United States General Accounting Office

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Report to the Chairman, Committee on Appropriations, U.S. Senate

December 1988

# NAVY ENGINEERING CENTERS

## Proposal to Change From Industrial Funding to Another Funding Method

GAO/NSIAD-89-47

GAO

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

**National Security and**
**International Affairs Division**

B-220255

December 7, 1988

The Honorable John C. Stennis
Chairman, Committee on Appropriations
United States Senate

Dear Mr. Chairman:

As you requested, we evaluated certain issues concerning the Department of Defense's (DOD's) proposal to convert two Navy activities—the Naval Avionics Center at Indianapolis, Indiana, and the Naval Air Engineering Center at Lakehurst, New Jersey—from industrial funding to another funding method. (Industrial fund activities are reimbursed by customers for the incurred cost of work, using appropriated funds.) Specifically, you asked us to review

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

## Background

The DOD proposal to convert the two Centers is part of a larger initiative to convert 14 Navy research and engineering activities from industrial funding to an alternative funding method. DOD did not require that the Navy convert to a specific alternative funding method but permitted it to select from various alternatives. The alternatives included using (1) appropriated funds to finance all costs, (2) a mixed funding arrangement where overhead would be funded by direct appropriations and direct labor and material would be reimbursed by customers, (3) revolving funds, similar to industrial funds, but with fewer requirements and restrictions, and (4) a totally reimbursable system where all costs (overhead, direct labor, and material) would be reimbursed by the customers. The fourth alternative is also similar to an industrial fund system but with less detailed cost accounting, budgeting, and other requirements of industrial fund activities. The Navy said that if it is required to convert these two Centers, it will use the mixed funding arrangement.

## Results in Brief

DOD's rationale and justification for its proposal to convert the Centers from industrial funding to another funding method essentially turns on three issues. First, DOD believes that an industrial fund accounting and financial management system costs more to operate than nonindustrial

fund systems and that the benefits of financing research and engineering activities through the industrial fund do not offset the added costs. Second, DOD believes that under the industrial fund concept, it and the Congress lose oversight of the research and engineering activities' funds. Finally, DOD believes the Centers do not meet DOD's revised criteria for financing activities through industrial funds.

Navy officials disagree with DOD on the conversion. They contend that removing the Centers from the industrial fund would adversely affect efficient operations, that conversion may adversely affect employment levels at the Centers, and that the conversion process itself would be costly. Furthermore, Navy officials believe that the Centers have met the revised criteria for industrial funding and that congressional oversight of the activities' funds is not lost.

We found that DOD has not performed the analysis to support its arguments that (1) an industrial fund accounting and financial management system is more costly to operate than other types of systems and (2) the more detailed data provided by an industrial fund accounting system is not worth the added expense. Furthermore, DOD's argument that congressional oversight is lost is not persuasive because, as we earlier reported,[1] industrial fund reporting that includes the results of operations for individual activity groups should actually facilitate congressional oversight. Finally, DOD's revised criteria for industrial funding, while more definitive than the previous criterion that such activities provide a common service within DOD, are still subject to interpretation.

With regard to the Navy's concerns, we found nothing inherent in direct appropriation funding that would adversely affect employment levels; however, if after conversion, the Navy did not fully fund the Centers' overhead budgets, employment could be affected. There is also nothing inherent in direct appropriation funding that would adversely affect the Centers' day-to-day operations. However, because the Navy said that if it converts it would have the Centers reimbursed by customers for direct material and labor and finance overhead costs with direct appropriations, an imbalance could occur between the level of funds available for overhead costs relative to the level of customer orders.

The Centers estimated that the costs associated with the conversion would be between $34.9 million and $37.9 million; mostly incurred for

[1] Industrial Funds: Recent DOD Reporting Changes Should Facilitate Congressional Oversight (GAO/NSIAD-86-58, Apr. 11, 1986).

converting funding documents, contracts, and other records from one financial management system to the other. Additional costs will be incurred for maintaining two accounting systems required under the conversion option selected: one for the material and labor costs to be reimbursed by the customers and another for overhead costs to be financed by operation and maintenance funds.

Other costs associated with modifying the Standard Automated Financial System (STAFS) currently being developed for all Navy industrial fund activities—including the Centers—will be incurred. The STAFS is an internal Navy initiative to install a new accounting and financial management system for industrial fund activities; modification would be needed to accommodate another funding method.

## Conclusions

DOD has not performed an analysis to support its contention that the research and engineering activities—including the two Centers—should be taken out of the Navy's industrial fund and converted to another funding method. DOD has asserted that it costs more to operate an industrial fund accounting system and that these added costs are not offset by the more detailed data such a system provides; however, this assertion has not been demonstrated. Second, DOD's argument that congressional oversight of the activities' funds is lost is not persuasive in view of the more detailed reporting of cost data now required. Furthermore, the conversion process itself would be disruptive to ongoing operations and is estimated to cost in excess of $30 million, plus other costs associated with modifying the STAFS to accommodate another funding method. In view of the disruptive and additional costs that would be incurred, we see no overriding advantage to converting the Navy research and engineering activities to another funding method at this time.

On September 13, 1988, we testified before the Subcommittee on Legislation and National Security, House Committee on Government Operations,[2] concerning the need for a Navy decision on the procurement of the STAFS. In that testimony, we recommended that the Secretary of Defense allow the Navy to continue to industrially fund the 14 Navy activities unless the need for a change can be clearly demonstrated. Because this recommendation covers the two Centers discussed in this report, we are making no further recommendation.

[2]Computer Procurement: Decision Needed on Navy's Standard Automated Financial System (GAO-T-IMTEC-88-7, Sept. 13, 1988); statement of the Comptroller General.

We requested written comments on a draft of this report from the Department of Defense, but none were provided. However, we did obtain agency views during an exit conference which were incorporated where appropriate.

We are sending copies of this report to interested congressional committees and subcommittees, the Secretaries of Defense and the Navy, and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of John Landicho, Senior Associate Director. Other major contributors are listed in appendix V.

Sincerely yours,

Frank C. Conahan
Assistant Comptroller General

# Contents



**Abbreviations**

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| ACP | Asset Capitalization Program |
| DOD | Department of Defense |
| GAO | General Accounting Office |
| NAC | Naval Avionics Center |
| NAEC | Naval Air Engineering Center |
| NAVAIR | Naval Air Systems Command |
| OASD(C) | Office of the Assistant Secretary of Defense (Comptroller) |
| STAFS | Standard Automated Financial System |

# Introduction

As part of the fiscal years 1988 and 1989 DOD internal budget decision process, the Deputy Secretary of Defense approved a recommendation by the Office of the Assistant Secretary of Defense (Comptroller) (OASD(C)) to convert 14 Navy research and engineering activities from industrial fund operations to another, unspecified funding method. The timetable established in November 1987 provided for converting three engineering activities—including the Naval Avionics Center (NAC), Indianapolis, Indiana, and the Naval Air Engineering Center (NAEC), Lakehurst, New Jersey—beginning in fiscal year 1989. The remaining 11 activities would be converted beginning in fiscal year 1990.

The Navy opposed the conversion, and we were informed by Navy officials that as of August 1988 there was no agreement between the Navy and DOD on when the research and engineering centers would be converted to another funding method. Navy officials informed us that from the Navy's point of view, plans to convert the research and engineering centers are on indefinite hold. Navy officials said that the Centers' fiscal years 1990 and 1991 budgets are being prepared on the basis that conversion will not occur.

NAC and NAEC are classified as aeronautical engineering centers and provide research, deployment, test and evaluation; manufacturing; engineering systems integration; and ship suitability; as well as engineering support to the fleet for assigned weapon systems. Limited production and procurement of aircraft catapult and arresting systems and missile, spaceborne, and undersea and surface weapons systems are also provided.

## Background

Conceptually, industrial fund activities operate as businesses and maintain a level of working capital to finance their operations. They provide goods and services to customers who reimburse the activities with appropriated funds. A customer's reimbursements are used to replenish the working capital.

In authorizing the use of industrial funds, the Congress expected them to foster

- business-like cost accounting practices and procedures that would (1) focus attention on costs, (2) simplify budgeting, and (3) provide better information for management control;

- increased efficiency and reduced costs by giving management greater freedom from the congressional budget cycle through the working-capital fund concept; and
- buyer-seller relationships between customers, who would be motivated to order only necessities and pay only the minimum price, and producers, who would be motivated to improve cost estimates and controls and to identify and correct inefficiency and waste.

In 1984, the OASD(C) reviewed DOD's industrial fund operations in response to congressional criticism and DOD's concerns about the perceived excessive costs, questionable benefits, and inadequate oversight of such activities. One result was that the OASD(C) developed more specific criteria for reviewing the Navy's 14 research and engineering activities to determine whether they should be operated under the industrial fund concept. Until that time, the primary criterion was the statutory requirement that industrial fund activities provide common services within DOD. The OASD(C) believes this criterion can be, and is, interpreted differently not only by each military service but also within each service.

The OASD(C)'s expanded criteria call for such things as a comparison of the economy and efficiency of industrial versus appropriated fund operations, the identification of costs and products, the buyer-seller relationships, and the extent industrial fund activities accomplish work through private-sector contracts. The criteria are discussed more fully in appendix II.

Another result of this review was DOD's decision to convert the Navy's 11 research and 3 engineering activities from industrial fund operations to another funding method, beginning in fiscal year 1989. In approving the conversion, the Deputy Secretary of Defense was not specific about the funding method to be used; instead, he permitted the Navy to select from various alternatives. The alternatives ranged from converting to operations funded through direct appropriations to remaining as totally reimbursable operations but with less detailed cost accounting, budgeting, and other requirements of industrial fund activities. The Navy protested any conversion from industrial funding but stated that if conversion is required, the two Centers would charge customers for direct labor and material and would finance overhead with operation and maintenance funds appropriated for that purpose.

## Objectives, Scope, and Methodology

The Chairman, Senate Committee on Appropriations, aware of concerns that converting the funding method at two aeronautical engineering centers—NAC and NAEC—could affect employment levels and operations, asked us to review the proposed conversion. Our objectives were to review

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

We performed work at the following offices and commands:

- Office of the Assistant Secretary of Defense (Comptroller),
- Office of the Comptroller of the Navy,
- Naval Avionics Center, Indianapolis, Indiana, and
- Naval Air Engineering Center, Lakehurst, New Jersey.

At the DOD and Navy Comptrollers' offices, we reviewed information on industrial and appropriated funding concepts and operations and the conversion of the research and engineering activities. We reviewed the rationale and the justification for the conversion and the congressional criticism and DOD's concerns that prompted the OASD(C) to develop the expanded criteria for reviewing whether or not activities should be operated as industrial fund activities. We discussed the rationale and the justification for the proposal and DOD's concerns with key OASD(C) and Navy representatives, including those that would be affected by the conversion.

We obtained information regarding potential employment and operational impacts and costs and savings with OASD(C) and Navy officials and representatives of the Centers. We evaluated the information to determine the extent the impact, costs, and savings can be attributed directly to the proposed conversion.

We requested written comments on a draft of this report from DOD, but none were provided within the allowed comment period. However, we did obtain agency views during an exit conference, which were incorporated where appropriate. Our review was performed in accordance with generally accepted government auditing standards.

# DOD's Rationale and Justification for the Conversion

DOD's decision to convert the method of financing the Navy's engineering and research activities, including NAC and NAEC, stemmed from concerns about these activities being financed through industrial funds. As a result, DOD developed more specific criteria for determining whether the Navy's 14 research and engineering activities should be financed as industrial fund operations. DOD believes NAC and NAEC have not met the criteria.

Navy officials disagree with DOD's conclusion and argue that the criteria have been met. They also believe other actions have been taken to address DOD's concerns about industrially funded activities and the level of funded carryover.[1]

## DOD Believes the Advantages of Operating as Industrial Funds Have Not Been Demonstrated

DOD applied the revised criteria, considered information the Navy provided, and concluded the Navy had not demonstrated that operating the research and engineering activities as industrial fund activities offers any appreciable benefits or cost savings. Also, DOD believes oversight of Navy research and engineering activities needs to be improved.

The revised criteria and DOD's conclusions after applying it to the Navy's 14 research and engineering activities are described below.

- Industrial fund financial accounting and management systems should result in an appreciably more economical and efficient organization than appropriated funds. Further, there must be a need for and an effective use of detailed cost accounting data. DOD believes industrial fund accounting systems are more costly to operate than appropriated fund accounting systems and the Navy has not demonstrated that the more costly industrial fund systems reduce overall DOD costs below those that would be incurred using appropriated fund systems.
- The activity should have a product or service that is readily quantifiable and easily measured. According to DOD, output from research and engineering activities is frequently difficult to measure.
- The activity should have a sound and verifiable basis for identifying direct costs to specific products or services provided, as well as for allocating indirect and general and administrative costs. DOD does not question that industrial fund systems allocate costs. However, it does question whether or not such systems enhance an activity's ability to manage and reduce such costs and to predict and control future costs.

[1]The funded carryover is the amount of appropriated funds obligated by customers for work not completed by industrial fund activities during the fiscal period in which the funds were obligated.

DOD believes the Navy has not demonstrated that the costs incurred to maintain its industrial fund accounting systems produce "comparable benefits."

- The activity should have an operational cycle where costs are incurred in response to specific requests for products or services, and receipts are generated from the sale of such goods or services. DOD believes that in deciding whether or not an activity should be industrially funded, it is important to consider more than administrative procedures established to fit that funding method. DOD points out that research and engineering customers frequently request and fund a "level-of-effort," providing money for a specific number of days, weeks, or months. Thus, the OASD(C) believes that research and engineering activities are ill-suited for industrial funding.
- The activity should have bona fide customers. According to DOD, the Navy acknowledges that the buyer-seller relationship is "more theoretical and apparent than real" in that many customers of the research and engineering activities are not free to "take their business elsewhere." For example, about 54 percent and 87 percent of all new work at NAC and NAEC, respectively, is for subordinate activities of the Naval Air Systems Command (NAVAIR), which oversees the operations of NAC and NAEC.
- The preponderance of costs should not be incurred through private-sector contracts. Until recently about one-half of the Navy's research and engineering activities' work was done through contracts with organizations in the private sector. Only after substantial appropriated fund reductions and the threat of converting the method of financing did the Navy exclude contractual efforts from its industrial fund for these activities.

DOD believes that, given the legal penalties associated with exceeding appropriated amounts, appropriated fund activities may exercise better control over their resources than industrial fund activities; however, it offered no evidence to support that assertion.

The OASD(C) stated that the Army and Air Force operate their research and engineering activities using appropriated funds. Although the OASD(C) recognizes that the functions performed at a number of Navy activities are not fully comparable to those of the other services, it believes comparable funding methods can be applied to those operations.

According to OASD(C), "industrial funds are all too often perceived as being used in an attempt to avoid more direct congressional oversight of operating programs" and "one obstacle to removing these activities from

the Navy Industrial Fund appears to be an unwillingness by the Navy to subject the operations of these activities to the additional congressional scrutiny that could result if these activities were included as appropriated funds."

We recently reported[2] that because of changes in DOD's reporting of individual fund activity groups, congressional oversight should be enhanced. Our report pointed out that information is now disclosed to the Congress that enhances visibility and monitoring of fund performance and that this should strengthen congressional oversight of how appropriated funds are used to finance industrial fund activities.

Finally, the OASD(C) asserts that it could have reduced its budgetary requirements by about $1.2 billion during fiscal year 1987 had these 14 activities been operated as appropriated fund activities. Such reductions, however, would not have been a cost savings, but rather a one-time budgetary change attributable to reductions in funded carryovers. These 1-year reductions, nevertheless, would have required funding in subsequent fiscal years.

## Navy Disagrees With DOD's Conversion Proposal

The Navy does not agree with DOD's basis for proposing the conversion and believes NAC and NAEC meet the revised criteria. In this regard, we found the following.

- The OASD(C) has not compared the cost of operating industrial and appropriated fund accounting systems. OASD(C)'s conclusion that industrial fund accounting systems are "more costly" was a subjective judgment based on OASD(C)'s experience from overseeing industrial fund activities; it was not demonstrated. Industrial fund accounting systems do provide greater refinement of cost information than appropriated fund accounting systems; however, the added cost of providing this additional information has not been calculated.
- NAC and NAEC provide quantifiable products and services. For example, NAC produces test equipment, computers, power supplies, missile guidance systems, and spare parts. It also produces specifications, engineering drawings, and research and engineering reports.
- NAC currently has about 600 customers, including the Naval Air Systems Command, the Naval Sea Systems Command, the Naval Supply Center, the Departments of the Army and Air Force, and private industry. NAEC

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

has a similar mix of customers. While many of the customers are under the overall management of NAVAIR, if the Navy implements the conversion as planned, NAVAIR will finance the overhead costs attributable to the work for other customers.

- Navy policy now precludes research and engineering activities from doing more than 49 percent of the work through private-sector contracts.

We also found that, according to Navy Comptroller data, the funded carryover at NAC, NAEC, and the Naval Civil Engineering Laboratory has been reduced from $708.8 million in fiscal year 1985 to $504.8 million in fiscal year 1987. The current estimate for fiscal year 1988 is $260 million. Moreover, the Navy now requires that private-sector contracts in support of in-house projects be directly funded by the customer, thus further reducing the carryover.

# Employment and Operational Impacts

## Employment Impacts

Neither DOD nor the Navy has identified any employment impacts that can be directly attributed to the conversion. Such impacts would depend mainly on the level of activity at the Centers and the availability of appropriated funds. The Centers are concerned that there could be employment impacts if their budget requests for appropriated funds to finance overhead costs are not fully met. Employment impacts would depend on how the Centers absorb any reduced funding.

## Operational Impacts

The conversion could affect NAC and NAEC's operations. The impacts could result from

- separating the funding for material and labor costs from the funding for overhead costs;
- eliminating use of the Asset Capitalization Program (ACP), which could decrease funds for modernization efforts; and
- decreasing the inventories that the Centers are authorized to maintain to support customer orders.

DOD believes many of these potential problems stem from the way the Navy said it would implement the conversion, rather than from the conversion itself.

### Separation of Funding Sources

Conceptually, industrial fund activities are reimbursed by customers for their material, labor, and overhead costs for work performed. Thus, a balance is maintained between direct and indirect costs.

The conversion, as it would be implemented by the Navy, will separate the sources of funding. Estimated material and labor costs will still be reimbursed by customers, and estimated overhead costs will be financed from operation and maintenance funds appropriated for that purpose. Because the Navy chose to finance overhead costs with appropriated funds, NAC and NAEC 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 customer's 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 the ACP, improvements are financed by recovering depreciation through charges to customers and adding a surcharge to the cost of the work. ACP funds can be used to purchase equipment and to finance minor construction projects and management information systems.

Because the ACP is a program established for industrially funded activities, upon conversion, Navy research and engineering activities will no longer be able to finance their modernization plans through this program. NAC and NAEC officials believe that if they again have to compete for procurement appropriations, their plans to continue upgrading facilities and equipment will not be adequately financed.

According to the OASD(C), the Navy is generally correct in its belief that industrial fund activities have had difficulty in successfully competing with weapons systems for procurement funds. It also believes this is a problem the Navy can resolve by placing an additional priority on equipment for such activities. Alternatively, the OASD(C) believes that most of the equipment used by the research and engineering activities should be funded from the Navy's research, development, test, and evaluation appropriation, not from procurement appropriations.

We found that since the ACP was initiated in fiscal year 1983, industrial fund activities have had more money available for purchasing equipment. For example, we reported[1] that for fiscal years 1983-85, about $1.4 billion was available for this purpose, 42 percent more than the $975 million spent to acquire industrial fund equipment in the 3 years prior to the period. More recently, however, we reported[2] that many equipment purchases have not achieved expected benefits and that the Navy needed to develop guidance for effective program management at its aviation depots. We noted that generally accepted elements of an effective capital investment program, such as management support,

[1]Industrial Funds: DOD Should Improve Its Accounting for Asset Capitalization Program Funds (GAO/NSIAD-86-112, May 23, 1986).

[2]Navy Maintenance: Naval Aviation Depot's Asset Capitalization Program Needs Improvement (GAO/NSIAD-88-134, Apr. 28, 1988).

well-defined program criteria, and post investment analysis, were needed.

## Inventory Levels Will Be Reduced

Industrial fund activities are authorized to acquire and maintain direct material inventories for projected work. If removed from the industrial funding, NAC and NAEC will have to return inventories maintained for anticipated work to the respective inventory managers (e.g., Navy supply centers, Defense Logistics Agency, and the General Services Administration).

According to NAC officials, the limitation on inventory levels could adversely affect their operations by eliminating the flexibility they currently have to purchase material and supplies in anticipation of receiving customer orders. They may experience difficulty responding to unexpected work requests if material is unavailable from local private-sector sources or if it requires a lengthy time to procure.

# Costs and Savings Associated With the Conversion

The conversion at NAC and NAEC would cost an estimated $34.9 million to $37.9 million. These costs would be incurred for converting accounting and other records from one financial management system to another, purchasing new data processing equipment, and training personnel to use the new system. Also, other costs would result from the need to modify a new industrial fund accounting and financial management information system, known as the Standard Automated Financial System (STAFS), to accommodate appropriation accounting requirements. If the Navy converted, NAC and NAEC would have to maintain two accounting systems until the STAFS became fully operational: one for reimbursable material and labor costs and one for overhead costs.

DOD believes that conversion of these two Centers to another funding method would save money 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 that monetary savings would occur. DOD has shown that a onetime budgetary reduction would be associated with decreasing 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.

## Additional Costs Associated With the Conversion

NAC and NAEC accounting and other records for work underway at the time a conversion would take place would have to be amended to fully implement the conversion. NAC estimates this effort would cost $14 million, while NAEC's estimates range from $3 million to $6 million. NAC estimates that other implementation actions required would cost $4.3 million. (NAEC did not provide a comparable estimate.) Other costs associated with STAFS equipment and training to expand the system to NAC are estimated to be $13.6 million.

Also, the STAFS, which is an industrial fund accounting system, would have to be modified to accommodate the way the Navy has said it would implement the conversion, if required to convert. The current Navy estimate for the modification at all 14 research and engineering activities, which includes life-cycle maintenance costs, is about $68.4 million. An unspecified portion of this estimated cost would apply to NAC and NAEC.

Additional costs would be incurred for maintaining two accounting systems—one for material and labor costs and another for overhead costs—until the STAFS is implemented. However, such costs would result from the way the Navy has said it would implement the conversion and

are not directly related to the decision to convert the financial management system.

## Savings Associated With the Conversion

The OASD(C) believes the conversion would result in lower overall costs. Although the OASD(C) offered no analytical evidence to support that claim, it believes the savings would be due, in part, to the elimination of funding-related information desired by appropriated fund customers. However, the way the Navy has said it would implement the conversion—billing customers for material and labor and financing overhaul with direct appropriation—would preclude all of this type of potential savings from being realized. This is because the Navy would not have entirely eliminated DOD's concern about the cost of maintaining industrial fund accounting systems at these activities.

A onetime budgetary reduction associated with the funded carryover could be achieved. As the Navy said it would implement the conversion, the customers would reimburse the Centers only for the costs incurred during the fiscal period for direct labor and material. Overhead costs for the period would be financed with funds appropriated for that purpose.

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