

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

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Improperly Subsidizing The Foreign Military Sales Program-- A Continuing Problem

Over the years, GAO has issued numerous reports on the Department of Defense's continued failure to operate the foreign military sales program at no loss to the Government, as intended by law. This failure has resulted in large subsidies to the sales program, a practice which the Congress wants Defense to avoid.

This report discusses another example of Defense's inadequate methods of carrying out its pricing policies. Defense has not charged for the quality assurance services it provides on equipment sold to other countries even though recovery of costs for these services has been required since at least 1970.

As a result, during the past 6 fiscal years the Government has absorbed costs estimated up to \$370 million that should have been recovered from foreign customers.

GAO is recommending that the Congress require the Secretary of Defense to present a plan for overcoming the foreign military sales pricing problems. GAO also recommends that Defense improve pricing policies and practices and insure that the policies are effectively implemented.



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COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

Over the past decade, we have issued numerous reports on the Department of Defense's continued failure to recover all costs incurred for foreign military sales. The primary causes of this failure have been inadequate implementation of Defense's pricing policies by the military departments and Defense agencies, and insufficient followup or monitoring of actual cost recovery practices by Defense policy-makers. As a result, the foreign military sales program has been subsidized by hundreds of millions of dollars, a practice which the Congress wants the Defense Department to avoid.

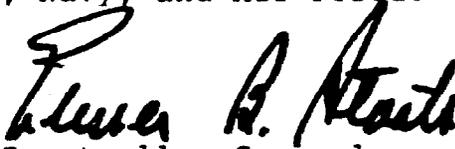
This report discusses Defense's failure to recover, as required, up to an estimated \$370 million during the last 6 fiscal years for quality assurance services performed by U.S. Government employees on items sold to foreign governments. As you know, the Congress, in passing the Arms Export Control Act of 1976, intended that indirect as well as direct costs of goods and services sold to foreign governments be recovered so that the foreign military sales program would not be subsidized by Defense appropriations. Further, since 1973, the Government-provided quality assurance services have been specifically identified in Defense pricing instructions as a recurring support cost to be recovered. Since at least 1970, Defense pricing instructions have required that items sold to foreign governments be priced to recover the full Defense contract costs. Defense Department officials indicated that full Defense contract costs should include Government-provided quality assurance services.

Until the Department expands its efforts to insure that its pricing policies are effectively implemented, the full recovery of costs cannot be assured, and the foreign military sales program will continue to be subsidized. In view of the substantial losses resulting from the Defense Department's failure to effectively implement foreign military sales policies, we believe it is in the national interest for (1) the Congress to require the Secretary of Defense to come forward with a plan for overcoming the foreign military sales pricing problems and (2) the Defense Department to assign specific responsibility to an organization to improve pricing policies and insure that these policies are effectively implemented by

the military services. Also, action must be taken immediately to recover the costs of quality assurance services currently being performed by Defense on foreign military sales items, as well as to recover costs recently incurred by Defense.

Appendix I describes the Defense Department's failure to recover quality assurance costs and to insure that the military departments and Defense agencies effectively implement pricing policies. We informally discussed our findings with Defense officials responsible for foreign military sales policy, and their comments were obtained and incorporated as appropriate. A list of our previous reports concerning foreign military sales costs recovery is in appendix II. The scope of our review is in appendix III.

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretaries of the Army, Navy, and Air Force.


Comptroller General
of the United States

FINDINGS AND RECOMMENDATIONS ON THE DEPARTMENT OF
DEFENSE'S CONTINUED FAILURE TO RECOVER ALL COSTS
INCURRED FOR FOREIGN MILITARY SALES

In recent years, increased public and congressional awareness has focused upon the dramatic increases in the dollar volume of U.S. foreign military sales. Department of Defense sales of articles and services to foreign governments have grown from \$953 million in fiscal 1970 to \$13.4 billion in fiscal 1978.

COST RECOVERY PROVISIONS

Foreign military sales are transacted under authority of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2751, et seq.), which amended and re-named the Foreign Military Sales Act of 1968.

Foreign sales under which quality services are provided, where the U.S. Government purchases defense articles or services from a private firm for sale to a foreign government, are governed by 22 U.S.C. 2762 (Procurement for Cash Sales). That section, which has remained basically unchanged since the enactment of the Foreign Military Sales Act of 1968 with respect to cost recovery requirements, requires foreign governments to agree to pay the full amount of the contract, thus insuring the United States against any loss on the contract.

The act also specifically requires the charging of certain indirect costs for "procurement for cash" sales, including appropriate charges for administrative services (22 U.S.C. 2761(e)(1)). The legislative intent of this provision was to insure that indirect, as well as direct, costs of goods and services sold to foreign governments be recovered so that the foreign military sales program would not be subsidized by Defense appropriations.

As a matter of policy, Defense has long recognized its responsibility under foreign sales legislation to recover from foreign buyers all direct and indirect costs associated with foreign military sales. A Defense instruction of July 17, 1973, pertaining to pricing of articles sold to foreign governments (Defense Instruction 2140.1), required Defense components to recover recurring support costs, which specifically included Government-provided quality assurance, by directly charging the applicable foreign sales cases.

This same requirement is now contained in the existing Defense Instruction 2140.1, dated March 9, 1977. The 1973 instruction had amended a Defense instruction, dated January 29, 1970, that required that items sold to foreign governments be priced to recover full Defense contract costs. Defense officials stated that full contract costs included costs for Government-provided quality assurance services. Prior to 1970, this policy was unofficial.

Performance of quality assurance

Within the Defense Logistics Agency are nine Defense Contract Administration Services Regions which perform contract administration for most procurement contracts let by Defense organizations and for some contracts let by other Government agencies. The regions manage the contracts in their geographical area through representatives located at contractors' plants. One major responsibility of the representatives is quality assurance--that is, determining whether a contractor has fulfilled his obligations pertaining to the quality and quantity of items delivered under a contract. During fiscal 1978, the 5,100 quality assurance representatives logged about 11.8 million regular and overtime hours for inspections.

The individual military services also have personnel who perform quality assurance for contracts that each service retains for administration. Our review did not cover whether the costs for the military services' quality assurance were charged on foreign military sales items.

On foreign military sales items, the contract administration services regions prepare bills for processing by the military services, charging the quality assurance time at the rate per hour established by the Defense Comptroller. The fiscal 1978 rate was \$18.86 per hour. In recent years, foreign military sales requirements have been substantial in relation to U.S. requirements. For example, during fiscal 1978, foreign military sales acceptances were about \$13.4 billion while Defense's purchasing authority totaled about \$30.3 billion. Between fiscal 1973 and 1978, foreign sales represented approximately a third of Defense's purchasing authority. Substantial quality assurance services have been rendered on these sales between fiscal 1973 and 1978.

FOREIGN GOVERNMENTS NOT CHARGED
FOR QUALITY ASSURANCE

Defense is subsidizing the foreign military sales program by not recovering from foreign governments the cost of quality assurance services performed by the Defense Contract Administration Services Regions, as intended by law and required by Defense instructions. We estimated 1/ that since fiscal 1973, up to \$370 million has not been recovered. Most of this amount has not been recovered because the Defense Department lacks a workable system through which the contract administration services regions can learn which items are being procured for foreign customers. Lacking adequate identification, quality assurance inspectors cannot provide to the regions the data that must be included in billings to foreign customers for inspection services.

When the cost of quality assurance inspections of items produced for foreign customers has been identified for billing, Defense has failed to make recoveries. At the time of our audit, \$13 million in quality assurance costs had been identified by contract administration services regions, but had not been collected from foreign countries.

Lack of a system to identify
foreign sales items

Military services' contracting officials had no standard or consistent system for writing prime contracts that would readily identify items for foreign sales. As a result, the only way the contract administration services regions could determine whether and to what extent foreign sales items were included in the contracts was through a detailed and time-consuming review and analysis of the contracts. These evaluations require extensive knowledge of both contracts and aspects of the military services' accounting systems. The contract administration services regions do not have enough qualified personnel to effectively perform the evaluations.

1/No statistics were available to show the amount of quality assurance spent on foreign military sales items. To obtain a rough approximation of the quality assurance costs incurred by contract administration services regions on foreign military sales items, we determined the ratio of the dollar values of foreign military sales acceptances to Defense procurement appropriations and multiplied the ratio by the cost of the contract administration services regions' quality assurance for fiscal 1973 through 1978.

The problem of identifying foreign sales requirements is compounded by the fact that prime contractors often have subcontracts and purchase orders (referred to as second-level procurements) to obtain components and subassemblies to be used in producing the major items ordered in the prime contracts. The subcontractors also often have subcontracts for some items (third-level procurements) and so on, down to sixth-level procurements, which may require inspections by Government quality assurance personnel. For the production of major items such as tanks, planes, or missiles, the contracts, subcontracts, and purchase orders may number in the thousands. It would appear that a system to track foreign sales requirements through all the subcontracts and purchase orders would be cumbersome and expensive.

We found several procurement documents that included foreign sales items the contract administration services regions were not aware of. As a result, the costs of quality assurance services provided on these items were not accumulated and billed to the foreign countries. Some examples follow:

- The Dana Corporation filled Army purchase orders for about \$6 million of transmissions which were subsequently used by AM General in the assembly of 5-ton trucks. We found that 8,782 of the trucks ordered were for foreign sales and that the transmissions for these trucks required 9,191 hours of quality assurance. Almost \$180,000 for quality assurance has not been billed.
- The Excello Corporation produced about \$9 million of vanes and blades under 32 Air Force purchase orders. The vanes and blades were used by Pratt and Whitney in producing aircraft engines that were subsequently used in aircraft sold to foreign customers. About 7,055 hours valued at \$137,600 were spent inspecting the vanes and blades included in the foreign military sales, but that cost was not included in the billings.
- The Aeronca Corporation received purchase orders from the Navy and the Air Force for air foils and fuselage parts to be used by Grumman and McDonnell-Douglas in aircraft, some of which were produced for foreign sales. The Aeronca components required 2,136 hours of quality assurance services which cost the United States \$41,650, which was not recovered.

We discussed our findings with the Defense officials responsible for foreign military sales policies. They believe the estimate of \$370 million for quality assurance costs not recovered was too high, but they were unable to provide statistics or an alternate procedure to estimate the amount of quality assurance spent on foreign military sales items. The lack of statistics is further evidence of the need for better accounting for foreign sales quality assurance costs.

We also discussed with the Defense officials the need for a simplified system to identify quality assurance costs incurred on foreign sales items. We suggested that in lieu of attempting to identify such costs at low-level procurements, cost factors be devised and used for billings. Defense officials agreed that a need exists for a simplified system and advised that our suggestion would be considered.

\$13 million of costs identified
but not recouped

Between fiscal 1976 and 1978, some prime contracts did identify foreign sales items and the contract administration services regions identified costs of about \$13 million for quality assurance services on these items. These costs have not been reimbursed to the contract administration services appropriations.

Initially, the contract administration services regions submitted billings to the military services for these costs, and the services would, in turn, collect from foreign countries. The billings were rejected and returned to the contract administration services region.

The military services indicated several reasons for not processing the billings. Each of the military services complained that, in some instances, the information provided by the contract administration services region was not detailed enough to bill the countries. The Army and Air Force also stated that, in estimating the prices in foreign sales cases, the cost of quality assurance was not included and, therefore, foreign government funds were not available to cover quality assurance costs. (The Army and Air Force appear to have ignored the fact that the prices quoted on sales contracts are estimates and that standard foreign sales contract provisions require the recovery of all costs actually incurred.) Further, the Navy contended that the rate charged for quality assurance was too high, although Navy officials were unable to furnish evidence of that.

When the Security Assistance Accounting Center was established in 1976 as the central foreign military sales billing activity, the Center accepted all of the contract administration services regions' quality assurance billings. However, when some foreign countries questioned whether they had agreed to pay for quality assurance, the Center stopped including the costs in billings. The billings were then returned to the responsible contract administration services region.

After we inquired into the status of the \$13 million in billings for quality assurance costs, the Defense Logistics Agency, in a message dated September 6, 1978, directed the contract administration services regions to again submit billings to the military services.

FAILURE TO INSURE PROPER IMPLEMENTATION
OF FOREIGN SALES PRICING POLICIES

The failure to charge foreign countries for Government-provided quality assurance is symptomatic of Defense's continuing problems of implementing foreign military sales pricing policies. As shown in appendix II, during the past decade, we have issued many reports covering a wide range of problems resulting in the failure to recover hundreds of millions of dollars of costs from foreign countries. These were, in effect, improper subsidies.

The major reason Defense has consistently failed to recover all costs is a general lack of effort on its part to insure that pricing policies are properly implemented by the military services. In an August 25, 1978, report entitled "The Department of Defense Continues to Improperly Subsidize Foreign Military Sales" (FGMSD-78-51), we discussed the need for improved administration of foreign military sales pricing policies and implementing systems. We recommended that the Secretary of Defense assign specific responsibility for administering pricing policy and monitoring pricing systems to a new organization or some existing organization that can be sufficiently freed from other work to provide careful surveillance over the pricing functions.

In a November 6, 1978, letter commenting on the August 25, 1978, report and specifically on this recommendation, the Assistant Secretary of Defense (Comptroller) stated that the existing Defense organization provided adequate surveillance over the pricing function.

"The Office of the Secretary of Defense (OSD) prescribes overall policies. Subordinate DOD Components are then responsible for implementing and administering these policies, including establishment of the required internal controls. Compliance with DOD policies and the adequacy of internal controls is monitored by a number of internal audit organizations * * * ."

Subordinate Defense components have not been effective in implementing Defense pricing policies, and internal audit coverage has been sporadic. Over the past decade, our reports in the foreign military sales area have continued to show that ineffective implementation of pricing policy remains a primary cause of inadequate recovery of costs. A recent report, "Summary of Efforts to Recover U.S. Government Costs in Foreign Military Sales" (ID-77-56; Sept. 27, 1978), summarized our past reviews and Defense's responses concerning cost recoveries in foreign military sales. The report concluded that Defense's problem was inadequate implementation by the military departments of foreign military sales policy and insufficient followup or monitoring by Defense policymakers of actual cost recovery practices.

There is a lack of personnel at the Office of the Secretary of Defense level who are assigned to make sure that pricing policy is effectively implemented. The Office of the Secretary has only two accountants who are assigned to prepare and update pricing policy. They are also responsible for the billing, collecting, and accounting policies for foreign military sales.

Funding for additional personnel who would insure that pricing policies are properly implemented by the military services should not be a problem for Defense. The Arms Export Control Act requires foreign countries to reimburse Defense for the cost of administering the sales program. The cost of any additional personnel needed to administer the program should be covered by reimbursements. However, military and civilian personnel ceilings do exist, having been imposed on Defense by the Congress, which restricts the hiring of additional personnel for administration of the sales program. As noted in a recent GAO Report 1/, we

1/"The Department of Defense's Continued Failure to Charge for Using Government-owned Plant and Equipment for Foreign Military Sales Costs Millions," FGMSD-77-20, Apr. 11, 1978.

believe Defense has placed more emphasis on customer satisfaction than on implementing good pricing and accounting practices. This approach, combined with the ceiling constraints, has contributed to the lack of personnel assigned to insuring that foreign governments reimburse all costs, as required by law.

CONCLUSIONS

Considering the military departments' continued failure to implement pricing policies and the resulting losses totaling hundreds of millions of dollars, the Secretary of Defense should assign the additional personnel needed to overcome the pricing problems discussed in this report. Also, our previous recommendation to specifically charge an existing or newly created organization with insuring effective and consistent implementation of pricing policies throughout Defense should be reconsidered and given a high priority.

To comply with congressional intent that Defense not subsidize foreign military sales, Defense must ensure that its pricing policies are effectively and consistently implemented in systems used by the military departments to price and bill foreign military sales. Also, Defense must devise a process to insure that Government-provided quality assurance costs are recovered from foreign governments.

In recovering costs of foreign sales, up to and including final billing, the Defense standard sales contract provides that adjustments may be made to estimated costs that are not commensurate with actual costs. Therefore, any costs, including quality assurance costs incurred, that have not been recovered on those sales contracts for which final billing has not been made should be included in the final billing.

As to undercharges that may be found after final billing, Defense Instruction 2140.1 provides that adjustments to final billings are permitted when there are unauthorized deviations from Defense pricing policies. The longer the Defense Department takes to attempt to collect undercharges, the more difficult the recovery of these amounts from foreign governments will be.

RECOMMENDATIONS TO THE CONGRESS

We recommend that the Congress require the Secretary of Defense to ~~come forward~~ with a plan for overcoming the foreign military sales pricing problems, discussed in this

report. The plan should specify any organizational changes that will be made and set forth the number of additional personnel--with a description of their duties--to be assigned to these activities. If the Secretary determines that the expanded staff cannot be provided from present resources, then he should request an increase in the Department's personnel ceiling.

RECOMMENDATIONS TO THE
SECRETARY OF DEFENSE

We also recommend that the Secretary

- reconsider our previous recommendation to assign specific responsibility for ensuring effective and consistent implementation of foreign military sales pricing policies to a new or existing organization that can be sufficiently freed from other work to carefully follow up or monitor implementation of the policies in pricing systems,
- develop and implement practical procedures to recover the cost of Government-provided quality assurance, and
- direct responsible organizations to make a reasonable attempt to identify and recover undercharges on foreign sales resulting from nonrecovery of the costs of Government-provided quality assurance services.

PREVIOUS GAO REPORTS
CONCERNING FOREIGN MILITARY
SALES COST RECOVERY

Reports to the Congress

1. "Omission of Significant Costs From Charges to the Federal Republic of Germany for Pilot Training," B-167363, Nov. 19, 1969.
2. "Opportunity to Recover Certain Foreign Military Sales--Administrative Expenses," B-165731, Feb. 26, 1973.
3. "Reimbursements From Foreign Governments for Military Personnel Services Provided Under the Foreign Military Sales Act," ID-75-6, Aug. 16, 1974.
4. "Issues Related to U.S. Military Sales Assistance to Iran," B-133258, Oct. 21, 1974.
5. "Pilot and Navigator Training Rates," FPCD-75-151, Apr. 11, 1975.
6. "Airlift Operations of the Military Airlift Command During the 1973 Middle East War," LCD-75-204, Apr. 16, 1975.
7. "The U.S. Should Recover Full Costs of Reimbursable Satellite Launches," LCD-74-107, May 6, 1975.
8. "The Department of Defense Can Improve Its Free-Asset Management," LCD-76-414, Mar. 3, 1976.
9. "Millions of Dollars of Costs Incurred in Training Foreign Military Students Have Not Been Recovered," FGMSD-76-91, Dec. 14, 1976.
10. "Defense Action to Reduce Charges for Foreign Military Training Will Result in the Loss of Millions of Dollars," FGMSD-77-17, Feb. 23, 1977.
11. Letter report 1/ discussing DOD's estimates of increased reimbursements resulting from revision of pricing policy, FGMSD-77-40, May 6, 1977.

1/Letter reports are untitled.

12. "Inadequate Methods Used to Account for and Recover Personnel Costs of the Foreign Military Sales Program," FGMSD-77-22, Oct. 21, 1977.
13. "The Department of Defense's Continued Failure To Charge for Using Government-Owned Plant and Equipment for Foreign Military Sales Costs Millions," FGMSD-77-20, Apr. 11, 1978.
14. "The Department of Defense Continues to Improperly Subsidize Foreign Military Sales," FGMSD-78-51, Aug. 25, 1978.
15. "Cost Waivers Under the Foreign Military Sales Program: More Attention and Control Needed," FGMSD-78-48, Sept. 26, 1978.
16. "Summary of Efforts to Recover U.S. Government Costs in Foreign Military Sales," ID-77-56, Sept. 27, 1978.

Reports to the Secretary of Defense

1. "Action Needed to Recover Full Costs to the Government of Producing Weapons for Sale to Foreign Governments," B-174901, Sept. 7, 1972.
2. "Recovery of Costs to the Government for Producing Weapons for Sale to Foreign Governments," B-174901, Apr. 9, 1973.
3. "Recovery of Costs on Government-Owned Plant and Equipment," B-174901, Oct. 7, 1974.
4. "Reimbursement for Foreign Military Student Training," FGMSD-76-21, Dec. 1, 1975.
5. Letter report discussing weaknesses in DOD's research and development recoupment program, PSAD-76-131, Dec. 18, 1975.
6. "Recovery of Costs Incurred by the Defense Department in Providing Technical Assistance and Training in Iran," FGMSD-76-64, July 13, 1976.
7. "Improvements are Needed to Fully Recover Transportation and Other Delivery Costs Under the Foreign Military Sales Program," LCD-77-210, Aug. 19, 1977.

8. Letter report discussing DOD recoupment of normal inventory losses on foreign military sales, FGMSD-77-43, Sept. 8, 1977.
9. Letter report discussing underpricing of M2 machinegun sales to foreign customers, LCD-77-449, Oct. 7, 1977.
10. Letter report discussing unserviceable equipment returned by foreign governments for credit, FGMSD-78-60, Sept. 29, 1978.

SCOPE OF REVIEW

We reviewed the Defense Department's system for identifying and billing for Government-provided quality assurance services provided on items sold to foreign governments. The military services also have personnel who perform quality assurance for contracts that the services retain for administration. Our review did not cover whether or not the costs for the military services' quality assurance were charged on foreign military sales items.

Our review included an examination of legislative policies, procedures, documents, transactions, and reports concerning Government-provided quality assurance on sales to foreign governments. We interviewed responsible officials to discuss policies and operating procedures and other related matters. We examined Defense's pricing policies and procedures on foreign sales and considered information from a number of our reviews dealing with cost recoupment on foreign sales.

We made our review at the following departments and organizations:

- Headquarters, Department of Defense, Defense Audit Service, and Defense Logistics Agency, Washington, D.C.
- U.S. Army Tank-Automotive Readiness Command, Warren, Michigan.
- Air Force Systems Division, Dayton, Ohio.
- Security Assistance Accounting Center, Denver, Colorado.
- Defense Contract Administration Services Region, Cleveland, Ohio.



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