United States General Accounting Office

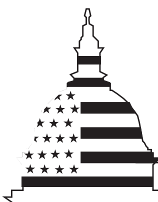
GAO

Report to the Chairman and Ranking Minority Member, Special Oversight Panel on Morale, Welfare, and Recreation, Committee on Armed Services, House of Representatives

August 2001

DEFENSE MANAGEMENT

Better Guidance Needed in Selecting Operating Methods for Name-Brand, Fast-Food Restaurants



G A O

Accountability * Integrity * Reliability

GAO-01-683

Contents

Letter 1

Results in Brief 3
Background 5
The Indirect Method Has Been More Profitable for the Exchange Services 7
Factors Other Than Profitability Are Important When Choosing an Operating Method 16
DOD's Policy Lacks Guidance for Evaluating Operating Methods and Criteria for Approving Deviations From the Policy 20
Conclusion 22
Recommendation for Executive Action 22
Agency Comments 23

Appendix I **Scope and Methodology** 25

Appendix II **Fiscal Year 1999 Inventory of AAFES and NEXCOM Fast-Food Restaurants** 32

Appendix III **Comments From the Department of Defense** 33

Appendix IV **Staff Acknowledgments** 36

Glossary 37

Tables

Table 1: Fiscal Year 1998 and 1999 AAFES and NEXCOM Hamburger Restaurants' Profitability (For the Periods Feb. 1, 1998 – Jan. 31, 1999, and Feb. 1, 1999 – Jan. 31, 2000) 8
Table 2: Profitability of Name-Brand, Hamburger Restaurants by Sales Volume 11
Table 3: Profitability of Name-Brand, Hamburger Restaurants by Restaurant Type 11

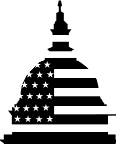
Table 4: Profitability of Name-Brand, Hamburger Restaurants by Location 12
Table 5: 20-Year Net Present Value of Discounted Cash Flows for the Direct and Indirect Methods – Free-standing and Food Court Name-Brand, Hamburger Restaurants (Fiscal Years 1998 and 1999) 13
Table 6: Factors That Benefit the Direct and Indirect Methods 16

Figure

Figure 1: Military Exchanges' Food Sales for Fiscal Year 1999 6

Abbreviations

AAFES	Army and Air Force Exchange Service
DOD	Department of Defense
NEXCOM	Navy Exchange Service Command
MCCS	Marine Corps Community Services
MWR	morale, welfare, and recreation



United States General Accounting Office
Washington, DC 20548

August 24, 2001

The Honorable Roscoe G. Bartlett
Chairman
The Honorable Robert A. Underwood
Ranking Minority Member
Special Oversight Panel on
  Morale, Welfare, and Recreation
Committee on Armed Services
House of Representatives

The military exchange services operate a wide range of retail activities such as department stores, florist shops, barber and beauty shops, gasoline stations, and restaurants. Profits from these activities provide funds for the Department of Defense's (DOD) morale, welfare, and recreation programs. In recent years, the exchange services' annual sales exceeded $9 billion—in fiscal year 1999 about $734 million involved food operations.[1] About 50 percent of the food sales came from about 615 name-brand, fast-food restaurants (e.g., McDonald's, Burger King, Subway, and Pizza Hut) operating on military installations around the world. Name-brand, fast-food restaurant operations, particularly hamburger restaurants, are the topic of this report. It focuses on hamburger restaurants because they represent a major segment of the exchange services' name-brand, fast-food sales and because exchange services' contracts with two large companies, Burger King and McDonald's, will expire in 2004.

The exchange services use either a direct or an indirect method to operate name-brand, fast-food restaurants. A DOD policy, issued in 1988, expresses a preference for the direct method at overseas installations and the indirect method at U.S. installations. Under the direct method, the exchange service enters into a franchise agreement with a name-brand company to sell its product on a military installation. As the franchisee, the exchange service builds and operates the restaurants and directly employs and trains the personnel. In return, the exchange service receives all revenues and profits and usually pays the company a licensing fee plus a

[1] The sales total includes sales from activities operated by the exchange service and from activities operated by concessionaires under contract with the exchange services, which include some food operations.

percentage of the restaurant sales. Under the indirect method, the exchange service contracts with a name-brand company that, in turn, builds the restaurant and either operates it as a company restaurant or provides a licensed operator. The company or its licensed operator hires, trains, and pays the restaurant personnel and usually pays annual fees and commissions to the exchange service based on restaurant sales. Under this arrangement, the exchange service receives a percentage of the restaurants' annual sales, annual licensing fees, and, in some cases, a signing bonus and/or minimum guaranteed commissions. The size of the bonus and guaranteed payments are determined through negotiations. With respect to name-brand, hamburger operations, the Army and Air Force Exchange Service uses the direct method to operate most of its hamburger restaurants, which are primarily Burger King, while the Navy Exchange Service Command uses the indirect method to operate most of its restaurants, which are primarily McDonald's.

In June 2000, representatives of the largest exchange service, the Army and Air Force Exchange Service, briefed a member of the House Special Oversight Panel on the profitability of the direct and indirect methods of operating name-brand, fast-food restaurants on military installations. Because the briefing did not address all of the Panel member's questions about the costs and profitability of the two methods, the former Chairman and Ranking Minority Member of the Special Oversight Panel asked us to review the two methods. This report discusses (1) which method is more profitable[2] and provides the greater return on investment; (2) other factors that can influence the choice between the direct and indirect methods; and (3) whether DOD's policy on name-brand, fast-food operations provides adequate guidance for determining which method to use.

Our analysis of profitability and return on investment compared only the name-brand, hamburger restaurants operated by the two largest exchange services—the Army and Air Force Exchange Service and the Navy Exchange Service Command. Sales from these restaurants, primarily

[2] In this report, the terms "profit" and "profitability" refer to economic earnings for the direct method of operation or net profit for the indirect method of operation. Throughout this report, profits and profitability are expressed as a percentage of restaurant sales. Profitability under the direct method represents a restaurant's total revenues less its operating costs, overhead costs, and the opportunity cost associated with invested capital (also known as cost of capital). Profitability under the indirect method represents the revenues (sales commissions, signing bonuses, and licensing fees) received from the name-brand company less the exchange service's overhead costs. Profitability and cost of capital are discussed in more detail in appendix I.

Burger King and McDonald's, represented about 50 percent of the exchange services' total name-brand, fast-food sales in fiscal years 1998 and 1999, the 2 years that formed the basis of our analysis.[3] Our analysis of profitability involved and relied on information provided to us by the exchange services. We performed procedures to evaluate the reasonableness of the exchange services' data but did not verify its accuracy or reliability. More information on the scope and methodology of our work is included in appendix I.

Results in Brief

Our analysis of fiscal year 1998 and 1999 financial data from the two exchange services showed that the indirect method of operating name-brand, hamburger restaurants was more profitable than the direct method. In each of the 2 years, for example, the Navy Exchange Service Command's profits were about 11.5 percent of restaurant sales. In comparison, the Army and Air Force Exchange Service's profits were 7.8 percent and 5.5 percent of restaurant sales, respectively. The indirect method was also more profitable, regardless of the restaurants' sales volume, restaurant type (free-standing or part of a food court), or location (continental United States or overseas). Also, our investment analysis projected that if new name-brand, hamburger restaurants were to be built, the indirect method would provide a greater return on investment over a 20-year period.[4]

Profitability or return on investment, however, has not always been the deciding factor when military exchanges select an operating method for fast-food restaurants. Other factors (e.g., financial and operating risks, customer service issues, employment opportunities for military dependents, and management control of restaurant operations) were also important in choosing between the direct and indirect methods. Officials of the Army and Air Force Exchange Service said that the direct method best suits their mission objectives because the exchange can directly operate unprofitable restaurants in remote locations or overseas for the purpose of maintaining or boosting servicemembers' morale. Name-brand

[3] In general, the fiscal year for the exchange services covers the period from February 1st of a given year to January 31st of the following year. This period is consistent with the fiscal year used by the retail industry.

[4] The investment analysis was based on present value techniques that consider variables such as sales, costs, capital investment requirements, and inflation rates. In essence, the analysis compared discounted cash flows, both outlays and revenues, expected over a 20-year period. This analytical technique is discussed in more detail on p. 12 and in appendix I.

companies operating under the indirect method are not likely to build and operate restaurants in such dangerous or unprofitable locations. The direct method also provides the exchange service with greater management control over restaurant operations and more flexibility in providing employment opportunities to military dependents. In addition, the direct method allows the Army and Air Force Exchange Service to take advantage of its existing infrastructure (i.e., warehousing and distribution capabilities) to support rapid mobilizations to such locations as Bosnia. On the other hand, the indirect method requires very little, if any, investment. The Navy Exchange, for example, has no capital invested in its 64 restaurants, which were built by a name-brand, food service company, while the Army and Air Force Exchange Service has invested over $131 million in its 171 hamburger restaurants. The indirect method also minimizes the potential liabilities and risks associated with operating restaurants and reduces the federal government's competition with the private sector, which is one of the objectives of the Department's fast-food policy.

While DOD's policy on name-brand, fast-food restaurants establishes preferences for when the direct and indirect methods should be used, it does not provide sufficient guidance or criteria for determining which method to use or when it is appropriate to deviate from the policy. In addition, DOD has not been actively involved in monitoring compliance with the policy. As a result, the exchanges have, over time, adopted operating philosophies and business models that they believe best suit their particular circumstances. Because of the exchanges' preferences and operating philosophies, they do not routinely develop a business case analysis, which would include weighing financial benefits with other factors, when determining which operating method would be the most beneficial. However, a 1998 departmental instruction, which addresses public-private ventures, has the potential to give greater visibility to this issue.[5] The instruction requires the exchange services to consider public-private ventures as an alternative source to meet capital requirements that exceed $1 million. Each public-private venture requires an economic analysis. Also, it is to be reviewed by DOD policy officials when it involves an overseas restaurant or liabilities to the government or

[5] A public-private venture, as used here, is an agreement between a DOD nonappropriated fund activity, such as an exchange service, and a non-federal entity under which the entity provides goods, services, or facilities to authorized morale, welfare, and recreation activities and exchange patrons. The non-federal entity may provide a portion or all of the financing, design, construction, equipment, and staffing associated with the activity.

a nonappropriated fund activity in excess of $500,000. Thus far, however, the instruction has had no impact on the exchange services' restaurant operations because contracts for most name-brand, fast-food restaurants were in place before the instruction was issued. Moreover, it is not yet clear how the instruction will be integrated with DOD's name-brand, fast-food policy.

We are making recommendations to improve the Department of Defense's policy for operating name-brand, fast-food restaurants by clarifying when deviations from the policy can occur and by developing a more formal decision-making process for choosing between the direct and indirect methods of operation. In written comments on a draft of this report, DOD concurred with our conclusions and recommendations.

Background

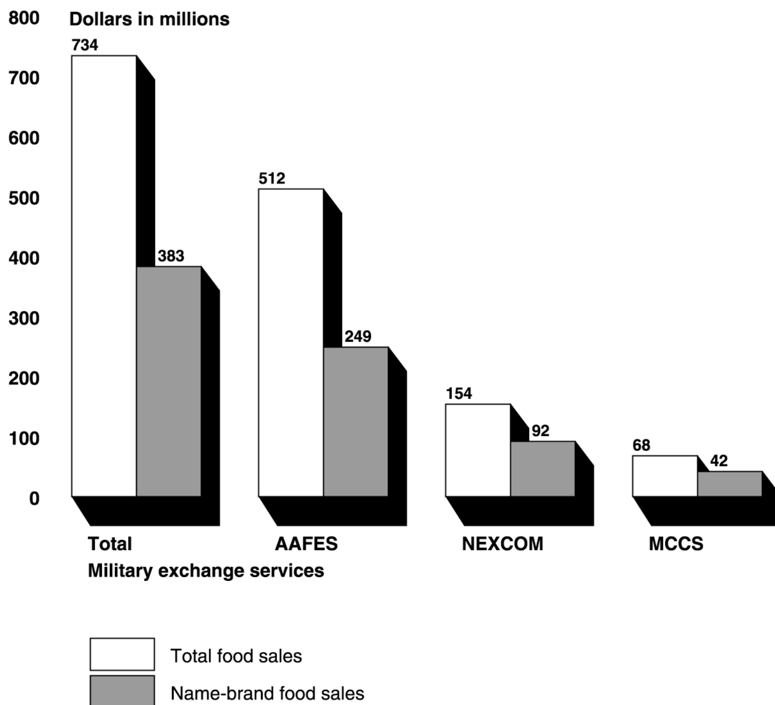
The military exchanges are nonappropriated fund activities that are established, controlled by, and operated for the benefit of DOD components. Their mission is to provide (1) authorized patrons with articles and services necessary for their health, comfort, and convenience and (2) DOD's morale, welfare, and recreation (MWR) programs with a source of funding. In carrying out this dual mission, the exchanges operate retail stores, similar to department stores, and provide a host of other services and specialty stores, including furniture stores, florist shops, barber and beauty shops, optical shops, liquor stores, and fast-food restaurants. For fiscal year 1999, the exchange services had over $9 billion in sales. For the past several years, about 70 percent of the exchange services' profits from sales were allocated to MWR activities and about 30 percent to new exchange facilities and related capital projects.

Military exchange services' food operations generated about $734 million in sales during fiscal year 1999, or about 8 percent of the exchanges' total sales. The sales occurred at about 2,200 food outlets operated by three military exchanges—the Army and Air Force Exchange Service (AAFES), the Navy Exchange Service Command (NEXCOM), and the Marine Corps Community Services (MCCS).[6] These outlets, located on military installations around the world, included name-brand, fast-food restaurants, in-house signature brand restaurants, and more generic food operations such as cafeterias and snack bars. As shown by figure 1, over

[6] AAFES and NEXCOM operate as separate nonappropriated fund entities. Exchange operations that support the Marine Corps are combined with all MWR activities and are managed by MCCS. Sales totals presented in the background section of this report include restaurants managed by MCCS as well as the other exchange services.

50 percent of the $734 million in sales came from name-brand, fast-food outlets.

Figure 1: Military Exchanges' Food Sales for Fiscal Year 1999



Source: GAO analysis of AAFES, NEXCOM, and MCCS financial data.

Modern name-brand, fast-food restaurants began to appear on military installations in the early 1980s. In 1984, the Burger King Corporation and AAFES signed a 20-year, master contract authorizing AAFES to construct and operate 185 Burger King restaurants around the world. Each Burger King restaurant has a separate contract consistent with the terms of the master contract. Also in 1984, NEXCOM awarded a 10-year, master contract to McDonald's Corporation. This contract, which was recompeted and renewed in 1994, allowed McDonald's to construct and operate restaurants at more than 40 locations around the world. Both Burger King and McDonald's contracts will expire in 2004.

Today, other national brands, such as Baskin Robbins, Kentucky Fried Chicken, Pizza Hut, Popeye's Chicken & Biscuits, Subway, Taco Bell, and Wendy's, can also be found on military installations. (See app. II for the number of facilities and sales totals for AAFES and NEXCOM fast-food

operations.) Fast-food restaurants are generally categorized by their location, size, and/or physical characteristics. A free-standing restaurant is often referred to as a traditional or stand-alone restaurant—it is located in a separate, distinct building with signage and logos that clearly identify its brand. A restaurant located in a food court is often referred to as a non-traditional or in-line restaurant. Free-standing restaurants are usually larger in size and have higher sales volumes than those found in food courts.

The Assistant Secretary of Defense (Force Management) is responsible for establishing uniform policies for armed services exchange operations.[7] In that capacity, the Assistant Secretary issued a policy memorandum for name-brand, fast-food operations in January 1988. The policy memorandum, which responded to recommendations from the House Committee on Armed Services, was issued to control the proliferation of fast-food restaurants on military installations and avoid a "fast-food strip" effect, award business to American investors, and ensure that name-brand, fast-food prices on military installations in the United States were comparable to those in communities adjacent to the military installation. The memorandum stated that the policy would be strictly followed and any deviations had to be approved in writing by the Assistant Secretary. However, the memorandum provided no criteria for approving a deviation. In addition, the primary armed services regulations governing MWR activities and the exchange services give the secretaries of the military services a stake in prescribing and overseeing the activities that can operate on their facilities, including the method that will be used to operate fast-food restaurants.[8]

The Indirect Method Has Been More Profitable for the Exchange Services

Our analysis of fiscal year 1998 and 1999 financial data showed that the indirect method of operating name-brand, hamburger restaurants provided greater profitability than the direct method. This was true regardless of whether the restaurants were grouped and analyzed by sales volume, restaurant type (stand-alone or part of a food court), or location (continental United States or overseas). We also projected that if new

[7] The Assistant Secretary reports to the Under Secretary (Personnel and Readiness) who, in turn, reports to the Deputy Secretary of Defense.

[8] DOD Directive 1015.1, Establishment, Management, and Control of Nonappropriated Fund Instrumentalities, dated April 8, 1986, and DOD Directive 1330.9, Armed Services Exchange Regulation, dated December 15, 1986.

name-brand, hamburger restaurants were to be built, the indirect method would result in a higher return on investment over a 20-year period. In conducting our analyses, we found that the exchange services had appropriately considered the various types of costs of their fast-food operations, except for overhead. We included overhead costs and the cost of capital in our analyses.

Financial Analyses Show That the Indirect Method Provided Greater Profitability

For fiscal years 1998 and 1999, NEXCOM's profits on 64 indirectly operated hamburger restaurants were about 11.5 percent and 11.4 percent, respectively, when measured as a percentage of total sales. Over the same period, AAFES' profits on 164 and 171 directly operated hamburger restaurants were 7.8 and 5.5 percent, respectively. Table 1 provides the results of our analysis.

Table 1: Fiscal Year 1998 and 1999 AAFES and NEXCOM Hamburger Restaurants' Profitability (For the Periods Feb. 1, 1998 – Jan. 31, 1999, and Feb. 1, 1999 – Jan. 31, 2000)

Dollars in thousands

	Fiscal year 1998				Fiscal year 1999			
	AAFES' direct method		NEXCOM's indirect method		AAFES' direct method		NEXCOM's indirect method	
	Total	Percent of sales	Total	Percent of sales	Total	Percent of sales	Total	Percent of sales
Number of restaurants	164		64		171		64	
Total sales	$ 183,985	100.0	$ 66,392	100.0	$176,435	100.0	$ 67,430	100.0
Total revenues[a]	184,336	100.2	8,006	12.1[b]	176,632	100.1	8,121	12.0[b]
Operating costs[c]	155,653	84.6	N/A[d]	N/A[d]	152,555	86.5	N/A[d]	N/A[d]
Overhead costs	9,015	4.9	359	0.5	9,051	5.1	421	0.6
Net profit	19,668	10.7	7,648	11.5	15,026	8.5	7,700	11.4
Cost of capital[d]	5,358	2.9	N/A[e]	N/A[e]	5,354	3.0	N/A[e]	N/A[e]
Economic earnings	$ 14,310	7.8	$ 7,648	11.5	$ 9,672	5.5	$ 7,700	11.4

Note: Figures may not total due to rounding.

[a]Revenues under the direct method include restaurant sales plus other income, which is primarily the proceeds from selling surplus equipment and additional revenue realized in overseas locations from foreign currency conversions at the point of sale. Revenues under the indirect method are commissions based on restaurant sales plus licensing fees and signing bonuses.

[b]An alternative way of expressing NEXCOM's profitability would be as a percentage of total revenues. Revenues under the indirect method are not restaurant sales but are payments (sales commissions, signing bonuses, and licensing fees) to an exchange service from the name-brand, fast-food company based on restaurant sales. If expressed as a percentage of revenues, NEXCOM's profits would be 95.5 and 94.8 percent, respectively, for fiscal years 1998 and 1999.

[c]Operating costs include the cost of goods sold and depreciation.

[d]Cost of capital represents the opportunity cost (or economic cost) associated with alternative uses for invested capital of comparable risk. For AAFES, this would include funds invested in buildings and equipment (including periodic renovations and upgrades) and inventory. AAFES used a cost of capital of 10 percent for both fiscal years. We applied a cost of capital charge to the average inventory value and the undepreciated value of assets associated with AAFES' Burger King restaurants.

[e]N/A is being used to note that, under the indirect method, NEXCOM does not have operating costs or a cost of capital. These costs are borne by the name-brand, fast-food company or restaurant operator.

Source: Our analysis of AAFES and NEXCOM fiscal year 1998 and 1999 financial data.

Although the table does not show major differences in results between fiscal years 1998 and 1999, we have several observations about the profitability of the two alternatives.

- For servicemember morale purposes, AAFES operates a number of unprofitable Burger King restaurants in remote locations and overseas. In fiscal year 1999, for example, 56 of its 171 Burger King restaurants lost a combined $2.7 million. Eliminating these 56 restaurants from our analysis showed that the remaining 115 restaurants had profits of 9.2 percent of restaurant sales—this compares more favorably with NEXCOM's 11.4 percent for that year.
- AAFES' overhead rates (4.9 percent and 5.1 percent of sales) were significantly higher than NEXCOM's (0.5 percent and 0.6 percent of sales) because of the different operating method. AAFES' overhead rates captured the numerous support activities needed to manage the large infrastructure, distribution network, and personnel associated with the exchange's operations. NEXCOM, on the other hand, had only a small number of support personnel to oversee its contracts with McDonald's.
- NEXCOM's revenues under the indirect method were derived from one-time signing bonuses, minimum guarantees, and annual licensing fees as well as commissions on restaurant sales. Signing bonuses and licensing fees accounted for approximately 25 percent of the revenues.
- Neither AAFES nor NEXCOM had established overhead rates for its restaurant operations. Therefore, we used the AAFES exchangewide rates, which are the rates AAFES applied to its overall operations for each of the 2 fiscal years. In response to our review, NEXCOM computed overhead rates that showed its limited support costs for overseeing its food service contracts.
- AAFES applied a 10-percent cost of capital to its restaurant operations, which, when measured as a percentage of sales, was 2.9 and 3.0 percent, respectively, for fiscal years 1998 and 1999. Because NEXCOM relies on McDonald's and its licensed operators to build and periodically renovate the restaurant facilities, it had no capital costs.

- AAFES' restaurant sales decreased about 4 percent between fiscal year 1998 and 1999 while its operating costs, as a percentage of sales, increased about 2 percent. These changes did not appear to be related to the method used to operate the restaurants.
- Both AAFES and NEXCOM rely on the military services for certain real property maintenance activities, particularly for repairs to the exterior of the restaurant building and the surrounding property. The exchanges, however, did not show these costs, and they were not readily available from the military services. In addition, both exchanges received similar support, which would tend to mitigate the cost impact on relative profitability. Therefore, we did not include them in our analysis.

Indirect Method Was More Profitable Under Various Scenarios

As part of our analysis, we evaluated the profitability of both methods from several perspectives—by sales volume, restaurant type (free-standing or food court), and location (continental United States or overseas). Each analysis showed that the indirect method was more profitable.

- Profitability by Sales Volume: We arrayed AAFES' directly operated and NEXCOM's indirectly operated restaurants by annual sales volumes. As shown in table 2, the profitability of both types of restaurants improved as sales volumes increased. However, NEXCOM's profits measured as a percentage of sales were higher than AAFES' in all categories for both fiscal years. For some categories, such as sales over $500,000 but less than $1 million, they were more than twice as high. For example, in fiscal year 1998, AAFES' restaurants had profits of 3.0 percent of sales while NEXCOM's restaurants had profits of 6.6 percent of sales. AAFES' profitability was negatively affected by a large number of smaller restaurants that lost money in fiscal years 1998 and 1999. In 1999, for example, 44 of its 97 restaurants with sales under $1 million lost money. As table 2 shows, AAFES' restaurants with sales of $500,000 or less lost 3.1 percent of sales and 1.7 percent of sales for fiscal years 1998 and 1999, respectively.

Table 2: Profitability of Name-Brand, Hamburger Restaurants by Sales Volume

Sales volume	Fiscal year 1998: AAFES' direct method (profits expressed as percent of sales)	Fiscal year 1998: NEXCOM's indirect method (profits expressed as percent of sales)	Fiscal year 1998: Difference	Fiscal year 1999: AAFES' direct method (profits expressed as percent of sales)	Fiscal year 1999: NEXCOM's indirect method (profits expressed as percent of sales)	Fiscal year 1999: Difference
$0 to $500,000	-3.1[a]	2.4	5.5	-1.7[a]	2.4	4.1
Over $500,000 to $1 million	3.0	6.6	3.6	0.9	6.8	5.9
Over $1 million to $1.5 million	7.7	10.8	3.1	6.6	11.5	4.9
Over $1.5 million	10.9	15.0	4.1	9.0	14.8	5.8

[a]These percentages are preceded by a minus sign to indicate that AAFES' restaurants in this sales volume category collectively lost money in both 1998 and 1999.

Source: Our analysis of AAFES and NEXCOM financial data.

- Profitability by Restaurant Type: Both AAFES and NEXCOM operate traditional or free-standing hamburger restaurants and smaller non-traditional or food court type restaurants. As shown in table 3, free-standing restaurants, which tend to have higher sales volumes, were more profitable than restaurants located in a food court. NEXCOM's average profits, however, were higher in both fiscal years for each type of restaurant.

Table 3: Profitability of Name-Brand, Hamburger Restaurants by Restaurant Type

Restaurant type	Fiscal year 1998: AAFES' direct method (profits expressed as percent of sales)	Fiscal year 1998: NEXCOM's indirect method (profits expressed as percent of sales)	Fiscal year 1998: Difference	Fiscal year 1999: AAFES' direct method (profits expressed as percent of sales)	Fiscal year 1999: NEXCOM's indirect method (profits expressed as percent of sales)	Fiscal year 1999: Difference
Free standing	9.1	12.4	3.3	6.6	11.9	5.3
Food court	2.6	8.2	5.6	2.0	9.8	7.8

Source: Our analysis of AAFES and NEXCOM financial data.

- Profitability by Location: About 60 percent of AAFES' restaurants and 80 percent of NEXCOM's restaurants are located within the continental United States. As shown in table 4, NEXCOM's indirectly operated restaurants were more profitable, regardless of their location. The biggest difference in profitability, however, was in restaurants located outside the continental United States. In fiscal year 1999, for example, the 69 overseas restaurants operated directly by AAFES had profits that averaged about 2 percent of sales, or $21,000 per restaurant. Almost half of its overseas restaurants, which were located in various

countries around the world, lost money in 1999. On the other hand, NEXCOM's 12 overseas restaurants had average profits of about 14 percent of sales, or about $224,000 per restaurant.

Table 4: Profitability of Name-Brand, Hamburger Restaurants by Location

	Fiscal year 1998			Fiscal year 1999		
Location of restaurant	AAFES' direct method (profits expressed as percent of sales)	NEXCOM's indirect method (profits expressed as percent of sales)	Difference	AAFES' direct method (profits expressed as percent of sales)	NEXCOM's indirect method (profits expressed as percent of sales)	Difference
United States	9.3	10.2	0.9	7.9	10.4	2.5
Overseas	5.6	15.3	9.7	2.0	14.0	12.0

Source: Our analysis of AAFES and NEXCOM financial data.

Investment Analysis Projected That the Indirect Method Would Provide a Greater Return on Investment if New Restaurants Were Built

In addition to our profitability analysis of fiscal year 1998 and 1999 financial data, we performed a 20-year, cash flow analysis for a capital investment in a new name-brand, hamburger restaurant. This analysis showed that the indirect method would produce about twice the net cash flow, in current-year dollars, as the direct method. A recent Army consultant's study reached a similar conclusion.

A cash flow analysis is a technique that is sometimes used at the beginning of a project to assess investment alternatives or strategies. Net present value techniques can show, in today's dollars, the relative net cash flow of various alternatives over a long period of time—in the case of our study, 20 years. Simply stated, net cash flow is the amount of dollars that is left after sales or revenues have offset expenses. In general, the greater the net cash flow for a particular investment, the greater the return on the investment. In conducting this analysis, we combined the fiscal year 1998 and 1999 data for both AAFES and NEXCOM and calculated average annual sales, net profit, and depreciation per restaurant for free-standing and food court restaurants. In conducting our analysis, we assumed that the financial data would remain constant over the 20-year period. We also made a number of assumptions about factors such as the frequency of renovations (which require incremental capital investments), inflation rates, and the exchange services' cost of capital. Using the data and applying the assumptions, we discounted the restaurants' projected cash flows for a 20-year period. The methodology we used for the analysis is discussed more thoroughly in appendix I.

As indicated in table 5, our analysis shows that over a 20-year period the direct method has a significantly lower net cash flow, in today's dollars,

for both free-standing and food court restaurants than the indirect method. This is due primarily to the significant initial investment, shown as $1,025,000 for the free-standing restaurant and $375,000 for the food court restaurant, required to build and equip the facilities and the subsequent periodic capital improvements that are required about every 5 years by AAFES' contract with Burger King. We also performed a number of other cash flow analyses using alternative assumptions (see app. I). While the bottom-line numbers changed somewhat, the overall results were generally the same.

Table 5: 20-Year Net Present Value of Discounted Cash Flows for the Direct and Indirect Methods – Free-standing and Food Court Name-Brand, Hamburger Restaurants (Fiscal Years 1998 and 1999)

	Free-standing restaurants		Food court restaurants	
	AAFES operated under direct method	NEXCOM operated under indirect method	AAFES operated under direct method	NEXCOM operated under indirect method
Financial information:				
Sales per restaurant	$ 1,348,598	$ 1,282,381	$ 634,845	$ 637,216
Net profit per restaurant	146,054	156,109	34,849	57,510
Depreciation per restaurant[a]	52,058	N/A	37,654	N/A
Capital requirements:				
Initial facility, equipment, and fixtures	$ 1,025,000	N/A	$ 375,000	N/A
Incremental capital investment applied in years 5, 10, and 15	100,000	N/A	25,000	N/A
Economic assumptions:				
Real cost of capital[b]	7.5%	N/A	7.5%	N/A
Discounted cash flows:				
Year 0	$ -1,025,000	0	$ -375,000	0
Year 1-4	663,543	$ 522,861	242,836	$ 192,618
Year 5	68,341	108,739	33,089	40,059
Year 6-9	462,196	364,203	169,150	134,170
Year 10	47,603	75,743	23,048	27,903
Year 11-14	321,947	253,689	117,823	93,457
Year 15	33,159	52,760	16,054	19,436
Year 16-20	270,893	213,459	99,139	78,637
Net present value of cash flows	$ 842,682	$ 1,591,454	$ 326,138	$ 586,280

[a]Annual depreciation expense was added to annual net profit to determine the annual cash flow. Although depreciation is an expense that reduces net profit, it does not involve cash payments. Therefore, we included depreciation in the calculation of cash flows for the direct method.

[b]Because the current projection of future inflation is about 2.5 percent, we subtracted this rate from AAFES' 10 percent nominal cost of capital rate to arrive at a real cost of capital rate of 7.5 percent. We also conducted this analysis using cost of capital rates of 7 percent and 8 percent to determine if changes in the rate would affect the outcome of the analysis. Under these scenarios, the indirect method still produced higher net cash flows, in today's dollars, than the direct method.

Source: Our analysis of AAFES and NEXCOM financial data.

The Army, which plans to open name-brand, fast-food restaurants at some of its MWR activities, sponsored a study in April 2000 to determine which method—direct or indirect—would provide the greatest returns on its investment. This study, which was conducted by a consulting firm in the food and hospitality industry, used the net present value technique to project cash flows for five different name-brand food types—hamburgers, chicken, pizza, Mexican, and sandwiches. The study was based on sales, cost, overhead, and profit data from AAFES, NEXCOM, and industry sources. It applied the data to a 10-year investment period and concluded that the indirect method provided more cash flows for both free-standing and food court hamburger restaurants and generally was the best value for the Army's MWR activities.

Except for Overhead, Exchanges Considered the Various Types of Costs When Assessing Fast-food Operations

Our analysis of AAFES and NEXCOM financial data showed that the exchanges had, with only one exception, considered the various types of costs associated with their fast-food operations. The one exception was overhead. Neither AAFES nor NEXCOM used overhead costs when determining the profits associated with its individual restaurants.

At AAFES, we found that it did not include overhead costs when reporting profits from fast-food operations. Instead, it calculated and applied an exchangewide overhead rate to its total operations to determine exchangewide profits. In doing this, AAFES accumulated its general and administrative costs from local exchanges and regional and headquarters operations. Its overhead rates were 4.9 percent of sales and 5.1 percent of sales for fiscal years 1998 and 1999, respectively. We compared the rates with overhead rates of fast-food restaurants in the private sector and found that the AAFES rates were reasonable. We also reviewed the work completed by AAFES' internal auditors that related to reviewing the exchangewide overhead rates. We concluded that the methodology used by the internal auditors to review the rates was reasonable. Before using the exchangewide rates for our analysis, however, we asked AAFES food service and financial management officials if they had an overhead rate for just fast-food operations. They responded in writing, as well as in several follow-up discussions on this topic, that they did not have such a rate. They told us that previous efforts to develop one had proved too difficult because of the way costs were accumulated and accounted for.

Accordingly, we used the 4.9 percent and 5.1 percent rates in our analysis of 1998 and 1999 financial data.

However, after completing our work at AAFES, representatives of AAFES informed us they had developed overhead rates specifically for name-brand, hamburger restaurants operating under the direct method. The rates were 3.3 percent for both fiscal years 1998 and 1999. We discussed the approach AAFES used to develop these new rates but were unable to readily assess their accuracy because the information AAFES provided was not sufficient to support the differences in overhead costs between food service direct operations and exchangewide operations. We assessed the reasonableness of the new rates by comparing them with the rates of eight food service companies. All of the companies were included in *Fortune Magazine's* list of top 10 food service companies based on revenues. This comparison showed that the new rates were substantially lower than those used by the food service companies included in our analysis. Based on the results of this comparison, we did not use the new rates in our detailed analysis shown in table 1. However, if we had used the revised rates, the profitability of the direct method would remain less than the indirect method, but the differences would not be as great.

At NEXCOM, we found that it had not considered overhead costs when assessing the financial results of its fast-food operations. As a result of our work, the exchange developed overhead rates for its indirect fast-food operations. The rates developed were 0.5 percent and 0.6 percent of the franchisees' sales for fiscal years 1998 and 1999, respectively. We used these rates in our analyses. Before using the rates, however, we reviewed the methodology NEXCOM used to develop them. We found that the methodology and costs included in the overhead rates appeared reasonable. When compared to AAFES' overhead rates, NEXCOM's rates appeared small. This condition exists because the indirect method requires significantly fewer people to manage and oversee fast-food operations. For example, to support such operations, NEXCOM had to negotiate and oversee several contracts, while AAFES had to manage all of the operations of about 170 restaurants.

Factors Other Than Profitability Are Important When Choosing an Operating Method

Exchange officials identified a number of factors, other than profitability, that are important when deciding between the direct and indirect methods. As shown in table 6, we grouped these factors into six categories: financial risk, customer service, employment opportunities, management control, operational risk, and investment opportunities. The relative importance of individual factors might vary depending on the circumstances involved in selecting an operating method for a planned restaurant. However, neither exchange used a standard approach or methodology to determine their relative importance or to evaluate them along with profitability considerations.

Table 6: Factors That Benefit the Direct and Indirect Methods

	Benefits applicable to	
Benefits	**Direct method**	**Indirect method**
Financial risk		
Minimizes capital investment for buildings, equipment, and fixtures		X
May provide revenues, at least in the short term, if restaurant does not make a profit		X
Customer service		
Serves equivalent American menus at or below local market prices worldwide	X	X
Serves equivalent American products worldwide	X	
Provides name-brand food to remote locations that may not be profitable	X	
Provides name-brand food service overseas	X	X
Customers are not charged sales tax	X	
Employment opportunities		
Provides job opportunities to members and family	X	X
Provides employment preference to family members	X	
Provides portable employment benefits	X	
Management control		
Minimizes the size of the management infrastructure		X
Provides direct control over customer service issues	X	
Can respond quickly to support deployment requirements	X	
Can change hours of operation to meet military needs	X	
Provides a single point of contact worldwide to address issues and implement changes	X	
Reduces construction/renovation cycle time		X
Operational risk		
Potentially reduces liability for losses and claims		X
Minimizes the risk to profits due to poor performance		X
Investment opportunities		
Minimizes competition with the private sector		X
Supports DOD's policy to assess opportunities for public-private ventures		X

Source: Our analysis of information provided by AAFES and NEXCOM.

- Indirect Method Minimizes Financial Risk: Under the indirect method, the name-brand, fast-food company builds the restaurants and assumes the financial risk of recovering its capital investments and operating at a profit. The exchange service, in this situation, has no capital investment and generally receives a commission on restaurant sales, regardless of whether the restaurant makes a profit. Under the direct method, the opposite is true. The exchange service provides the capital for building and periodically updating the restaurant, assumes all financial risks of operations, and generally pays the name-brand company an annual licensing fee and a royalty or commission on its annual sales.

- Both Methods Provide Customer Service: Both methods can be used domestically and overseas and require the exchange services to offer menus and prices equivalent to those in the private sector.[9] Under the direct method, however, an exchange service can establish restaurants in less profitable, remote locations in order to boost military members' morale. For example, AAFES officials told us that soon after the military was deployed to Bosnia for the peacekeeping mission, it opened three hamburger restaurants. It also opened 14 food service outlets in the Balkans and Kosovo, including 4 hamburger restaurants, and it has responded to many other emergencies or humanitarian deployments over the years. AAFES believes this would not have been possible under the indirect method because it did not believe name-brand companies would have been willing to operate in such potentially dangerous or unprofitable locations. In fact, NEXCOM officials provided us information showing that several restaurants operating under the indirect method at Navy installations had been closed during the last several years due to low sales. Nevertheless, NEXCOM officials believe the indirect method of operation adequately meets the deployment needs of the Navy, which are fundamentally different than those of the Air Force and the Army. Moreover, NEXCOM officials believe some of the name-brand companies that support its indirect operations are capable of providing emergency service as well as service to remote locations around the world. Another advantage of the direct method is that customers do not have

[9] AAFES officials agreed that both methods offer equivalent menus worldwide. However, they noted that product consistency, such as the taste of hamburgers, may vary under the indirect method because concessionaires may have to use local sources of supply rather than a single supplier. AAFES, on the other hand, is the major supplier for its restaurants and contends that it can provide a more consistent product overseas.

to pay sales tax. This advantage provides varying degrees of savings to the customer, depending on the state and local taxes applicable at each location.

- Direct Method Provides Greater Employment Opportunities for Military Dependents: Both methods provide employment opportunities for military dependents. However, because AAFES has control over the hiring practices at its directly run restaurants, it gives military spouses and other family members employment preferences. According to AAFES, about half of its work force are military dependents, some of which have worked for years with AAFES as they have moved from one installation to another. These employees retain their benefits (medical, sick leave, etc.) when they move as long as they continue to work for AAFES.

- Direct Method Provides More Control Over Operations: Under the direct method, the exchange services have more control over operations. AAFES officials said that this control gives them the ability to (1) establish restaurant hours that best support military needs, (2) address customer service issues consistently throughout the AAFES restaurant network, and (3) support the Army and Air Force mission objectives, which involve deploying personnel in war zones or other remote areas throughout the world. With its large supply and distribution network and access to resources, it can respond quickly to emergency situations almost anywhere in the world. On the other hand, the indirect method requires practically no infrastructure because the name-brand company and/or its restaurant operator handles all construction and operating issues. NEXCOM personnel agreed that the indirect method gave the exchange limited operating control of its restaurants but did not think such control was necessary because it does not provide fast-food operations on ships. Instead, most of its restaurants are located at large seaports or bases in the United States and overseas and generally operate in a normal commercial environment.

- Indirect Method Limits Operational Risks: Under the indirect method, the food service company and its restaurant operators are responsible for achieving sales goals, procuring and managing product inventories, maintaining the physical plant and equipment, developing promotions and marketing strategies, planning and updating menus, managing the food preparation process (including controlling the size of food portions), hiring and training all personnel, and assuming losses associated with breakdowns in internal controls. In addition, restaurant

operators assume the primary risk for workers' compensation claims and litigation associated with such things as accidents, harm caused by products, and employee injuries. Under the direct method, these issues fall primarily with the exchange service.

- Indirect Method Promotes Private Sector Investment Opportunities: The indirect method provides investment opportunities for private sector citizens, who are likely to be members of the local business community, and reduces concerns about government encroachment into private-sector functions, one of the objectives of DOD's 1988 fast-food policy. AAFES officials told us that requests to build name-brand, fast-food restaurants on a military installation have sometimes been denied because an existing franchise restaurant would have been adversely affected. The indirect method is also consistent with DOD's more recent 1998 policy to consider public-private ventures as an alternative for enhancing business activities that support MWR programs.[10] This policy, which involves the indirect method of operation, calls for the exchange services to consider public-private ventures as an alternative source to meet capital requirements that exceed $1 million.

NEXCOM and AAFES officials told us that they need flexibility to determine how best to meet their mission objectives and satisfy the military services' needs. Therefore, they are opposed to the adoption of a single method of operating name-brand, fast-food restaurants. Even NEXCOM officials, who use the indirect method to operate most of the exchange's fast-food restaurants, said situations exist where the direct method makes more sense. Neither exchange, however, used a business case analysis that weighed the factors identified in table 6 with profitability considerations, which then led to a decision to choose a particular operating method.

[10] DOD policy for public-private ventures is in Instruction 1015.13, Department of Defense Procedures for Implementing Public-Private Ventures (PPVs) for Morale, Welfare, and Recreation (MWR) Category C Revenue-Generating Activities, dated June 17, 1998.

DOD's Policy Lacks Guidance for Evaluating Operating Methods and Criteria for Approving Deviations From the Policy

DOD's policy on operating name-brand, fast-food restaurants established a preference for using the indirect method within the continental United States and the direct method overseas. The exchanges, however, have not always followed this policy because, in part, DOD has not provided guidance for evaluating operating methods or criteria for determining when a deviation from the policy might be justified. In general, each exchange service has adopted the operating method that it believes best fits its particular circumstances. While the exchanges may need flexibility to choose an operating method that best meets their mission requirements, DOD may be missing opportunities to reduce the exchanges' operating risks and increase the amount of funds provided to MWR activities because DOD's policy is not clear and department officials have provided limited management oversight.

In early 1988, when DOD issued its current policy memorandum on name-brand, fast-food operations, its stated goals were to control the proliferation of fast-food restaurants on military installations, award business to American investors, and ensure that restaurants on military installations charged prices that were comparable to those in adjacent communities. To help achieve these goals, the policy expressed a "preference" for using the indirect method within the continental United States and the direct method overseas.[11] The policy also stated that the requirements would be strictly followed and any deviations had to be approved in writing by the Assistant Secretary (Force Management). However, the policy memorandum provided no criteria for approving a deviation. The policy memorandum also stated that construction of fast-food restaurants would continue to be reviewed as part of the annual nonappropriated fund construction program.

Officials in the Office of the Assistant Secretary told us that the policy is still the primary guidance for determining how name-brand, fast-food restaurants should be operated. They acknowledged that the policy lacks criteria for determining when a deviation from the policy should be approved. They also stated that, for the most part, they have not been actively involved in overseeing how well the exchanges were adhering to the policy. They pointed out, however, that, in June 1998, the Department issued a new instruction that bears on this issue. This instruction calls for

[11] DOD's policy objectives generally relate to U.S. restaurants. Although the policy did not state a rationale for preferring the direct method overseas, DOD officials told us that there was a recognition that relying on the private sector to provide fast-food services in other countries might not be a viable alternative.

the military secretaries and exchange services to consider public-private ventures as an alternative way of meeting capital requirements when the requirement exceeds $1 million. Each public-private venture is to be supported by an economic analysis. In addition, whenever a venture involves construction financed by the private sector, an overseas fast-food restaurant, or liabilities to the government in excess of $500,000, it is to be reviewed by DOD policy officials. These officials pointed out that they have taken a more active role in overseeing compliance with the instruction. Thus far, however, the instruction has had minimal application to the exchange services' restaurant operations since contracts for most of these restaurants existed before the instruction was issued. DOD policy officials' recent reviews have applied, for the most part, to public-private ventures associated with the military services' MWR activities, rather than the military exchanges. Consequently, it is somewhat unclear if and how the instruction will affect the Department's long-standing name-brand, fast-food policy.

Since name-brand, fast-food restaurants first appeared on military installations in the 1980s, each exchange has tended to adopt an operating method that it believes best fits its overall mission objectives, operating philosophies, and access to capital resources. AAFES, for example, has a large support infrastructure, access to investment capital, and a long history of directly operating the majority of its business operations. It seldom deviates from the direct method, either within the United States or overseas.[12] While this approach appears to be in conflict with DOD's preference for using the indirect method in the continental United States, AAFES officials believe they are following DOD policy and congressional guidance. In explaining this situation, they noted that both DOD and the Congress had annually approved construction projects for directly operated restaurants in the United States. This was, in their view, an indication that AAFES had the flexibility and approval to deviate from the policy without asking for a formal waiver. NEXCOM, on the other hand, does not have a large support infrastructure and prefers not to invest capital in such restaurants. It has, therefore, adopted the indirect method of operating its restaurants, even in overseas locations.

[12] AAFES uses the indirect method to operate several name-brand restaurants in the United States, including three McDonald's restaurants. AAFES officials told us the indirect method was selected in these situations to address private sector concerns about AAFES building and operating restaurants that would compete with or encroach on the business of existing restaurants in nearby communities.

While exchange personnel told us that they generally prepared an analysis prior to building a new restaurant, the analysis focused primarily on what type and/or size of restaurant would best meet an installation's requirements (free-standing or food court) and whether it would be profitable under the specific circumstances. It did not include an analysis of the relative benefits—including profitability and other factors such as those discussed in this report—of the direct and indirect methods of operating the restaurant. As a result, the exchanges are not conducting the type of business case analysis that we believe would help them select and justify the operating method that best balances restaurant profitability with other factors.

Conclusion

The Department may have missed opportunities to increase profits for MWR activities because its policy for operating name-brand, fast-food restaurants has not been clear and policy implementation has not been subject to consistent management oversight. As a result, the exchange services have not always had a compelling reason to analyze the financial and operational benefits of the two operating methods. While our analyses clearly showed that the indirect method produced greater profitability in the recent past and has the potential to generate higher profits if new restaurants are built, other factors can be important when deciding on which method to use. Nevertheless, the exchanges do not systematically develop a business case analysis to justify an operating method—an analysis that considers profitability and other factors before deciding which operating method to use. To address this situation, DOD needs a clear policy—one that includes a standard approach or methodology for selecting a name-brand restaurant's operating method. A rigorous financial analysis and consideration of other factors would be part of the methodology. In addition, the policy needs to specify criteria that will help DOD evaluate when deviations from any preferred method are justified. Finally, the policy needs to address how the Department's new instruction on public-private ventures bears on its fast-food policy. Having a sound name-brand, fast-food policy is likely to become increasingly important to DOD because the exchange services' contracts with major name-brand companies will expire in 2004 and the exchanges will have to decide which method will be used to continue providing name-brand fast food.

Recommendation for Executive Action

To properly weigh profitability and other factors in selecting operating approaches for name-brand, fast-food operations on military installations, we are recommending that the Under Secretary of Defense (Personnel and Readiness), in conjunction with the secretaries of the military services, revise the Department's name-brand, fast-food policy by

- incorporating a standard methodology that considers both profitability and other factors to be used by the exchange services to identify the most appropriate method for operating fast-food restaurants,
- including criteria to approve deviations from any preferred operating method specified in the revised policy guidance, and
- clarifying how the instruction on public-private ventures affects the policy.

We also recommend that the exchange service commanders ensure that the standard methodology is used before they renew a restaurant contract or open a new restaurant.

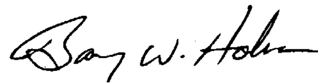
Agency Comments

In commenting on a draft of this report, the Assistant Secretary of Defense (Force Management Policy) concurred with its conclusions and recommendations. The Assistant Secretary stated that the Department will revise its name-brand, fast-food policy by (1) including a methodology that evaluates both economic and noneconomic factors when selecting an operating method, (2) including criteria and procedures for approving waivers from using the preferred operating method, and (3) clarifying how its instruction on public-private ventures applies to its policy. DOD expects to issue updated policy by November 1, 2001. DOD's comments are in appendix III.

We are sending copies of this report to the Secretary of Defense; the Under Secretary of Defense (Personnel and Readiness); the Secretaries of the Air Force, the Army, and the Navy; the Commander, AAFES; the Commander, NEXCOM; the Director, Office of Management and Budget; and interested

congressional committees and members. We will also make copies available to others upon request.

If you or your staff have questions concerning this letter, please contact us on (202) 512-8412. Staff acknowledgments are listed in appendix IV.



Barry W. Holman, Director
Defense Capabilities and Management

Gregory D. Kutz, Director
Financial Management and Assurance

Appendix I: Scope and Methodology

To develop an understanding of the military exchanges' name-brand, fast-food operations, we reviewed the history of these operations in the Department of Defense (DOD). We met with management officials from the Office of the Under Secretary of Defense (Personnel and Readiness) responsible for DOD's name-brand, fast-food policy and discussed the Department's implementation of its policy. We also met with senior management officials from the Army and the Air Force responsible for food services that supported morale, welfare, and recreation (MWR) activities to obtain their views on the direct and indirect methods of operating fast-food restaurants. We reviewed applicable DOD policies and regulations, related policy memorandums, and reports related to exchange service fast-food operations. We met with senior executives and managers responsible for financial management and food services at the Army and Air Force Exchange Service (AAFES) and the Navy Exchange Service Command (NEXCOM) headquarters to discuss fast-food operations and review documentation, financial reports, internal and external audit reports, and contract data.

To determine which method of operating name-brand, fast-food restaurants was more profitable, we obtained and analyzed detailed financial information from AAFES and NEXCOM for their fiscal year 1998 and 1999 name-brand, hamburger sales; associated costs and expenses; commissions; and related data. The financial data for these years was the most current data available at the time of our review. The data involved primarily Burger King restaurants operated by AAFES and McDonald's restaurants operated by either McDonald's Corporation or its licensed operators (also called concessionaires) under NEXCOM's purview. Because hamburger sales represented over 50 percent of the exchanges' name-brand, fast-food sales for these years, we primarily analyzed hamburger restaurants, which represented the largest segment of name-brand, fast-food sales and therefore provided a sound basis for comparing the direct and indirect methods of operation.

We analyzed the overall profitability of the restaurants operated under each method. For the direct method, net profit represented a restaurant's total revenues less its operating costs and overhead costs. Economic earnings represented net profit less the opportunity cost associated with invested capital—this is also known as the cost of capital. For the indirect method, net profit and economic earnings represented the revenues—comprised of sales commissions, signing bonuses, and licensing fees—received from the name-brand company less overhead costs. Operating costs and the cost of capital were not applicable to the indirect method. Besides assessing overall profitability, we also analyzed profitability by

sales volume, restaurant type (free-standing and food court), and general location (continental United States or overseas) to isolate unique conditions that might exist under one of the methods of operation. In this report, our use of the terms “profit” or “profitability” refers to economic earnings for the direct method of operation and net profit for the indirect method of operation, which are expressed as a percentage of restaurant sales.

To determine if the exchange services considered all of the costs of their name-brand, fast-food operations, we reviewed financial reports, general ledger balances, and other data provided to us by each exchange service. However, we did not verify the accuracy and reliability of the data submitted to us by AAFES and NEXCOM management and express no opinion on its reliability. Both exchanges are audited annually by independent public accountants. For the fiscal years we reviewed (1998 and 1999), NEXCOM received an unqualified opinion and AAFES received an “except for” qualified opinion on their financial statements.[1] We read the audit opinions for each exchange service to determine if there were any material weaknesses that came to the auditors’ attention that would indicate the financial data were unreliable. Except for AAFES not recording the cost of a defined benefit pension plan in accordance with Statement on Financial Accounting Standard No. 87, Employer’s Accounting for Pensions, material weaknesses were not reported by the exchange services’ independent public accountants. We discussed this issue with AAFES management and concluded that it did not have a bearing on the financial data we used in our analysis.

To determine the reasonableness of the exchanges’ overhead rates, we reviewed the methodologies the exchange services used to capture and allocate overhead costs. We met with management and internal audit representatives of each exchange service to review steps they had taken to validate the methodologies and costs included in the overhead rates. We also compared the exchange services’ overhead rates to rates reported by leading name-brand, food service companies in their annual financial reports. NEXCOM developed its overhead rate after we inquired about overhead costs related to name-brand fast foods. AAFES had corporatewide overhead rates of 4.9 and 5.1 percent of sales for 1998 and

[1] In general, the fiscal year for the exchange services covers the period from February 1st of a given year to January 31st of the following year. This period is consistent with the fiscal year used by the retail industry.

1999, respectively, which we used in our financial analysis. Before using them, however, we met with AAFES financial management and food service officials to determine if the exchange service had or could develop a rate for food operations in general or for restaurants operating under the direct method. AAFES officials told us they were unable to develop an overhead rate for food operations. Subsequent to completing our work at AAFES, representatives of AAFES informed us they had developed new overhead rates specifically for name-brand, hamburger restaurants operating under the direct method. The rates were 3.3 percent for both fiscal years 1998 and 1999. We discussed the approach AAFES used to develop these rates. We also compared AAFES' new overhead rates with the rates of eight food service companies that included a range of name-brand companies. All of the companies were included in *Fortune Magazine's* list of top 10 food service companies based on revenues. We obtained these food service companies' overhead rates from their published financial statements. This comparison showed that AAFES' new rates of 3.3 percent were substantially lower than those used by the food service companies included in our analysis. Rates for these companies ranged from 3.8 percent to 11.8 percent, with the mid-range rate being about 6.3 percent. Based on the results of this comparison, we did not use AAFES' new rates in our detailed analysis shown in table 1. However, if we had used the new rates, AAFES' profitability as a percentage of sales would increase from 7.8 percent to 9.4 percent in fiscal year 1998, and from 5.5 percent to 7.3 percent in fiscal year 1999 – still less profitable than the indirect method.

The cost of capital applies to AAFES because, under the direct method, it builds and equips its restaurants. When making a decision to build and operate a restaurant, an exchange needs to evaluate the costs of initial construction, initial equipment and fixtures, and subsequent scheduled renovations (to the extent they are known). These costs, generally referred to as capital costs, are usually paid for by AAFES through borrowing or through cash that is available from its profits. Also, other potential uses of the capital should be considered in the evaluation to ensure that committing capital to building the restaurant is a sound and defensible financial decision. These costs may include implicit costs, such as opportunity costs, that would not appear on an entity's financial statements but should be considered when evaluating profitability and making capital investment decisions. The ability of a restaurant to recover these costs will depend on the expected profitability of the restaurant as well as financial and operational risks associated with the restaurant's operations. Some companies and organizations, such as AAFES, establish

a cost of capital rate, normally expressed as a percentage, to evaluate their existing and planned capital projects.

AAFES used a 10-percent cost of capital during both fiscal years 1998 and 1999 and applied this rate to capital investment decisions. In other words, AAFES expects to earn at least 10 percent on its capital investments. With respect to assessing profits from its fast-food operations, AAFES also applied this rate to the average cost of its supply inventories and the undepreciated value (net book value) of its buildings, equipment, and subsequent improvements and replacements. In our profitability analysis, we applied a cost of capital charge to net profits to determine economic earnings. Our method of calculating the cost of capital charge was consistent with the method AAFES used.

To test the reasonableness of AAFES' 10-percent cost of capital rate, we calculated a cost of capital number that could apply to a private sector company in the food services industry. We used a standard approach, a weighted average cost of capital, found in corporate finance text books to calculate a cost of capital that would be appropriate for firms in the name-brand, hamburger industry. We also used financial data from Value Line Publishing for two major food service corporations, McDonald's and Wendy's, to make our calculation.[2] Because the financial situation of every business entity will be different, we did not expect our calculation to produce the same rate that AAFES used, but we did want to assure ourselves that AAFES' reported cost of capital was reasonable for firms in the fast-food, hamburger business. The cost of capital rate we calculated was close enough to AAFES' to assure ourselves that it was appropriate to use it in our calculation.

We also conducted a 20-year, net present value analysis of future cash flows for a capital investment in a new name-brand, fast-food hamburger restaurant for both methods. Our analysis was based on fiscal year 1998 and 1999 sales and cost data provided by the exchange services. We applied an investment planning tool, called net present value, which measures both the magnitude and timing of projected cash flows and discounts the expected annual cash flows by applying the time value of money to reflect their value today. As a result, the analysis shows, in today's dollars, the financial return that an investment in such a restaurant

[2] We did not use financial data for Burger King because a European firm whose primary business is wine and spirits owns Burger King.

operated under each method is expected to contribute to an exchange service's profits. We chose 20 years because this is generally the useful life of the facilities and equipment. We calculated a per restaurant average for sales and cost of operations. For the direct method, we added depreciation expenses to net profit to arrive at the annual positive cash flow. We included depreciation in the cash flow because, although it is an expense that is considered in arriving at net income, it does not represent an outlay of cash. The net present value technique also calls for depreciation to be included in the cash flows. We used initial construction and equipment costs provided by AAFES. The required incremental capital investments were based on historical data also provided to us by AAFES.

We conducted several analyses using the net present value technique. First, we combined the fiscal year 1998 and 1999 sales data obtained from each exchange service and calculated per restaurant average sales over the 2-year period. This analysis is presented in the body of the report. We also conducted several other analyses. They included analyses of (1) fiscal year 1998 data, (2) fiscal year 1999 data, and (3) a pro forma analysis that used equivalent sales for each exchange. The pro forma analysis was intended to neutralize the difference in sales volumes of AAFES and NEXCOM.

Our analysis was also based on a number of assumptions. For example, we assumed that combining or averaging 1998 and 1999 financial data would be representative of sales and costs for each year in the 20-year period. We also used a facilities and equipment renovation cycle of every 5 years, which is consistent with the information provided by AAFES and NEXCOM. For each method, we analyzed free-standing and food court restaurants separately because of significant differences in their capital costs, sales volumes, and cash flows.

The discount rate we used to calculate the net present value figures was based on AAFES' cost of capital, which was 10 percent. We needed to use a real cost of capital so we adjusted AFFES' cost of capital by subtracting projected future inflation to derive a real cost of capital. We used the March 2001 Blue Chip Economic Indicators, which are averages of the projections of many major economic forecasters, to derive a long-term inflation forecast of the Consumer Price Index (for all urban consumers). The long-range forecast was about 2.5 percent. The Congressional Budget Office and the Office of Management and Budget were also forecasting around 2.5 percent in their latest long-range projections for this price index. We subtracted the long-term inflation forecast of 2.5 percent from

AFFES' 10 percent cost of capital to derive a real cost of capital of 7.5 percent, which we used in our cash flow analysis.

We also did a sensitivity analysis for the inflation forecast with two other scenarios to see if this would change our results. We assumed the inflation rate could be as low as 2 percent and as high as 3 percent, which would change the real cost of capital to 8 percent and 7 percent, respectively. Under these two scenarios, our conclusions did not change. We also projected the results beyond 20 years to determine when AAFES' total net cash flows for a new name-brand, hamburger restaurant would break-even with and begin to exceed NEXCOM's. We knew this might eventually happen because AAFES' annual net cash flows exceeded NEXCOM's, except in the years that involved additional capital investment for required renovations. This analysis showed that, before the annual net cash flows were discounted, AAFES' cash flows would not begin to exceed NEXCOM's until after the 35th year of operation for a food court restaurant and after the 80th year for a free-standing restaurant. If the cash flows were discounted, it would take longer for AAFES' net cash flows to exceed NEXCOM's.

To determine if a single method of operating name-brand, fast-food restaurants would be more beneficial to DOD when factors other than profitability were considered, we obtained documentation related to this issue from the exchange services. We also interviewed officials in the Office of the Under Secretary of Defense (Personnel and Readiness) and exchange service representatives to obtain their views on this subject. We categorized DOD officials' written and oral responses under the general topics of financial risk, customer service, employment opportunities, management control, operational risk, and investment opportunities.

We also met with officials of the Marine Corps Community Services office, which manages all MWR activities for the Marine Corps, to obtain their views on name-brand, fast-food operations. We also obtained documentation related to the number of fast-food restaurants located on Marine Corps installations and their sales and costs for fiscal years 1998 and 1999. Although we limited our analysis to AAFES and NEXCOM, we did use some of the Marine Corps data in the background section of this report.

Our methodology has some limitations. First, the financial analysis was based on historical data that may or may not represent future market conditions, operating efficiencies, or the way name-brand, fast-food operations will be carried out in the future. Second, our analysis did not

assess the overall tax implications of using the direct and indirect methods. Presumably, the indirect method would provide tax revenues to the government because concessionaires' profits are subject to federal taxes and the direct method would also provide some tax revenues because royalties paid by an exchange service to the franchiser would also be taxable. Lastly, our financial analysis considered only one food concept, hamburgers, and may not be appropriate to other food concepts such as chicken and pizza.

Our work was performed at the Office of Force Management Policy, Undersecretary of Defense (Personnel and Readiness) in Washington, D.C.; AAFES headquarters in Dallas, Texas; NEXCOM headquarters in Virginia Beach, Virginia; the Food and Hospitality Branch, Marine Corps Community Services, United States Marine Corps at Quantico, Virginia; the Army Community and Family Support Center in Alexandria, Virginia; and the Air Force Combat Support and Community Services Office, in Washington, D.C. We also met with representatives of the Burger King Corporation located in Miami, Florida, and McDonald's Corporation located in Oak Brook, Illinois. We performed our work from September 2000 through May 2001 in accordance with generally accepted government auditing standards.

Appendix II: Fiscal Year 1999 Inventory of AAFES and NEXCOM Fast-Food Restaurants

	AAFES		NEXCOM	
Direct	**Facilities**	**Sales**	**Facilities**	**Sales**
Name-brand, fast-food	324	$249,064,463	27	$3,689,329
Other food	993	$214,515,148	161	$35,654,669
Deactivated food facilities[a]	92	$5,700,379		[b]
Total direct	**1,409**	**$469,279,989**	**188**	**$39,343,998**
Indirect				
Name-brand, fast-food	29	$19,016,589	193	$92,257,892
Other food	284	$24,134,321	53	$22,007,643
Total indirect	**313**	**$43,150,910**	**246**	**$114,265,534**
Total food	**1,722**	**$512,430,899**	**434**	**$153,609,532**

[a]During fiscal year 1999, AAFES closed or deactivated 92 restaurants. The sales for these restaurants are shown as a separate total.

[b]Data was not available from NEXCOM. NEXCOM officials told us that this number is likely insignificant.

Source: AAFES and NEXCOM fast-food financial and inventory data.

Appendix III: Comments From the Department of Defense

FORCE MANAGEMENT POLICY

ASSISTANT SECRETARY OF DEFENSE
4000 DEFENSE PENTAGON
WASHINGTON, D.C. 20301-4000

AUG 7 2001

Mr. Barry W. Holman
Director, Defense Capabilities and Management
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Holman:

This is the Department of Defense (DoD) response to the GAO draft report, "DEFENSE MANAGEMENT: Better Guidance Needed for Selecting Operating Methods for Name-Brand Fast-Food Restaurants, dated June 27, 2001 (GAO Code 709550/OSD Case 4030)."

The DoD concurs with the overall comments and recommendations in the report. Specific comments on the recommendations are enclosed.

Thank you for the opportunity to comment on this report.

Sincerely,

Charles S. Abell

Enclosure:
As stated

GAO DRAFT REPORT - DATED JUNE 27, 2001
GAO CODE: 709550/OSD CASE 4030

"DEFENSE MANAGEMENT: BETTER GUIDANCE NEEDED FOR SELECTING OPERATING METHODS FOR NAME-BRAND FAST-FOOD RESTAURANTS"

DEPARTMENT OF DEFENSE COMMENTS TO THE RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Under Secretary of Defense (Personnel and Readiness), in conjunction with the Secretaries of the Military Services, revise the Department's name-brand, fast-food policy by incorporating a standard methodology that considers both profitability and other factors to be used by the exchange services to identify the most appropriate method for operating fast-food restaurants.

DOD RESPONSE: Concur. It is current DoD policy that concession operations are preferred for military bases in the United States, and that for overseas bases, exchange direct-run operations are the preferred method. The policy requires that deviations be approved in writing by the Assistant Secretary of Defense (Force Management Policy) (ASD)(FMP). The Department will modify the policy to specify the evaluation of both economic and non-economic factors. In addition to profitability, the following factors will be considered in the aggregate: financial risk, customer service, employment opportunities, management control, operational risk, and investment opportunities. This methodology will be used to decide upon the method of operation that best meets exchange mission objectives for each location. Primary consideration shall be given to the quality of life needs and welfare of the active duty military community.

RECOMMENDATION 2: The GAO recommended that the Under Secretary of Defense (Personnel and Readiness) in conjunction with the Secretaries of the Military Services, revise the Department's name-brand, fast-food policy by including criteria to approve deviations from any preferred operating method specified in the revised policy guidance.

DOD RESPONSE: Concur. The Department will issue procedures to be followed when requesting a waiver to the preferred method of operating name brand fast food operations. The request will be based on the evaluation of economic and non-economic factors and the method of operation that best fulfills the exchange mission for each location. Primary consideration will be given to the overall quality of life and welfare of the active duty community.

ENCLOSURE

RECOMMENDATION 3: The GAO recommended that the Under Secretary of Defense (Personnel and Readiness), in conjunction with the Secretaries of the Military Services, revise the Department's name-brand, fast-food policy by clarifying how the instruction on public-private ventures affects the policy.

DOD RESPONSE: Concur. The Department will review the policy on public-private ventures and provide necessary guidance on its applicability to name-brand fast-food operations.

RECOMMENDATION 4: The GAO recommended that the exchange service commanders ensure that the standard methodology is used before they renew a restaurant contract or open a new restaurant.

DOD RESPONSE: Concur. The Department expects to issue updated policy by November 1, 2001. Until issuance of the revisions, existing policy shall remain in force for name-brand fast-food operations.

2

Appendix IV: Staff Acknowledgments

Acknowledgments

Cherry Clipper, Eric Essig, Cleggett Funkhouser, James Fuquay, James Hatcher, Charles Perdue, Bob Preston, Jerry Thompson, and John Van Schaik made key contributions to this report.

Glossary

This glossary is provided for reader convenience in understanding terms as they are used and applied in this report, not as authoritative or complete definitions.

Commissions

A percentage paid on gross sales either as a flat percentage rate or a graduated rate based on sales brackets identified in the contract between the exchange and the franchise.

Concession

A food service provided under contract to provide any segment of food service, either branded or non-branded, at a given installation in a permanent structure or temporary unit (i.e., mobile unit or kiosk).

Cost of capital

The opportunity cost (or economic cost) associated with alternative uses for invested capital of comparable risk. Includes funds invested in buildings, equipment (including periodic renovations and upgrades) and inventory.

Directly operated

The operation of either non-branded or branded food service staffed by an exchange service's direct hire associates. The exchange is responsible for providing/building and maintaining its own facilities, inventory, equipment, utilities, financial records, and personnel.

Discounted cash flow

Method of measuring the cash inflows and outflows of a capital investment or project as if the flows occurred at a single point in time so that they can be appropriately compared. Because the method considers the time value of money, it is usually the best method to use for evaluating long-term investment decisions.

Economic earnings

Net profit less the opportunity cost, also referred to as the cost of capital, associated with invested capital.

Franchise

A restaurant chain, either nationally or regionally recognized, providing a standardized system of policies, procedures, marketing/advertising schemes, logos, trademark, source of supply, source of equipment, and access to the franchise contracts.

Indirectly operated

The operation of either non-branded or branded food service by a concessionaire or third-party contractor via a contract with an exchange service.

License agreement

A term for the legally binding agreement between a franchisee and a franchiser.

Licensing fee	An amount, usually paid on a per site basis, for the right to operate a concession at awarded site(s). The fee is remitted to the exchange service prior to the sites' or facilities' availability/operational date.
Name-brand	Refers to a food service concept that is national (more than 10 states), regional (less than 10 states), or in-house (operated only with a given company's units).
Name-brand, fast-food	A nationally recognized fast-food restaurant chain that operates in more than 10 states.
Net cash flow	The dollars that are left after sales or revenues have offset expenses. The dollars can be expressed at current value or at a discounted value, if the time value of money is considered.
Net present value	A discounted cash flow technique that calculates the expected net monetary gain or loss from a project by discounting all expected future cash inflows and outflows to the present point in time, using a specified rate of return.
Net profit	Total sales/revenues less operating costs and overhead costs.
Operating costs	The cost of goods sold and operating expenses, including depreciation.
Profitability	Refers to economic earnings for the direct method of operation or net profit for the indirect method of operation and is expressed as a percentage of restaurant sales. Under the direct method, profitability represents a restaurant's total revenues less its operating costs, overhead costs, and the opportunity costs associated with invested capital (the cost of capital). Under the indirect method, profitability represents the revenues (sales commissions, signing bonuses, and licensing fees) received from the name-brand company less the exchange service's overhead costs.
Public-private venture	An agreement between a DOD nonappropriated fund activity, such as an exchange service, and a non-federal entity under which the non-federal entity provides goods, services, or facilities to authorized MWR activities and exchange patrons. The non-federal entity may provide a portion or all of the financing, design, construction, equipment, and staffing associated with the activity.

Revenues	Under the direct method, revenue includes restaurant sales plus other income. Other income is primarily the proceeds from selling surplus equipment and additional revenue realized in overseas locations from foreign currency conversions at the point of sale. Revenues under the indirect method are sales commissions based on restaurant sales plus licensing fees and signing bonuses.
Sales	Gross restaurant or food sales less all applicable taxes and coupon redemptions recorded at the point of sale.
Signing bonus	A lump sum payment made to an exchange service by a concessionaire or a third-party contractor at the time a contract is signed.

Ordering Information

The first copy of each GAO report is free. Additional copies of reports are $2 each. A check or money order should be made out to the Superintendent of Documents. VISA and MasterCard credit cards are also accepted.

Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:
U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013

Orders by visiting:
Room 1100
700 4th St., NW (corner of 4th and G Sts. NW)
Washington, DC 20013

Orders by phone:
(202) 512-6000
fax: (202) 512-6061
TDD (202) 512-2537

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

Orders by Internet
For information on how to access GAO reports on the Internet, send an e-mail message with "info" in the body to:

Info@www.gao.gov

or visit GAO's World Wide Web home page at:

http://www.gao.gov

To Report Fraud, Waste, and Abuse in Federal Programs

Contact one:

- Web site: http://www.gao.gov/fraudnet/fraudnet.htm
- E-mail: fraudnet@gao.gov
- 1-800-424-5454 (automated answering system)

PRINTED ON RECYCLED PAPER