

GAO

Report to the Honorable  
Charles E. Grassley,  
U.S. Senate

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October 1998

# FOREIGN MILITARY SALES

Millions of Dollars of  
Nonrecurring Research  
and Development  
Costs Have Not Been  
Recovered



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

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**Accounting and Information  
Management Division**

B-280771

October 20, 1998

The Honorable Charles E. Grassley  
United States Senate

Dear Senator Grassley:

This report responds to your request that we review the Department of Defense's (DOD) ability to account for and report on the full costs of the foreign military sales (FMS) program. It was agreed with your office that we would take a two-step approach in responding to your request. First, we agreed to evaluate DOD's recoupment of monies owed by FMS customers for the U.S. government's research, development, and production costs of major defense equipment. Second, we agreed to evaluate DOD's accountability over expenditures of FMS customers' funds. This report, which discusses the first of these efforts, focuses on Air Force and Navy activities. As agreed with your office, we did not review the Army-managed cases because the U.S. Army Audit Agency is currently completing an audit of the Army's recoupment of nonrecurring costs. We will respond to the other segment of your request in a subsequent report.

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## Background

The Arms Export Control Act gives the President authority to sell defense articles and services to eligible foreign countries, generally at no cost to the U.S. government. While the Defense Security Assistance Agency (DSAA) has overall responsibility for administering the FMS program, the Army, Navy, and Air Force normally execute the sales agreements—commonly referred to as sales cases.

Foreign military sales are made on an individual case basis. The cases are initiated by a foreign country representative sending a letter of request to DOD asking for various information, such as precise price data. Once the customer decides to proceed with the purchase, DOD prepares a Letter of Offer and Acceptance (LOA) stating the terms of the sale for the goods and services being provided. The Arms Export Control Act requires that, after September 30, 1976, letters of offer for the sale of major defense equipment shall include a proportionate amount of nonrecurring costs related to the research, development, and production of major defense equipment. DOD interpreted the act as requiring the recovery of these costs on a pro rata basis. The military services calculate the pro rata rate by dividing the total research and development and other one-time production costs by the anticipated total number of units to be produced

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for both domestic and foreign use. A separate charge is calculated for each item of major defense equipment and is included in the LOA as part of the price that FMS customers are to pay for the purchase of major defense equipment.

After the LOA is accepted, the FMS customer is generally required to pay, in advance, amounts necessary to cover costs associated with the sales agreement, including any nonrecurring costs. These advance payments are held in an FMS trust fund by the Department of the Treasury. DOD then uses these funds to pay private contractors and reimburse DOD activities for the costs of executing and administering the FMS agreement.

In addition, as deliveries of major defense equipment occur, the military services are to prepare delivery reports and related cost statements which, among other things, are used as support to charge FMS customers' trust fund accounts for applicable nonrecurring research, development, and production costs. Nonrecurring costs collected from the FMS trust funds are to be deposited into the general fund of the Treasury. The funds are returned to the Treasury instead of to DOD since the Congress had previously provided DOD with appropriated funds to pay for the research, development, and production costs of major defense equipment. If, for some reason, DOD fails to process the charges to recover applicable nonrecurring costs from the FMS customers' trust fund, amounts paid in advance to reimburse the U.S. government for nonrecurring costs would eventually be returned to the FMS customer.

As deliveries of major defense equipment are made, the military services are to report the detailed delivery and recovery of nonrecurring costs within 30 days to a central accounting activity—the Defense Finance and Accounting Service (DFAS), Denver Center—which maintains records of each country's trust fund balance and issues quarterly statements to foreign customers summarizing deliveries and amounts charged to their cases.

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## Results in Brief

We found that the Air Force and Navy were not always recovering nonrecurring research, development, and production costs from the FMS trust fund as major defense equipment items were delivered to the FMS customer. Specifically, we identified over \$183 million of nonrecurring costs related to items that were delivered—some as long ago as 1989—that had not been charged to the FMS customers' trust fund account.

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For example, between July 1993 and November 1995, South Korea received 48 F-16 aircraft on an FMS case managed by the Air Force. Our review of the case disclosed that no deliveries had been reported for the purpose of recovering nonrecurring research, development, and production costs. Had the Air Force followed DOD's procedures and reported the deliveries and recouped the nonrecurring costs within 30 days of physical delivery of the aircraft, it would have already charged South Korea's trust fund account for over \$49 million of nonrecurring research, development, and production costs. Air Force and Navy officials agreed that FMS customers were not being properly charged for millions of dollars of nonrecurring costs for major defense equipment items they had received and have begun to take actions to recover the outstanding amounts.

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## Objective, Scope, and Methodology

The objective of this assignment was to determine if the Air Force and Navy were correctly recovering nonrecurring research, development, and production costs owed by FMS customers for purchases of major defense equipment. To determine the regulatory requirements for charging and collecting these nonrecurring costs from FMS customers, we obtained and reviewed applicable laws, policies, procedures, regulations, and guidance. During our visits to DOD locations, we gathered and analyzed financial information from pertinent accounting reports and records to identify data on reported deliveries of major defense equipment items and related charges for nonrecurring research, development, and production costs.

We judgmentally selected 30 FMS cases for detailed review from a total of 93 Air Force and Navy FMS sales cases listed on their March 1998 reports entitled Recoupment of Nonrecurring Costs on Sales of USG Products and Technology (RCS DSAA (Q) 1112). According to DOD accounting officials, the quarterly reports are to include only ongoing current FMS cases since all nonrecurring costs should be recovered and transferred to the general fund of the Treasury before a case is completed and closed. The reports generally included the country, case, item description, quantity of items to be sold, scheduled delivery dates, quantity of items delivered to date, amount of nonrecurring research, development, and production costs to be collected, and amount of nonrecurring research, development, and production costs collected to date.

We selected the 30 FMS cases for detailed review based on whether the unrecovered amount of nonrecurring research, development, and production costs was large and whether the report showed, among other

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things, that (1) items had been delivered to the customers, but that there had been little or no recovery of nonrecurring costs or (2) scheduled delivery dates were for March 1998 or earlier and no or few deliveries had been made. The 30 FMS cases accounted for about \$266 million (40 percent) of the two services' total unrecovered nonrecurring research, development, and production costs of over \$655 million. For the selected cases, we contacted the staff responsible for managing the case or other responsible officials knowledgeable about the case, to determine the (1) quantity of items to be delivered, (2) quantity of items delivered to date, (3) total amount of nonrecurring costs to be recovered, and (4) total amount of nonrecurring costs recovered to date. We also asked the staff to provide an explanation for why nonrecurring research, development, and production costs that should have been recovered earlier had not yet been recovered. The dollar values of nonrecurring research, development, and production costs related to major defense equipment items discussed in this report were obtained from DOD reports or responsible program officials. We did not independently verify these costs.

We performed our work at the headquarters, departments of the Navy and Air Force; Defense Security Assistance Agency; Office of the Under Secretary of Defense (Comptroller), Washington, D.C.; Naval Air Systems Command, Patuxent River, Maryland; Naval Sea Systems Command, Arlington, Virginia; Air Force Aeronautical Systems Center and Air Force Security Assistance Center, Wright Patterson Air Force Base, Dayton, Ohio; and the Defense Finance and Accounting Service centers in Denver, Colorado, and Columbus, Ohio.

We performed our work between February 1998 and August 1998 in accordance with generally accepted government auditing standards. We requested written comments on a draft of this report from the Secretary of Defense or his designee. The Under Secretary of Defense (Comptroller) provided written comments. These comments are discussed in the "Agency Comments and Our Evaluation" section and throughout the report where appropriate and are reprinted in appendix I.

## Activities Not Charging Customers' Accounts for Nonrecurring Research, Development, and Production Costs

We found that the Air Force and Navy were not following prescribed policies and procedures for reporting the delivery of items to FMS customers in order to recover the nonrecurring research, development, and production costs. As a result, FMS customers' trust fund accounts were not being charged for millions of dollars of these costs for major defense equipment items they had received.

## FMS Customer Accounts Are to Be Charged for Nonrecurring Costs as Items Are Delivered

Volume 15 of DOD's Financial Management Regulation 7000.14-R, entitled Security Assistance Policy and Procedures, states that "Charges for nonrecurring costs are earned as items are physically delivered to the FMS customer." It also requires that deliveries be reported to DFAS Denver within 30 days of shipment. While the DOD policy is not specific about the length of time after delivery during which an activity is to charge an FMS customer's trust fund account for the nonrecurring costs, responsible DOD accounting officials told us that the nonrecurring costs should be recouped as items are delivered. According to the DOD accounting officials, DOD activities should prepare the delivery report, recover the nonrecurring costs, and submit both the delivery and recovery of costs data to DFAS Denver within 30 days of shipment of the items. Therefore, DOD policy recognizes delivery reporting as a key step toward initiating the charges to recover nonrecurring costs from FMS customers' trust funds.

The following describes what generally should be a typical transaction flow to report the delivery of major defense equipment and recovery of nonrecurring research, development, and production costs.

- The military service program office is generally responsible for reporting the delivery of items as they are made. It also prepares a cost statement, which serves as the supporting documentation for recording earnings, and forwards these data along with the delivery report to its budget or finance office.
- The budget or finance office reviews the information and reports the delivery to DFAS Denver. The budget or finance office also attaches a letter to the cost statement requesting that the area accounting office prepare a voucher to collect the nonrecurring costs. The letter and cost statement are then forwarded to the area accounting office for processing.<sup>1</sup>

<sup>1</sup>At some activities, the program office may bypass the budget or finance office and forward the documents directly to the appropriate area accounting office. In these instances, the program office would be responsible for reporting the delivery of items to DFAS Denver.

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- The area accounting office processes the transaction to charge the FMS trust fund and transfer the amount to the general fund of the Treasury and reports the transaction to DFAS Denver, which records the charge against the FMS customer's trust fund account.

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## Millions of Dollars Not Recovered

DOD's reports on nonrecurring costs for current sales cases show that as of March 1998, the Air Force and Navy had over \$655 million of nonrecurring research, development, and production costs for major defense equipment sales that had not been recovered from FMS customers. Our analysis and discussions with program officials concerning \$266 million of this amount found that at least \$183 million of the reported outstanding nonrecurring costs was related to equipment that had been delivered, and therefore, should have already been recovered from the FMS customers' trust fund accounts and deposited in the general fund of the Treasury. In most cases where nonrecurring costs had not been recovered, we found that the military activities' program offices generally had failed to provide the budget or finance office or appropriate accounting station with the proper delivery or cost documentation to support the recoupment of the nonrecurring costs. Following are several examples of FMS cases where nonrecurring research, development, and production costs were not recovered.

- From July 1993 through November 1995, 48 F-16 aircraft were delivered to South Korea. While DOD's accounting records showed that the FMS customer's account had been charged for over \$1.3 billion to pay the contractor and DOD activities for their costs, the Air Force program office had not completed the necessary delivery and cost reports in order to recover the U.S. government's nonrecurring costs of \$1,018,050 per aircraft. As a result, as of May 1998, 5 years after the first aircraft had been delivered and over 2 years after the delivery of the 48th aircraft, nearly \$49 million of nonrecurring research, development, and production costs, which should have been charged against South Korea's trust fund account and transferred to the general fund of the Treasury, was still outstanding. The program official responsible for preparing the delivery reports could not explain why he had not reported the deliveries of the aircraft. Air Force officials agreed that they had not prepared the delivery reports to recoup the nonrecurring costs and told us that, in response to our finding, they were in the process of preparing the necessary delivery reports and cost statements in order to recover the nearly \$49 million from South Korea's trust fund account.

- Between April 1996 and March 1998, the Air Force reported that it had delivered a total of 78 F-16 aircraft to Taiwan. Based on these reported deliveries, the Air Force should have charged Taiwan's trust fund account \$49,920,000 for nonrecurring research, development, and production costs—\$640,000 for each delivered aircraft.<sup>2</sup> We found, however, that while Taiwan's trust fund account had been charged over \$2.3 billion to pay the contractor and other costs, only \$1,574,366 of nonrecurring research, development, and production costs had been charged against the trust fund account. In discussing this case with officials in the program and budget offices, we found that the program office had reported the delivery of the items to the budget office and DFAS Denver but that the delivery report did not include the cost statement, which the budget office required for processing nonrecurring costs charges. As a result, over \$48 million of nonrecurring costs had not been charged to Taiwan's trust fund account and transferred to the general fund of the Treasury. Air Force officials agreed with our finding and told us that they have instructed the program office to include the cost statement with the delivery report so that this does not happen again, and that they have begun the process of preparing the necessary cost statements for the aircraft that have already been delivered. The officials anticipate that they will recover the \$48 million from Taiwan's trust fund account.
- A review of the nonrecurring costs report for another Taiwan case, this one managed by the Navy, showed that between June 1993 and February 1998, Taiwan had received 43 attack helicopters, 53 night target systems, and 20 spare engines. Based on these reported deliveries, the Navy should have charged Taiwan's trust fund account for \$19,819,858 of nonrecurring research, development, and production costs. While our review of financial records disclosed that Taiwan's trust fund account had over \$600 million recorded against it for contractor payments and other miscellaneous charges, we found that none of the over \$19 million of nonrecurring costs had been charged to Taiwan's account. Navy program officials responsible for reporting the delivery of the items agreed that Taiwan's trust fund account had not been charged for nonrecurring costs but could not explain why this was allowed to happen. They added that they were not aware of this problem until we brought it to their attention. They now plan to take the necessary actions to charge Taiwan's trust fund account for the over \$19 million of outstanding nonrecurring costs.
- A review of the nonrecurring costs report for a Navy sale of 482 target detectors to Japan showed that all of the items had been delivered as of 1989. However, the report showed that only \$163,398 of the \$557,444 of the

<sup>2</sup>The F-16 aircraft sold to Taiwan was a different model than the F-16 sold to South Korea. This resulted in different nonrecurring costs.

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nonrecurring research, development, and production costs associated with the items had been recovered. At our request, the Navy program official reviewed the case and told us that the original amount had been miscalculated and should have been \$376,442, not the \$557,444 shown on the report. He told us that based on his new calculations, an additional \$213,044 of nonrecurring costs should have been charged to Japan's trust fund account; but he could not tell us why this amount had not been recovered earlier. He told us that the Navy plans to recoup the \$213,044 of outstanding nonrecurring costs from Japan's trust fund account.

As noted earlier, our review focused only on 30 of the 93 FMS cases that were included in the March 1998 reports, which should only include current ongoing cases, of DOD recoupment of nonrecurring costs of U.S. government products and technology. Over the years DOD has routinely closed FMS cases as they were completed. In response to our request for nonrecurring cost data on these closed cases, DOD officials told us that a query of their FMS system's database disclosed that over 11,000 cases, involving major defense equipment, had been closed since 1976. However, their database did not include information on the total amounts of nonrecurring costs owed or collected. The officials did acknowledge, however, that there would have been hundreds of millions of dollars of nonrecurring research, development, and production costs associated with these closed cases.

Because of the magnitude of nonrecurring research, development, and production costs we identified that had not been charged to FMS customers' trust fund accounts as a result of the services' noncompliance with established DOD policies and procedures for recovering these costs, some FMS cases may have been erroneously closed before all nonrecurring costs were recovered from FMS customers' trust fund accounts. A responsible DOD accounting official agreed that this was a major concern and acknowledged that, given the level of the services' noncompliance with DOD's policies and procedures for reporting the deliveries of items and recovery of applicable nonrecurring costs, FMS cases could have easily been closed before all nonrecurring costs were recovered.

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## Conclusions

Not recovering nonrecurring research, development, and production costs from the FMS trust fund promptly after major defense equipment is delivered to the FMS customer represents a poor financial management practice that delays the transfer of millions of dollars into the general fund of the Treasury. Also, it raises the risk that amounts will never be

recovered and that these funds, deposited in advance into the FMS trust fund for this purpose, will erroneously be returned to customers. The Air Force and Navy should begin to comply with DOD's established policies and procedures for reporting the delivery of major defense equipment and recouping applicable nonrecurring research, development, and production costs. This will help ensure that all amounts of nonrecurring research, development, and production costs associated with the sale of major defense equipment are promptly recovered and deposited in the general fund of the Treasury and that no FMS cases are erroneously closed before all costs are recovered.

## Recommendations

We recommend the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to require the Air Force and Navy to

- recover the over \$183 million identified in this report as nonrecurring research, development, and production costs that have not been charged to FMS customers' trust fund accounts for major defense equipment that has already been delivered,
- review all the other open FMS cases that require FMS customers to pay a proportionate amount of nonrecurring research, development, and production costs for major defense equipment and recoup nonrecurring costs that have not yet been recovered for items that have already been delivered to FMS customers, and
- follow DOD policies and procedures for reporting the delivery of major defense equipment so that the FMS customers' accounts can be charged with nonrecurring research, development, and production costs and amounts transferred to the general fund of the Treasury within the 30 days required by DOD policy.

We also recommend that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to direct the Air Force and Navy to review closed FMS cases to ensure that all nonrecurring research, development, and production costs for delivered major defense equipment have been recouped. Initially, this review of closed cases could be limited to a specific period. For example, the review could include FMS cases that were closed during the last 5 fiscal years. If this review discloses that there have been FMS cases closed before all nonrecurring research, development, and production costs were recouped, (1) any amounts due the U.S. government should be recovered from the FMS customer and (2) the review should be expanded to include closed cases for additional fiscal years.

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## Agency Comments and Our Evaluation

The Under Secretary of Defense (Comptroller) agreed to instruct the Navy and Air Force to recover all applicable nonrecurring costs we identified as not billed to FMS customers. The Comptroller also agreed to require the Navy and Air Force to review all other open cases for outstanding nonrecurring costs and to instruct them to follow DOD policies and procedures for reporting the delivery of defense articles and the collection of applicable nonrecurring costs.

He also agreed with our recommendation that a review be conducted of closed foreign military sales cases to determine if any cases were closed before all nonrecurring costs were recovered. However, he pointed out that since the Air Force and Navy retain their respective records for the closed foreign military sales cases, it would be appropriate that they conduct those reviews rather than the Defense Security Assistance Agency. We have revised our recommendation accordingly.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Armed Services, the Senate Committee on Governmental Affairs, the House Committee on Government Reform and Oversight, the House and Senate Committees on Appropriations, and the House Subcommittee on Government Management, Information and Technology; the Secretary of Defense; the Secretary of the Navy; the Acting Secretary of the Air Force; the Director of the Office of Management and Budget; and other interested parties. We will make copies available to others upon request.

Please contact me at (202) 512-6240 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix II.

Sincerely yours,



Jack L. Brock, Jr.  
Director, Governmentwide and Defense  
Information Systems Issues

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## Abbreviations

DOD	Department of Defense
DFAS	Defense Finance and Accounting Service
DSAA	Defense Security Assistance Agency
FMS	Foreign Military Sales
LOA	Letter of Offer and Acceptance

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# Comments From the Department of Defense



COMPTROLLER

UNDER SECRETARY OF DEFENSE  
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WASHINGTON, DC 20301-1100



SEP 29 1998

Mr. Gene L. Dodaro  
Assistant Comptroller General  
Accounting and Information Management Division  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Dodaro:

This is the Department of Defense response to the General Accounting Office (GAO) draft report, "Foreign Military Sales: Millions of Dollars of Nonrecurring Research and Development Costs Have Not Been Recovered," dated August 21, 1998 (GAO Code 511640/OSD Case 1680).

The Department reviewed the draft report and partially concurs with the findings and the recommendations. Detailed comments on the specific findings and recommendations contained in the report are provided in the enclosure.

The Department appreciates the opportunity to comment on the draft report. My point of contact on this matter is Ms. Kay O'Brien. She may be reached by telephone at (703) 697-0586.

Sincerely,

William J. Lynn

Enclosure

**GENERAL ACCOUNTING OFFICE DRAFT REPORT,  
"FOREIGN MILITARY SALES: MILLIONS OF DOLLARS OF NONRECURRING  
RESEARCH AND DEVELOPMENT COSTS HAVE NOT BEEN RECOVERED,  
AUGUST 21, 1998 (GAO CODE 511640/OSD CASE 1680)**

**DEPARTMENT OF DEFENSE COMMENTS TO THE GAO RECOMMENDATIONS**

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**RECOMMENDATION 1:** The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to require the Air Force and Navy to:

- a. immediately recover the over \$183 million of nonrecurring research, development and production costs that have not been charged to foreign military sales (FMS) customers' trust fund accounts for major defense equipment that has already been delivered;
- b. review all the other open FMS that require FMS customers to pay a proportionate amount of nonrecurring research, development, and production costs for major defense equipment items and immediately recoup the nonrecurring costs for items that have already been delivered to FMS customers; and
- c. follow DoD policies and procedures for reporting the delivery of major defense equipment items so that the FMS customers' accounts can be charged with nonrecurring research, development and production costs and amounts transferred to the general fund of the Treasury within the 30 days required by DoD policy.

**DOD RESPONSE:** Partially concur. The Under Secretary of Defense (Comptroller) will issue a memorandum to the Navy and the Air Force emphasizing the need to follow DoD policies and procedures for reporting the delivery of defense articles and requiring the following actions be taken:

- a. Recover applicable nonrecurring research, development and production recoupment charges that were not billed to FMS customers for major defense equipment that have already been delivered.
- b. Review all other open FMS cases for major defense equipment and recover applicable nonrecurring research, development and production recoupment charges for items that have already been delivered to FMS customers.

**RECOMMENDATION 2:** The GAO recommended that the Secretary of Defense direct the Director, Defense Security Assistance Agency to conduct a test review of closed FMS cases to ensure that all amounts of nonrecurring research, development, and production costs for delivered major defense equipment have been recouped. The GAO suggested that initially, this test review of closed cases could be limited to a specific period—for example cases that were closed during the last 5 fiscal years. The GAO further recommended that if this test review discloses that there have been FMS cases closed before all nonrecurring research, development,

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**Appendix I**  
**Comments From the Department of Defense**

and production costs were recouped, (1) any amounts due the U.S. Government should be recovered from the FMS customer and (2) the test review should be expanded to include closed cases for additional fiscal years.

**DOD RESPONSE:** Partially concur. The Under Secretary of Defense (Comptroller) will direct the Navy and the Air Force to conduct the recommended review since these are the organizations that retain the records. The Under Secretary of Defense (Comptroller) will further direct that if the review discloses that applicable recoupment charges have not been billed, that the Component recoup such amounts and that if the unbilled amount is significant, the review be expanded to review cases in additional fiscal years if it is determined to be cost effective to do so.

# Major Contributors to This Report

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