



United States General Accounting Office

Report to the Chairman, Subcommittee on
Readiness, Committee on Armed Services,
House of Representatives

December 1988

INDUSTRIAL FUNDS

Proposal to Change Funding at Naval Civil Engineering Laboratory



**National Security and
International Affairs Division**

B-220255

December 23, 1988

The Honorable Nicholas Mavroules
Chairman, Subcommittee on Readiness
Committee on Armed Services
House of Representatives

Dear Mr. Chairman:

As you requested, we evaluated certain issues concerning the Department of Defense (DOD) proposal to convert the Naval Civil Engineering Laboratory (NCEL) at Port Hueneme, California, from industrial funding to another funding method. (Industrial fund activities are reimbursed by customers for the estimated cost of work, usually using appropriated funds.) Specifically, the objectives of our review were to determine

- DOD's rationale and justification for the proposal,
- employment impacts,
- operational impacts, and
- any additional costs and savings involved in the conversion.

Our objectives, scope, and methodology are discussed in the appendix.

Background

DOD's proposal to convert the funding for NCEL is part of a larger initiative to use alternative funding for 14 Navy research and engineering activities. The Naval Avionics Center at Indianapolis, Indiana, the Naval Air Engineering Center at Lakehurst, New Jersey, and NCEL would be the first activities converted. NCEL is the Navy's principal research, development, test, and evaluation center for shore facilities, fixed surface and subsurface ocean facilities, and Navy and Marine Corps construction forces.

DOD did not specify the alternative funding method to be used by the Navy, but permitted it to select from various alternatives. The Navy opposes DOD's conversion proposal, but said that if it converts, it would use a mixed funding arrangement in which only overhead costs would be funded by direct appropriations. Direct labor and material costs would continue to be reimbursed by the customers.

Results in Brief

In September 1988, we testified and reported¹ on DOD's conversion proposal and a matter concerning the Navy's acquisition of a Standard Automated Financial System. In December 1988, we also reported² on (1) DOD's rationale and justification for the conversion, (2) employment and operational impacts, and (3) additional costs and savings involved in converting the Naval Avionics Center and the Naval Air Engineering Center. We found no overriding advantage to converting to another funding method; therefore, we recommended that the Navy continue industrially funding the activities unless the need for a change could be clearly demonstrated. Our review of the proposed funding conversion at NCEL further supports our previously reported observations. At NCEL we found no evidence that DOD's proposal to convert from industrial funding to an alternative funding method is advantageous.

DOD's Rationale and Justification

DOD believes that the conversion of funding for the Navy's research and engineering activities is needed because (1) industrial fund accounting and financial management systems cost more to operate than nonindustrial fund systems, and the benefits do not justify the added costs, (2) industrial funds are all too often perceived as being used to avoid more direct congressional oversight of operating programs, and (3) the activities do not meet DOD's revised criteria for industrial funding.

DOD has not performed an analysis to support its arguments that an industrial fund accounting system is more costly to operate than other types of systems or that the cost of operating an industrial fund accounting system is not justified by the added benefits. Further, DOD is not persuasive in its argument that congressional oversight is lost through industrial funding. We have reported³ that industrial fund reporting that includes results of operations for individual activity groups should facilitate congressional oversight. Finally, DOD's revised criteria for what activities should be industrially funded, although more definitive than previous criteria, are still subject to interpretation.

¹Computer Procurement: Decision Needed on Navy's Standard Automated Financial System (GAO/T-IMTEC-88-7, Sept. 13, 1988) statement by the Comptroller General, and Computer Procurement: Decision Needed on Navy's Standard Automated Financial System (GAO/IMTEC-88-47, Sept. 13, 1988).

²Navy Engineering Centers: Proposal to Change From Industrial Funding to Another Funding Method (GAO/NSIAD-89-47, Dec. 7, 1988).

³Recent DOD Reporting Changes Should Facilitate Congressional Oversight (GAO/NSIAD-86-58, Apr. 11, 1986).

According to NCEL officials, the Laboratory meets DOD's revised criteria for being an industrially funded activity. They pointed out, for example, that NCEL's

- accounting system provides control of all resources;
- products or services are quantifiable and can be traced to specific customer orders;
- direct costs are related to specific products or services, and indirect costs are allocated based on established rates;
- direct costs are incurred in response to specific customer orders;
- customers include over 150 Navy and DOD components, civilian federal agencies, and private-sector customers; and
- contracted-out work is within regulations—57 percent of NCEL's work load is performed in-house.

Employment Impacts

Neither DOD nor the Navy has identified any employment impacts that can be directly attributed to the conversion. Such impacts would mainly depend on the level of activity at NCEL and the availability of appropriated funds. However, NCEL officials are concerned that employment could be affected if NCEL's annual budget requests for appropriated funds to finance overhead costs are not fully met. Officials at NCEL stated that the Naval Facilities Engineering Command (NAVFAC), NCEL's parent command, has projected a cut in NCEL's overhead budget if the conversion is implemented. Employment impacts would depend on how NCEL absorbs any reduced funding.

Operational Impacts

We believe the conversion could affect NCEL's operations as a result of

- separating the funding for material and labor costs from the funding for overhead costs;
- eliminating the Asset Capitalization Program (ACP), which could decrease funds for modernization efforts; and
- giving NAVFAC control over NCEL's overhead funds.

Separation of Funding Sources

Industrial fund activities are reimbursed by customers for estimated material, labor, and overhead costs for work performed. However, the way in which the Navy said it would implement the conversion, if required to convert, would separate the sources of funding and potentially create a funding imbalance. Estimated material and labor costs would still be reimbursed by customers, but estimated overhead costs

would be financed by NAVFAC with appropriated funds. Because the Navy said it would finance overhead costs with appropriated funds, NCEL officials are concerned that an imbalance could develop between the amount of direct labor and material costs customers finance and the amount of appropriated funds available to finance overhead costs. Thus, if the appropriated funds provided for overhead costs are inadequate to support customers' orders, operations could be affected.

Modernization Efforts Could Be Impeded

Before fiscal year 1983, industrial fund activities financed the modernization of their facilities by competing for the same appropriated procurement funds made available to acquire ships, aircraft, and other weapon systems. They were generally less than successful. As a result, the Congress authorized industrial fund activities to use the ACP to finance capital improvements. Under this program, improvements are financed by recovering depreciation through charges to customers and adding a surcharge to the estimated cost of the work. These funds can then be used to purchase equipment and to finance minor construction projects and management information systems.

Because the program was established for industrially funded activities and NCEL would no longer be considered such an activity if converted to alternative funding, it may not be able to finance its modernization plans. NCEL officials believe that if they have to compete for procurement appropriations again, their plans to continue upgrading facilities and acquire equipment will be impeded.

NAVFAC Control of Overhead Funds

According to the way in which the Navy said it would implement the conversion, NAVFAC would control NCEL's overhead funds. NCEL officials said that such control would disrupt the buyer/seller relationship between NCEL and its customers. Further, NAVFAC would have to fund the overhead costs of work for other Navy and DOD components, federal civilian agencies, and private-sector customers who would only pay for estimated direct labor and material costs.

Costs and Savings Associated With the Conversion

NCEL officials have not estimated the costs associated with the proposed conversion. However, they believe that costs would be incurred for converting accounting and other records from one financial management system to another and that other costs would result from the need to modify NCEL's industrial fund accounting and financial management

information system to accommodate appropriation accounting requirements. Further, if the Navy converts, two accounting systems would have to be maintained: one for reimbursable material and labor costs and one for overhead costs. However, such costs would result from the way the Navy decided to implement the conversion, if required to do so, and are not directly related to the conversion decision itself. The Navy could select an alternative funding method that would not require the maintenance of two accounting systems.

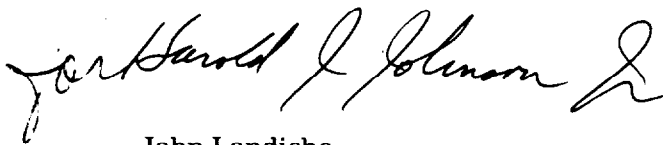
DOD believes that the conversion would result in savings over the long term because accounting systems applicable to other funding methods are less complex and thus less costly to operate. However, DOD has not performed a study to demonstrate the savings that would occur. DOD has shown that a onetime budgetary reduction would occur by decreasing the amount of appropriated funds obligated by customers for work to be done in a later fiscal period (the "funded carryover"), but the exact amount is unknown. The onetime budgetary reduction is not, however, a cost savings but rather a shift of funds from one fiscal year to another.

As previously stated, our September 1988 report recommended that the Navy be permitted to continue industrially funding the activities unless the need for a change could be clearly demonstrated. That recommendation applies to NCEL; therefore, we are not repeating that recommendation in this report.

We are sending copies of this report to interested parties and making copies available to others upon request.

Richard J. Herley, Group Director, and Dennis DeHart, an Assignment Manager from our Los Angeles Regional Office, were the principal staff members responsible for this review. If you have any questions, please contact me at 275-6504.

Sincerely yours,

A handwritten signature in cursive script, reading "John Landicho".

John Landicho
Senior Associate Director

Objectives, Scope, and Methodology

The Chairman, Subcommittee on Readiness, House Committee on Armed Services, asked us to review the proposed conversion of NCEL. Our objectives were to determine

- DOD's rationale and justification for the proposal,
- employment impacts,
- operational impacts, and
- any additional costs and savings involved in the conversion.

Our work at NCEL is related to an earlier review of the proposed conversion that was requested by the Chairman, Senate Committee on Appropriations. In conducting that earlier review, we met with representatives of the Office of the Assistant Secretary of Defense (Comptroller) and the Office of the Comptroller of the Navy. Our purpose was to obtain their views on DOD's rationale and justification for the conversion. We relied on that information for the purposes of this review. We also met with NCEL officials to discuss the rationale and justification for the proposal and whether or not that activity meets DOD's revised criteria for operating under industrial fund procedures.

At NCEL we also discussed and obtained information regarding employment and operational impacts, costs, and savings. We evaluated this information to determine the extent the impacts, costs, and savings could be directly attributed to the proposal.

During the earlier review of the conversion proposal, we sought the views of responsible officials of the Departments of Defense and the Navy. Those comments were incorporated into this report where appropriate. Our review was performed during August and September 1988 in accordance with generally accepted government auditing standards.

Requests for copies of GAO reports should be sent to:

**U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877**

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are \$2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

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

**Official Business
Penalty for Private Use \$300**

First-Class Mail Postage & Fees Paid GAO Permit No. G100
--