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Recommended basic premises and technical features of system of financial management in the Department of Defense

H. W. Bordner

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RECOMMENDED
BASIC PREMISES AND TECHNICAL FEATURES
OF SYSTEM OF FINANCIAL MANAGEMENT
IN THE DEPARTMENT OF DEFENSE
1953
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INTRODUCTION

The purpose of this memorandum is to set forth in highly condensed form a "first draft" of recommendations for basic premises or concepts upon which the system of financial management in the Department of Defense should be developed and improved, together with a specific statement of technical features which should be built into the system based upon these concepts. Until there is general agreement and understanding with respect to this subject, there will be slow and inconsistent progress in the establishment of improved financial management in the military departments.

This memorandum has been prepared upon the basis of extensive study of the technical features of financial management in the Department of Defense (including each of the military departments) over a period of years, including specific systems still being tested or developed. Many of the features of this outline have been suggested by one or the other of the military departments. No one department has been completely in the forefront in the development of all of its individual systems.

While there presently exist many basic elements of a system of financial management in the Department of Defense, including each of the military departments, there are many deficiencies and gaps which should be corrected or filled in. Moreover, there are numerous inconsistencies in techniques applied between the military departments and a lack of clear conception as to many features of the ultimate goal. To catalogue specific defects and needs for further development and improvement in each military department would be a major work in itself.

Some of the technical features set forth in this memorandum are controversial. At the present point it would be impossible to prepare a statement that would be completely accepted by all concerned. While there would doubtless be no differences of opinion with respect to the basic premises or objectives of the system of financial management, there would be many differences of opinion with respect to techniques. Some of these differences of opinion would result from disagreement as to the relative expense of one technique as compared with another, but other differences of opinion might reflect long standing "doctrine" in a particular department without thorough study of possible alternatives. Resolution of these differences is highly important at this time from the standpoint of expediting development of the system of financial management in each department along common lines. There is no attempt in this memorandum to be argumentative with respect to controversial matters. To merely state the pros and cons of the many controversial issues would be impossible without writing a book.

Uniformity of the systems of financial management for the entire Department of Defense is believed desirable, provided such uniformity is confined to broad lines of management, budgets, and reports, and does not extend to an attempt to make uniform all of the procedural details, including such matters as completely uniform documentary-forms and charts of transaction-flows within the departments. An attempt to achieve detailed uniformity would be doomed to failure.

Each of the military departments is different from each other department in general organization and methods of operations, partly as a matter of the different
nature of their forces, partly as a result of tradition, and partly as a matter of choice (or plain individualism). While the statutory independence and autonomy of each department has an important bearing upon the problem of bringing about uniformity in their systems of financial management, the management problems resulting from mere size of each military department are even more significant. In general, it has been found that the individual operating agency* is the primary unit of management and that problems of improved management must be approached at that level for successful solution. Hence, coordination of systems development within any one military department is in itself a serious problem.

Of basic importance at the present time from the standpoint of future developments are two major technical problems.

First and foremost is the problem of staffing at all levels with an adequate supply of trained comptrollers and supporting technicians under a special career program. Without attention to this problem all efforts to solve the problems of financial management by redrawing organization charts or devising improved procedures will result in slow progress and meet with only limited success. A closely related problem is the basic training of all military officers in business administration.

The second problem of major importance is a closer working relationship between budget and accounting personnel in basic technical developments of mutual concern in each of these two major technical areas. Of primary importance is a joint approach on an objective basis to the problem of establishing principles and criteria for account structures to be used as a basis of all financial management, including appropriation budgeting, budgeting for management control, and accounting for management control, including reporting. In this endeavor it is necessary to bring the Bureau of the Budget, the General Accounting Office, and Appropriations Committees of Congress into partnership, because without their participation improvements in this direction cannot be effected. Any ultimate failure on this score would require the adoption of a completely different concept of financial management than is set forth in this memorandum. Such a failure would require the adoption of a very significant alternative assumption, which heretofore has been generally rejected in the Department of Defense; namely, that if a system of broad financial control for the purpose of Congress is completely inadequate and inconsistent with management needs in the Department of Defense, there must be two completely separate systems of financial management -- one for the Congress and one for the Department of Defense. The implications of such a concept would be so serious as to result in a complete about-face in the approach to the whole problem of financial management. Most people would agree that there should be no conflict.

It is realized that any attempt to outline technical features recommended to be followed in financial management at this time would necessarily be subject to

*An operating agency is a technical service, bureau, or a military command below the departmental staff level.
further development, amplification, or even modification as time goes on. This, however, would be no adequate excuse for failure to face-up to this important task at this time.

H. W. Bordner

16 November 1953
I. BASIC PREMISES

1. The Congress establishes limitations on obligations and expenditures to be incurred by each military department and the Office of Secretary of Defense, largely by annual appropriation acts, following presentation of budget estimates approved by the President and the Secretary of Defense.

2. Notwithstanding appropriation authority by the Congress, obligations and expenditures may be incurred by the Office of Secretary of Defense and each military department only pursuant to authority of, and within limitations established by, the Director of the Bureau of the Budget (representing the President) and the Secretary of Defense. (The "apportionment" process.)

3. There must be a considerable degree of financial control over non-cash resources, including stock levels and the consumption or issue of materiel, comparable to and supplementing financial control over cash expenditures.

4. Each military department must be so organized and its programs so administered as to provide financial authority for and control over obligations, expenditures, and use of resources at the points where operating actions must be taken, with due regard to meeting needs for flexibility and minimizing requirements for high-level approvals of relatively minor program changes, thus encouraging good management by operating officials through assumption of individual responsibility. Decentralized responsibility is assumed with clearly defined assignments of responsibility, lines of authority, and accountability for performance of all activities. This means that:

   a. Officers responsible for management or operating control at any level shall also exercise control over related resources and expenditures within the scope of their authority and directions or limitations placed upon them by higher authority. Action directives shall carry related authority for expenditure or use of resources. There must be a kind of buyer-seller contractual relationship between activities in the procurement and furnishing of materiel and many intra-agency services. (Free goods and services must be limited.)

   b. There must be coordinated financial control over resources and expenditures at every level of command within a military department. (This includes the principle of "checks and balances" sometimes termed "internal control.")

   c. Continuous coordination between current budgeting and related plans and programs must take place at every level in order to utilize available resources effectively.

   d. Each level of management responsibility is accountable in financial terms to the next higher level for performance, both absolute and within limitations imposed. Accountability in financial terms covers costs, obligations, and expenditures incurred as well as use of resources. Evidence of discharge of financial accountability is provided in large
part through reporting and auditing (both internal by the department and external by General Accounting Office).

5. Budgets and reports at departmental level must be as informative as possible in terms of programs and missions for the guidance of top Defense officials in making basic policy decisions as to procurement and operating levels. Such an objective is also important from the standpoint of the review of budgets and actual performance by the Bureau of the Budget and the Appropriations Committees.

6. All technical procedures should be as simple as it is possible to make them. They should be as appropriate for use in time of war as in time of peace; or to the extent they would not be appropriate in time of war, provisions for specific modification should be included in the system.

7. It is the responsibility of the Department of Defense to establish its own system of financial management, subject to overall Government requirements and to overall regulations of the General Accounting Office, the Bureau of the Budget, and the Treasury Department -- largely with respect to principles of budgeting, administrative control of funds, and accounting (including reporting), but also including certain uniform, Government-wide, detailed rules with respect to the handling of and accounting for cash transactions.
II. TECHNICAL FEATURES OF FINANCIAL MANAGEMENT

A. Comptroller organization and personnel -- general

1. There will be implementation of the provisions of the Department of Defense Directive of 27 September 1950 concerning Comptroller Organization and Functions, pursuant to Title IV of the National Security Act. That directive requires establishment of supervision and direction of fiscal management at the Secretarial level in each military department as well as in the Office of the Secretary of Defense.

2. As further provided by the Department of Defense Directive on Comptroller Organization and Functions, budgeting, financial control, and accounting will be decentralized within each military department, so far as feasible, to meet the needs of management at each operating level. This means that comptroller organization elements will be established for each command, technical service, or bureau, and at their installations other than small stations where the expense of such a procedure would not be justified. In the case of a "complex" of activities at one location, a single comptroller organization may be established as a service function for all the activities included therein. Similarly, the comptroller function of a small, isolated activity may be provided as a service by the comptroller organization at the nearest larger installation which has such an organization. A comptroller of a command, technical service, or bureau, or a subordinate installation shall be subject to the administrative supervision and direction of the head of the respective organizational unit, and to the functional control* of the comptroller of the next superior organizational unit or level to which the respective organizational unit is accountable.

3. Each military department will maintain strong central staffs for developing and supervising the installation of accounting systems and for performance of internal audits throughout the department, independent of the commands. While the systems staff would be located in the Office of the departmental comptroller, the audit staff should be made responsible directly to the official at Secretarial level who serves as comptroller, or to whom the comptroller reports if the comptroller is concurrently responsible to the Chief of Staff.

4. The Office of the Assistant Secretary of Defense (Comptroller) shall provide informal basic guidance and direction in the performance of all comptroller functions in the military departments as well as establish policies and basic procedures, subject to observance of the principle of functional control.

* "Functional control," states the above-mentioned DoD directive, "signifies the power and duty to prescribe policies and procedures, to require compliance therewith, and to review or audit activities within the area of responsibility. Under this type of control, it is appropriate for the Departmental Comptrollers to establish channels of working relationships throughout the Department, but it is required that all directives shall be issued only through normal organizational or command channels. Thus functional control is to be distinguished from the power to command or from administrative control."
5. Steps shall be taken to establish comptrollership positions under a special career program and to provide an adequate supply of trained technicians. Such a career may be established for military personnel as well as civilian personnel. While comptrollers need more than technical qualifications, no person should hold a comptroller position unless he is technically qualified.

6. A special Defense-wide program of education and training of comptroller personnel shall be established under the direction of the Assistant Secretary of Defense (Comptroller).

B. Funds to be employed

1. The financing of the procurement of property and expenses for operation and maintenance of the several departments will be from the General Fund of the Treasury. The following types of fund accounts will be employed:

   a. Appropriation accounts.
   b. Special fund accounts.
   c. Management fund accounts.
   d. Working fund advance accounts.
   e. Working capital funds (revolving funds).
   f. Deposit funds accounts.

2. Appropriation accounts represent amounts authorized for obligation and expenditure by the Congress. These amounts include cash receipts credited to such accounts, when authorized by law, as well as amounts specifically appropriated. Special fund accounts reflect cash receipts segregated for expenditure for special purposes as authorized by the Congress. Management fund accounts are used as a means of collecting expenses for joint projects and distributing them to the participating activities. Working fund advance accounts are used for the purpose of one agency accounting to another for expenditures made against cash advances for a given purpose. Working fund advances shall not be made by one agency to another within the Department of Defense.

3. Working capital funds will be used as a vehicle to finance: (a) procurement and holding of inventories of expendable or saleable materiel, the costs of which will be charged when issued to appropriation accounts except when sold to departmental personnel; (b) the production and furnishing of goods and services (and procurement and holding of production materials) under orders from various agencies, the costs of such goods or services being charged to the ordering agencies. (Included in such services at any station may be common support services, the costs of which are to be allocated to two or more missions or related functions.)

4. Deposit fund accounts are largely temporary suspense accounts to hold cash receipts pending appropriate disposition.
5. Trust funds of the Treasury are used to separately account for funds received or set aside for the accounts of others, such as foreign governments and departmental personnel.

6. Nonappropriated funds are used at local levels to finance activities for the personal benefit of local groups, such as Officers' Clubs, Officers' Messes, Chaplain's Welfare Funds, etc. The Department of Defense is not generally accountable for these funds as a public trust, because the funds are derived from personnel in their private capacity, and are expended for their personal benefit. Hence, the cash of such funds is not deposited in the Treasury.

C. Account structures

1. There will be one general system of account structures for each military department for all management purposes, including budgeting, financial control, and accounting (including reporting). The principles to be uniformly applied in each military department and the Office of Secretary of Defense in designing such account structures will be as follows:

a. Appropriation classifications and subclassifications (budget activity accounts) will be of a broad, general character designed primarily in consideration of the following:

(1) Separation of capital expenditures for construction, acquisition of plant equipment, and procurement of major items of military materiel, with a classification by categories of materiel or construction, identified so far as feasible by missions (or types of military forces) and supporting functions.

(2) Separation of expenses for operation and maintenance with a classification by mission (or types of military forces) and supporting functions without reference to organizational assignments of responsibilities for performance, except as coincidentally the organization structure corresponds to mission and function assignments.

(3) Each of the above classifications will include all direct costs and such variable indirect costs as may feasibly be associated therewith. Other indirect costs will be classified only by support functions.

(4) To the extent possible and appropriate, there will be uniformity or comparability of these classifications between the military departments.

b. There will be an expansion of the appropriation account structures (expenditure or cost classifications) for purposes of internal budgeting, financial control, and accounting (including reporting), based upon the following considerations:

(1) Classification by organizational responsibility assignments.
(2) Subclassifications by component functions, classes of materiel, or construction projects.

(3) Further subclassifications (lowest level of classification) by so-called object of expenditure (actually subject of expenditure).

(4) Uniform "tailor-made" systems of account classification in entire Department of Defense will be designed for each identifiable type of major activity or capital expenditures, and for objects of expenditure (but not otherwise even at the level of a military department). Such uniformity in account classifications will still be on a fairly broad basis to satisfy needs of the Congress, Office of the Secretary of Defense, Bureau of the Budget, or the Secretary or staff of the individual military department concerned. More detailed but still uniform subdivisions of account classifications may be prescribed by the respective military departments, bureaus, technical services, or commands.

(5) Detailed account classifications will be designed to satisfy recurring management needs so far as may be foreseen, and not to provide data to aid in answering every conceivable question that may be asked. It will be expected that compilation of financial data will often require special analysis of transactions data available in the accounts, including analysis by sample. Frequently, financial data based upon estimates will be more useful in financial management (as well as available at less expense) than data provided by analysis and classification of financial transactions. Sometimes non-dollar statistics serve better than financial data.

(6) Detailed account classifications will be as simple as possible to design for the purpose intended, and so far as may be foreseen will provide flexibility to permit modification for normal changes that may be required in the future without destroying the consistency of classification between fiscal years.

c. Account classifications designed in accordance with (a) and (b) will require the use of property accounting and cost accounting in order to associate expenditures with the appropriate account classifications on the basis of the end-purpose of such expenditures. Cost accounting is required in order to allocate indirect costs to primary missions or functions and to determine and assess the costs of production of goods or services by appropriate classifications of procurement or activity. Property accounting is required in order to assign the cost of materials and supplies consumed to the benefiting activities. Revolving (working-capital) funds will be utilized to facilitate such costing.

d. Similar principles of account classification will be applied in financial control and accounting for property, other resources, and liabilities, whether or not financed by revolving funds or appropriations. Property (including inventory) classifications will conform to related procurement expenditure classifications.
e. Similar principles of account classifications will be applied in each type of industrial or commercial activity or support function financed by revolving funds.

f. Due regard shall be given to questions of security in establishing account classifications. Indications of appropriate security classification shall be established.

D. Bases of accounting

1. The technical accounting bases to be used in budgeting, financial control, and accounting (including reporting) for all types of activities, regardless of the type of fund accounts under which they are financed (except as otherwise noted), will be as follows:

   a. "Obligations incurred" is the basis of budgeting, financial control, and accounting required by law for appropriations. Under this basis, receipts are accounted for in the fiscal year in which they are earned or receivable. For interim purposes, receipts are required to be anticipated in advance. Liabilities for unliquidated obligations must be accounted for regularly.

   b. The cash receipts and disbursements basis is also required by law to be used in budgeting and accounting. This is the basis for determining the overall Government budget-surplus or deficit. This basis is required, therefore, in the integration of the accounts (including reports) of each Government agency with the accounts of the Treasury Department. There is no formal system of financial control over periodic cash receipts and disbursements other than the initial control over obligations incurred.

   c. The Department of Defense and the military departments also require the use of the accrual basis of accounting for receipts and expenditures for purposes of financial control. Hence, internal budgeting and accounting must be conducted upon this basis. The accrual basis of accounting is substantially the same as the obligation basis of accounting except for expenditures under contracts* for procurement of material and plant equipment, construction, research and development work, maintenance work, and similar services. It is necessary in such excepted areas, therefore, to also account (in addition to obligations incurred and unliquidated) for: (1) costs of goods and services when delivered, under such contracts; (2) costs of materials, equipment, and supplies applied at the time they are withdrawn from stock for consumption or use (or at the time they are sold, retired, or scrapped); (3) costs of property acquired and on hand; (4) costs of property in

* Includes project orders for work to be performed in, or goods to be procured from, Defense industrial or commercial establishments.
process of construction; and (5) contract payments made in advance of delivery. This type of accounting also requires distinction in accounting for unliquidated obligations between, on the one hand, accounts payable and accrued liabilities (for goods and services delivered) and, on the other hand, liabilities for goods or services on order.

Note: Through the system of accounting for property and the use of revolving funds for financing stocks of common items of supplies and the production of goods or services, the impact of the accrual basis upon accounting for appropriated funds is minimized. In other words, obligations incurred under appropriated funds are more nearly synonymous with applied costs in the area of expenses for operation and maintenance; for example, obligations incurred for purchases of stock fund materiel equal cost of materiel used. In the area of procurement of materiel or services from Defense industrial or commercial establishments, costs of materiel or services delivered, pursuant to orders (obligations), can usually be made synonymous with disbursements, or if not, the distinction is no different than exists in accounting for procurement from outside contractors.

d. In addition to obligation accounting, the Department of Defense and the military departments also require the use of the commitment basis of accounting for procurement of materiel and plant equipment in advance of the actual incurring of contractual obligations, in order to keep informed on the status of procurement actions. A commitment, is defined for this purpose, as the issuance of a bona fide directive to commence procurement action; this includes inter-agency orders.

2. In addition, so far as feasible and as rapidly as possible of development, cost standards will be used in budgeting and measurement of reasonableness of cost of performance of all activities and production of goods or services.

3. All appropriations should be continuing or no-year appropriations in order to simplify accounting for obligations and expenditures. Annual appropriations for operation and maintenance (or any other purposes) are now required to be separately accounted for until they lapse for expenditure (two years after end of current year in which they are available for obligation). This means there are three separate accounts open at one time for each annual appropriation. One compromise for achieving the desired result, without permitting unrestricted carryovers of unused balances of annual appropriations, is for the Congress to reappropriate the amounts obligated at the end of each fiscal year and merge such funds with the related annual appropriations for the next fiscal year.

4. In general, each military department will be accountable for and, therefore, will budget for all costs of procurement and services furnished through other departments. However, this principle will not be applied to minor items of materiel and services in order to avoid excessive accounting expenses; neither will it be applied where it is impractical, as for example in field operations or combat areas.
5. The principle of "home-office and branch-office" accounting will be followed under which duplicate accounting for transactions and assets or liabilities will be avoided in the records of the "home-office," to the extent the accounting for transactions may be placed solely under the control of the "branch."

E. Budgeting for appropriated funds

1. Budgets for use in presentation to the Congress as a basis for appropriations (annual, supplemental, or deficiency) will be prepared in consideration of the following:

   a. Budget estimates will be predicated upon approved military program plans, including strength of forces and training schedules.

   b. Budget estimates for major procurement items will be based upon additional program requirements considering the current status of procurement and stock levels of such items, the procurement lead-time thereof (including industrial capacity), consumption or attrition rates, desired stock levels (including mobilization reserves), and requirements for the Military Assistance Program. While the same factors will be considered in a general way in making budget estimates for procurement of other items of a capital nature, detailed estimates of quantities and dollar data by items of materiel will not be made.

   c. Budget estimates for construction and for research and development should be made by specific major projects, similar to budget estimates for major procurement items. Estimates for lesser projects should be lumped by classes. It would be desirable to make budget estimates for major military construction on an accrued-expenditure and applied-cost basis similar to estimates for construction of civil works, with separate estimates for cost of completion by years.

   d. So far as feasible, budget estimates for operation and maintenance should be made on the basis of applied costs by appropriate major expense account classifications using overall program cost factors to be developed. No procurement of materiel should be budgeted under this heading — instead the cost estimates therefor should be based upon consumption of materiel to be obtained through revolving funds. Budget estimates for maintenance work should be both in terms of obligations (for orders) and costs of work performed (on the basis of completion).

   e. All the foregoing budget estimates shall also be submitted in terms of cash disbursements, but only by major account classifications.

   f. Budget estimates should be developed at the lowest organization levels or by the agencies responsible for managing the respective programs with appropriate reviews and adjustments at higher levels to conform to balanced programs and budget ceilings.
g. Personnel costs for the fiscal year, both military and civilian, included in the various expenditure categories should be separately estimated in the detail required by the Appropriations Committees.

2. Budget estimates for the ensuing fiscal year should be revised immediately after the annual Appropriation Act is passed, in somewhat the same form and same manner as required for the annual budget document but without such detail as is required only for the Appropriations Committees. Such estimates should be subdivided by quarters with respect to all features except obligations to be incurred for construction and procurement of "hard goods." (To the extent such construction and procurement programs are not reasonably firm, the budget should include only the portion that is firm.)

3. Budget estimates should be revised quarterly during each fiscal year in a similar manner, in order that timely action may be taken to place programs in balance or obtain additional funds.

4. So far as feasible, budget estimates should be made with the use of accounting data, including the application of unit cost standards to the planned programs. However, reliance should not be placed blindly upon the use of unadjusted experience data for this purpose.

5. Budget estimates should be subject to critical review and analysis by all staff elements, including the Budget Division of the Comptroller's Office, as a matter of good internal management control.

F. Administrative control of appropriated funds

1. The annual apportionment of appropriations by quarters and any subsequent reapportionments should be based upon current budgets (see E 2 and 3).

2. Normally apportionments are made in terms only of the appropriation account classifications without further subdivision. Apportionments for construction and procurement of hard goods will be made only upon the basis of annual programs and not by quarters. All apportionments of construction and procurement will be in terms of providing authority for commitments (which precede actual obligations).

3. Internal departmental budget allocations to operating agencies (and periodic revisions thereof) will be made through the departmental comptrollers within approved apportionments based upon current budgets for such agencies after revision to conform to the total approved departmental budget. Such allocations will be made in terms of budget activity account classifications.

4. Operating agencies will make quarterly allotments within fund allocations to organizational units responsible for incurring obligations and expenditures based upon current approved budgets thereof. Such allotments will be made in accordance with the following rules:
a. No installation or other activity will receive an allotment except through the chief of the operating agency to which it is responsible or from a subordinate command or office within such operating agency, pursuant to delegation of authority.

b. Allotments will be classified at the level of budget activity accounts but not below. (So-called budget project account classifications will become major group account classifications for expenditures in order to permit more flexibility in budgetary control.)

c. Allotments for procurement will be based upon firm programs by material categories and major items; such allotments will carry the authority to issue procurement directives (commitments). Construction allotments will be based upon firm programs by project. Allotments for construction and procurement of hard goods will be made without quarterly limitations.

d. Allotments made to any installation or activity for operation and maintenance will cover all expenses which are locally controllable in any significant degree.

e. All allotments will be made in terms of commitments, obligations (or applied costs), as appropriate, less budgeted reimbursements. Amounts of actual reimbursements (to be accounted for by allottees of related funds) will be treated as an automatic increase in allotments to be accounted for to the respective grantors.

f. All unobligated balances of allotments lapse at the end of each fiscal year. In the case of uncompleted procurement actions at the end of the year under continuing appropriations, the operating agency concerned shall normally make new allotments to cover such uncompleted actions in the following fiscal year without necessarily reprogramming the procurement. (Similarly, there should be a carry-over of fund allocations to the operating agency, after appropriate review, but there should be no requirement for reapportionment in the following fiscal year.) Similarly, unliquidated obligations at the end of a fiscal year should be carried forward and merged for accounting purposes with obligations incurred in the following fiscal year.

g. No cash advances shall be made by one agency to another in lieu of making allotments. No cash advances to Management-Fund or Working-Fund Accounts will be permitted by one agency to another within the Department of Defense.

5. No commitments, obligations, or expenditures shall be incurred in excess of related authorized allotments. However, it will be no violation of law to obligate or expend more than an individual authorized commitment or quarterly budget estimate for an element of expenditures, provided the related allotment as a whole is not exceeded.
6. As an interim measure, prior to the complete implementation of the concept that all expenses of any activity shall be the subject of appropriation and allotment control, the following alternative procedure may be followed in control of those elements of costs not yet "funded": Allotments shall exclude amounts "not funded" but shall be accompanied by budget estimates of such items for use as a less formal control over such expenditures -- these costs shall be grouped separately in expense accounts as "unfunded costs" and classified pursuant to the same system of classification as funded costs.

G. Reporting for appropriated funds

1. Every allotment holder shall submit to the grantor a monthly report on the status of his allotments, with supporting schedules of classified commitments, obligations, accrued expenditures, (or expenses), as appropriate, in comparison with the latest approved, revised budgets. These reports also shall set forth similar comparison of budget allowances and expenses for "unfunded costs" (see F 6). Such reports will also be a medium for furnishing revised quarterly budgets for the remainder of the current fiscal year.

2. Each operating agency, and military department as a whole, in turn, shall prepare summarized, consolidated reports of the budgeted and actual status of appropriations, including commitments, obligations, accrued expenditures, (or expenses), disbursements, and "unfunded costs," as appropriate, based upon the allotment reports, the appropriation-apportionment accounts, appropriation-allocation accounts, and summary accounts of cash receipts and disbursements (see H). Such reports at the overall departmental level shall also include condensed, appropriate similar data relative to revolving funds.

3. The monthly and annual reports of each military department and Office of Secretary of Defense shall be submitted to the Secretary of Defense, the Director of the Bureau of the Budget, and the Secretary of the Treasury. Such reports will provide the basic data for the respective agencies to be included in consolidated financial reports for the Federal Government as a whole.

4. To the extent appropriate and helpful, reports at every level should contain statistical data of performance, work loads, etc., in comparison with costs, for use in review and analysis of the reports.

5. Reports at every level shall be the subject of review and analysis by Controller personnel. Written comments on an "exceptions" basis shall be prepared and included with the reports as an aid to operating officials at the appropriate level in undertaking corrective actions, when required. Likewise, written comments of appropriate operating officials shall be passed up to the next higher level in explanation of unsatisfactory situations, with indications of corrective action being taken, when appropriate. Such data shall include reports on violations of law in incurring obligations.
H. Bookkeeping for appropriated funds

1. The Comptroller's Office of each military department shall keep account of all appropriations authorized (in terms of budget activity accounts), related appropriation reimbursements (including estimates), apportionments, and allocations thereof to each operation agency.

2. The Comptroller's Office of each operating agency of a military department shall keep account of each appropriation allocated (in terms of budget activity accounts), related appropriation reimbursements (including estimates), and allotments granted (by activities or installations).

3. Each allotment holder shall keep allotment and subsidiary reimbursement, obligation, expenditure, or applied cost accounts, as appropriate, in accordance with the following rules:

   a. When any allotment holder is too small an activity to justify the establishment of a local budget and accounting office (or such activity is but one of a number of activities present in a complex at one geographical location), the allotment accounts may be maintained as a service in a central budget and accounting office for the entire complex or at the nearest convenient major activity which has such an office, provided there is adequate liaison to prevent overobligations or overexpenditures of allotments.

   b. Cash reimbursements and disbursements shall be recorded for each allotment precisely as reported by disbursing officers in each fiscal period (including adjustments of errors so reported).

   Note: The Chief Disbursing Office of each department (or regional disbursing offices) shall maintain accounts with each disbursing officer and total net disbursements for the year for each station where allotment accounts are maintained. Such station disbursement totals will be used as a check on the accuracy of disbursements reported in the station allotment reports; this is vital in the integration of cash accounting and appropriation accounting. (Present duplication of disbursement accounting in terms of appropriations and budget activity accounts at central or regional disbursing offices will be eliminated.)

   c. Commitments and obligations shall be recorded as incurred for each allotment for procurement, construction, and research and development, but not for operations and maintenance, except for contracts and project orders issued for maintenance and similar work.

   d. Otherwise, obligations for operation and maintenance will be determined in terms of net applied costs (expenses less reimbursements) by recording the increase or decrease in accounts payable and accrued liabilities each month and the similar changes in accounts receivable for reimbursements (determined by an "inventory" of documents) as an adjustment of cash transactions. Accounts payable will include amounts
due to revolving funds for materials, supplies, and services received. Such obligations will be controlled by monthly budgets subdivided by local assignments of responsibility for control, together with the use of payroll analyses, reservations for the cost of maintenance and similar work to be performed under contract or project order, and other devices such as subsistence ration controls, etc.

e. Contract advances and progress payments (including payments under cost-reimbursement-type contracts) will be accounted for as an asset under procurement allotments with liquidations as the materiel is delivered. The cost of all deliveries of materiel under procurement allotments shall be subject to reconciliation with the cost of goods received under the property accounting system.

f. Amounts of commitments, obligations, expenditures, and applied costs recorded under each allotment will be classified in detail (together with monthly, quarterly, or annual budget estimates, as appropriate) in subsidiary accounts.

g. Standard procedures will ordinarily provide for the use of stock funds for financing all consumable materiel, including that held for consumption at the activity level. The cost of such materiel, when consumed, will be treated as an expense under the appropriate allotment accounts based upon the amounts reimbursable to the stock fund. However, an alternative procedure may be used in some instances, under which the cost of materiel obtained from a depot will be treated, when received, like local purchases, as expenditures under the allotments of the respective activities. A further added alternative also exists for charging expense accounts under activity allotments for the cost of such materiel when consumed (if so desired) by the creation of two additional accounts under the allotment financing the procuring and using activity -- one to record purchases, the other to record the credit for the total cost of materiel consumed as distributed to the appropriate expense accounts. (The difference between these two accounts will be reconciled with the increase or decrease in local inventories of the related supplies under the property accounting system.)

h. When joint expenses are to be incurred which are chargeable to more than one allotment, a Management Fund Account may be utilized as a means of accounting for and distributing the expenses, provided such expenses may be distributed monthly as incurred. Otherwise (including cases where related inventories must be financed) a working capital fund may be utilized for financing the joint activity.

i. Except in special circumstances, no double-entry bookkeeping system in the usual sense will be employed in connection with allotment bookkeeping which is essentially a very simple matter in most instances. However, all the cross-checks of figures normally provided in double-entry bookkeeping will be established, as indicated above.
j. Balances of allotments uncommitted, unobligated, unexpended, or undisbursed at any given date will be obtained from the allotment records, as well as balances of accounts receivable, contract advances and progress payments, accounts payable, and accrued liabilities.

I. Disbursing

1. In general, disbursing activities will be decentralized and conjoined with accounting activities at every level in a military department in order to facilitate and expedite accounting and provide adequate data on financial transactions for special analyses for management use. Pursuant to this policy, central disbursing offices may be created in conjunction with central accounting offices to service a number of activities included in a complex at one geographical location. Also smaller activities may be serviced at the nearest convenient major activity, whether or not a similar accounting service is so provided. An exception to this policy will be made in connection with payments of allotments from military pay; these must be paid centrally.

2. For the purpose of internal check, there will be a subdivision of accounting and disbursing functions at each location in such a manner as to separate the performance of the two responsibilities. The examination and preaudit for payment of vendors' invoices, bills of lading, expense reports, etc., and the preparation of payrolls will be performed as an accounting function. The control over checks to be issued (including check signatures and check distribution) and the making of cash payments will be performed separately as a disbursing function.

3. Cross-disbursing by one military department for another department will be provided only to the limited extent necessary based upon the elimination of unnecessary expenses for maintaining a separate disbursing activity in small outlying stations and upon the demonstrated need for cross-disbursing under single-service procurement assignments (as when consolidated contracts involve progress payments, including payments on the basis of cost-reimbursement).

4. Charges by one activity to another within the same military department or between military departments will be cleared at the activity level by the making of payments and collections through disbursing officers' accounts, generally without the use of checks. Generally, such charges will be cleared without prior acceptance by the recipient activity (but subject to subsequent adjustment) except that in the case of interdepartmental charges, the recipient department may demand opportunity of prior acceptance in any specific area until evidence is furnished as to the general reliability of such charges.

5. All charges made to any activity will be reported daily to the accounting office serving such activity by the disbursing office making payment, except that in the case of disbursing officers serving troops in the field, ships at sea, etc., reports of such charges to central accounting offices need not be made more frequently than monthly.

6. All expenditures in foreign currencies shall be included in disbursing transactions and converted to U. S. dollars (at cost) for accounting purposes. All foreign
currencies acquired for expenditure must be "purchased," including acquisitions through the Treasury of contributed currencies.

7. All expenditures in Military Payment Certificates shall be included in disbursing transactions and accounted for in U. S. dollars. Payments shall be made to the Treasury in amounts equal to MPC's placed under the accountability of disbursing officers; such amounts shall be credited to a Special Deposit Fund Account for redemption of MPC's.

J. Industrial Funds

1. Industrial Funds are revolving funds used to finance working capital of industrial, commercial, and service-type activities which produce or furnish goods or services pursuant to orders from other activities which are financed from appropriations or other revolving funds. Working capital includes the usual types of current assets of similar private commercial enterprises, less current liabilities. Such working capital is provided from appropriated funds, including the capitalization of inventories.

2. The National Security Act should be amended to permit: (a) the use of Industrial Funds to finance the acquisition (including replacements*) of machinery and equipment in those installations which are of an industrial or commercial type, and (b) the charging of depreciation on such machinery and equipment, except for substantial idleness thereof, to the cost of work or services performed. It would not be appropriate (at least at present) to so finance the acquisition, construction, or replacements of real estate, aircraft, or ships, or of depreciation thereon.

3. Each major industrial or commercial-type installation financed under the Industrial Fund is a separate accountable entity, and therefore is subject to separate financial management under the immediate direction and control of the official responsible for its overall management. However, when the Industrial Fund is used to finance two or more activities providing common services at a military or administrative installation (e.g. printing plant, laundry, motor pool), the several activities at the one installation shall be similarly treated as one accountable entity under the management of the commander of the installation. In all cases, however, the military command, technical service, or bureau responsible for management control or supervision of the installation shall be responsible for the financial aspects of such control or supervision.

4. All work or services performed by any installation financed by an Industrial Fund shall be provided only pursuant to specific orders of authorized "customer" agencies. Generally, such orders shall be considered to be project orders (whether or not so termed) which are roughly equivalent to contracts with outside suppliers for specific goods or work. A project order establishes a limitation on

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* Excluding, of course, costs of replacements of components of such facilities, which are normally treated as maintenance, an element of overhead expenses of the installation. Also excluded are special tooling costs which are appropriately chargeable to specific orders and the costs of expendable tools which are treated as an element of overhead expenses.
the amount which may be charged to the ordering agency, and therefore a limitation on the costs to be incurred thereunder by the performing agency. However, when common services are rendered which are chargeable monthly at actual cost (including prorated costs) without identification with individual orders for specific lots or units of work or services, the costs of such services in the aggregate shall be subject to overall control by budget limitations upon the costs of such services established for each of the ordering activities.

5. In general, Industrial Funds should be operated without gain or loss. Therefore, the basis of the amount chargeable under a project order is generally actual cost of the specific goods or work (similar to a cost-reimbursement-type contract).* However, provision may be and should be made for using predetermined prices whenever price schedules may be established with confidence that the charges thereunder will closely approximate cost. Predetermined overhead rates may be used similarly in combination with actual direct costs of material and labor. Moreover, direct costs of standard stock items of materials used may be determined at standard prices (see L 4).

6. Ordering agencies generally should be billed upon deliveries of goods, completion of specific work, or upon a monthly basis for services rendered which are not so identifiable. However, in the case of performance of specific work covering a long period of time, monthly progress billings may be made in a manner similar to commercial practice under like conditions, in order to aid in financing the cost of the work.

7. The cost of all materials furnished under orders for goods or services (but excluding equipment items normally furnished by the Government under similar contracts with private industry) and the cost of all expense supplies, shall be paid from Industrial Funds and included in the amounts estimated and billed under the orders. Whenever practicable, such materials should be procured initially under Industrial Funds, but whenever such materials are procured and stocked in bulk under separate financing for common purposes, the departmental stock fund or applicable appropriation shall be reimbursed from the Industrial Fund for the cost of such materials and supplies.

8. Military personnel costs and other expenses actually incurred by the military departments applicable to operations financed under Industrial Funds shall be paid from Industrial Funds, either directly or indirectly by reimbursement of the applicable appropriations or accounts originally used to finance such expenses.

9. Detailed estimating and planning for job performance in terms of material requirements and labor operations, production scheduling and control, and procurement and inventory control, shall be coordinated in their financial aspects with budgeting and cost control.

10. Costs shall be closely controlled through the use of techniques such as the following:

* If a system of standard cost accounting is employed (see paragraph 10), actual costs under a project order may be determined simply by adjusting the standard cost estimates to reflect an allocation of actual cost variances, thus avoiding job order cost accounting which is presently considered to be a normal procedure.
a. The actual cost of work performed shall be measured against close cost estimates; cost variances shall be assessed by responsibility and cause to the extent feasible, with reference primarily to the specific operations being performed rather than the specific end-products or services. So far as appropriate, such variances shall be determined daily and made the subject of review by the responsible supervisors with explanation to their supervisors. (This is most appropriate from day to day with respect to labor costs and defective work.) By "close" cost estimates is meant, costs that may be attained with efficient operation -- not ideal operation. However, such cost estimates should be exceeded frequently. The "limitation" concept of Government appropriation accounting must not be used for the purpose of establishing cost estimates for purposes of effective cost control. (However, see subparagraph d with reference to "fund" control on limitation basis.)

b. Cost estimates used for standards shall be based upon detailed engineering standards for material, machine-time, and labor-time requirements to the extent feasible, using standard material prices and current labor rates.

c. Actual overhead expenses shall be measured monthly against budgeted expenses at the actual level of production for each appropriate supervisory responsibility. Such expense budgets can only be established after the end of the month when the actual production is known. (The "flexible" or "variable" budget concept.) Overhead expenses shall exclude all material and labor cost variances, such as price or rate variances, lost time, and defective work, which are separately measured and assessed.

d. Cost estimates shall be made for individual project orders (broken down when desirable by component jobs) based upon the specific work to be performed and materials to be used, using the cost standards referred to above. (In the case of overhead costs, normal overhead expense rates shall be used.) Only these estimates shall be disclosed to shop people. However, for purposes of overall fund control, there shall be added to these cost estimates, allowances estimated to be required for contingencies (which will be included in actual costs to be billed the ordering agencies). Such contingencies shall include all possible cost variances except price variances for standard materials, costs of maintenance of major idle facilities, and idle time of employees (if significant in amount) when such costs are incurred during slack periods in order to maintain the organization. (Costs of idle facilities and manpower of this character shall be financed separately under appropriation allotments. Price variances for standard materials shall be treated as a monetary gain or loss to the industrial fund -- see K 7.) The total estimated costs for each project order shall be kept within the project-order limitation (as adjusted) by those responsible for overall planning and estimating. The same people (not those in the shops) shall be responsible for continuous, timely review of actual costs, in comparison with the overall estimates on the billing basis, and for necessary action to keep them in line with limitations, as well as for the normal action
required where actual costs are out of line with the primary close estimates. The actual cost of procurement or requisitions of scheduled special materials and equipment shall be followed item by item, in relation to estimated cost, although this responsibility may be delegated to those responsible for incurring the obligations therefor.

e. In cases where predetermined prices are used for purposes of ordering and billing, a similar system shall be used in estimating costs for the purpose of setting prices. However, for purposes of cost control, accounting for the cost of each order will not be required. Generally in such instances it will be appropriate to use the flexible-overhead budget approach to determine cost estimates for work actually performed by responsibility centers without reference to specific orders for the end-product or service; actual costs and variances would then be controlled in those terms.

f. Summarized cost estimates for work actually performed each month (to the extent determinable), together with reasonable advance estimates of cost variances (on the basis described in (d) above), will constitute the budget for the month and fiscal year to date for reporting purposes. Work for which no such estimates are available will be separately costed, and the budget therefor shown upon the basis of the best overall estimates available, except however that expenses of service functions may be budgeted on the normal advance basis of expense budgeting for purposes of justifying allotments. While annual budgets of industrial-fund operations are required in connection with the annual budget for appropriated funds, such budgets have limited usefulness in financial control of industrial- or commercial-type operations, because the precise work to be undertaken each month (including the volume of work) cannot be foreseen at the time the annual budget is prepared. The usefulness of such budgets is largely confined to establishing overall needs for working capital for such operations plus providing crude data on expenditures to round out the overall departmental budgets.

g. In many instances it will facilitate overall reporting for purposes of cost control, to record standard costs and cost variances in the formal accounts.

11. Industrial Funds have been exempted from that phase of top budgetary control known as "apportionment" (limitations of obligations incurred). Instead, there is a control over available funds by allocation to each installation or group of activities with the approval of the Bureau of the Budget. Such fund allocations must be justified by periodic financial reviews. However, there will be special continuous record-keeping of a commercial type in each installation in terms (as may be appropriate) of budget estimates and costs or obligations incurred by project order (or job subdivisions), classes of work, procurement, labor, and overhead expenses, all designed to prevent the overexpenditure of amounts authorized by ordering agencies, the accumulation of excess inventories of standard stock items in the fund, or the incurring of liabilities for expenditure in excess of available funds.
12. Each installation or group of service activities financed under the Industrial Fund shall employ a system of double-entry bookkeeping.

13. Each major installation financed by an Industrial Fund shall have a comptroller and all the functions normally involved in comptrollership activities, including budgeting, accounting, disbursing, and reports review and analysis, but excluding only internal auditing. In these respects it shall not be dependent in any way for servicing from outside budget, accounting, or disbursing offices.

14. Each accountable entity under a departmental Industrial Fund shall render a monthly or quarterly and an annual report. Such reports shall typically include the following exhibits (with appropriate comments):

   a. Statement of financial position (balance sheet) at end of fiscal period in comparison with the beginning of the fiscal period.

   b. Analysis of changes in capital for the fiscal period, fiscal year to date, and wherever possible from inception to date.

   c. Summary of revenue (including progress payments and unbilled work) in relation to costs incurred for the fiscal period and year to date.

   d. Summarized comparison of actual costs incurred in relation to budgeted costs for actual work performed, with analysis of variances by cause to extent of work which is subject to such measurement -- for the fiscal period and year to date.

   e. Schedule of project orders in process during the period with authorized amounts, estimated costs of job orders issued (or to be issued), and costs incurred to date (for local management use only).

K. Stock Funds

1. Stock Funds are revolving funds of working capital used to finance the acquisition and holding of common-use types of materials and supplies, principally of an expendable nature (including repair parts) and minor equipment. The costs of such materials, supplies, and equipment requisitioned for consumption or use are chargeable to the requisitioning activities; and the Stock Fund is reimbursable for such costs from the appropriation or other fund accounts used to finance the requisitioning activities. When supplies owned by a Stock Fund are sold to departmental personnel (e.g. clothing) or activities of other departments, the proceeds from sale (at cost) are receivable in the Stock Fund. Proceeds from sales of excess stocks and salvage are treated similarly. The working capital of Stock Funds is provided from appropriated funds, including the capitalization of inventories.

2. In the case of at least one category of materiel (Air Force depot stocks of repair parts, aircraft equipment, and aviation supplies), it would be appropriate to finance stocks of such materiel and the related depot aircraft maintenance and overhaul activities, jointly, under the Industrial Fund. (Maintenance and overhaul
activities use repair parts and repair or rebuild used equipment for return to the supply division for issue.)

3. Stocks appropriately financed by Stock Funds should include mobilization reserves, excess stocks, and unserviceable stocks, as well as normal peacetime operating stocks, but there should be separate accounting for each of these types of stocks, and separate budgeting for, and financial control of, procurement and stock levels of mobilization reserves and normal peacetime operating stocks.

4. Stocks appropriately financed by Stock Funds should include those stored at air bases, posts, camps, and stations and those held overseas except stocks in minor stations and aboard ships (other than supply ships).

5. The management of Stock Funds, including financial management, in each military department should conform to assignments of responsibility for supply management. This will not require dividing each departmental Stock Fund into segments below the level of the respective technical services having cognizance over the various materiel categories financed under the Stock Fund.

6. The following general policies shall govern the establishment of Stock Fund prices:

   a. Each item financed under a Stock Fund shall have a single standard price which shall be used for both inventory accounting (including the determination of losses, gains, or adjustments) and for effecting reimbursements for sale or issue.

   b. Standard prices for Stock Fund items shall be determined in accordance with the rules set forth in paragraph 4, Section L.

   c. The expense of procurement, warehousing, redistribution, repacking and handling, or any other function of supply administration pertaining to a Stock Fund item will not be financed from the Stock Fund or included in the standard price of the item but will be charged to appropriations made specifically therefor. (This may be subject to minor exceptions, as specifically authorized.)

7. Stock Fund expenditures will include the purchase cost of materiel procured therefor, including transportation, and the cost of processing or repairing materiel (including processing or repairing in Government-owned plants). Variances between such actual costs and the standard prices, including surcharges for authorized expenses and losses, will constitute a gain or loss to the Stock Fund after charging there-against authorized expenses and losses of every description.

8. Stock Fund commitments, obligations, and expenditures will be subject to "apportionment" control in a manner similar to apportionment of appropriations (see F), except that reimbursements shall be anticipated for the procurement lead-time period beyond the end of the fiscal year in determining amounts available for apportionment and obligation during the fiscal year. Such apportionment limitations shall be reduced to correspond with any reductions in actual reimbursements during the fiscal year, or in anticipated reimbursements beyond the end of the fiscal year.
9. Budgeting and financial control for Stock Fund operations will be continuous based upon forecasts of materiel requirements in the light of appropriate stock levels, issues (reimbursements), and procurement lead-time. In this respect no different practices are contemplated than under procurement appropriations, except for the avoidance of a rigid statutory fiscal-year limitation on obligations (see 8). Procurement budgets by materiel category in terms of expenditures shall be established and revised from time to time in a manner to prevent cash overdrafts in the fund or unpaid accounts because of lack of available cash. Related cash budgets shall be prepared, and available cash shall be restricted to needs established by procurement budgets after considering anticipated cash reimbursements as being available for procurement expenditures when due; excess cash shall be held in "reserve." When desirable, additional cash shall be requested to be made available by appropriation.

10. Based upon budgets and subject to apportionment limitations, the standard procedures for administrative control of appropriations and bookkeeping and reporting for allotments (see F, G, and H) will be followed.

11. Financial accounting for Stock Fund inventories will be integrated with financial transactions of the Fund. Detailed stock records will be maintained, subject to overall dollar control of the Stock Fund accounts. See Section L for further property accounting requirements.

12. Each Stock Fund shall be the subject of double-entry bookkeeping, except at air bases, posts, camps, and stations where the use of a more simplified method is generally appropriate without loss of accuracy in the record-keeping.

13. Reporting for Stock Fund operations will combine the best features of commercial and Government practice. Such reports shall include the following exhibits and appropriate comments:

a. Statement of financial position (balance sheet) at end of fiscal period in comparison with the beginning of the fiscal period.

b. Analysis of changes in Stock Fund capital for the month or quarter, fiscal year to date, and (wherever possible) from inception to date.

c. Summary of stocks on hand by category, classified between: (1) normal peacetime operating stocks, mobilization reserves, and excess stocks, and (2) serviceable stocks, reparable stocks, and unserviceable stocks, with data on normal stock levels in relation to current monthly consumption.

d. Summary of financial transactions and stock balances by stock category (mobilization reserves separately) for the month or quarter and year to date.

e. Projection of budget estimates for stock transactions and balances and for cash transactions and balances for the remainder of the current fiscal year (with estimates of goods on order at end of year and anticipated reimbursements to be available to meet payments thereon after the end of the fiscal year).
L. Property accounting (excluding real estate and installed equipment)

1. Property accounting will be maintained in terms both of cost and physical quantities for all materiel of every type of all locations except small stations, aboard ships at sea (other than supply ships and aircraft carriers), materiel in hands of troops, materiel in the hands of air squadrons, etc. Property accounting in such excepted areas will be maintained only in physical terms. Property accounting shall be designed to (a) furnish data required for supply management, especially for control of stock levels and procurement requirements; (b) provide accurate data for cost control over consumption or use of property; and (c) provide evidence of discharge of accountability for receipt and disposition of property.

2. In the maintenance of financial accounting for property, there will be integration between the property transactions, expressed in financial terms, and the related financial transactions under applicable appropriations or revolving funds. This means there will be agreement or reconciliation between: (a) the cost of materiel received into the property accounting system and expenditures made therefor; (b) the cost of property issued for consumption or use and the expenses therefor reflected under the applicable appropriations or funds.

3. In the maintenance of financial accounting for property, there will be provided a continuing accountability, in the common denominator of dollar cost, for all property on hand or received into the system until disposed of in an authorized manner, except for such losses as will inevitably arise. However, such losses will be subject to appropriate higher review and approval or disciplinary action of the accountable officers. Such complete accounting requires record-keeping for materiel in transit between installations (or accountable officers) and transfer of financial accountability to installations (or accountable officers) to which such materiel is transferred.

4. In order to simplify accounting for the cost of property, a system of standard cost prices shall be applied in each military department based upon the following policies:

a. In general,* each item shall have a single standard price at any time which shall be used for inventory accounting, including the determination of losses, gains, or adjustments, and the recording of costs of the items issued for consumption or use or the sale or transfer of the items to other agencies or department personnel.

b. Standard prices shall be reviewed whenever necessary, but at least annually, with revisions to price lists issued as frequently as required by sound business practice.

c. The standard price of each item shall include the following elements:

* Exceptions must be permitted such as in the case of ships, where it is feasible as well as appropriate to account for the cost of the units at actual cost.
(1) The current market or production cost of the item at the time the price is established.

(2) The transportation costs for the item from manufacturer or contractor to the first point of destination within the supply system.

(3) In the case of items carried in stock funds only, a surcharge to cover all foreseeable net losses relating to such item based upon estimated losses by categories of items.

d. In general, an item in less than new condition or its equivalent, shall not be considered as identical to the same item when new and shall be priced at less than the new item. (This does not apply to items of a capital nature such as ships, aircraft, tanks, and automotive vehicles.)

e. All goods received from procurement into the supply system shall be recorded at standard cost in the property accounts, and the difference between such standard cost and actual invoice cost shall be treated as a price variance. Furthermore, whenever standard prices are changed, all stocks on hand shall be repriced and the aggregate changes in total costs of all stock on such basis shall be recorded as a repricing variance.

5. For each accountable activity, summary (or control) accounts for transactions and stock balances shall be maintained in financial terms (at standard prices to the extent applicable) by the stock classifications adopted for supply management purposes. Such classifications shall be based upon the following policies:

a. Basic classifications shall be maintained by categories or subcategories in terms of type of materiel.

b. Subclassifications shall be maintained under each category by stock condition.

c. Separate complete classifications shall be maintained by ownership when materiel is held for another agency or program.

d. Further subclassification required for supply management, in terms of the purposes for which the property is held, will be maintained for each accountable activity only to the extent appropriate (e.g. excess stocks awaiting disposal). The remainder of such subclassification (e.g. normal operating stocks (including temporarily excess stocks held for use) and mobilization reserve stocks (in peacetime)) may be provided by overall accounting records of transactions and stock balances maintained at central stock-control points without reference to stock locations.

In general, such financial accounts as are required to be maintained by accountable activities shall be maintained at the respective sites where the property is located and the detailed stock records (see 6) are maintained. Under special conditions,
such financial accounts may be maintained centrally (or at other stations as a service) only when the detailed stock records are maintained at the same location, and provided there is positive assurance of reasonable accounting accuracy by reason of the lack of stock activity or the extraordinary degree of stock control exercised.

6. Detailed stock records (by items) shall be maintained generally for each accountable activity (except retail activities) in support of the summary (control) accounts, but it will not be required that the detailed item records show prices or the amounts of transactions in financial terms.

7. Property transactions (including adjustments for losses, whether or not identifiable) shall be documented in terms of dollar amount and quantities by items, with evidence of authorization or approval to the extent appropriate, except for retail activities where cash registers may be used in accounting for sales.

8. Periodic or continuing, rotating, physical checks of stock items shall be made by count, weight, or measurement, and the detailed stock records and summary (control) accounts shall be adjusted in accordance therewith. Similarly periodic balancing in terms of cost of detailed stock records and summary (control) accounts shall be effected by pricing the stock balances by item.

9. Appropriate principles of internal control shall be observed in property accounting. Such principles require the separation of duties between custody of materiel, receipt and inspection of materiel, record-keeping, examination and approval of purchase vouchers for payment, authorization of issues, review of losses, and physical inventory-taking.

10. Reports in financial terms of property transactions and balances, by stock categories, shall be submitted at least quarterly by all activities, and such reports shall be the subject of consolidation at the levels of the operating agencies and military departments. Such reports shall be designed to show normal operating stock-levels of different types of materiel in relation to issues (e.g. turnover or days of supply on hand); mobilization-reserve stock levels in relation to authorized levels; the extent of excess stocks held for disposal; the extent of unserviceable stocks held for repair; the amounts and character of stock losses by responsibility levels; and a proof of broad accountabilities by the custodian activities.

11. Reports for specific property items in terms of quantities shall be rendered as required for purposes of supply management (see III B and C).

12. Property in the hands of contractors (Government furnished property) shall be accounted for by contractors in a manner generally similar to the property accounting requirements for defense activities. The respective procurement agencies concerned shall maintain accounting control over accountability for such property in the hands of contractors. In most instances such control may be maintained by the procurement agency without the use of detailed item records, but with reliance upon item records of and reports by the contractors; however, in some instances, even though not required for purposes of accountability, it is necessary for the procurement agency to maintain detailed item records for procurement purposes. The cost of Government furnished materials incorporated in end-items procured should be included in the cost of the end-items.
M. Property accounting -- real estate and installed equipment

1. Property accounting will be maintained for real estate and installed equipment both in terms of cost and physical units. Such accounting shall be designed to meet needs for data as to costs of such facilities by activities, as well as to provide accountability for such property.

2. As in the case of other property, there will be integration between the property transactions, expressed in financial terms, and the related financial transactions under applicable appropriations or revolving funds (provided, however, the laws are changed to permit ownership of this type of property by revolving funds).

3. Accounting for this type of property will generally be performed at the site, including accounting by contractors for Government-owned plants and equipment in their custody, under principles of internal control generally applicable in property accounting.

4. The basis of valuation of this type of property will be actual cost by item accounted for, without provision for depreciation except for property which may be owned by revolving funds (provided legal authority is obtained for such ownership -- see J 2). Units of plant and installed equipment shall not be broken down below natural units for purposes of accountability or retirement accounting, and any replacements of units below such level of accounting shall be treated as maintenance expense.

5. Movable equipment in use in connection with fixed installations shall be subject to accounting similar to installed equipment, except that "cost floors" or other criteria will be established as a practical means to eliminate or reduce the problem of accounting for small items, especially those having a relatively short-life or low-temptation-value. Replacements of items not subject to financial accounting shall not be treated as additions to capital assets for purposes of expenditure control, but rather as maintenance charges.

N. Auditing

1. The Assistant Secretary of Defense (Comptroller) will have a small audit division which will formulate audit policy for guidance of the military-department audit agencies. This division will also be responsible for reviewing and examining the audit operations of the individual departments and reporting thereon. In some instances, this division will undertake special audits for the purpose of reporting to the Assistant Secretary of Defense (Comptroller), although in general any specific questions originating at the level of the Office of Secretary of Defense and requiring audit or investigation and report will be referred through the departmental Secretaries to the respective departmental audit agencies for necessary action, including reporting to OSD.

2. Each military department will have an audit organization under a director who shall report directly to the Secretary, Under Secretary, or Assistant Secretary of the department charged with responsibility in the comptroller area. These central audit organizations shall be responsible for worldwide audit operations of a
professional nature in each department. They shall be concurrently responsible
to the Secretary of Defense (or his designee) for reporting on certain specific as­signments as directed through the respective departmental secretaries.

3. No other formal audit organization (except for the detailed auditing of non­appropriated funds) shall be established at any lower echelon. This will avoid
duplication of audit effort and achieve the highest practical degree of audit inde­pendence. To the degree necessary, echelons below the departmental level will be authorized and encouraged to utilize "trouble-shooters" (mobile supervisory personnel) to survey areas where deficiencies exist and achieve on-the-spot cor­rection with a minimum expenditure of time and effort. Moreover, each depart­mental audit agency shall service the operating agencies and installations, through the appropriate channels, by furnishing audit reports covering matters in which they have a basic interest. Methods must be established for effecting and reporting on corrections and improvements required, as approved by competent authority.

4. The internal audit functions shall be designed to provide through first-hand on-the-spot review and examination, and independent evaluation and report on sig­nificant matters having a financial or business implication. These matters may include all operating, organizational, and procedural aspects of financial manage­ment, as herein outlined, or related matters having to do with such fields as procurement, production, and supply management. However, without being confined thereto, systematic attention shall be given to review and examination of the quality of budgeting and reporting, to the satisfactory functioning of internal controls safe­guarding the expenditure of funds and the use or disposition of property, and to compliance with basic policy and procedures in the area of financial management at all levels and installations. Necessarily, audits of this nature will be selective and predicated upon staff resources, priorities, and findings as to the degree of reliance which may be placed upon the system of internal control in any area or installation. It will be necessary to more clearly define the relation and fields of interest of the audit agency and Inspector General in each department.

5. The highest degree of cooperation should exist between auditors and con­tracting officers in the auditing of contractors' costs for purposes of procurement pricing. While the auditors' independence must be preserved, it is also necessary that they serve contracting officers as advisors without undertaking to decide for them matters of substance which should be determined by the use of business judgment and negotiation. In this respect the auditor's judgment is primarily significant in application to technical accounting questions and disclosing facts. The scope of contract auditing shall be reduced, whenever feasible, predicated upon the demonstrated integrity of the specific contractor and the proven quality of his system of internal control and accounting.

6. Gradual extension of the practices of "comprehensive auditing" by the General Accounting Office will be assumed. The GAO acts as the independent au­ditor for the Congress. Comprehensive auditing takes place in the offices of the departments, including their operating agencies and installations. It is understood that the scope of such comprehensive audits will be limited to the extent that may be justified by the internal controls established in the departments (including internal auditing) and the quality of demonstrated performance. The scope of in­ternal auditing shall not be predicated upon the scope of GAO audits.
III. CERTAIN TECHNICAL FEATURES OF RELATED
FIELDS OF SUPPLY MANAGEMENT

A. Assignments of procurement authority and responsibility

1. Responsibilities for procurement in the Department of Defense are largely centralized in each of the military departments under the immediate direction of the Army technical services, Navy bureaus, and the Air Materiel Command of the Air Force. However, there is a varying degree of central overall supervision and direction of procurement in the several military departments.

2. Single-service assignments of procurement responsibility in specific materiel areas have been made by the Secretary of Defense. Under such assignments, a technical service, bureau, or AMC is responsible for procurement for all three military departments, including the Marine Corps. It is the general practice not to create separate independent procurement agencies outside the three military departments. However, a few joint procurement agencies have been created with joint participation of the three departments, but under very broad supervision (or monitorship) of one of the military departments.

3. In addition to normal single-service procurement assignments, the Army technical services continue to service the Air Force in all central procurement of certain categories of technical materiel. (For most of these categories, the Army technical services are also the general warehousing and distribution agents of the Air Force.)

4. Local procurement authority in each department (at depots, posts, bases, etc.) has been limited largely to procurement of certain perishable subsistence and items needed in an emergency, but the Army and Air Force have been experimenting with limited extension of local procurement to standard commercial items which are available locally or which are the subject of procurement schedules under open-end contracts negotiated centrally. This includes items procured through or stocked by General Services Administration.

5. The Assistant Secretary of Defense (Supply and Logistics) is responsible for the determination of procurement policy, but in the performance of this function he is advised by the Under Secretary or Assistant Secretaries of the three departments responsible for procurement and by the Assistant Secretary of Defense (Comptroller) with respect to the financial aspects of procurement.

B. Assignments of responsibility for supply-management functions other than procurement

1. Assignments of responsibilities for department-wide supply-management functions are made much differently in the three military departments, although in each one there is the common feature of central overall supervision and coordination. However, it should be assumed that each military department will have a definite assignment of the following responsibilities for supply-management functions (not all inclusive):
a. Determination of periodic and special central procurement requirements, based generally upon department-wide stock-status and consumption reporting and program data -- separate assignments to organization units by commodity area except for major primary items.

b. Central determination of stock-level ceilings for each type of installation by commodity area.

c. Central determination of mobilization reserve requirements.

d. Review and "audit" of procurement requirements determinations and stock levels.

e. Identification and disposal of excess stocks.

f. Direction of rehabilitation and repair of unserviceable stocks.

g. Review and approval of stock losses, whether or not identifiable by responsibility.

h. Custody and storage of stocks, preservation of stocks, receipt and inspection, packing and shipment or delivery of stocks requisitioned, and stock accounting to extent required at every level (all of these functions subject to separate assignments pursuant to the principle of internal control).

2. In general, each department will have the function of storage and distribution of its own materiel, regardless of the existence of single-service procurement assignments. However, this is presently subject to exception to the extent that the Army technical services provide this function for Air Force for certain categories of materiel. Consistent with the basic system of departmental supply-autonomy, will be a requirement for making cross-servicing arrangements between departments whereby many local installations will requisition common items of supply from nearby depots of other departments in order to reduce transportation costs and permit the consolidation of some depots.

C. Determination of procurement requirements

1. There will be a regular, timely, central determination of procurement requirements for every item centrally procured in each commodity area.

2. This determination will take into consideration the consolidated status of stocks as reported by all depots and stations, including overseas, but excluding small stations and ships (other than aircraft carriers and supply ships). Also to be considered for each item will be the estimated total consumption for the procurement lead-time, minimum consolidated stock-levels, stocks on order, "dues out" under unfilled requisitions, mobilization reserves, repairable stocks, and obsolescence of the item. While generally this data will be obtained from quarterly reporting, more frequent reporting (even daily) may be required in the case of major items or temporarily sensitive items.
3. Estimated total consumption (or withdrawals for use) of each item shall take into consideration the following factors, as may be appropriate: current rate of issues for consumption or use (per month or in ratio to program measures, such as flying hours), experienced rate of issues for similar items (in case of new items for which there is no experience), tables of organization and equipment, troop strength or program measures, new units to be activated.

4. Mobilization reserve requirements (in peacetime only) will be estimated by item (necessarily roughly) upon the basis of the additional stocks required at M-Day (over current normal operating stock levels) in order to meet all demands for issue or withdrawal for use between that day and P-Day when it may be assumed that the rate of deliveries from industry will meet the then current requirements. In this connection the following factors shall be considered; tables of organization and equipment; plans for units to be activated; requirements for prepositioned stocks and assemblies of components; estimated consumption between M-Day and P-Day, less estimated deliveries between M-Day and P-Day; increase in stock levels required after M-Day as compared with present normal operating stock levels.

5. Estimated normal operating stock-level requirements will be a minimum considering, as may be appropriate, for each supply level the following factors: procurement lead-time, in-transit time between depot and station, rate of issues or withdrawals, minimum allowances for unusable or unserviceable stocks awaiting repair. Procurement lead-time includes, as may be appropriate, time required for administrative planning; negotiating contracts; advance time required by contractor in production engineering, tool design, procurement of tools and materials (including subcontractors' lead-time), employee training, and experience before attaining optimum rate of production; risks of strikes; possible delays in acceptance of products; in-transit time from factory to depot, etc.

6. Determination of estimated procurement requirements ultimately may require adjustment based upon availability of funds (translated into possible sacrifice of procurement of one item in favor of another).

7. Requisitions from any level for emergency procurement are inevitable, but should be held to a minimum. Moreover, such requisitions from depot or field level should be translated into redistribution of available stocks whenever practicable before establishing emergency procurement requirements. (Periodic stock redistribution, in connection with quarterly reviews of stock status, is assumed.)

8. While the foregoing is directed towards centrally controlled and procured items, similar considerations are applicable at depot or station level in determining local procurement requirements. However, the application to local procurement is generally much simpler, especially since mobilization reserves are not involved.

D. Single-service procurement

1. To the extent feasible and appropriate, inter-departmental procurement requisitions shall be filled by delivery from stocks of the procuring agency with reimbursement to it, rather than by separate procurement from a contractor for the account of the ordering agency. In this connection, it shall not be permissible
for the procuring agency to separately procure and stock common items, or com-
mon components of end-items, for the account of the ordering agency; such items
shall be procured and stocked on a consolidated basis solely for the account of the
procuring agency. (This practice does not apply to items peculiar to the ordering
agency, when such items are stocked for it by the procuring agency.)

2. To the extent inter-departmental procurement requisitions are to be filled
by contracting,* the procuring agency shall separately contract for, or separately
schedule in consolidated contracts, the items, quantities, and prices for each
ordering agency (including itself), and separately cite the funds chargeable. The
vendor shall be instructed to submit separate invoices for goods shipped for the
account of each ordering agency. In addition, when the procuring agency is not
also the warehousing agent, the contractor shall be instructed to ship and bill the
ordering agency directly. An exception to these rules will be made when the con-
tracts are of a cost-type nature or require progress payments or when there are
to be separate procurements of components and assembly of end-items peculiar
to the ordering agency; in such case the procuring agency may order on a con-
solidated basis against its own appropriations, receive and pay consolidated in-
voices, and rebill the ordering agency for its share of the payments, or in the
alternative bill the ordering agency for the estimated cost of deliveries of end-items
(with adjustment upon completion of the contract). In this case, reimbursements
may be anticipated by the procuring agency as a source of available funds to finance
procurement lead-time.

3. All deliveries from stock of one agency to another shall be upon a reim-
bursable basis, except in the case of stocks declared excess or minor items where
the expense of making charges would be justified. (In the latter case, no charge
shall be made to the ordering agency, but where the items are owned by a revolving
fund, reimbursements shall be made from appropriations of the owning agency.)
Arrangements for replacements in kind will not be permitted. Nor will it be per-
missible for any reason to establish monetary credits to ordering agencies, against
which credits the ordering agencies would be authorized to withdraw stocks, except
that temporary stock withdrawal credits may be established under working capital
funds in connection with the initial capitalization of inventories.

4. When any deliveries under a contract for two or more agencies are diverted,
by materiel allocation or otherwise, the agency to whom diversion is made shall pay
therefor, and the contracts shall be modified accordingly to reflect the changes in
the respective interests.

E. Contracting

1. While ordinarily the standard method of contracting requires advertising
and competitive bidding, with the award to the lowest responsible bidder at a firm
fixed price, there are many situations requiring and justifying negotiation of con-
tracts and pricing by less formal means, as authorized by the Armed Services

*For this purpose, the term "contracting" will be construed to include the issuance of a project order to a
Government-owned industrial establishment.
Procurement Act. Among these are small purchases, emergency purchases, and major technical items for which the contractor cannot estimate his costs with reasonable accuracy, at least before beginning production. However, in all such exceptional cases, informal competition shall be used to the extent appropriate and feasible, in negotiating contracts, with the objectives of serving the best interests of the Government, all things considered, and avoiding preference of individual suppliers.

2. Procedures for making small purchases will be simplified as to negotiation, approval for availability of funds, decentralization of payment-location, receiving and inspection, use of local credit accounts, use of petty cash funds, etc.

3. The use of letters of intent preceding negotiation of formal contracts (including prices) will be held to a minimum. When used, the definitive contracts will be issued within at least 90 days thereafter.

4. The use of firm fixed-price contracts shall be favored over all other types whenever practicable, whether or not such contracts are let as a result of advertising and competitive bidding.

5. The use of cost-reimbursement-type contracts will be held to a minimum. In general, such contracts will be used only when it is impossible or impracticable to use other types of contracts, including firm fixed-price contracts or those containing escalation, price-redetermination, or incentive clauses.

6. Price-redetermination clauses should be used when a contractor's costs cannot be estimated with reasonable accuracy at the time of negotiating a contract, because of such reasons as lack of previous production experience or the existence of contingencies (other than risks of material-price or wage-rate increases, which may be provided for in escalation clauses) for which the contractor would otherwise require cost allowances in pricing that might prove to be grossly excessive, provided that it is believed it will be feasible to establish reasonable, firm fixed prices before completion of 50% of the contract in the light of actual and estimated costs. In general, retroactive price-redeterminations will be permitted only under such a condition, unless incentive clauses are used.*

7. Incentive clauses should be used in cases when it is not believed it will be feasible to establish reasonable prices at any time during the period of contract performance, because of the continued existence of contingencies, provided that it is believed it will be feasible at the outset (or shortly thereafter during the period of contract performance) to establish a reasonable target cost and target price as a basis for determining the respective shares of the contractor and the Government in actual cost increases or decreases in the performance of the entire contract.*

8. Whenever escalation, price-redetermination, or incentive clauses are used, ceiling prices as well as initial (or target) prices will be specified in the contract. Moreover, such prices shall be adjusted from time to time to reflect the price effect of contract changes.

*Such special forms of pricing should not be used for small contracts or those for which the period of performance is relatively short.
9. A uniform statement of contract cost principles will be employed in determining either actual or estimated costs for purposes of contract pricing, including pre-contract negotiations, price revisions, and contract claims, at any time during or subsequent to the period of contract performance, including cases of contract termination for the convenience of the Government. All actual costs required to be considered in retroactive pricing or repricing or contract settlements shall be subject to audit by the independent audit agency of each military department. Audits of cost estimates for purposes of forward pricing will be optional with contracting officers. The General Accounting Office also has the right to audit contractors' costs, but it is understood, will exercise this right to the degree it believes required based on the character of audits by the military departments' own audit agencies.

10. In general, contract prices are not to be set by formula, except as required in the case of cost-reimbursement-type contracts and escalation or incentive clauses. However, uniform principles of pricing all negotiated contracts shall be formulated and observed.

11. Responsibilities for contract negotiation and contract administration shall be assigned to contracting officers in the respective procurement agencies of the military departments under appropriate review and supervision. However, responsibilities for materiel inspection and receiving, maintaining financial records of contracts, contract payments, reviewing the financial qualifications of a contractor, arrangements for and administration of contract financing, and auditing of contract costs and Government furnished property, shall be placed in agencies or officials independent of the contracting officers. With the exception of the first listed function, all of these functions will be administered by comptroller personnel.