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## FINANCIAL MANAGEMENT IN THE NAVY: 1950-1960

J. SINCLAIR ARMSTRONG\* AND LAWRENCE E. CHERMAK\*\*

The United States Navy and the United States Marine Corps with defense as their primary purpose must differ in most respects from private business corporations and from other Government agencies except their sister services. Yet financial management, as a method of assuring more complete use of assets and of measuring performance, has shown remarkable development in the Navy and the Marine Corps during the past decade. There is no doubt that this improved financial management has increased the efficiency of the fighting forces in their constant effort toward ultimate preparedness for all types of war.

War, or even preparation for war, in a social sense, is essentially wasteful. This becomes apparent when defense expenditures are related to the more constructive ends that civilized man could pursue. But in spite of this social waste, we must concede that the demonstration of American resistance to aggression in Korea and the high level of defense activities and expenditures since then have been a substantial contributing cause of the maintenance of peace during the past decade.

Business corporations measure their performance by balance sheets and profit-and-loss statements. It is necessary to match income and expenses for a period to compute the profit of the operation and thereby determine the equity of the shareholders in the business effort of the period. The control of public funds requires a different approach. Management in the Navy must make certain that the usage of the cash asset is for a proper purpose, in a proper amount, during a proper period. Good financial management in the case of private corporations involves techniques quite different from those employed in good financial management in the Government.

The extent of the difference can be seen in the sheer size and range of activity of the Department of the Navy. A few pertinent facts will put the picture of financial management in context. In the fiscal year commencing 1 July 1960, the Navy and the Marines will have 620,000 and 175,000 military personnel respectively on the payroll, and will operate in the active fleet and support activities 817 ships

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steaming 2,000,000 hours, and 6000 aircraft flying 2,800,000 hours. The naval forces will include carrier, striking, submarine, antisubmarine, amphibious and mobile logistic support forces. The three Marine Corps Divisions and Marine Corps Air Wings will continue to be vital ingredients of our defense program. All the ships, aircraft and forces will continue to be deployed or maintained in readiness for deployment to potential trouble spots in any part of the world at a moment's notice as abundantly demonstrated by our 1958 landings in Lebanon.

The Navy fiscal problem also differs from that of private corporations in the rate and character of the technical changes in its facilities and equipment, and the rapidity of its obsolescence. Proper preparation for war requires the best ships, aircraft, missiles, and weapons that man can devise, and the best personnel that man can secure and train. Thus, whole concepts of undersea warfare have been revolutionized by the nuclear powered submarine, now being adapted to contribute to strategic deterrence through the ballistic missile firing "Polaris" submarine. Likewise, concepts of limited war capability have been drastically modified by the Marines' vastly improved helicopter borne vertical envelopment doctrine.

Even though the shopping list for military procurement may use the same words today as it did ten years ago, the products purchased are more complex, faster, more automatic and vastly more expensive. The fleet-type submarine at the end of World War II cost \$4.5 million. A "Nautilus" costs about \$50 million, and is three times as expensive to operate. A World War II fighter plane cost \$70 thousand; today, its counterpart costs about \$1.5 million. An "Essex" class carrier cost \$65 million while the nuclear-powered "Enterprise" will probably cost at least \$400 million. These extraordinary cost increases require comparable improvements in cost consciousness and control under competent financial management if this Nation is to defend itself within its resources.

An interesting example of the type of forward, "edge of space," venture into which the Navy must get today, is the world's largest steerable radio telescope, under construction in West Virginia.<sup>1</sup> To build this, the Navy will use 20,000 tons of steel, 600 tons of aluminum and 14,000 cubic yards of concrete. This instrument of research will be higher than the Washington Monument, more extensive than the Nation's Capitol and as expensive as the world's largest office building—the Pentagon.

<sup>1</sup> McClain, *The 600-foot Radio Telescope*, *Scientific American*, Volume 202, No. 1, 45 (January, 1960).

At this point many people will ask why would the United States Navy be building this apparatus which has the proportions of the largest pyramid of Egypt and yet is capable of moving its 600-foot reflector a full 360 degrees in a horizontal plane and of tilting it to any angle of elevation from 0 to 90 degrees. These people can only be thinking of the United States Navy as it was in World War II, when the problems of running the Navy did not require operating at the very edges of scientific knowledge. The nuclear Navy with its operation and control through electronic devices—which cannot be adequately described except as “brains”—compels a constant probing into every aspect of the physical and social sciences that have expanded at logarithmic rates during the past decade.

Of course this expanding Navy must continue to be constructed, supplied and maintained, which in itself is a monumental task. The procurement of \$60 billion of goods and contractual services over the past decade is a measure of its extensiveness. The tabulation of the various items obtained would be fabulous for they include wonders as fantastic as the 600-foot telescope just described. The legal problems surrounding this procurement are so extensive that an incidental result has been the recent publication of a 1000-page treatise on Navy Contract Law.<sup>2</sup> Every major problem of this military department, whether it is logistic, strategic, legal or fiscal, takes on gargantuan proportions.

For the past decade, financial management in the Navy has shown extraordinary growth. The simple reason for this lies in the massive fiscal processes that the cold war has created. Current preparedness of the Navy requires biennial spending in excess of the total naval spending for all the years of its history prior to Pearl Harbor.<sup>3</sup> Fiscal problems, which, in earlier years, reached cabinet levels and made history, today must be solved as a matter of normal operations. These singular times demand uncommon effort and skill in this specialized and technical area. A survey of recent fiscal developments has not found these traits wanting.

#### COMPTROLLERSHIP

Financial management of any public body is circumscribed by both statutory and administrative controls and restrictions. This is particularly true of the Department of the Navy. Not only must it

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<sup>2</sup> Navy Contract Law (2nd Ed., 1959). The Government Printing Office has run off ten thousand copies to meet the public demand for this legal work.

<sup>3</sup> Navy spent over 22 billion for the Fiscal Years 1958 and 1959. Expenditures prior to 30 June 1941 totalled 18,689 million dollars. Navy Department, Office of the Comptroller, Financial Report, Fiscal Year 1959.

be responsive to standards established by legislation and by congressional committees, but it must also consider the policies and procedures established by the Treasury Department, the Bureau of the Budget, the General Accounting Office and the Office of the Secretary of Defense. However, this complexity of restrictions has not prevented the progress anticipated with the establishment of an Office of the Comptroller in each military department in 1950.<sup>4</sup>

Congress reorganized the fiscal organization of the Department of Defense by the National Security Act Amendments of 1949 and set the stage for the growth which followed. Under these amendments, the military Comptrollers were given the responsibility for all budgeting, accounting, progress and statistical reporting, and internal audit in their respective departments. Performance budgeting was initiated. Working-capital funds were established. Management funds were utilized. Cross-disbursing was adopted. Property accounting was required. All this was as a result of specific requirements of the legislation.

The establishment of a comptroller organization at all levels throughout the Department of the Navy did, of necessity, take much time, effort and training. In addition to the Office of the Navy Comptroller, comptroller organizations were established in the various bureaus and offices to provide coordinated service, advice and assistance in financial management to the bureau and office chiefs. This organization was extended to the field in shipyards, ordnance plants and other major installations. To do this it was necessary to train hundreds of civilian personnel and Navy and Marine Corps officers in Navy Comptrollership at classes conducted by the Office of the Navy Comptroller. Dozens of Navy and Marine Corps officers participated in the advanced degree Navy Graduate Comptrollership Program given at George Washington University.

#### PERFORMANCE BUDGETING

Performance budgeting occurs with the preparation, presentation and justification of budget estimates before the Congress on the basis of the cost of performance of readily identifiable functional programs. Prior to the use of performance budgets, budgets were initiated on an object basis in which monies were segregated for personal services, travel, materiel shipment, rent, utilities, printing, supplies, equipment and other similar objects of expenditure.<sup>5</sup> Budgeting for medical care

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<sup>4</sup> National Security Act Amendments of 1949, Title IV, 63 Stat. 585 (1949), 5 U.S.C. § 172.

<sup>5</sup> See Budget-Treasury Regulation No. 1, now superseded by Bureau of the Budget Circular No. A-34.

at hospitals had been done through dozens of budget items rather than through a single hospitalization fund. Performance budgeting eliminated a major portion of the practices characteristic of object budgeting and reporting. Vestiges of this early practice, however, still remain in the reporting requirements continued by Congress. It is quite apparent that budgeting and reporting for functions or programs could be made much more effective with the removal of these vestigial congressional requirements.

The Navy pursued performance budgeting after World War II<sup>6</sup> and Congress finally adopted it by cutting back Navy appropriation accounts from 47 titles to 24 titles in 1950<sup>7</sup> and 10 titles in 1958.<sup>8</sup> The consolidation of these accounts into broader, functional appropriations permits a greater flexibility in the use of funds made available by the Congress. In a period of changing military requirements, funds covering broader authorizations may be programmed through congressional committees before whom the original justifications were made without additional legislation. This freedom of action under congressional direction avoids the loss of valuable production and development time and permits financial management to meet changing defense needs before the next annual budget can be presented to Congress.

Similar legislation has been adopted for the rest of the Federal Government.<sup>9</sup> Currently, the President presents his budget by major functions which in their broadest categories are broken down into (a) Major National Security, (b) International Affairs and Finance, (c) Veterans' Services and Benefits, (d) Labor and Welfare, (e) Agriculture and Agricultural Resources, (f) National Resources, (g) Commerce and Housing, (h) General Government, and (i) Interest.<sup>10</sup> Of these categories, Major National Security takes 57% of the total budget, eight-ninths of which is covered by the military functions of the Department of Defense, the balance being allocated to atomic energy requirements, stockpiling and expansion of defense production, and foreign military assistance.

Within the Department of Defense, military functions are broken down into major categories: military personnel; operation and maintenance; major procurement; research, development, test and evaluation; and military construction.<sup>11</sup> Uniformity among the military

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<sup>6</sup> Mosher, *Program Budgeting: Theory and Practice*, 79 (1954).

<sup>7</sup> 64 Stat. 595 (1950).

<sup>8</sup> 72 Stat. 711 (1958).

<sup>9</sup> The Budget and Accounting Procedures Act of 1950 ch. 946, 64 Stat. 832, 31 U.S.C. §§ 2, 11 (1958).

<sup>10</sup> The Budget of the United States Government for the Fiscal Year ending June 30, 1961. Washington, D.C. (1960).

<sup>11</sup> Department of Defense Appropriation Act, 1960, 73 Stat. 366 (1959).

departments is sought in a further breakdown of these major categories. This is difficult in view of the differences in organization existing among the military departments due to their differences in assigned missions. However, a functional stratification for comparison purposes has been evolved without the necessity for a reorganization of each military structure. This functional stratification permits the evaluation of the effective use of funds made available for similar purposes and provides a greater uniformity of treatment among the military departments.

The current reorganization of the Navy which resulted in the abolishment of the Bureaus of Aeronautics and Ordnance and the establishment in their place of the Bureau of Naval Weapons represents the type of organizational change necessary for the bringing together of similar functions.<sup>12</sup> Such permits the development and production of whole weapon systems under single funding plans. Procurement and operations will consequently be made from broader funding authority controlled by the enlarged new bureau.

The National Security Act requires additionally that the programs and activities in a performance budget be segregated on an operating and capital basis. The major classification of the Department of Defense makes the segregation of capital items possible by providing that all major procurement and production, such as missiles, planes, ships, tanks and other similar nonconsumable items be placed in separate appropriation titles. Similar treatment is accorded real estate acquisition and military construction. Research and development has followed the same pattern. Similarly, operating costs are kept separate in military personnel funds and in an operation and maintenance fund. During the past decade the Department of the Navy has been laboriously sorting out the budget functions within these classifications. For the fiscal year 1959, the consolidation of ten annual appropriations into a single operations and maintenance appropriation on a Navywide basis laid the groundwork for further refinements in this area.

#### COST-BASED BUDGETS

In an effort to bring meaning to the annual fiscal planning which expresses itself in the Department of Defense Appropriation Act, the Congress has adopted legislation requiring all federal agencies to make three primary changes in budgeting and accounting structure and practices.<sup>13</sup> All budgets presented to Congress must show planned

<sup>12</sup> 73 Stat. 291 (1959).

<sup>13</sup> 70 Stat. 782 (1956), 31 U.S.C. §§ 11, 18c, 24, 66a; 72 Stat. 852 (1958), 31 U.S.C. § 11 (1958).

costs based upon an accrual accounting system. When these changes become effective, Congress will be in a position to provide annual accrued expenditure limitations on each appropriation made.

The requirement that budgets be placed upon a cost-basis is not new to the Navy Department. It has long been recognized that not only cash but other resources should be included in the annual operating plan. Otherwise, offices and bureaus can operate at a higher consumption rate than budgeted by living off the unbudgeted inventories, undelivered orders, work in process and advances made in prior periods. To some extent this is denied by the working capital funds authorized under the National Security Act Amendments of 1949.<sup>14</sup>

The Department of the Navy set up working capital funds decades before the passage of these Amendments.<sup>15</sup> In fact, it was the experience of the Navy with these funds that laid the groundwork for their adoption by the Department of Defense. Under the new law, the "Naval Stock Fund" was renamed the "Navy Stock Fund" and a separate stock fund was established for the Marine Corps. These funds are used to finance the procurement of stocks of common-use items. The stocks become available for issue within the Navy, or to any other military department on a reimbursable basis. The inventory can only be used if paid for by the ordering agency, and is not available as a bailout of appropriation deficiencies. With working capital funds, it would not be necessary to include inventories and work in a cost-based budget, since the control lies in the cash usage of the operating appropriation.

Stock funds promote cross-servicing between the military departments and permit a single service to procure for the needs of the remaining military departments. Goods are made available in anticipation of the passage of the consuming appropriations. Reimbursements must be made to the Stock Fund which continues to procure additional inventory to meet the needs of the various ordering activities. With the establishment of these funds, inventory control has tightened. Enormous quantities of material have been catalogued both within and without the fund. Approximately 1,400,000 items of supply have been identified and catalogued. About a quarter of a million items have been added and approximately the same number of items have been dropped, having outlived their usefulness. This has resulted in extending the fund to the financing of an expanding list of new items

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<sup>14</sup> National Security Act Amendments of 1949, Title IV, 63 Stat. 585 (1949), 5 U.S.C. § 172.

<sup>15</sup> The Navy Stock Fund under a different name has been in use by the Navy since 1893.

such as photographic material, ship, electronic, submarine, ordnance, and vehicular equipment repair parts.

The past decade has seen an expansion of the use of the Industrial Fund for financing industrial type activities through a revolving working capital fund. The fund pays for labor, material and overhead costs of work performed at the activity and is replenished from the appropriated funds of the agency ordering the work. This greatly simplifies business procedures and induces the activity to utilize its available facilities most efficiently and economically. Attention is focused on costs, and inventories are kept under control through the use of modern business methods. The unit cost of the items produced aid greatly the review of budget estimates and the management of program costs both within the fund and under contract work for similar items. At present all shipyards, various ordnance plants, public works transportation centers, printing plants, laboratories, the David Taylor Model Basin and the Military Sea Transportation Service are under the Navy Industrial Fund. Dollar savings totalling many millions have been annually reported by the Secretaries of the Navy and of Defense as the result of the use of the industrial fund structure.

Adequate budgeting demands the scheduling of production and procurement of military equipment and supplies on an orderly basis. Any annual financial plan must be correlated to procurement and production schedules. This financial plan must consider new obligating authority, expenditure limitations and use of resources. By using modern techniques in budgeting, accounting, auditing, progress reporting and statistics, a periodic checkout of performance is made. Once the budget structure has been established, the primary requisite is an adequate accounting system productive of the facts and reports essential to good financial management.

#### ACCOUNTING

At the time of the establishment of the Department of Defense, the Joint Committee on Accounting Policy stressed, as the first order of business in the handling and accounting for receipts and disbursements of funds, the revision of appropriation and fund accounting. It recommended the coordination of appropriation and account structure, initiation of cost accounting for financial management usage and establishment of property and inventory accounting.<sup>16</sup> The Department of the Navy had already adopted adequate accounting systems in all these cases. Much of the accounting and disbursing done aboard vessels since the American Revolution was geared to keeping track

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<sup>16</sup> Annual Report of the Secretary of Defense, Fiscal Year 1948, 48.

of cash, supplies and equipment for long voyages. Programming controlled by ship records was a basic consideration for operations of ships unable to rely on support from the sea or foreign lands.

Accounting systems naturally evolve around the type of industry served. In the Navy, where dozens of different industries exist, a variety of accounting systems must be established. In addition to the establishment of uniform accounting procedures throughout the Navy Establishment, modern accrual accounting systems for industrial fund activities in shipyards, ordnance plants, aviation repair shops, printing plants, steamship operations, laboratories, model basins and clothing factories have been established. Simplified accounting systems have been developed for commissioned officers' messes as well as new commercial-type accounting procedures for nonappropriated fund activities such as civilian cafeterias and welfare activities. Resale activities doing an annual business comparable to the largest private counterparts are covered by the Navy and Marine Corps exchanges, commissary stores, and ship stores ashore located overseas. These have accounting systems patterned after their private counterparts. Special accrual accounting systems involving construction work have been instituted. At the other end of the complex logistic action, for the fighting forces afloat a simplified accounting system was created devoid of the treatment normally accorded more intricate business activities.

#### FUND CONTROL

The administrative control of appropriations and funds requires, under the provisions of the Anti-Deficiency Act,<sup>17</sup> the maintenance of control records at all levels to insure keeping within fund limits. Overobligation or overexpenditure, if done knowingly and willfully, could result in a fine of \$5,000 and imprisonment for 2 years. In addition, Congress redefined obligations which may be recorded.<sup>18</sup> Such compelled a review of thousands of different types of transactions. The result was extensive changes in accounting manuals. Obligation accounting became more detailed and complex. Collateral support had to be obtained by the introduction of commitment accounting. Each shift in the budget structure required parallel changes to keep the accounting system consistent with the manner of budget formulation and presentation. Conversely, as each new working capital fund was established, changes in budgeting were made so that costs of the products stocked or produced were reflected in the respective

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<sup>17</sup> Rev. Stat. § 3679 (1875), 31 U.S.C. § 665.

<sup>18</sup> 68 Stat. 800 (1954), 31 U.S.C. § 200 (1958).

appropriations of the purchasing bureaus. Accounting practices must constantly change to meet changing budget structures and concepts.

Disbursement of cash is the focal point of expenditure control. This work had been performed by Navy Regional Accounts Offices and Navy Accounts Disbursing Offices and the Navy Finance Center operating under the control of the Bureau of Supplies and Accounts. On November 6, 1958,<sup>19</sup> these offices were transferred to the Office of the Navy Comptroller in order to permit a fuller compliance with Public Law 863 of the 84th Congress and Public Law 85-759. The logical place to operate a Navy-wide accounts payable system would be in the Navy Regional Accounts Offices under Comptroller of the Navy management. These offices are at the most convenient levels for collecting, consolidating and integrating the detailed accounting data generated in support activities ashore and operating units afloat. Reports could be made on a Navy-wide basis and also fed as summary information into the control accounts of the Comptroller of the Navy.

Due to the regulations issued by the Treasury Department and the General Accounting Office,<sup>20</sup> it was necessary to change the fund accountability of Navy disbursing officers. The disbursing operation was streamlined. Disbursing accounts of the Navy Settlement Officer and the Navy Funding Officer were eliminated, as were checking account balances of all Navy disbursing officers and all transfer of funds between disbursing officers. A new "account current" form, together with a new balance sheet and cash book for all Navy and Marine Corps officers, ashore and afloat, was adopted.

The task of cash control is intimately tied into expenditure control which is basic to the balanced budget. Congress does not establish expenditure limits to fit the resources expected to be collected in a particular year. This is the task of the Chief Executive. It is also a major burden of the Department of Defense and its constituent military departments which spend more than half these resources. To accomplish this with some success, all the tools of adequate reporting and advanced statistical techniques are required. Spending patterns of different fund structures must be studied and evaluated as the financing and procurement patterns change. For the past four years the Navy has substantially maintained its expenditure position under the President's Budget. Each succeeding year finds a better use being made of the skills and technology of prediction. In fact, the required information has become more readily available through the progressive installation of automatic data processing equipment.

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<sup>19</sup> SecNav Instruction 5430.43 dated 6 November 1958.

<sup>20</sup> General Accounting Office Policy and Procedures Manual for Guidance of Federal Agencies, Title 7, § 7050.

### ACCRUAL ACCOUNTING

The Department of the Navy is currently developing comprehensive accounting plans to synchronize the accrual system required by law with its well-known and long-established property as well as fund accounting. This development must proceed gradually. As indicated earlier, full consideration must be given to the extensive training and indoctrination necessary at all levels of accounting control and record keeping. Each phase must be fully exposed to each level of operation before it can be adopted. Accordingly, the Navy has established its objectives and policies on an incremental basis, first modifying its system of fund accounting to assure full compliance, upon adoption of accrual accounting, with the requirements of Public Law 798 of the 84th Congress, Section 3679 of the Revised Statutes and Section 1311 of Public Law 663 of the 83rd Congress. This was done when the Department implemented phase one of its modified system of fund accounting commencing with fiscal year 1958.<sup>21</sup>

Currently phase two of the accounting revisions which deals primarily with the limited aspects of annual accrued expenditures is being re-formulated. With financial property accounting in effect for the bulk of consumable and capital-type material, it should not be difficult in time to establish accrual accounting in the major areas of operations and maintenance, procurement, research and development, and military construction. Modern commercial-type accrual systems have already been installed in all activities financed by working capital funds. In any event, the creation of any accrual accounting system will require that a permanent budget structure be established, as the basis of the accounting support.

### FINANCING CONTRACTORS

The Department of the Navy may aid the financing of defense contracts through making of progress or advance payments or the guarantee of V-loans supporting this work. Appendix E of the Armed Services Procurement Regulation sets forth the basic contract financing policy and procedures covering these types of financing.<sup>22</sup> In the Navy, the Office of the Comptroller has the responsibility for these functions. The guaranteed loan, progress and advance payments are made primarily for working capital purposes.

Expenditure targets placed on total Navy expenditures necessitate

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<sup>21</sup> Accounting for Fund Resources at the Allotment Level, NAVEXOS P-1662, dated March 4, 1957.

<sup>22</sup> Defense Contract Financing Regulations, issued May 25, 1959 superseding joint regulations dated 17 December 1956; Chermak, Contractor Financing, 18 Fed. B.J. 286 (1958).

a full consideration of the cycle of financing which may be given to each contract obligated under particular appropriations. The manner and rate of payment determines the flow of expenditures under a specific contract. For this reason, contract payments must be tailored to stay within the expenditure limits established for a particular year. Currently, if progress payments are made, only payments not in excess of 70 percent of costs are permitted. Although advance payments can be made greater than costs incurred, such are limited by regulation. Cost reimbursement contracts cannot, under production contracts, permit payments greater than 80 percent of costs. Each type of contract payment has been sharply curtailed, requiring government contractors to make a fuller use of their own resources during the production period.

The Office of the Navy Comptroller has been active in providing financial support within the level of the expenditure targets established by the President. As of September 30, 1959, more than 730 million dollars of V-loans were authorized under guarantees amounting to approximately 603 million dollars. Advances amounted to about 10 percent of this sum, some 64 million dollars being authorized. Progress payments outstanding continue at a high level with 1,218 million dollars paid. This is, however, less than the progress payments outstanding two and one-half years ago, which amounted to 2,528 million dollars.

The problem of cash flow not only involves payments to contractors but also collections from them. Indebtedness to the Navy from contractors amounted to 58 million as of September 30, 1959. As of this date almost 20 million has been collected by the Comptroller of the Navy. This indebtedness results from renegotiation, price re-determination and adjustments required under contracts. Over the past ten years, the Navy has procured from outside contractors more than 60 billion dollars in supplies and services. Currently, the annual procurement rate exceeds 7.7 billion dollars. This extensive activity is bound to create extensive payment and collection problems.

#### AUDITING

Internal auditing of the department's moneys, physical assets, expenditures and fiscal procedures has been extended and strengthened in the past decade, paralleling a similar growth in private industry.<sup>23</sup> This independent auditing activity is a part of the Office of the Navy Comptroller and evaluates the compliance by the Navy Establishment with established policies, plans and procedures. Auditing covers con-

<sup>23</sup> *The Field of Internal Auditing*, The Institute of Internal Auditors, New York.

tract, central, and field audit. On December 1, 1953 the Cost Inspection Service was transferred from the Bureau of Supplies and Accounts to the Comptroller of the Navy and, as the Contract Audit Division, was assigned to a new Assistant Comptroller, Audit, who was also made responsible for the audit of bureaus and offices of the Navy Department, the Headquarters of the Marine Corps, and all field activities.

The military departments have for some years followed a program of coordinating procurement contract auditing in order to eliminate overlapping or duplicating audit at a contractor's plant. To this end a single defense contract audit manual has been issued for use by all three military departments.<sup>24</sup> Costs are audited in accordance with the provisions of Section XV of the Armed Services Procurement Regulation as prescribed by the provisions of the applicable contracts.

Effective July 1, 1960 a new Section XV will replace the present section in its entirety.<sup>25</sup> In addition to setting forth the general cost principles and procedures for the determinations and allowance of costs under cost-reimbursement contracts, this section also establishes guidelines for the evaluation of costs for pricing certain fixed-priced negotiated contracts and contracts terminated for the convenience of the Government. The explanatory material in the new section is more extensive in regard to allowable and unallowable costs. The changes made were developed over a period of years after considerable industry and Government discussion.

During the past decade the Contract Audit Division in the Office of the Navy Comptroller has taken audit action under tens of thousands of contracts covering tens of billions of dollars. Yearly savings have on occasion exceeded one hundred million dollars. These savings consisted chiefly in disallowances of costs under cost reimbursement contracts, price reductions under audit reports covering negotiation of fixed-price contracts, and audit exclusions under termination settlement proposals.

Internal operations as well as procurement practices have benefited from audit work within the Naval Establishment. Savings are being accomplished through the elimination of duplicate nonessential or overlapping records and reports, disclosure of excess stocks, discovery of errors in billings, charges and other transactions and the development of less costly procedures. The review of the soundness and adequacy of accounting and fiscal controls affords a constant check on the quality of performance had in the carrying out of as-

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<sup>24</sup> Contract Audit Manual, NAVSANDA Publication No. 261.

<sup>25</sup> Armed Services Procurement Regulation, Revision No. 50 dated November 2, 1959.

signed responsibilities. Unfortunately, government does not have a shortcut check on efficiency such as is afforded industry by the profit and loss statement. Consequently, the tests of audit must be used to assure efficient and economic operations. Internal auditing does not manage; it furnishes the information which becomes the basis of action by management.

#### FUTURE IMPROVEMENTS

The work of the Navy Comptroller has been cut out for him under the program for the improvement in financial management in the area of appropriations for Operation and Maintenance.<sup>26</sup> Basic objectives were established which included "improved budgeting and justification of appropriation and apportionment requests, based upon coordinated programming and planning, through the use of information on costs and accomplishments of programs and activities appropriately classified to meet management requirements." This would be supported by "the use of cost-based operating budgets and simplified, more flexible, funding practices based upon such operating budgets." Also, it would require the "use of reports on performance in terms of costs and related program data, especially in relation to operating budgets, and reports on the status of resources."

Under the proposed improvement program it will become necessary to set up operating budgets for each operating unit of each technical bureau within the military department. These operating budgets will be cost based. The President's Budget will only consider the funding requirements of the aggregate of these operating budgets. The operating budgets will report their status to the bureaus, which in turn will use this information to show the aggregate of commitments, obligations and expenditures under each appropriation subhead. The consolidated statement of financial condition of the appropriation as a whole will be derived from the particular information in each operating budget. The consolidated statement need not carry to the military department level the cost controls exercised at lesser operating levels. In fact, the current apportionment and appropriation controls over obligations and expenditures are sufficient for effective controls by the President and the Congress.

For decades the Department of the Navy has issued an annual financial report in the form of a Statement of Assets and Liabilities.<sup>27</sup> This statement is supported by and related to subsidiary statements covering appropriations, costs, inventories and industrial funds. Of

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<sup>26</sup> Department of Defense Directive No. 7040.1 dated May 29, 1959.

<sup>27</sup> Navy Department, Office of the Comptroller, Financial Report Fiscal Year 1959, NAVEXOS Publication P-1170.

interest is a statement of expenditures of the Navy covering each year from 1794 to date. The statements are prepared from the central accounts of a single integrated accounting system of the Navy and have been reconciled to the official statements published by the Treasury. Recently, the other executive departments have been following this lead. In fact, the Treasury Department and the Bureau of the Budget have considered the need for a balance sheet of the entire United States Government. Even Congress has requested comprehensive data on assets of the Federal Government. This data on assets is now published in the Annual Report of the Secretary of the Treasury.<sup>28</sup> It is not a complete statement of assets since current assets such as cash, accounts receivable, prepaid material, advances and deferred charges are not fully included.

The inventory statements show that the money value of stores was in excess of 14 billion dollars, of which approximately 12 billion was special material not in the stock fund accounts. Most of these special stores consist of equipment and consumable items in the appropriation purchases account. To meet the program for financial improvement in the area of appropriations for operation and maintenance, it will be necessary to transfer the consumable stores from the appropriation purchases account to the stock accounts. Failure to do this will deny the control over these resources that reimbursement to the working capital funds creates. Annual appropriations can measure usage of resources only if the holders of the appropriation are required to pay for the inventory they consume or are limited to the inventory authorized in their operating budget.

In evolving the account structure necessary for the establishment of an integrated maintenance and operation appropriation, the joint purposes of budgeting, programming, planning, accounting and reporting must have a similar segregation and classification of costs. This would permit uniformity among the three military departments for identification of functions and comparison of costs. Budget planning at all levels should benefit considerably by this scheme.

The Department of Defense has set a timetable for the implementation of the policies established in this program. The fiscal year 1960 should find all three military departments developing and installing the first phases of the program. If the accomplishments of the past decade are any measure of the success that may be expected, the assumption of the Department of Defense that the implementa-

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<sup>28</sup> Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year ended June 30, 1958. 86th Congress, 1st Session, House Document No. 3.

tion of the required program must be completed by July 1, 1962 is not too visionary. It must be remembered that no program furnishes a grand panacea for financial management problems. Each year will find the Comptrollers tackling new problems with the perpetual unfolding of new programs. The expenditure of 41 billion dollars each fiscal year requires a constant try for the moon in all its phases.

From the above, it must be apparent that the Department of the Navy as well as the remaining military departments must evolve a budget and accounting system differing from that employed by industry. Military financial management, to be efficient, must create accounting systems fitting the requirements of its military ends, not merely imitate industry's practices.<sup>29</sup> Suiting the system to the purposes to be served should be the primary guide. Accounting must furnish reports meaningful to management if costs are to be controlled and funds to be employed wisely. The overall purpose of industry is to make a profit. The overall purpose of defense is to be ready for any foreseeable war. Readiness and profit cannot be measured by the same systems of cost determination.

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<sup>29</sup> Chermak, *Fitting Accounting Technique to Purpose*, XIX *Pub. Admin. Rev.* 173 (Summer, 1959).