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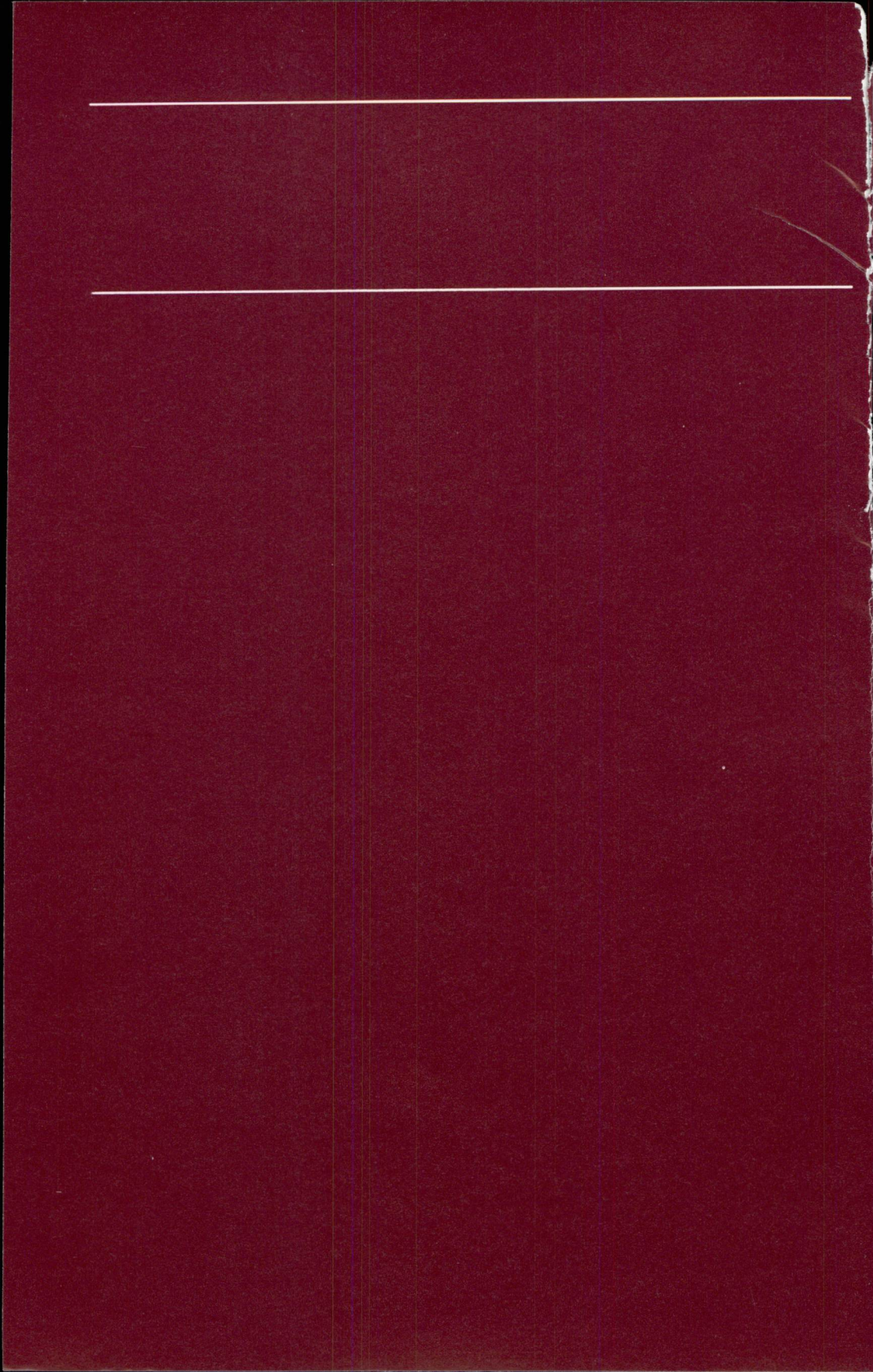
GAO

High-Risk Series

December 1992

Management of Overseas Real Property







United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

December 1992

The President of the Senate
The Speaker of the House of Representatives

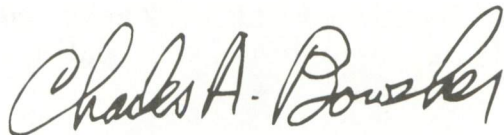
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Department of State's management of the government's overseas real estate programs. It focuses on the need for better oversight of the government's facilities abroad to avoid mismanagement and waste of funds.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Secretary-designate of State.

A handwritten signature in black ink that reads "Charles A. Bowsher". The signature is written in a cursive, flowing style.

Charles A. Bowsher

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Overview

The State Department, through its Office of Foreign Buildings Operations (FBO), manages overseas properties of the U.S. government. These include 8,300 leased properties and 1,750 government-owned properties at nearly 300 locations worldwide. The properties, which include embassies, consulate office buildings, residences, warehouses, garages, and construction sites, are worth approximately \$8 billion to \$10 billion.

FBO oversees acquisition, construction, sales, operations, and maintenance. It establishes standards and procedures for overseas posts, which conduct routine maintenance and implement housing programs for U.S. government employees overseas. FBO also manages a \$2.1 billion Diplomatic Security Construction Program to build secure facilities at overseas sites that face threats of terrorism and violence.

The Problem

The State Department's program of overseas real estate and construction has long been susceptible to waste and mismanagement. Overseas posts have built facilities and made other questionable expenditures without FBO's approval. Some have provided over-standard housing for U.S. employees

living overseas, at increased cost to the government. Maintenance has been postponed or ignored, while many buildings continue to deteriorate to the point of being unsafe. Further, decisions on the acquisition and disposal of overseas property have not always reflected the best long-term interest of the U.S. government.

The security construction program has experienced significant delays and cost increases, and the State Department does not know whether the objectives of the program will be achieved. In the meantime, U.S. government employees and facilities overseas remain vulnerable to acts of violence and breaches of security.

The Causes

FBO's management has demonstrated four areas of weakness:

- **Lax oversight.** FBO's mechanisms for oversight have not ensured that overseas posts are complying with established policies and procedures. Area managers responsible for monitoring post activities have not given this task a high priority, and FBO has not monitored posts' compliance with housing standards.

- Inadequate information systems. FBO does not maintain the financial data that managers need to track costs for specific buildings, to budget for future costs, or to assess management efficiency. The data FBO does collect has traditionally been inaccurate and incomplete.
- Insufficient maintenance. The poor condition of many buildings overseas is a direct result of a lack of professional maintenance capabilities at the posts, a lack of programs for systematic rehabilitation, and inadequate funding for maintenance. Also, FBO has neglected to assess the condition of its properties, leading to costly repairs that might have been avoided by preventive maintenance.
- Poor planning. Although FBO needs to develop facilities plans at key posts to link the Department's foreign policy and security objectives, to this date FBO has not established milestones to develop such plans.

In the \$2.1 billion security construction program, inadequate planning and coordination have contributed to delays and cost increases. Since 1986, FBO has completed only 8 of the 57 projects under

this program. In addition, FBO has not adequately assessed contractors' performance and has lacked sufficient staff to manage construction.

**GAO's
Suggestions for
Improvement**

FBO has begun to correct some of its chronic problems in accordance with many of our previous audits and recommendations. It intends, for example, to establish priorities for construction projects based on specific criteria, to better evaluate contractors' performance, to hire additional qualified staff, to survey the maintenance conditions of posts worldwide, to require yearly maintenance inspections, to streamline and update housing standards, and to improve information systems.

We believe that these reforms show promise. But some key improvements are still in the initial stages and will take years to implement. It is important to continue these efforts to make long-lasting improvements especially in consideration of the increased work load and the demand for resources associated with opening new posts in the former Soviet Union.

Managing Real Estate Overseas

The Foreign Service Buildings Act of 1926, as amended, directs the State Department to manage overseas properties of the U.S. government. The Department has delegated responsibility for overseas real estate operations to FBO. These operations include acquiring, constructing, selling, operating, and maintaining U.S. government-owned and leased property at several hundred locations abroad.

To manage the maintenance of overseas real property, FBO establishes policies, standards, and procedures and provides technical guidance to posts on real estate matters. Posts are responsible for implementing overseas housing programs for U.S. government employees and for conducting routine maintenance, repairs, and minor improvements in accordance with FBO's policies, standards, and procedures.

FBO also manages overseas construction projects. In 1986, the Department initiated a \$2.1 billion Diplomatic Security Construction Program in response to the need to build secure new facilities at posts facing threats of terrorism and other acts of violence. FBO estimated that 57 projects could be completed under the program. To date, FBO has completed only eight projects, and funds

appropriated for the program total about \$1.2 billion.

Management of Real Estate Overseas Has Been Ineffective

For the past three decades, ineffective management practices have caused overseas posts to make questionable expenditures without FBO's approval and have perpetuated problems in the maintenance of real estate property overseas. In addition, State's information systems to track funds and resources have proved inadequate, and ineffective planning has led to decisions that were not in the best interest of the U.S. government. Persistent problems with the Department's maintenance of real property have led the Department to identify it as an area that carries a heightened risk for waste or mismanagement.

Oversight Has Been Limited

FBO's mechanisms for the oversight of overseas post activities have not ensured that posts were complying with established policies and procedures. In the absence of sufficient oversight, some posts have acted unwisely in taking real estate actions without the knowledge or approval of FBO. For example, a past GAO audit uncovered improper expenditures at one post for the construction of buildings to house racquetball and squash courts without FBO's approval. Another post executed an unnecessary \$8.5 million extension on a lease without FBO's knowledge or approval.

Another audit revealed that posts were not complying with FBO's standards for leased residential housing provided to Department employees living overseas and, as a result, many employees resided in houses that exceeded FBO's standards, at greater cost to the U.S. government.

FBO's primary mechanisms for oversight of overseas post activities are (1) monitoring by FBO area managers and other officials and (2) automated information systems that provide data on posts' real property inventory and expenditures of resources. In the past, monitoring of posts' activities has not been a high priority in FBO. Although area managers seemed to be aware of their responsibilities, they had not made monitoring a priority because (1) they did not want to give the impression that they did not trust post managers and (2) they had not been trained to perform monitoring activities.

The U.S. government provides free housing for its personnel assigned to overseas posts. To determine the appropriate size of a housing unit for an employee, the Department of State developed standards based on (1) comparable housing available in the metropolitan Washington, D.C., area;

(2) family size; and (3) the employee's position at the overseas post. In 1989, a GAO review of Department posts in seven countries showed substantial use of leased residential housing that was over-standard. Specifically, one of every three of the housing units in these countries was over-standard. A recent review of one overseas post showed that only 19 percent of the families were provided housing in accordance with FBO's standards. Our reviews indicate that posts are not following FBO procedures, post officials are not adequately controlling housing costs, and FBO has not monitored posts' compliance with housing standards.

**Information
Systems Have Not
Provided
Necessary Data**

The Department's property managers do not have relevant and useful financial information on the government's investment in or the cost to maintain the extensive inventory of buildings and real estate holdings overseas. Financial information of this nature is necessary to assess the value of the Department's assets and the manner in which it maintains stewardship over them.

FBO relies on two information systems—the Real Estate Management System and the Central Financial Management System—to

**Management of Real Estate Overseas
Has Been Ineffective**

monitor real estate programs at overseas posts. The Real Estate Management System does not fully support the Department's property managers in managing foreign buildings because it does not provide historical cost information on government-owned and leased property or maintenance and repair cost information for each building overseas. Consequently, FBO cannot (1) track costs for each building, (2) determine the total costs of operating properties and the feasibility of retaining them, (3) budget for future building costs, and (4) develop performance measures to assess the efficiency and effectiveness of the management of overseas property. Without this information, it is difficult for the Department to adequately predict funding for FBO operations. The system also relies on data reported by the posts, and this data has traditionally been inaccurate and incomplete.

The Real Estate Management System also does not include information on changes in the value of buildings and real estate, the current service life and replacement cost of property, changes in the condition of property, backlogs of deferred maintenance, exposure to possible loss, and programs to

safeguard assets. This information would assist property managers in their work.

Financial data categorized by functional program and project would also be helpful to property managers. Currently, however, FBO cannot provide such information for many overseas transactions. Further, the Department's Bureau of Finance and Management Policy, which operates the Central Financial Management System, has postponed indefinitely a system modification that would support FBO's needs for project cost accounting.

Facilities Are Deteriorating

With an average age of 37 years, the support systems in many of the buildings overseas are approaching the end of their useful lives.¹ The deterioration of the Department's aging inventory is a direct result of the lack of (1) professional maintenance capabilities at the post level, (2) programs for systematic maintenance and rehabilitation, and (3) adequate funding for maintenance and repair of facilities. These deteriorating facilities create health, safety, and environmental hazards for employees of the Department and other federal agencies

¹Support systems in buildings include heating, ventilation, electrical, and other systems.

**Management of Real Estate Overseas
Has Been Ineffective**

overseas and impede the operations of embassies and consulates abroad.

The poor condition of many buildings overseas is a direct result of FBO's past neglect in assessing the condition of its properties. In 1990, we found that a number of overseas buildings and building systems had deteriorated to the point that rehabilitating them would cost a significant amount. For example, the ambassador's residence at one post required rehabilitation and maintenance at a cost of \$10 million. According to FBO officials, many of the repairs and costs could have been avoided if routine and preventive maintenance had been done.

Persistent management problems with the Department's maintenance of real property overseas have led the Department to identify it as an area that carries a heightened risk for waste or mismanagement.

**Real Estate
Program Has Not
Been Well
Planned**

FBO established a policy in 1990 requiring a master facilities plan for each overseas post. The plan is to match each post's requirements for the short and long term with current assets to develop cost-effective alternatives. FBO has made very limited

progress in preparing master plans and has not developed master plans for posts where multimillion-dollar construction programs are planned. For example, FBO undertook an \$80 million construction and renovation project at one post without a master plan.

FBO officials are considering modifying this policy because they do not think all posts require the same detailed level of planning. Instead, FBO would like to develop abbreviated plans at posts where such plans can materially affect the decision-making and budgeting process. These plans would be developed based on criteria such as security and foreign policy considerations. To date, FBO has not established milestones to develop the abbreviated and full master plans. At the very minimum, FBO will need to establish milestones for the development of both types of plans to link the Department's foreign policy and security objectives, among others, to FBO's operations.

In 1989, FBO developed a 5-year plan for its real estate program for fiscal years 1992 through 1996. This plan, which outlines FBO's budgetary and staffing needs for the 5-year period, represents a major step in FBO's planning efforts. However, this plan does not include the potential proceeds from sales of

**Management of Real Estate Overseas
Has Been Ineffective**

properties that FBO reviews periodically in its asset management studies. The proceeds from the sale of high-valued properties could substantially offset FBO's costs in other areas, such as the capital construction program. Linking the asset management studies with the 5-year plan would provide options for the use of proceeds from sales of property.

Delays in Construction Programs Persist

In 1986, the Department of State initiated a \$2.1 billion Diplomatic Security Construction Program to build secure new diplomatic facilities at high-threat and serious risk posts around the world. The Department began this program in response to (1) the increased risk from terrorist attacks and other acts of violence posed to U.S. diplomatic personnel overseas beginning in the late 1970s and (2) the placement of sophisticated Soviet listening devices in the structural shell of a new U.S. embassy office building in Moscow in 1985.

As revealed in audits since the 1960s, the Department of State has encountered significant problems in managing its overseas construction programs. These problems have resulted in delays and cost increases in the Department's security construction program. Due to continuing delays in construction, U.S. facilities and personnel stationed overseas still remain vulnerable to acts of violence. The Department has identified the security of U.S. facilities and personnel abroad as a material internal control weakness.

The Department has made limited progress in implementing its \$2.1 billion security construction program and cannot be assured

**Delays in Construction Programs
Persist**

that program objectives are being met. FBO has completed an average of less than two projects per year since the program began in 1986. Specifically, FBO has completed only 8 of the 57 projects under the construction program, and costs continue to escalate. At the current pace, at least 20 years would be required to complete all the projects.

**Inadequate
Planning and
Coordination Led
to Delays and
Cost Increases**

The Department has planned the security construction program inadequately from the beginning. The program has experienced delays and cost increases as a result.

The program's initial estimated costs in the 1986 budget request were inaccurate. As shown in an internal 1988 review, one of the major causes of cost overruns was the lack of coordinated planning of post requirements prior to project programming and budgeting. As noted in our 1991 review, building size and cost requirements for specific projects were poorly defined in many instances. Inadequate planning resulted in cost increases of \$47 million for three projects. For example, the lack of coordination between FBO and the Department in establishing requirements for the size of a new building at the post in Pretoria, South Africa, led to a 4-year delay

in the award of the construction contract and subsequent cost increases of \$17 million.

FBO officials believe that the division of responsibility between FBO and the Bureau of Diplomatic Security for the security-related aspects of construction management has led to delays in both construction design and certification of security procedures. In 1990, State transferred the responsibility for construction security management to FBO, a decision FBO officials believe will lead to better management of overseas projects.

State Has Not
Assessed
Contractor
Performance
Adequately

The Department relies on contractors to implement its security construction program at specific overseas sites. These contractors can affect the program positively or negatively based on their performance. Although State acknowledged that the performance of contractors significantly affects construction, in the past it did not adequately assess their performance.

Some contractors have failed to perform as expected, and as a result, projects have been delayed, and costs have increased. For example, all 26 projects under one contract had been delayed. In spite of these delays, FBO had not assessed the contractor's

performance. Due to the delays, this contract had to be extended, and the cost increased by \$20 million. In addition, for one project alone, FBO faced additional costs of \$3 million—an increase of 8 percent of the total cost for the project—due to contractor performance problems.

Staffing Levels to
Manage
Construction Are
Low

FBO has encountered difficulties in filling authorized staff positions to manage increasingly complex construction projects. Reasons cited by FBO include its reorganization in 1987, the need to develop position classifications when the security construction program started, and the time it takes to obtain security clearances for new employees. Staff shortages in critical areas like program planning, project management, construction monitoring, and cost estimation have directly contributed to program delays and cost increases. According to FBO, shortages of direct-hire employees in the construction area can create the undesirable condition of too small a ratio of direct-hire to contract employees.

Other Factors
Adversely Affect
Construction
Program

Several problems encountered in the implementation of the security construction program have been beyond FBO's control. These problems include the difficulty

encountered in getting construction sites and changing security requirements within the Department.

In its initial planning, FBO believed that site selection and acquisition for most posts would be completed within 6 months after funds were authorized. However, the process often took much longer than expected, often years instead of months. In some cases, the lack of coordination within the Department delayed the process; in other cases, factors beyond FBO's control made acquisition difficult, if not impossible. These delays have contributed to cost increases of over \$37 million. Changing security requirements also led to delays and increased construction costs by approximately \$5 million in some projects.

Planned Reforms Will Take Years to Implement

After many years of neglect, the Department has recognized the urgency of improving its chronic mismanagement of overseas real estate programs and is taking action to correct past problems. Many of the actions will take time to fully implement because they are still in the planning stages or early stages of implementation. Consequently, it may take years before expected improvements are fully realized.

To improve the management of the security construction program, the Department and FBO are instituting the following reforms:

- The establishment of priorities for construction projects based on security standards, threat categories, budgetary realities, potential for successful execution, and other criteria.
- A value engineering program to identify potential savings in initial construction plans. This program resulted in \$6 million in savings in 1991.
- A configuration management system to control unnecessary design changes for projects costing more than \$5 million.

- A system to periodically evaluate the performance of contractors and a directive requiring FBO officials to consider FBO's previous experience with contractors before executing contracts exceeding \$25,000.
- A method to fund security construction projects on a yearly basis to enable FBO officials to more precisely estimate project costs. In the past, entire projects were funded at their beginning.
- An effort to hire a sufficient number of qualified staff to manage the security construction program. Of 163 positions authorized for direct-hire employees in fiscal year 1992, 74 employees (45 percent) are either on duty or awaiting imminent entry, 26 candidates (16 percent) are awaiting security clearances, 26 positions (16 percent) are in the recruitment process, and 37 positions (23 percent) are awaiting classification within the Department's personnel structure.

FBO has also initiated many actions to improve its management of real estate property overseas. These initiatives include the following:

Planned Reforms Will Take Years to Implement

- Determining the maintenance conditions of posts worldwide through engineering surveys. FBO expects to complete surveys at all posts worldwide toward the end of 1994.
- Enhancing maintenance assistance to posts through the establishment of two maintenance assistance centers in Europe and Washington, D.C. Both centers are fully staffed.
- Requiring post officials to conduct yearly maintenance inspections and provide inspection reports to FBO.
- Establishing new streamlined housing standards that realistically reflect the types of housing available to Department employees in the Washington, D.C., area and requiring posts to submit a list of the types of housing provided to employees for FBO's review and approval.
- Creating a facilities maintenance skill group within the Foreign Service and hiring experienced building professionals to handle the technical requirements of maintaining posts. FBO has hired 48 facilities maintenance specialists and expects to have 130 at posts by the end of fiscal year 1996.

Planned Reforms Will Take Years to Implement

- Installing an enhanced version of the Real Estate Management System at many posts worldwide to better support post management and improve the data reported by posts. FBO has installed this enhanced system at 66 posts and expects to install it at 156 posts by the end of 1996. According to FBO officials, this system is easier for post officials to use than the previous version, and FBO has already seen a great improvement in the data that posts provide.
- Conducting financial audits of the administration and use of FBO program funds at overseas posts with significant FBO resources.

Conclusions and Action Needed

For many years, we have reported long-standing problems with the Department's overseas real estate programs. It is important that Department and FBO officials continue their commitment to management reform and oversight of post activities if these problems are to cease. While FBO has recently initiated many corrective actions within a short time, FBO may face obstacles in fully implementing these actions. Likely challenges include overcoming uncertainty over the availability of funding and responding to shifts in foreign policy objectives due to changing political circumstances. For example, the added work load and costs associated with opening new posts in the former Soviet Union are the kinds of changes that without continued commitment could deflect FBO's attention from correcting its problems with overall real estate management.

Related GAO Products

Financial Management: Serious Deficiencies in State's Financial Systems Require Sustained Attention (GAO/AFMD-93-9, Nov. 13, 1992).

State Department: Management Weaknesses in the Security Construction Program (GAO/NSIAD-92-2, Nov. 29, 1991).

State Department: Efforts Under Way to Enhance Management of Overseas Real Property (GAO/NSIAD-91-277, Sept. 5, 1991).

State Department: Status of the Diplomatic Security Construction Program (GAO/NSIAD-91-143BR, Feb. 20, 1991).

U.S. Embassy, Moscow: Alternatives for Reconstruction and Their Costs (GAO/NSIAD-91-43FS, Dec. 28, 1990).

State Department: Need to Improve Maintenance Management of Overseas Property (GAO/NSIAD-90-216, Sept. 24, 1990).

State Department: Proposed Housing Standards Not Justified (GAO/NSIAD-90-17, Dec. 18, 1989).

Related GAO Products

State Department: Management of Overseas
Real Property Needs Improvement
(GAO/NSIAD-89-116, Apr. 13, 1989).

High-Risk Series

Lending and Insuring Issues

Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1).

Guaranteed Student Loans (GAO/HR-93-2).

Bank Insurance Fund (GAO/HR-93-3).

Resolution Trust Corporation (GAO/HR-93-4).

Pension Benefit Guaranty Corporation (GAO/HR-93-5).

Medicare Claims (GAO/HR-93-6).

Contracting Issues

Defense Weapons Systems Acquisition (GAO/HR-93-7).

Defense Contract Pricing (GAO/HR-93-8).

Department of Energy Contract Management (GAO/HR-93-9).

Superfund Program Management (GAO/HR-93-10).

NASA Contract Management (GAO/HR-93-11).

Accountability
Issues

Defense Inventory Management
(GAO/HR-93-12).

Internal Revenue Service Receivables
(GAO/HR-93-13).

Managing the Customs Service (GAO/HR-93-14).

Management of Overseas Real Property
(GAO/HR-93-15).

Federal Transit Administration Grant
Management (GAO/HR-93-16).

Asset Forfeiture Programs (GAO/HR-93-17).

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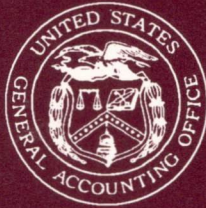
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High-Risk Series

December 1992

Internal Revenue Service Receivables





United States
General Accounting Office
Washington, D.C. 20548

**Comptroller General
of the United States**

December 1992

The President of the Senate
The Speaker of the House of Representatives

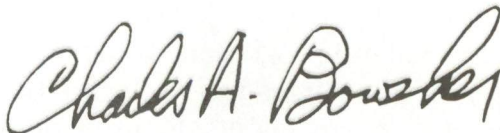
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This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Internal Revenue Service's (IRS) ability to collect the tax debts owed the federal government. It focuses on what IRS needs to do to increase collections. We believe it is time for IRS to consider fundamental changes that would lead to improved staffing decisions, a shorter collection process, accountability, and delinquency prevention.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, the Secretary-designate of the Treasury, and the Commissioner of Internal Revenue.

A handwritten signature in black ink that reads "Charles A. Bowsher". The signature is written in a cursive, flowing style.

Charles A. Bowsher

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High-Risk Series

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Overview

The Internal Revenue Service (IRS) is responsible both for routine tax collection and for pursuing delinquent payments. Although IRS routinely collects about a trillion dollars each year, its efforts to collect delinquent taxes have been inefficient and unbalanced. As a result, billions of dollars in taxes remain uncollected, representing a serious loss of revenue for the government.

Moreover, IRS' poor performance in collecting overdue tax debts suggests to taxpayers that IRS is neither fair nor serious about collecting delinquent taxes. If IRS were to improve its efforts, the result could be not only increased revenue but also greater compliance. IRS recognizes its collection problem and has a number of initiatives under way that address it. But progress has been slow, and much vigor is needed in the future to enhance these efforts and bring them to fruition.

The Problem

As of the end of September 1991, IRS reported an accounts receivable inventory totaling about \$111 billion. IRS estimated that nearly 75 percent of that amount cannot be collected because either the records are inaccurate and taxpayers do not actually owe the money, IRS cannot locate the

taxpayers, or the taxpayers cannot pay. That leaves almost \$30 billion that IRS has estimated as potentially collectible.

IRS based these estimates on its record of success at collecting delinquent taxes. If IRS were to improve its ability to collect, it could recoup more of the unpaid debt. Yet IRS' collections have actually declined, dropping by 5 percent in fiscal year 1991. Meanwhile, reported delinquent tax debts—the accounts receivable inventory—continue to grow and age.

The Causes

Several problems have interfered with IRS' ability to collect unpaid taxes.

First, the agency's records are inaccurate and insufficient. Because IRS does not know how many accounts are valid, its estimates of receivables are unreliable as a measure of performance. Because IRS employees do not know which accounts are valid, they waste time and money pursuing nonexistent debts. And because IRS cannot tell which of its many collection tools produces the best results, the agency has not known how best to direct its efforts.

Second, the collection process is lengthy, antiquated, rigid, and inefficient. The first step of the process alone may take 6 months. By comparison, delinquencies in the private sector are usually resolved in 6 months.

Third, IRS has had difficulty balancing collection efforts with the need to protect the taxpayer—an objective embodied in legal restrictions on IRS' efforts.

Fourth, IRS' decentralized structure tends to blur lines of responsibility and accountability.

And fifth, IRS does not have enough information to allocate staff effectively. Staffing varies dramatically among districts and is independent of collection needs.

GAO's
Suggestions for
Improvement

We have made numerous recommendations to IRS over the years to improve its collection efforts; IRS has responded to some. For example, IRS has begun to develop much-needed information on the age of delinquencies and the types of taxpayers and taxes making up the accounts receivable inventory.

But many areas remain to be addressed. Among other actions, IRS should gather more and better data and use that data as a basis for decisions. IRS could also shorten and improve its debt collection process and remove organizational impediments to collections and determine the appropriate size and mix of collection staff. Further, Congress could revisit the issue of the appropriate balance between the need to protect taxpayers and the need to collect delinquent tax debts.

The government has the opportunity to realize substantially more revenue from taxes already owed if it could more effectively and efficiently carry out the process of collecting those debts. Still, even as IRS works to improve collection methods, it should also give attention to preventing taxpayers from becoming delinquent in the first place. In addition to pursuing its current strategy for increasing compliance, IRS would do well to examine existing tax rules, whose complexity may encourage delinquencies. A good example is IRS' recent simplification of employment tax deposit rules—another of our recommendations. And, in general, ensuring that IRS' operations are competent and evenhanded may also help maintain

Overview

**public trust and voluntary compliance with
our tax laws.**

IRS Collections

IRS is responsible for collecting \$1 trillion in taxes each year and for ensuring that people pay their fair share of taxes. Some Americans do not report all of their income or claim too many deductions. The taxes that they should have paid make up the so-called "tax gap." As part of its job, IRS attempts to identify delinquent taxes—whether they stem from honest mistakes, inability to pay, or outright fraud. Once debts are identified, IRS classifies them as accounts receivable.

Few people would question the wisdom of pursuing known delinquencies. Yet IRS' poor performance in collecting unpaid taxes has suggested that the agency has not been seriously committed to this task. For many years, IRS has collected only a small portion of the billions of dollars of reported accounts receivable, and its own numbers showed that its collections have actually declined even as the accounts receivable inventory has grown. Moreover, IRS' collection efforts have been unbalanced; they have not always been proportionate to the severity or the geographic distribution of the delinquencies themselves.

Inefficient and inequitable collection efforts not only mean lost or delayed revenue, but they have broader consequences as well: the

public comes to believe that IRS is not fair in its operations and is not serious about collecting unpaid taxes. Allowing some people to get away without paying their tax debts may discourage voluntary compliance among the millions of taxpayers who do pay their share. At the same time, IRS does little to prevent taxpayers from becoming delinquent in the first place. An approach emphasizing delinquency prevention could help reduce the need for collections.

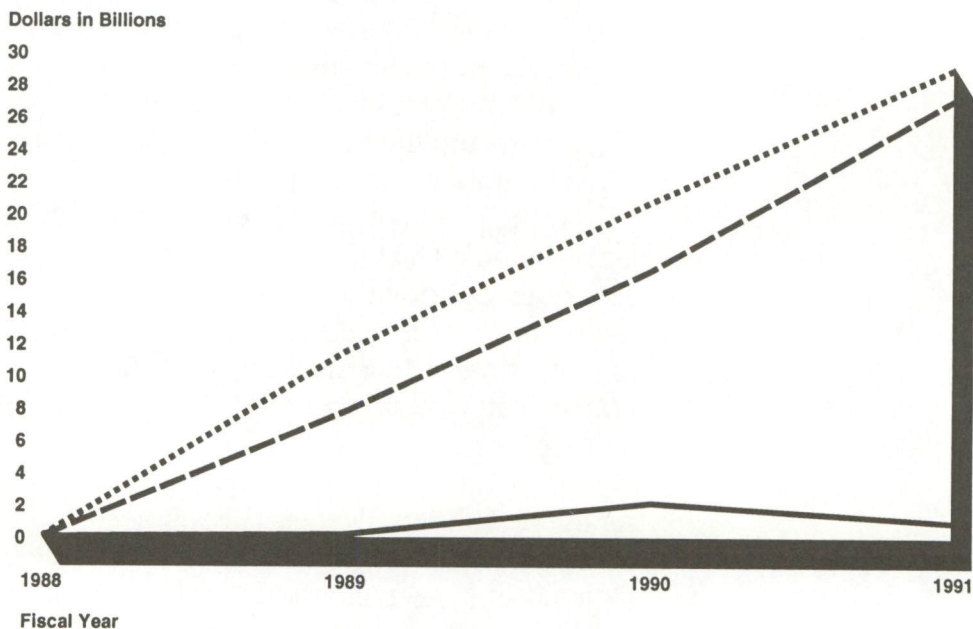
Billions of Dollars Uncollected

As of the end of September 1991, IRS reported that its accounts receivable inventory totaled about \$111 billion. On the basis of experience, IRS estimated that nearly 75 percent of the inventory will never be collected because either records are inaccurate and the taxpayers do not actually owe the money, IRS cannot locate the taxpayers, or the taxpayers cannot pay. This leaves almost \$30 billion that IRS has estimated as potentially collectible, assuming that IRS maintains its current rate of collections. Clearly, improved collection efforts would mean more of this debt would be recovered.

As figure 1 shows, even as the reported accounts receivable inventory has continued to grow and age, collections have not kept pace. For fiscal year 1991, IRS reported that collections of receivables actually declined by 5 percent while its receivables inventory increased by 15 percent.

Billions of Dollars Uncollected

Figure 1: IRS' Delinquent Tax Collections and Accounts Receivable Trends, Fiscal Years 1988 to 1991



- Change in Total Delinquent Tax Collections
- - - Change in Accounts Over 1 Year Old
- Change in Total Accounts Receivable

Note 1: All values include interest and penalties on Individual and Business Master File accounts.

Note 2: Fiscal year 1991 inventory and age data have been adjusted from a 10-year to a 6-year statutory collection period.

Source: IRS data.

Several conditions have interfered with IRS' ability to collect unpaid taxes. These include a lack of complete and accurate information about accounts, an inefficient collection process, the need to balance collection efforts with taxpayer protection, a highly decentralized organizational structure, and uneven staffing among offices.

Lack of Information

IRS' collection efforts have long been hampered by erroneous and insufficient information. To begin with, IRS' accounts are riddled with errors and duplications; many of the recorded debts do not even exist. Moreover, IRS does not collect some information that could help it better guide its efforts. These problems mean that IRS does not know how many accounts are valid, which accounts are worth pursuing, and which of its collection tools are most effective in particular cases. As a result, IRS wastes valuable resources because it cannot productively focus its collection efforts.

How Many Accounts Are Valid

In general, IRS has reported accounts receivable significantly higher than could ever be collected; IRS itself estimated that less than \$30 billion of its \$111 billion inventory is collectible. Yet because IRS does not know how many records are valid, no one really knows the true number of receivables, much less how many of them are collectible. We are now reviewing IRS accounts receivable as part of our ongoing financial audit required by the Chief Financial Officers (CFO) Act of 1990. Our preliminary data suggest that even IRS' estimate of \$30 billion in potential collections may be overstated.

Because Members of Congress and the public have relied on IRS' information, many have an exaggerated idea of the impact increased collections could have on reducing the deficit. Members have also depended on these inflated figures when making decisions about IRS' staffing needs.

The financial audit should provide, for the first time, a reliable estimate of IRS' collectible receivables, based on a detailed analysis of a statistical sample of individual accounts. IRS' annual audited financial statements will also give Congress credible information on receivables and IRS' other operations for oversight and accountability.

Which Accounts Are Valid

While the overall number of valid accounts can be estimated from an analysis such as ours, no one knows specifically which accounts are valid and which ones are not. This uncertainty has several implications.

First, because IRS employees trying to collect individual tax debts do not know which accounts are valid, they waste time and money pursuing debts that are not real and will not generate revenue. In addition, taxpayers who are contacted about nonexistent debts feel harassed and may

lose confidence in IRS' competence and fairness.

Second, no one knows how invalid accounts are distributed among IRS' various offices. Nor does anyone know how much time it takes to resolve an invalid account. Because of these uncertainties, there is no way to determine whether some offices are managing proportionately more workload with less payoff.

Third, what summary information IRS does have reflects both valid and invalid accounts. This makes it unreliable as a basis for decisions on staffing or collection strategies.

In the last few years, IRS has taken steps to develop such basic information as the age of the accounts receivable, types of tax owed, and how closed accounts were resolved. IRS is now working on the largest accounts to identify and remove errors, prevent future errors, and identify obstacles to increasing collections. IRS also plans to study why some tax debts have been abated. This is a start, but it will not be enough. IRS needs accurate and complete information on all of its accounts.

Which Tools
Work Best

To develop a good collection strategy, IRS needs far more information than it currently has about the nature of tax debts, the characteristics of delinquent taxpayers, and the relative effectiveness of collection tools. Without these data, IRS does not know which of its approaches work best, in which cases they work best, or when in the collection process they work best.

Congress has provided IRS with an extensive array of collection tools: IRS may negotiate installment agreements, settle for lesser amounts, garnish wages, levy bank accounts, and seize assets. IRS uses these tools frequently and often automatically, but it has no solid data with which to guide their use. For example, IRS knows that its employees garnish wages or levy bank accounts more than 2 million times each year. But IRS does not know how much money is collected in this way, how often the debt is satisfied as a result, or how often the bank account is empty by the time the levy notice arrives. Nor does IRS know whether one of these techniques is more productive than the other or whether it is more effective to use one before the other.

Similarly, IRS does not know the most effective collection approaches for specific

types of tax debts or taxpayers. For example, employment taxes (employee wages withheld for social security and income taxes as well as the employer's share of social security taxes) make up about a third of reported accounts receivable—a sizable amount. IRS has specific tools to apply to employment tax debts. But IRS does not know whether these tools are in fact used for such accounts, much less whether they are successful.

Since the late 1970s, we have been pointing out that IRS needs better information to manage and evaluate its collection activities. Without it, IRS has no empirical basis for selecting a cost-effective mix of collection tools and programs. With it, IRS could allocate staff and other resources in a way that would recover more revenue.

IRS' annual audited financial statements should help in part by enabling the agency to better measure its collection performance and, in turn, better direct its collection efforts. The ability to tie program decisions to financial results in this way is one goal of the CFO Act.

Inefficient Collection Process

Good business practice dictates that after a debt arises, efforts be made to secure some type of payment agreement as quickly as possible. IRS' decades-old collection process, however, is not based on this premise. The IRS collection process involves three steps. In step one, IRS mails the taxpayer a series of three to five computer-generated bills, at 30-day intervals, to notify the taxpayer that a tax debt is owed. In step two, IRS telephones the taxpayer to collect the money or otherwise resolve the debt. In step three, a revenue officer visits the taxpayer. In most IRS offices, smaller debts are not handled until a revenue officer becomes available or until the debt (which is accumulating interest) grows large enough to be of higher priority. If not handled, the revenue will be lost when the 10-year statute of limitations expires.

The process is outdated, costly, and inefficient. A comparison with private sector debt collection illustrates several areas in which the IRS process needs improvement.

First, IRS' process takes too long. Delinquencies in the private sector are usually closed after 180 days. By that time, IRS has probably not even tried to telephone the taxpayer. IRS officials have explained that

one reason the agency spends up to 6 months sending bills is to clear up as many errors as possible before employing more intrusive and more costly collection techniques. Correcting errors is important, especially since so many occur, but this could be done more quickly by telephone. Another reason IRS takes so long is to allow enough time to receive and verify any replies from the taxpayer and to update the taxpayer's account. This is a time-consuming process in IRS' antiquated computer environment.

IRS is now in the midst of a long-term massive computer modernization effort that should eventually create an environment in which taxpayer information is not only timely and accurate from the beginning but is also available to any IRS employee that needs it to do the job. Recent IRS commissioners have recognized the importance of this modernization initiative and have built on their predecessors' efforts to bring it to reality. This trend must continue.

Second, the process is too rigid. IRS follows the same three-step process for all types of accounts. If a debt remains unpaid, IRS will eventually use its more powerful tools,

regardless of the taxpayer's compliance history. In contrast, private debt collectors often tailor their collection process to the individual delinquent on the basis of experience or analyses of the behavior of specific types of delinquents. IRS is beginning to make some changes. For example, the agency now allows employees who have early contact with delinquent taxpayers to attempt collection before the first bill is sent. But such movement toward change has been slow.

Third, the IRS collection process relies too heavily on step three, visits by a revenue officer. Private sector companies avoid personal contact because of the cost and potential dangers involved. Although IRS may need some personal contact—to exercise its seizure power, for example—it may not need to give this method the emphasis it currently has.

Balancing Collection Efforts With Taxpayer Protection

IRS' attempts to collect debts using the same tools regardless of the taxpayer's compliance history—and, in some cases, even when the debt was not actually owed—led, understandably, to complaints from taxpayers. To ensure that IRS always treats taxpayers fairly and does not abuse the substantial powers it has to enforce the tax laws, Congress passed the Taxpayer Bill of Rights in 1988 to strengthen taxpayer protections and placed conditions on IRS' use of certain collection tools. An unintended result of this legislation was to hamper tax collection, both because of elements of the legislation itself and because IRS has evidently become reluctant to take actions that might provoke further constraints.

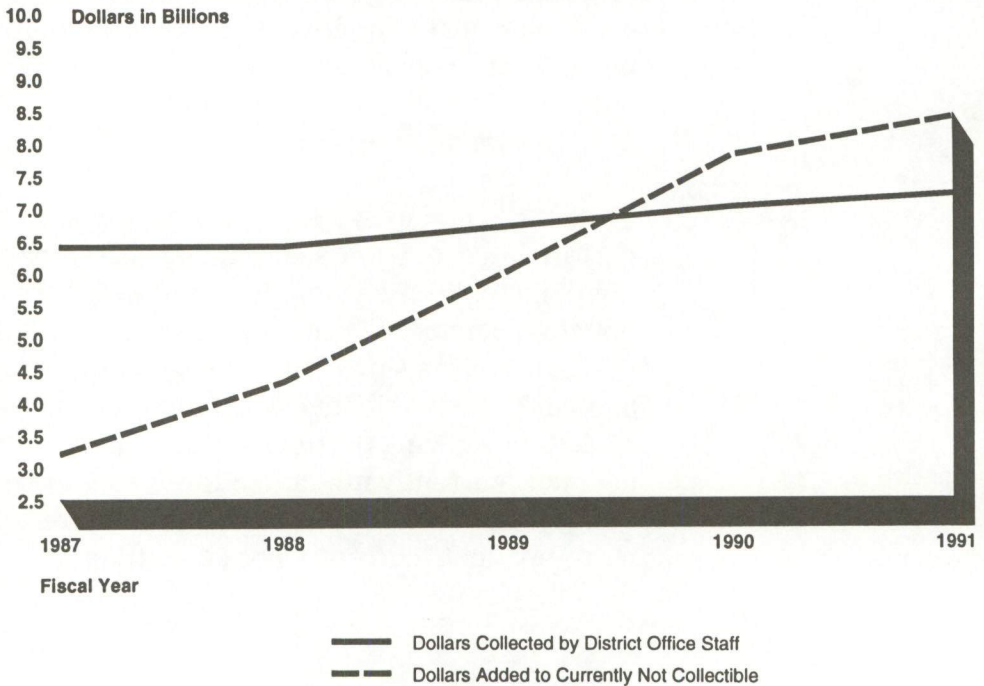
For example, one provision of the 1988 legislation prohibits IRS from evaluating staff members on the basis of dollars collected. IRS already had a similar policy, but Congress was concerned that the policy was not followed and that IRS employees, perceiving a "quota" system, were too harsh in their collection efforts. We said then, and continue to believe now, that taxes collected is a reasonable basis on which to judge the performance of employees whose job it is to collect taxes, as long as other criteria, such as fair and courteous treatment of taxpayers,

are also evaluated. Virtually all private sector collection managers with whom we talked said that dollars collected was one criterion used to evaluate employees and that it would be difficult to have an effective collection operation if dollars collected could not be used to evaluate performance.

Under IRS' current system of evaluating staff performance, accounts classified "currently not collectible" are given the same weight as dollars collected. This could contribute to the fact that the single largest segment of the accounts receivable inventory—and one of its fastest growing portions—is accounts deemed "currently not collectible." As shown in figure 2, district office staff now declare more tax debt "currently not collectible" than they collect.

**Balancing Collection Efforts With
Taxpayer Protection**

Figure 2: District Office Staff Collections Compared to Dollars Added to Currently Not Collectible Status, Fiscal Years 1987 to 1991



Source: IRS data.

Further, perhaps to avoid prompting further legislative intervention, IRS collection agents now seem reluctant to use some of the tools available to them. For example, the number of cases in which IRS seized property

**Balancing Collection Efforts With
Taxpayer Protection**

dropped from 25,000 in 1985 to less than 10,000 in 1991. Also, IRS staff has stopped collection action, even when taxpayers earn a substantial income, if the taxpayers have reported an equal amount of expenses to maintain their existing lifestyle.

These results reflect IRS' struggle to balance the need to protect the rights of taxpayers with the need to collect tax debts. IRS must be fair; its employees should follow appropriate laws and procedures and not harass taxpayers. But on the other hand, taxpayers need to know that IRS is serious about collecting taxes.

Decentralized Organizational Structure

IRS' organizational structure has impeded its ability to implement nationwide changes. IRS is a highly decentralized organization: all 7 regions, 63 districts, and 10 service centers share responsibility for collecting tax debts. Each district has a great deal of independence in deciding which accounts to pursue and which tools to use in pursuing them. Assistant commissioners in IRS' National Office direct various functions—including collection, examination, returns processing, taxpayer service, and criminal investigation—but none of these people has direct line authority over field operations.

In 1991, IRS took a step toward establishing a unified collection strategy by appointing an accounts receivable executive officer who reports to IRS' chief financial officer. IRS also appointed multifunctional task forces to study specific aspects of the collection problem. The accounts receivable executive officer and the task forces face the challenge of operating in a decentralized organization in which they have no line authority over the people directly responsible for collections.

IRS is also using a strategic planning process to improve accountability. Executives are expected to meet goals and annual targets.

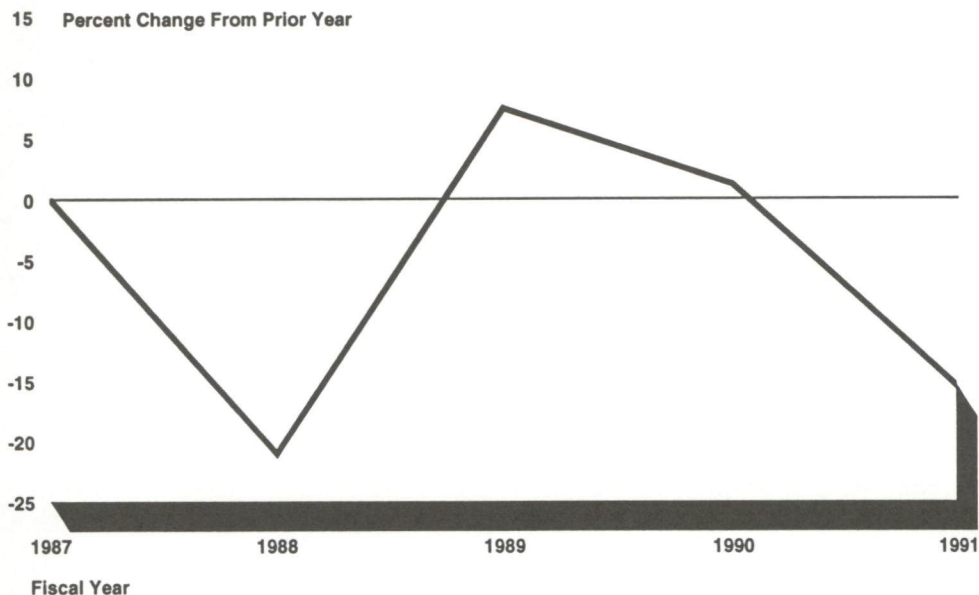
The 1992 collection target, for example, calls for the accounts receivable inventory to remain level or decrease and for debt collections to increase by 8 percent. The strategic planning process seems to have prompted better interunit cooperation, but so far tax debt collection has not improved.

Uneven Staffing

IRS' traditional solution to collection problems has been to add staff. Given increasing tax debts and number of accounts waiting to be handled, it would be easy to conclude that more staff is the best response. However, although we supported the staff increase Congress authorized IRS for 1991, we noted that more staff is not necessarily the answer in the long term. We also cautioned policymakers not to overestimate the amount of additional revenue that would result from adding staff. Debt collections actually declined that year.

IRS' own experience suggests that there is reason to doubt that adding staff will automatically lead to better collections. To begin with, productivity of collection staff has not been constant. As figure 3 shows, the number of accounts closed per staff year in district offices has fluctuated considerably since 1987.

Figure 3: Percent Change in Revenue Officer Case Closures Per Staff Year, Fiscal Years 1987 to 1991



Source: GAO analysis of IRS data.

Further, IRS may not be making the best use of the staff it already employs. Imbalances are common. In some districts, enough staff is available to pursue small debts as well as large ones while in other districts large debts go uncollected because staff is not available. Aside from the potential revenue losses,

such imbalances mean that taxpayers in different parts of the country are treated differently.

Therefore, rather than simply adding staff, IRS must ensure that it is making effective use of its staff. Because of IRS' lack of data, little is known about the optimum size and mix of staff for collections. Without better information, IRS cannot make rational decisions on how best to allocate staff in the long term.

Conclusions and Action Needed

We have made numerous recommendations over the years to IRS on ways to improve its tax debt collection efforts. In the last several years, IRS has begun responding to some of these recommendations. For example, IRS is developing much-needed information on the age of delinquencies and the types of taxpayers and taxes making up the accounts receivable inventory. And IRS has improved its review process for evaluating the performance of field offices and started to identify performance measures that reflect its mission. IRS has also responded to our most significant recommendation on preventing employment tax delinquencies by simplifying the requirements for employment tax deposits, making it easier for employers to understand and comply with the rules. In addition, as required by the CFO Act of 1990, IRS is now preparing an annual financial statement that we are auditing.

But many areas still need improvement, and the next commissioner must build upon the successes of prior commissioners. Most of our recommendations have addressed IRS' need to gather more and better data and to use that data as a basis for decisions. Among other steps, we have recommended that the agency develop more specific information on the validity and characteristics of accounts

that are written off to determine whether new collection measures might help. We have recommended that IRS gather more extensive information on employment tax delinquencies and measure the effectiveness of IRS programs for dealing with them. And we have recommended that IRS find ways to give Congress more reliable estimates of revenues expected from proposed staffing increases.

We have also proposed ways in which IRS could improve the collection process—for example, by analyzing the experience of private industry and by setting priorities on the basis of likelihood of collection rather than on the size of the debt. In addition, IRS should identify and correct elements of its organizational structure that impair its collection ability and should work with the Office of Management and Budget to determine the appropriate size and mix of collection staff. And we have suggested that Congress revisit the issue of balancing the need to protect taxpayers and the need to collect delinquent tax debts.

Perhaps most important, IRS must remember that collections are only part of its job. Even as it works to improve collection methods, IRS should also give attention to preventing

taxpayers from becoming delinquent in the first place. Preventing delinquencies would reduce the problem—and cost—of collecting tax debts later on. In addition, tax revenues would be more certain, and the money would be available for use sooner. IRS' delinquency prevention programs are modest; the agency has agreed that it could do more in this area and recently introduced a strategy called Compliance 2000.

By ensuring that its operations are evenhanded and competent, IRS could do much to prevent the loss of public trust that can contribute to delinquency. In addition, although IRS has taken a step forward by simplifying employment tax deposit requirements, IRS needs to take a close look at the complexity of other tax rules, which are often thought to cause taxpayers to become delinquent. Taxpayers plan their finances on the basis of their understanding of the rules. By the time they learn their understanding was wrong, they may not have the money to pay additional taxes. IRS needs to identify the specific rules that cause the most problems and work with the Department of the Treasury and the Congress to simplify them.

Conclusions and Action Needed

The federal government has the opportunity to realize substantial revenue from taxes already owed if it can more effectively and efficiently carry out the process of collecting those debts. The delinquency problem is not straightforward, and it will not be easy to fix. But given the loss of billions of dollars in revenue—and the corresponding loss of public confidence in the system—IRS must aggressively address this problem as quickly as possible.

Related GAO Products

An Update on IRS' Progress on Accounts
Receivable and Strategic Management
(GAO/T-GGD-92-26, Apr. 2, 1992).

Tax System Modernization: Progress Mixed
in Addressing Critical Success Factors
(GAO/T-IMTEC-92-13, Apr. 2, 1992).

Tax Administration: IRS' System Used in
Prioritizing Taxpayer Delinquencies Can Be
Improved (GAO/GGD-92-6, Mar. 26, 1992).

Federal Contractor Tax Delinquencies and
Status of the 1992 Tax Return Filing Season
(GAO/T-GGD-92-23, Mar. 17, 1992).

Tax Administration: Federal Agency Tax
Compliance Problems Remain;
Improvements Are Planned (GAO/GGD-92-29,
Feb. 18, 1992).

Tax Administration: IRS' Implementation of
Certain Compliance Initiatives
(GAO/GGD-92-45FS, Jan. 30, 1992).

Tax Administration: Opportunities to
Increase Revenue Before Expiration of the
Statutory Collection Period (GAO/GGD-91-89,
Sept. 30, 1991).

Simplifying Payroll Tax Deposit Rules
(GAO/T-GGD-91-65, Sept. 12, 1991).

Tax Administration: Efforts to Prevent, Identify, and Collect Employment Tax Delinquencies (GAO/GGD-91-94, Aug. 28, 1991).

Identifying Options for Organizational and Business Changes at IRS (GAO/T-GGD-91-54, July 9, 1991).

Management Challenges Facing IRS
(GAO/T-GGD-91-20, June 25, 1991).

Collecting Back Taxes: IRS Phone Operations Must Do Better (GAO/IMTEC-91-39, June 18, 1991).

Tax Administration: Changes Are Needed to Improve Federal Agency Tax Compliance
(GAO/GGD-91-45, Apr. 16, 1991).

IRS' Budget Request for Fiscal Year 1992 and Status of the 1991 Tax Return Filing Season
(GAO/T-GGD-91-17, Mar. 20, 1991).

Tax Administration: IRS Does Not Investigate Most High-Income Nonfilers (GAO/GGD-91-36, Mar. 13, 1991).

Tax Administration: Extent and Causes of Erroneous Levies (GAO/GGD-91-4, Dec. 21, 1990).

IRS' Accounts Receivable Inventory (GAO/T-GGD-91-2, Oct. 18, 1990).

IRS' Accounts Receivable Inventory (GAO/T-GGD-90-60, Aug. 1, 1990).

Tax Policy: Federal Tax Deposit Requirements Should Be Simplified (GAO/GGD-90-102, July 31, 1990).

Tax Administration: Trends in the Growth and Age of IRS' Accounts Receivable (GAO/GGD-90-111FS, July 30, 1990).

Tax Administration: IRS Needs More Reliable Information on Enforcement Revenues (GAO/GGD-90-85, June 20, 1990).

Tax Administration: Erroneous Penalties for Failure to File Returns or Pay Taxes Can Be Reduced (GAO/GGD-90-80, Apr. 13, 1990).

IRS' Accounts Receivable Inventory (GAO/T-GGD-90-19, Feb. 20, 1990).

Related GAO Products

Tax Administration: IRS Can Improve the Process for Collecting 100-Percent Penalties (GAO/GGD-89-94, Aug. 21, 1989).

Tax Administration: Statistics on IRS' Use of Levies to Collect Delinquent Taxes (GAO/GGD-89-97FS, July 17, 1989).

Tax Administration: Periodic Evaluation Needed If IRS Uses Levies to Collect Deferred Accounts (GAO/GGD-89-34, Feb. 14, 1989).

Managing IRS: Actions Needed to Assure Quality Service in the Future (GAO/GGD-89-1, Oct. 14, 1988).

High-Risk Series

Lending and Insuring Issues

Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1).

Guaranteed Student Loans (GAO/HR-93-2).

Bank Insurance Fund (GAO/HR-93-3).

Resolution Trust Corporation (GAO/HR-93-4).

Pension Benefit Guaranty Corporation
(GAO/HR-93-5).

Medicare Claims (GAO/HR-93-6).

Contracting Issues

Defense Weapons Systems Acquisition
(GAO/HR-93-7).

Defense Contract Pricing (GAO/HR-93-8).

Department of Energy Contract Management
(GAO/HR-93-9).

Superfund Program Management
(GAO/HR-93-10).

NASA Contract Management (GAO/HR-93-11).

Accountability
Issues

Defense Inventory Management
(GAO/HR-93-12).

Internal Revenue Service Receivables
(GAO/HR-93-13).

Managing the Customs Service (GAO/HR-93-14).

Management of Overseas Real Property
(GAO/HR-93-15).

Federal Transit Administration Grant
Management (GAO/HR-93-16).

Asset Forfeiture Programs (GAO/HR-93-17).

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United States General Accounting Office
High-Risk Series

December 1992

Guaranteed Student Loans





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**Comptroller General
of the United States**

December 1992

The President of the Senate
The Speaker of the House of Representatives

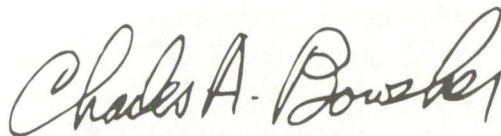
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Department of Education's management of the Guaranteed Student Loan Program, especially regarding defaulted student loans. It focuses on the program's structural flaws and the lack of adequate incentives that some participants have to prevent defaults. We have made numerous recommendations in the past, many of which have been implemented. We believe that other opportunities for improvement exist, specifically those aimed at improving program management and reducing risk, that should be considered and acted on.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Secretary-designate of Education.

A handwritten signature in cursive script that reads "Charles A. Bowsher". The signature is written in dark ink and is positioned above the printed name.

Charles A. Bowsher

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Overview

The Federal Family Education Loan Program (formerly known as the Guaranteed Student Loan Program), administered by the Department of Education, is designed to provide access to postsecondary education for those who cannot otherwise afford it, on the premise that, once educated, the borrowers will earn incomes sufficient to pay back the loan. In 1991, the program generated about 4.8 million new loans totaling over \$13 billion for students attending over 7,500 schools.

These loans are currently made by 7,800 lenders and administered by 46 state-designated guaranty agencies. The government generally pays interest on the loans while students are in school. Also, the government, through the guaranty agencies, guarantees the loans and repays lenders if borrowers fail to do so.

The Problem

While the program has generally succeeded in providing access to money for education, it has been less successful in protecting the taxpayers' financial interest. In 1991, the federal government paid out \$3.6 billion to make good its guarantee on defaulted student loans, continuing a trend of escalating losses.

The Causes

The increase in losses reflects fundamental problems in the student loan program's structure and management. In part, this stems from the tension between the goals of providing steadily increasing loan funds, often through expanded or new loan programs, to enable students to meet rising higher education costs and the need to maintain accountability to taxpayers. Over the years, the federal government has tended to emphasize access to loans at the expense of accountability.

The structure of the loan program is inordinately complex, and many participants have little or no incentive to prevent defaults. Lenders and guaranty agencies benefit from making loans, but generally do not bear any financial risk. Schools also bear little risk, and some use the program as a source of easy income, with little regard for students' educational prospects or the likelihood of their repaying the loans. Nearly all the risk falls to the federal government, whose only recourse is to pursue defaulters. Yet as loan volume and federal financial exposure grew, the government failed to establish adequate controls to minimize its losses.

Management weaknesses have plagued the Department's administration of the loan program. The Department has failed to weed out schools that collect tuition payments for marginal instruction. Its records have been inaccurate and incomplete, leading to erroneous payments and loans to ineligible borrowers. It had conducted little oversight of lenders and guaranty agencies, paying default claims without reliable documentation and failing to collect fees due the government. And it had inadequately trained and organized program staff.

GAO's
Suggestions for
Improvement

The Congress, the Department, and the Office of Management and Budget (OMB) have recognized these problems and attempted to correct many of them. The Congress enacted more than 100 legislative provisions in 1992 to improve the program's operations. The Department has worked to correct staffing inadequacies, controls over schools, and oversight of lenders and guaranty agencies.

Among other steps, we have suggested that the Department further toughen its screening of schools seeking initial and continued participation in the program and

expedite its plan for ensuring that program data are more useful, timely, and accurate.

While such improvements are essential, they would be unlikely in themselves to fix all the program's problems. Addressing the program's underlying flaws and reducing taxpayers' risks may require structural reform. In particular, we believe that the Congress should consider simplifying the loan program—perhaps by increasing the risk among participants. A pilot program to test a direct lending arrangement, which would eliminate lenders and guaranty agencies, is a possible step.

Federal Family Education Loan Program Operation: A Complicated, Cumbersome Process

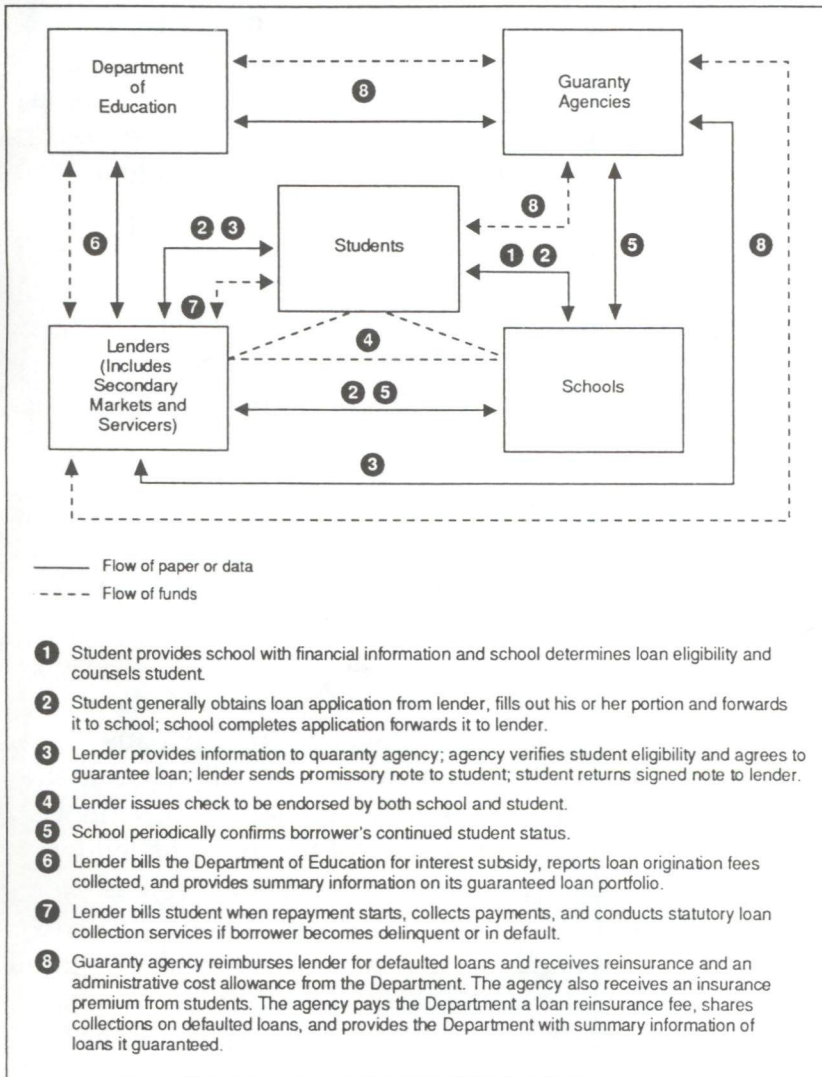
The Federal Family Education Loan Program functions through a complicated and cumbersome system of rules and requirements involving millions of students and thousands of schools, lenders, and other entities. As shown in figure 1, following the maze of responsibilities is difficult. The program basically involves five parties: students, schools, lenders, guaranty agencies, and the Department of Education. In the sections below, we highlight some of the key responsibilities each group performs.

The Student

The student, as borrower, initiates the loan process. The student applies to a lender for the loan, arranges for repayment with the lender, and repays the loan. Most students receive a federal subsidy throughout the period of their loans, including a low interest rate, and make no interest payments while they attend school. Generally, when the student completes or otherwise leaves school, he or she starts repayment. Between fiscal years 1966 and 1991, the number of student loans guaranteed each year increased from 89,000 to 4.8 million.

**Federal Family Education Loan
Program Operation: A Complicated,
Cumbersome Process**

Figure 1: Federal Family Education Loan Program: A Complicated and Cumbersome Process



The School

The school verifies students' eligibility and determines that the loan amount does not exceed students' cost of attendance. The major types of schools participating in the program are: 2-year public, 2-year private, 4-year public, 4-year private, and proprietary (for-profit trade and vocational) schools. In 1991, over 7,500 schools participated in the program, and 3,100 were proprietary schools.

The Lender

The lender makes loans and under the program's guaranty provisions, must exercise proper care in making, servicing, and collecting them and follows the applicable program requirements. The lender also collects from the student a loan origination fee for the Department and an insurance premium for the agency guaranteeing the loan. The lender bills the Department each quarter for the federal interest subsidy payment for the loans it holds. These payments normally include the students' interest while they are in school. Also, during the life of the loan, the lender receives an interest supplement that is intended to provide it with a market rate of return. If the borrower fails to make required payments, the lender files default claims with the guaranty agency, but cannot be

reimbursed for its claims until borrowers have been delinquent at least 180 days.

In 1991, about 7,800 lenders participated in the program. Approximately \$127 billion in student loans have been guaranteed since the program began. Most loans are held by relatively few lenders. For example, 25 lenders had 57 percent of the \$54 billion outstanding as of September 30, 1990, and one organization—the federally chartered Student Loan Marketing Association—had 29 percent (\$15.7 billion) of the total.

The Guaranty Agency

The guaranty agency carries out several tasks, including: (1) issuing guarantees on qualifying loans so that if a borrower fails to repay his or her loan due to death, disability, bankruptcy, or default, the lenders can be reimbursed for their claims; (2) charging students an insurance premium of up to 3 percent of the loan; (3) verifying that lenders properly service and attempt to collect loans before the agency pays default claims; and (4) remitting to the Department its portion of monies the agency subsequently collects from defaulted borrowers.

Guaranty agencies generally receive 100-percent reinsurance from the Department on the default claims amounts paid to lenders. The Department also pays the agencies a 1-percent administrative cost allowance based on the principal amount of the loans they guarantee. Guaranty agencies can also operate as a secondary market and purchase loans from lenders, as well as service loans for others. There are 46 guaranty agencies—state agencies or private nonprofit organizations—that administer the program in the 50 states, the District of Columbia, the Pacific Islands, Puerto Rico, and the Virgin Islands.

The Department of Education

The Department is responsible for administering the program and for overseeing the activities of the various participants. It determines which schools can participate (commonly referred to as the “gatekeeping” function), establishes loan collection requirements for lenders and guaranty agencies, pays lenders interest subsidies, and reinsures guaranty agencies for up to 100 percent of lenders’ claims. To partially offset program costs, the Department charges borrowers an origination fee and receives a reinsurance fee from the guaranty agencies.

Program Structure Is Flawed

The federal government's risk of losses has increased greatly as the program has evolved. The original plan was for a simple program involving unsubsidized loans that had no needs test and relied on states to guarantee the loans. This approach fell apart almost immediately because many states were reluctant to establish guaranty agencies. The program was replaced by the present system of interest subsidies and full federal guarantees.

Originally targeted to middle-income students, the program shifted to low-income students. Also, the loan program expanded to include students attending proprietary schools. The government also substantially increased its financial exposure when it provided interest subsidies to lenders, as well as full reimbursement to lenders and guaranty agencies for any default claims. In addition, when the growth of program participants exploded, the government failed to establish adequate controls to minimize its risk.

Original Focus
Has Changed
Dramatically

The program was originally intended to serve middle-income students, a relatively low-risk group, by helping them finance their education. It was meant to provide help to those experiencing cash flow problems. The loans were not meant to be subsidized and the program was expected to entail few, if any, costs.

As budget constraints reduced the availability of grants for low-income students, however, students from low-income families turned increasingly to the loan program to finance a postsecondary education. Establishing needs tests resulted in fewer middle-income students being eligible for program loans. A great debt burden was placed on those who often had little or no means to repay. This shift would normally have a minimal effect on the program if students, regardless of their income, would have received a quality education.

Expansion to
Proprietary
Schools
Escalated the
Risk

The program was also originally intended to finance a traditional college education. The program expanded to include other education and training institutions, such as proprietary schools, some of which have not always provided a high-quality education for

their students. Many students attending these schools are eligible not only for loans but also for other kinds of federal student financial aid, such as Pell Grants. The lure of plentiful financial aid for proprietary school students, as well as abusive practices of some proprietary schools—including fraud—has had a disproportionate impact on defaults. For example, in 1990, students attending these schools represented 41 percent of borrowers, but 77 percent of those that defaulted. The employment outcomes—and the probability of repayment of the loan—for some of these students are much less certain.

Incentives to
Promote Access
Have Been Costly

A fundamental tension exists within the program between its primary goal—providing access to a postsecondary education to students who otherwise could not afford it—and minimizing costs to U.S. taxpayers.

The government's assumption of some financial risk was recognized at the outset, but the program was not initially designed for the federal government to bear all the financial risks. States were to establish guaranty agencies—that initially shared 20 percent of the risk for all defaulted

loans—to operate programs in their states and, among their other responsibilities, encourage lenders to make loans to eligible student borrowers and pay for any defaults that occurred. Lenders, with guarantees provided by the agencies, were expected to make, service, and collect loans.

However, not enough states were establishing guaranty agencies and lenders were not making enough loans, so the Congress made several amendments to the Higher Education Act. It increased financial incentives—and reduced the limited financial risks—in order to get greater lender and guaranty agency participation. The financial risks, therefore, shifted almost entirely to the federal government, and U.S. taxpayers became the guarantor and assumed the risks of default. The government has paid a high price for the resulting increase in access to the program.

In addition, some guaranty agencies are engaged in, or extended their activities into, areas that have inherent conflicts of interest. Such conflicts occur when a guaranty agency is a loan servicer or it operates a secondary market for loans that it guarantees. The agencies in these cases are in the position of being both a lender servicing loans and a

guaranty agency auditing and overseeing lenders' responsibilities. These situations create environments in which an agency's financial transactions are "less than arms-length" because there is no clear separation of responsibilities among the entities.

Lack of Adequate Controls Has Increased Costs

Congressional and administration efforts, either by tightening the standards for participation or by sharing the risk with others, have not done enough to control the program's risks. Tremendous program growth in the availability of guaranteed student loans and the number of program participants followed congressional actions providing financial incentives to lenders and guaranty agencies. However, these incentives were not followed by actions necessary to limit the federal government's financial exposure. Rather, the Department's way of doing business basically remained the same and failed to keep pace with the growth.

Other changes, such as requiring greater risk sharing by lenders and guaranty agencies, were not authorized by the Congress, and this has also hampered the Department's ability to effectively manage the program.

Program Structure Is Flawed

The federal government, therefore, has been in the undesirable position of being financially liable for the actions of schools, lenders, and guaranty agencies who could do more to control the risk.

Flaws Have Been Costly

Federal requirements lack adequate incentives to encourage the participants to do more to prevent defaults. This lack of incentives also increases the government's risks. Schools, lenders, and guaranty agencies face few consequences for defaulted loans and can profit from defaults, yet students are heavily penalized if they do not repay. The absence of adequate incentives for default prevention through better loan origination and servicing has contributed to the default problem.

Students Punished the Most

Many people believe that students who typically default on their loans got a good education for their money, became doctors or lawyers, and simply chose not to repay. While this happens sometimes, the more common situation is far different. Many defaulters are poor, attended a proprietary school, dropped out of their course of instruction, and have little or no means to repay. Some were "pressured" by unscrupulous recruiters to enroll in proprietary schools that provided a poor-quality education and dismal employment prospects. As a result, many such students failed to get value for their money and are reluctant or unable to repay their loans.

Students who fail to repay their loans, however, may suffer greatly for that default. They may (1) be denied other federal student aid, (2) receive a negative credit rating, (3) have their income tax refunds seized, and (4) have their wages garnished.

Some Schools
Have Had Little
Concern for
Defaults

Some schools, particularly proprietary schools whose profits come from student tuition payments, have had a strong incentive to sign up students whose tuition is heavily financed by federally guaranteed loans. Partly because they were not accountable for their students' performance, these schools often did not use outcome measures, such as completion and job placement rates, to evaluate whether their students received the education and skills they were promised.

Some schools were also not overly concerned about the frequency of defaults by their students. That changed somewhat in 1990 and again in 1992, when the Congress mandated default rate thresholds for schools that, if exceeded, can result in future ineligibility for guaranteed student loans. However, the schools still lack incentives to further reduce their default rates below the legislative thresholds.

Lenders and
Guaranty
Agencies Should
Focus More on
Preventing
Defaults

Alternatives are needed to encourage more default prevention efforts by lenders and guaranty agencies. The lack of an effective risk-sharing mechanism for these participants has contributed to the loan default problem. Current loan collection requirements are detailed and prescriptive, emphasizing form over substance. Increased risk-sharing would persuade lenders and guaranty agencies to pay more attention to the kinds of schools their students attend and students' repayment practices.

Guaranty agencies are not guarantors in the truest sense. The name implies a financial protection that in reality does not exist. In general, neither the guaranty agencies themselves nor the states that designated the agencies have any capital at risk. If a guaranty agency experiences financial difficulties and is unable to perform its functions, especially in paying lenders' default claims, taxpayers, through the federal government—not the state—become the true guarantor. As a result, the “guaranty” agencies function primarily as loan processors. In addition, they have lacked incentives to manage their activities on behalf of the government in a cost-effective manner.

Department Mismanagement Contributed to Problems

The Department of Education has had a history of mismanagement and poor oversight of the program's activities. It generally (1) has used ineffective procedures for determining which schools can participate, (2) has had inadequate financial and management information systems that contain inaccurate and incomplete data, (3) has conducted little oversight of the lenders and guaranty agencies, (4) has experienced high turnover in key management positions and has not hired staff with adequate skills, and (5) has had a management structure that inhibited program improvements. Not adequately addressing these problems could jeopardize the Department's implementation of the direct loan demonstration program.

The Department's management and program deficiencies have been the subject of congressional hearings, reports by GAO and the Department's Office of Inspector General (OIG), and other studies and evaluations. Both GAO and OMB have identified this program as one of the government's high-risk areas. In addition, OMB and the Department conducted a review that concluded that the Department's management practices contributed to high

loan default rates, as well as fraud and abuse in the federal student aid programs.

Better
Gatekeeping
Needed

The Department's gatekeeping procedures for determining which schools can participate—and whether they should continue participating—in federal student aid programs have been weak. The Department must rely on others with limited accountability to U.S. taxpayers—such as state licensing organizations and school accrediting bodies—for assuring the quality of the education being offered. Little federal oversight has been directed at determining whether schools—especially proprietary schools—have the fiscal and administrative capability to provide a quality education. As a result, procedures for determining which schools participate in the program have been generally ineffective in weeding out abusive practices, such as collecting tuition payments for marginal instruction.

Accurate
Financial and
Management
Information
Systems Are Vital

Many of the Department's financial problems have been repeatedly cited in GAO and OIG reports, as well as in the Department's own reports required by the Federal Managers' Financial Integrity Act. The act requires federal agencies to evaluate and report on

their internal accounting and administrative controls annually. These problems stemmed from the Department's emphasis on program execution—quickly getting funds out to students—rather than fiscal accountability. For example, records supporting the Department's payments to lenders and guaranty agencies have been, at times, missing, incomplete, or inaccurate. Also, the Department has relied heavily on an honor system in its financial management activities. It pays over \$5 billion annually to lenders and guaranty agencies based on unaudited summary billings. This extends the risk the federal government—and ultimately the taxpayer—assumes.

Department, independent, and state auditors do not conduct in-depth examinations of the accuracy and validity of lenders' and guaranty agencies' claims for interest subsidies, defaulted loans, and administrative cost allowances. Generally, audits also fail to provide a positive attestation to the claims submitted or to the adequacy of the lenders' and guaranty agencies' internal controls structure. As a result, the federal government has little assurance that the "bills" it pays are proper.

The Department's management information systems contain data that are not always timely and accurate, which limits these systems' use for compliance and evaluation purposes. The limitations have hampered the Department's ability to effectively manage and monitor the guaranteed student loan programs, especially those activities concerning loan defaults and collections. As a result, millions of dollars in new loans have been made to borrowers for amounts exceeding statutory limits, or to borrowers who are already in default and, therefore, ineligible for additional loans.

However, the Department has made slow progress in improving its information systems, and the National Student Loan Data System, authorized by the Higher Education Amendments of 1986, will not be implemented until, at best, December 1993. This system could meet many of the Department's student loan information management needs and be an important tool in determining students' loan eligibility.

**More Effective
Oversight Needed**

Lenders and guaranty agencies have received little oversight and view their primary mission as getting loan monies to students. Until recently, as loan volume

**Department Mismanagement
Contributed to Problems**

increased, the number of Department reviews of participants generally decreased. In part, because of the large number of lenders and guaranty agencies, the Department's review efforts generally were not focused on those with the largest default volumes. In addition, when violations were found, the Department was slow at times to resolve them.

Also, better oversight could be obtained with fewer lenders and guaranty agencies. The advent of electronic fund transfers and automation improvements has reduced the need for the number of lenders and guaranty agencies that were once necessary to help ensure student access to the program.

More effective oversight could provide an increased focus on the Department's failure to collect origination fees due the government, accurately pay interest subsidies, require sufficient default prevention efforts in paying default claims for lenders, and ensure that borrowers obtain loans within statutory limits.

**Better Qualified
Staff Required**

A shortage of qualified Department personnel has also plagued program management. The Department has not had

**Department Mismanagement
Contributed to Problems**

adequately trained staff, and some lacked appropriate skills. For example, it has had few people with financial or accounting backgrounds to administer over \$13 billion in new loans made annually. Its staff have lacked experience, training, and proficient skills in finance, information systems, data analysis, planning, and policy making.

**Improved
Management
Structure Needed**

The Department's organizational structure has not adequately emphasized fiduciary responsibilities, but has focused instead on promoting services to participants. Responsibility for federal student aid has been divided among various offices. This fragmented management had contributed, at times, to inadequate communication and decision-making that, in turn, resulted in (1) delays in issuing guidance and regulations, (2) duplicate program compliance responsibilities, (3) reduced opportunities to develop comprehensive program and system changes, and (4) the failure to use Department resources and processes in a coherent and effective manner.

Existing
Problems Could
Hamper
Implementing
Direct Loan
Demonstration

The Higher Education Amendments of 1992 created a direct lending demonstration program. Under direct lending, the federal government becomes the lender, and private lenders and guaranty agencies—in their present form—would no longer be needed. Schools, acting as agents for the federal government, would use federal funds to make loans to qualifying students. The Department of Education would service and collect the loans, presumably by contracting with private firms.

The 1992 amendments also require that we evaluate the costs and experiences of the schools, students, parents, and the Department of Education participating in the direct loan demonstration program. The evaluation will also include a comparison with a control group of schools that are not participating in the demonstration program. We are to issue an interim report in January 1997 on our evaluation, with a final report due in May 1998.

We estimate that direct loans could save the federal government \$4.8 billion over the first 5 years of implementation. But the inventory of known problems in the Department's administration of guaranteed student loans raises questions about its ability to

**Department Mismanagement
Contributed to Problems**

adequately manage a direct lending program. The Department needs accurate financial and information management systems for it to not only manage the guaranteed loan program, but to properly implement the demonstration program.

Conclusions and Action Needed

The problem of billions of dollars in student loan defaults has not been ignored. The Congress and the Department have attempted to improve the integrity of the Federal Family Education Loan Program through many incremental legislative and regulatory reforms. For example, the Congress enacted over 100 legislative provisions in 1992 to improve default prevention, loan collections, and overall program integrity. Also, the Congress expanded loan eligibility to more middle-income families, while authorizing additional grant funds. Although some of these changes are dependent on available funding, they could help reduce the government's loan default risk.

The Department also has been taking many steps to improve its management and reduce the government's financial exposure. For example, the Department's staffing inadequacies have lessened since it has begun hiring staff with financial skills, while targeting its resources to areas with major problems. It has been strengthening its gatekeeping function and establishing stricter controls over which schools can participate in federal student aid programs. In addition, it has been improving its monitoring of lenders and guaranty agencies,

specifically in determining the guaranty agencies' financial stability. These actions should help improve program and fiscal integrity, as well as aid in the Department's implementation of the direct lending demonstration. We recognize that these improvements are in various stages of implementation and that other actions are planned or underway. We encourage the Department to continue implementing these efforts.

Better management alone, however, may not fix the program's problems. Structural reform may be necessary to simplify this complex program. Part of this reform may need to involve reducing the number of lenders and guaranty agencies through some form of consolidation or reorganization. In the interim, steps to strengthen the program through simplification, reorganization, and risk-sharing and better oversight of schools, lenders, and guaranty agencies should be considered.

Actions the Congress should consider in enhancing the existing program include:

- Reorganizing the roles of lenders and guaranty agencies, including having them

assume a greater share of the risk.

- Strengthening the incentives for effective loan servicing and default prevention by lenders and guaranty agencies, and establishing results-oriented default prevention incentives.

Actions the Secretary of Education should consider in enhancing the existing program include:

- Further strengthening the Department's gatekeeping procedures to more effectively determine the fiscal and administrative capabilities of schools seeking initial and continuing approval for participation in federal student aid programs. Part of this effort should include the use of outcome measures, such as completion and job placement rates, in recording the performance of such schools (especially those providing proprietary/vocational training).
- Ensuring that the Department expeditiously implements the recommendations contained in the joint OMB/Department study of the program.

- Requiring that independent public accountant audits of lenders and guaranty agencies include: (1) a positive attestation to the claims for payment that these parties submit to the federal government and (2) an opinion on the overall adequacy of the program's internal controls.
- Expediting efforts to develop a comprehensive plan to identify and correct longstanding problems in the Department's financial management of the program.
- Expediting efforts to implement an information resources management strategy and plan that will have as its primary focus improving program data so that these data are more useful, timely, and accurate.
- Proceeding cautiously with the implementation of the direct lending demonstration program to ensure its proper implementation and subsequent evaluation.

Related GAO Products

Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement (GAO/AFMD-93-20, forthcoming).

Student Loans: Direct Loans Could Save Billions in First 5 Years With Proper Implementation (GAO/HRD-93-27, Nov. 25, 1992).

Guaranty Agency Solvency: Can the Government Recover HEAF's First-Year Liquidation Cost of \$212 Million? (GAO/HRD-93-12BR, Nov. 13, 1992).

Guaranteed Student Loans: Prompt Payment of Origination Fees Could Reduce Costs (GAO/HRD-92-61, July 24, 1992).

Guaranteed Student Loans: Eliminating Interest Rate Floors Could Generate Substantial Savings (GAO/HRD-92-113, July 21, 1992).

Stafford Student Loan Program: Correspondence Schools' Loan Volume Declines Sharply (GAO/HRD-92-62FS, Mar. 13, 1992).

Student Financial Aid: Education Can Do More to Screen Schools Before Students Receive Aid (GAO/HRD-91-145, Sept. 27, 1991).

Student Loans: Direct Loans Could Save Money and Simplify Program Administration (GAO/HRD-91-144BR, Sept. 27, 1991).

Student Loans: Characteristics of Defaulted Borrowers in the Stafford Student Loan Program (GAO/HRD-91-82BR, Apr. 26, 1991).

Stafford Student Loans: Millions of Dollars Awarded to Ineligible Borrowers (GAO/IMTEC-91-7, Dec. 12, 1990).

Defaulted Student Loan: Analysis of Defaulted Borrowers at Schools Accredited by Seven Agencies (GAO/HRD-90-178FS, Sept. 12, 1990).

Guaranteed Student Loans: Analysis of Student Default Rates at 7,800 Postsecondary Schools (GAO/HRD-89-63BR, July 5, 1989).

Guaranteed Student Loans: Potential Default and Cost Reduction Options (GAO/HRD-88-52BR, Jan. 7, 1988).

Related GAO Products

Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs (GAO/HRD-87-76, Sept. 30, 1987).

High-Risk Series

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Defense Weapons Systems Acquisition
(GAO/HR-93-7).

Defense Contract Pricing (GAO/HR-93-8).

Department of Energy Contract Management
(GAO/HR-93-9).

Superfund Program Management
(GAO/HR-93-10).

NASA Contract Management (GAO/HR-93-11).

Accountability
Issues

Defense Inventory Management
(GAO/HR-93-12).

Internal Revenue Service Receivables
(GAO/HR-93-13).

Managing the Customs Service (GAO/HR-93-14).

Management of Overseas Real Property
(GAO/HR-93-15).

Federal Transit Administration Grant
Management (GAO/HR-93-16).

Asset Forfeiture Programs (GAO/HR-93-17).

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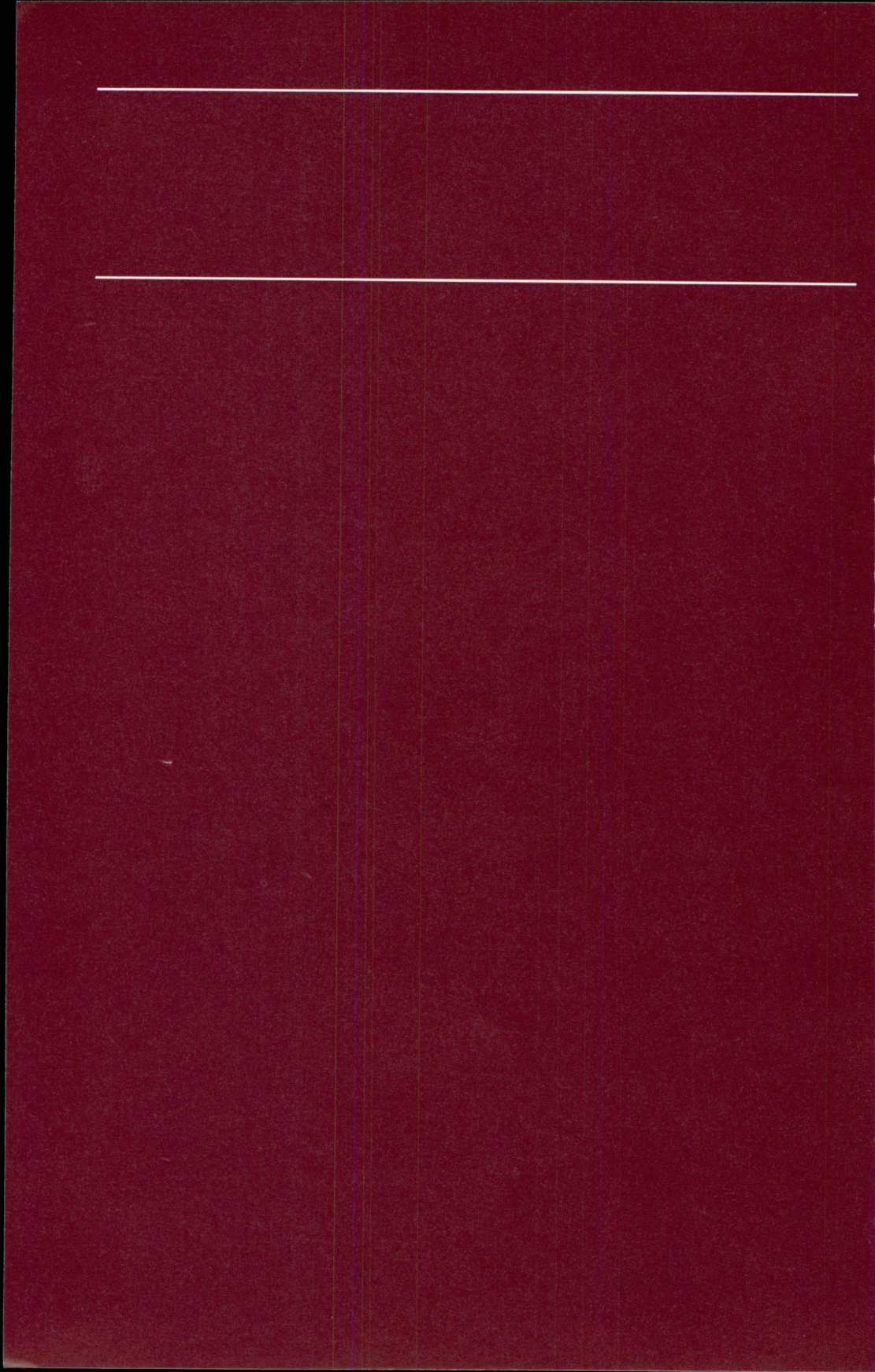
GAO

High-Risk Series

December 1992

Defense Inventory Management







United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

December 1992

The President of the Senate
The Speaker of the House of Representatives

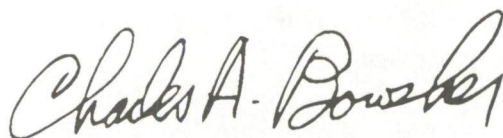
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Department of Defense's management of supplies that support the military services. It focuses on the Department's continued maintenance of high levels of excess inventory and inadequate systems for determining requirements for supplies.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Secretary-designate of Defense.

A handwritten signature in black ink that reads "Charles A. Bowsher". The signature is written in a cursive, flowing style.

Charles A. Bowsher

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Overview

The Department of Defense (DOD) maintains inventories of spare and repair parts, clothing, medical supplies, and other support ("secondary") items costing about \$100 billion. Not only has DOD bought more than it needs, but it has failed to apply standards of economy or efficiency to the purchase, maintenance, and distribution of its inventories. Based on their cost, DOD's excess supplies total about \$40 billion.

The Problem

DOD has wasted billions of dollars on excess supplies, burdened itself with the need to maintain them, and failed to acquire the tools or expertise to manage them effectively.

DOD frequently overestimates its supply requirements and ends up buying too much. The reason is that DOD uses inadequate data, fails to use new techniques that would allow lower inventory levels, and believes that keeping large inventories is the way to ensure always being able to fill orders. Using nonstandard, redundant, and overlapping computer systems, the military services and the Defense Logistics Agency independently buy and manage supplies, leaving DOD to make inventory determinations based on faulty and unintegrated data. In addition,

maintenance of the supplies themselves is inadequate. Weaknesses in DOD inventory records, in-transit controls, computer systems, and physical security programs create rampant opportunities for theft.

The Causes

DOD has traditionally failed to stress the importance of proper inventory management or to provide its personnel with the needed tools and incentives to promote satisfactory performance.

GAO's Suggestions for Improvement

The solution to these problems lies with a shifting of DOD's organizational culture toward economical and efficient inventory practices. Recent reductions in the threats to national security, along with the ensuing decline in defense budgets, demand that DOD reverse its traditional policy of acquiring supplies with insufficient attention to the enormous expense of buying and storing excess inventories.

DOD has begun to address its inventory management problems, but the services continue to develop systems independently, and plans to link the systems are at different stages of development. We believe that DOD must continue to work toward instilling the

appropriate priorities, incentives, and attitudes among its supply managers and users and should consider adopting modern commercial inventory practices that have found success in the private sector. In addition, DOD should develop and implement improved performance measures that stress cost-effectiveness and inventory reduction.

DOD has taken several steps that should help improve inventory management. For example, DOD established a Defense Business Operations Fund, which it plans to use to, among other things, charge customers for the full cost of inventory management, and DOD initiated a Corporate Information Management project that aims to simplify and modernize the services' distribution systems and standardize computer systems. Also, DOD has begun to carry out an inventory reduction plan. However, more needs to be done. At our recommendation, the Congress rescinded \$1 billion in past appropriations for secondary items and reduced the fiscal year 1993 budget request by \$3 billion. Since DOD no longer has sufficient funds to support its long-standing business inefficiencies, it is particularly important that DOD generate improved, accurate inventory data; develop and implement better inventory policies and

Overview

procedures; train supply staff in more effectively managing inventory operations; and bring sustained, high-level commitment to making DOD inventory management more efficient and cost-effective.

Managing DOD's Inventory Presents Challenges

In the 1980s, DOD had abundant funds available to procure secondary items. As a result, DOD now has a huge, widely dispersed inventory that is unnecessarily difficult to manage, expensive to maintain, and highly vulnerable to fraud, waste, and mismanagement. Between 1980 and 1990, the value of DOD's inventory of secondary items increased from \$43 billion to about \$100 billion, based on cost. This inventory includes consumable and repairable items—such as spare and repair parts; clothing; electronics; and medical, construction, and industrial supplies.

Our work over a number of years shows that DOD continued to buy and store items that greatly exceeded its operational and war reserve needs. During the 1980s, DOD's excess, or unrequired, inventory increased at a faster rate than its overall inventory. In 1991, over 40 percent of the inventory of secondary items, or over \$40 billion,¹ exceeded DOD's needs. In many cases, DOD's calculations of operational and war reserve needs were flawed, and as a result DOD purchased unnecessary secondary items.

¹This figure includes \$30 billion worth of unrequired inventory based on cost and \$10 billion worth of inventory DOD categorized as required. Based on its own requirements formulas, however, this \$10 billion in inventory is not needed.

DOD has experienced problems in obtaining accurate data about and controlling its secondary items. In addition, after it identifies and buys spare and repair parts needed to support principal items such as tanks, ships, or aircraft (generally for 2 years), each military service and the Defense Logistics Agency buy, manage, and oversee these types of supplies using their individual systems. Each military component independently determines the type and amount of items needed to support current and planned peacetime operations, and each acquires and positions supplies to meet wartime needs.

Because of the large size of the inventory (\$100 billion) and recurring problems, defense supplies are especially subject to fraud, waste, and mismanagement. Consequently, we and the Office of Management and Budget identified defense inventory management as a high-risk area. To address this concern, DOD created and has begun to implement an inventory reduction plan. In addition, in response to our recommendation to reduce funding for buying secondary items, the Congress rescinded \$1 billion in past appropriations for secondary items and reduced the fiscal year 1993 budget request by \$3 billion. With

the downsizing of the military and the declining defense budget, it is particularly important that DOD generate accurate reports, distribute and implement needed inventory policy and procedures, actively manage inventory, and devote top management attention and commitment to better managing secondary items. DOD is taking steps to reduce inventories, but more needs to be done.

Cost of Unmet
Inventory
Challenge Is
Enormous

According to DOD's own estimate, its unrequired inventory cost over \$30 billion. Unrequired inventory is material that is not supported by requirements. Requirements generally include war reserve stocks and operating stocks to last 2 years. Unrequired inventory is costly because it represents expended taxpayer funds that cannot be fully recovered when these inventories are disposed of and amounts to billions of dollars each year. In addition, it costs to store and handle these inventories.

Our reviews of each service's inventory have shown a larger rate of growth of unrequired than required inventory during the 1980s. Also, much of the inventory DOD had classified as required was actually unrequired. For example, of the \$39.6 billion

in inventory the Navy and the Air Force identified in September 1990 as required, we identified \$10 billion in inventory that exceeded the maximum amount needed on hand or on order, as defined by DOD instructions.

The services had built up their stocks of unrequired secondary items for many reasons. From 1980 to 1988, the Air Force increased its required inventory by 179 percent and its unrequired inventory by 295 percent (from \$2 billion to \$7.9 billion). The increase in unrequired inventory resulted primarily because the Air Force overestimated the rate at which inventory would be used. For example, in 1985 the Air Force used a 20-percent condemnation rate² in the requirements computation for a case assembly for the F-100 engine, which powers the F-15 and F-16 aircraft. By 1987, the condemnation rate used in the requirements computation was 1 percent based on actual historical data.

The Army's unrequired inventory increased by 168 percent between 1983 and 1988, whereas all inventories increased by 96 percent over the same period. The largest increase in the Army's unrequired inventory,

²The "condemnation rate" is the proportion of items needing repair that it is uneconomical to repair.

in terms of dollars, was at the Aviation Systems Command, one of the Army's six commodity commands. Its unrequired inventory increased in value from \$207 million in 1983 to \$804 million in 1988. The Command's unrequired inventory increased for three primary reasons: (1) the Army continued to stock items for systems being phased out, (2) forecasted demands for items often did not materialize, and (3) the data base for computing requirements contained erroneous data. Also, the Army did not reduce or cancel planned procurements when it found it did not need the items.

The Navy's total inventory of ship and submarine parts increased by 249 percent, from about \$2.7 billion in 1980 to \$9.3 billion in 1988. In 1988, 40 percent (\$3.7 billion) of the Navy's inventory was unrequired. The major causes for the unrequired inventory were that requirements for items did not materialize, older ships were deactivated, and equipment was replaced and phased out. We found that the Navy had no formal procedures to notify the Ships Parts Control Center of items being replaced or phased out and recommended that the Navy establish procedures to inform inventory control

points about systems being phased out or replaced.

We also looked at excess inventory held at naval aviation depots. For fiscal years 1987 to 1991, the value of excess inventory ranged from \$40.1 million to \$53.6 million. These large balances remained, even though \$138 million in excess material had been eliminated from depot records through write-offs during these years.

The cost of DOD's excess material should not be measured solely by the costs of acquiring and storing the material. Material that is stored in warehouses may become obsolete or may deteriorate to the point that it is unusable even if it eventually becomes needed. Also, employees faced with materials that are clearly overstocked are more likely to develop a casual attitude about the security and safety of those supplies.

DOD Does Not Use Effective Inventory Management and Control Techniques

For decades, DOD has not effectively managed its inventory. It (1) lacks oversight of all aspects of its inventory and the systems intended to control it, (2) frequently overstates requirements for secondary items and buys excess items, and (3) generally does not ensure that inventory data is accurate or integrated throughout the system and that the inventory is physically protected.

DOD has not kept pace with private industry in updating and streamlining its inventory management practices. At the expense of economy and efficiency, it has overbought secondary items to ensure that it has more than enough supplies. A change in this organizational culture of overbuying and the use of more modern commercial techniques would help DOD to resolve some of its long-standing difficulties in managing its inventory of secondary items.

Oversight of Inventory Is Limited

As we have noted in our reports over the years, the Army, the Navy, and the Air Force have not always given secondary item managers the information they need to ensure that they do not buy duplicate supplies. Army policy, for example, does not require approximately \$900 million in

inventory held by divisions to be included in either Army-wide logistics or accounting systems. As a result, Army item managers responsible for procuring inventory do not know these items are available. In January 1990, we reported that 13 Army divisions were holding excess spare and repair parts worth \$184 million. The divisions had not reported this inventory to the buying commands, which were procuring 1,669 of the same items for \$66.9 million.

The Air Force and the Navy wholesale item managers also have limited information about excess items at retail activities, such as at Air Force and Navy bases. These managers have purchased millions of dollars worth of unneeded items and have missed opportunities to redistribute assets on hand because they were not aware the assets were available. The Air Force wholesale item managers were aware of only \$1.5 million, or about 5 percent, of the \$32.1 million in excess material at retail activities. In addition, three naval aviation depots held over \$3 million in usable items that could have been used to fill supply system orders but were unrecorded on inventory records.

The Office of the Secretary of Defense also has little oversight over inventory as a whole

because the military services and the Defense Logistics Agency have developed and maintained separate data processing systems for common supply management functions. These nonstandard, redundant, and overlapping computer systems seriously impede efficient operations of inventory managers and monitors alike.

Requirements Are
Often Overstated

For years, DOD has experienced problems in determining how much inventory it needs to buy to meet its needs. In a May 1991 summary of 97 reports issued by us and the defense audit agencies over the past 6 years, we cited several reasons for DOD's failure to determine accurate requirements. The primary reason is that DOD maintains inaccurate or unsupported data in its computer systems. Relying on bad data, the services have often overstated requirements by millions of dollars and purchased items they do not need. The lack of accurate data stems from poor management control systems and a lack of oversight.

The Army, for instance, does not exercise enough control over the initial process to acquire spare parts for new systems to ensure that they are fully supported at the least possible cost. According to the Army

Audit Agency, the buying commands frequently acquired and fielded more parts than they needed to support new systems. In addition, DOD has not adequately trained or provided guidance to item managers. In one case, the Air Force did not emphasize the importance of using accurate essentiality codes¹ when computing requirements and thus overstated war reserve requirements by \$19.7 million. Finally, when item managers recognize that items on order are unnecessary, they often fail to cancel the orders because they want to avoid the termination of contracts. As of March 1991, DOD still had orders for excess material worth \$2.5 billion.

Since our summary report in May 1991, DOD either has failed to use available data or has used inaccurate demand rates to compute requirements. The Air Force, for example, ignored forecasting factors submitted by the contractor to determine spare parts for the F-16 C/D aircraft. Consequently, the Air Force prematurely spent \$43 million for spare parts. In addition, the Air Force's five air logistics centers used inaccurate demand

¹The logistics community has long recognized the importance of identifying and measuring the relative merit of maintaining stock of a given item over stocking some other item. Making this differentiation is ordinarily referred to as determining the "essentiality" of an item, and an essentiality code is assigned to each item based on this determination.

rates to buy repairable assets, spending \$93.8 million unnecessarily. The Air Force Inspector General reported that internal controls did not ensure that the air logistics centers did what they needed to do to satisfy requirements.

Improved
Accountability Is
Needed

DOD lacks financial accountability and control over its multibillion dollar inventory because it (1) does not have accurate, reliable data to support the quantity, condition, and value of items and (2) does not have integrated systems to provide accurate data. Without accurate inventory data, DOD cannot ensure that it can meet readiness demands. If DOD does not know what it has available, it cannot know what to order. Generally, the services' records have not been reconciled with contractors' records or by physical inventories. When we took a physical inventory of items at the Air Force Logistics Command, we estimated that 18.3 percent of the records differed from the actual inventory and that the inventory records for items worth \$14.8 billion erred by about \$2.3 billion. In addition, the Army Materiel Command could not resolve differences between its records and contractor records on items worth about \$11.3 billion. At one location, controls were

so poor that instead of attempting to reconcile Army and contractor differences in inventory records, Army officials assumed that any items over 15 months old had been used by the contractor, and they deleted the items from their records. Of the \$12.5 billion spare and repair parts inventory controlled by Army depots, about 35 percent of the recorded quantities were inaccurate by 10 percent or more.

Given the poor records on inventory, it is especially important that DOD physically protect what it has. We, the Federal Bureau of Investigation, and DOD recently reported that the weaknesses in DOD's inventory records, in-transit controls, and physical security programs have created opportunities for theft. Recent criminal investigations documented organized thefts at a defense depot in California, Army depots in Utah and Texas, an Air Force depot in Utah, and a Navy depot in Virginia.

A Change in
Organizational
Culture Is
Essential

To eliminate imbedded inventory management problems, DOD must change its "organizational culture"² to emphasize economy and efficiency. The reduced threat

²"Organizational culture" may be defined as the underlying assumptions, beliefs, values, attitudes, and expectations shared by an organization's members.

to national security and declining defense budgets demand a reversal of DOD's past policy of filling orders with little, if any, emphasis on the enormous expense associated with buying and storing excess items.

We obtained views from experts in the private sector on the techniques they have used in changing or perpetuating an organizational culture. These experts agree that an organization's beliefs and values affect the behavior of its members. According to several of these experts, an organization's decision to change its culture is generally triggered by a specific event or situation. A change in the world situation, international competition, or a severe budget reduction are some events that could provide the impetus for an organizational culture change. For example, the oil shocks of the 1970s and the increase in international, particularly Japanese, competition spurred Ford Motor Company's change in culture.

The experts generally agreed that a culture change is a long-term effort that takes at least 5 to 10 years to complete. Company officials believe that two key techniques are

of prime importance to a successful culture change:

- Top management must be totally committed to the change in both words and actions.
- Organizations must provide training that promotes and develops skills related to their desired values and beliefs.

The companies we visited indicated that effecting a successful culture change would require using a combination of many techniques—not just the two most important. Other techniques, of varying importance, include distributing a written statement of the desired values and beliefs to employees; creating a specific management style that reinforces the desired values and beliefs; offering rewards, incentives, and promotions to encourage behavior that reinforces these beliefs; holding company gatherings to discuss these beliefs; developing an organizational structure that is compatible with these beliefs; using systems, procedures, and processes to support organizational values; and using stories, legends, myths, and slogans to communicate these values and beliefs.

DOD Can Save
Money by
Adopting
Commercial
Practices

In 1991, we issued two reports in which we identified opportunities for DOD to save millions of dollars by adopting commercial practices. In each case, we compared private sector practices to specific segments of DOD logistics operations.

For example, we noted that DOD could save millions of dollars by adopting practices the private sector has used to minimize unnecessary expenses. Commercial airlines, for example, are relying more heavily on manufacturers' parts distribution systems to provide engines and spare parts when needed. They also use either a manufacturer or an outside contractor for maintenance services until the reliability of engines is proven through several years of use. The Air Force, on the other hand, bought excess F-108 engines and spare parts worth millions of dollars and acquired excess engine maintenance facilities and equipment to support the F-108 engine, which is commercially derived.

We also found that progressive civilian hospitals have obtained drastic reductions in inventories through improved ordering systems, the use of prime vendors, the standardization of supplies, and better communication with vendors. Vanderbilt

University Medical Center, for example, reduced inventory levels by \$1.7 million, or 38 percent. In contrast, DOD holds vast amounts of medical supplies that are expensive to maintain and often become obsolete before they can be used. DOD hopes to reduce its medical inventory levels by 60 percent in the next 5 years. However, DOD needs to explore the possibility of developing "quick response," "just-in-time," and "stockless" delivery systems in additional areas.

The following are examples of old medical inventory we found when looking at the medical logistics system:

- The Defense Logistics Agency depots were holding about 50,000 packages of radiopaque sponges dated from 1973 to 1980. The Agency issues about 11 packages of these sponges daily, which equates to approximately 13 years of inventory on hand. The Army and the Navy owned approximately 1,500 of these items for wartime purposes. For Operation Desert Storm, the Agency issued 580 packages of radiopaque sponges and almost 100,000 packages of a new sponge that is not radiopaque.

- The same warehouse also held about 5,100 robes packed in 1952 and 1967. A newer robe has been bought, but the older robes, owned by the Army and the Navy, were being kept for wartime purposes. However, Agency records indicated that none of these older robes were issued for use during Operation Desert Storm.
- The warehouse also stored many other items not commonly requested by the services. In total, approximately 25 percent of the line items held in this building were over 10 years old, and over 40 percent were at least 5 years old. The oldest item we observed was a patient jacket from 1945. Defense Logistics Agency depots were storing 29,474 of these jackets, which were packed from 1945 to 1983. The depot at Mechanicsburg, Pennsylvania, stored approximately 6,700 jackets, of which about 85 percent were dated from 1945 and 1969. The depots issued about one of these jackets a week.

Outcome of DOD Initiatives Is Uncertain

DOD recognizes that changes to its business processes are essential. In the last few years, DOD has implemented a number of initiatives that appear to be steps in the right direction for improving inventory management. DOD has much to gain and little to lose by making a major effort now to deal with the long-standing deficiencies in its inventory management systems. Through the Corporate Information Management project, DOD plans to modernize and simplify the military services' distribution systems and standardize computer systems in functional areas such as logistics. Of the \$36 billion savings expected from the project by 1997, approximately half is to be derived through improvements to material management business processes. Also, the establishment of the Defense Business Operations Fund has helped focus DOD on the need to operate its inventory in a more businesslike manner.

Although the Corporate Information Management project is DOD's best hope for attaining the modern computer systems needed to improve inventory management, in the 3 years since it began, the initiative has met with limited success. The logistics portion of the project has been restructured because of problems in making it work. In fiscal year 1992, DOD established the Joint

Logistics Systems Center to integrate the services' logistics policies, procedures, and systems and has recently begun to describe how it plans to streamline its business methods.

DOD is also focusing on automating the existing transportation systems part of the supply chain. However, it is not determining the best, most cost-effective means of resolving transportation problems. As a result, it has spent millions developing redundant transportation systems. DOD lacked accountability for most of the supplies returned to the United States after Operation Desert Storm and therefore jeopardized the safe delivery of supplies worth millions of dollars. Furthermore, DOD does not know how much defense property has been lost or stolen while being transported throughout the continental United States.

Many of the new automated systems will not be implemented for a number of years, while other critical systems have yet to be selected. In the meantime, the services continue to develop separate computer systems. Unless DOD carefully evaluates each of these systems, it runs the risk of wasting time and money on old, inefficient business

methods. More important, it will be doing little to attain the computer systems needed to improve the management and movement of its inventory. While the new automated systems are being designed and developed, DOD will have to continue to rely on existing systems and information for decision-making. During this time it is important that DOD place greater emphasis on improving the data accuracy and operations of the existing systems. This undertaking will require dedicated leadership and cooperation at all levels throughout DOD if savings and efficiencies are to be realized.

Aside from the Corporate Information Management project, DOD has various other initiatives aimed at cost awareness in its business practices. These initiatives, including the financing of repairable inventory items in the stock fund and the establishment of the Defense Business Operations Fund, are aimed at charging the military units the full cost of all inventory items and services provided to them. Previously, when military units needed inventory items, they received the items without paying for them or they did not pay the full cost of the items. The practice of charging the military units full inventory costs should help provide financial discipline

because the units will budget and pay for the items and be accountable for the management and control of the items. Also, this practice should save money by providing the military units incentives to replace items only when necessary. Under another of DOD's initiatives, each service will pay the full cost of storing, handling, and transporting inventory it orders.

DOD also has a plan to reduce inventory, including an aggressive program for disposing of excess inventory. In addition, for 1992, the Congress limited the replacement of inventory to \$0.80 for each \$1.00 in sales. For fiscal year 1993, the Congress has set the limit at 65 percent of sales. Finally, the financial statement audits required by the Chief Financial Officers' Act encourage fundamental improvements.

Conclusions and Action Needed

Although DOD is taking steps to manage its inventory effectively and economically, major changes are needed at all levels of the inventory system. These changes will translate into significant savings. To achieve these savings, however, DOD's top management will need to (1) change its organizational culture to eliminate the overstocking of items, (2) rapidly increase the use of commercial practices where commercial supply and distribution systems are well established, (3) put in place and monitor improved performance measures that stress cost-effectiveness and inventory reduction, and (4) improve its computer systems to accurately reflect inventory and requirements information. Item managers will need to stop buying items too far in advance, terminate orders for unneeded materials, and clear the warehouses of old, obsolete, and unneeded items.

DOD no longer has sufficient funds to support its long-standing business inefficiencies. Now is the time to make a major effort to improve its supply chain management practices. Although the Corporate Information Management project and establishment of the Defense Business Operations Fund are steps in the right direction, even under the best of

circumstances, they will not achieve their intended objectives for several years. In the meantime, to realize savings now, DOD must take the following steps:

- Continue its commitment to improving its inventory management operations by (1) developing and using inventory performance indicators that stress cost-effectiveness, such as the inventory turnover rate and the time it takes to deliver an item to a customer once an order has been placed; (2) incorporating these indicators in monthly reports to top management; and (3) providing training to staff on the use of these performance indicators.
- Improve the accuracy of the data used in determining the amount and type of inventory to buy from contractors so that cost-effective decisions are made. This would include improving the accuracy of the data on (1) the amount of inventory on hand and (2) the amount of inventory used by military activities and units.
- Direct the military activities and units to comply with existing policies and procedures, for example, to perform periodic physical inventories, employ

adequate physical safeguards over inventory, and document adjustments made to the logistical and financial records.

- Improve the accuracy of the data on the quantity, condition, and value of inventory in the existing inventory management systems.

DOD can also realize savings through the closure of supply depots under the 1993 base closure and realignment process. In previous reports, we have suggested actions that will prepare DOD to select depots for closure or consolidation and to create a modern supply system that takes advantage of the latest logistics concepts.

Reductions in force structure and associated operating tempos are translating into reduced demands on the inventory system. Some supplies are being returned to the system as bases are closed. These supplies take longer to process than new supplies, present unique problems, and could impede DOD's inventory reduction efforts. Close congressional oversight is needed to sustain the momentum for reducing inventories and to require DOD's top management to continue its focus on this issue.

Related GAO Products

Defense ADP: Corporate Information Management Must Overcome Major Problems (GAO/IMTEC-92-77, Sept. 14, 1992).

Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82, Aug. 7, 1992).

Air Force ADP: Status of Logistics Modernization Projects and CIM Impacts (GAO/IMTEC-92-66, July 30, 1992).

Navy Supply: Excess Inventory Held at the Naval Aviation Depots (GAO/NSIAD-92-216, July 22, 1992).

Defense Transportation: Ineffective Oversight Contributes to Freight Losses (GAO/NSIAD-92-96, June 18, 1992).

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Organizational Culture: Techniques Companies Use to Perpetuate or Change Beliefs and Values (GAO/NSIAD-92-105, Feb. 27, 1992).

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