-5140.

Sincerely yours,

Frank C. Conahan
Director

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