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REPORT BY THE

RELEASED

# Comptroller General

OF THE UNITED STATES

## Improvements Still Needed In Recouping Administrative Costs Of Foreign Military Sales

Defense is still unable to determine whether the surcharge on sales to foreign customers is sufficient to recover, as required by law, the full costs of administering the foreign military sales program.

Budget estimates necessary to obtain reimbursement for certain costs incurred during fiscal 1981 were understated because military services (1) were directed to exclude certain costs from their budget submissions and (2) made inaccurate or incomplete estimates of other costs.

GAO is recommending actions necessary to ensure that Defense recovers full administrative costs of foreign military sales from the governments making the purchases.



117454

AFMD-82-10  
FEBRUARY 2, 1982

520371

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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON D.C. 20548

B-205888

The Honorable Charles H. Percy  
United States Senate

The Honorable Ernest F. Hollings  
United States Senate

Your letter of May 27, 1980, expressed concern that General Accounting Office recommendations to improve the accounting and financial management of the foreign military sales program had not been implemented by the Department of Defense. You asked that we evaluate recent Defense actions to improve its financial management of the program and to reduce its budget by eliminating subsidies to the foreign military sales program.

This report focuses on the actions taken by Defense to improve the accounting and financial management of the program. Specifically, the report discusses Defense's failure to charge enough to cover all administrative costs of foreign military sales resulting in subsidy of the program.

At your request, we did not obtain official agency comments on the matters discussed in this report.

As requested by your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from its date. At that time, we will send copies to interested parties and make copies available to others upon request.

A handwritten signature in cursive script that reads "Milton J. Fowler".

Acting Comptroller General  
of the United States



D I G E S T

The Department of Defense is still unable to estimate the full cost of administering the foreign military sales program. Although the Congress has made it clear that the program is not to be subsidized, Defense has no assurance that the 3-percent surcharges on sales to foreign customers is sufficient to recover the full costs of administering the program.

As the total sales volume of the program has expanded, the efforts required by the military services to administer the program have also expanded. The Arms Export Control Act requires Defense to recover the full estimated costs of administering this program. In fiscal 1981, these costs were expected to exceed \$300 million.

Administrative costs of the program are incurred by Defense activities primarily for personnel who operate the Defense logistical, procurement, and accounting systems. These personnel handle sales negotiation, case implementation, contract administration, resolution of discrepancy reports, program control, accounting, and budgeting. The cost of utilities, office supplies, travel, rent, and other overhead to support these functions is considered part of the administrative or indirect cost of the program.

Senators Percy and Hollings asked GAO to review Defense actions on previous GAO recommendations for improving the accounting and financial management of the foreign military sales program.

The system established by Defense to recover these administrative costs depends upon the accounting system to determine the full cost incurred. If all costs are not identified and recouped from the foreign customers, the appropriated funds provided to Defense will, of necessity, be used to subsidize the program.  
(See p. 2.)

Funds to reimburse Defense activities for administrative costs of the program are obtained

from foreign customers through a surcharge added to the sales price of goods and services provided. The amounts collected are retained in a surcharge trust fund.

Defense activities are required to develop annual budgets for administering the foreign military sales program. These budgets, which must be approved by the Defense Security Assistance Agency, are used in updating the administrative surcharge rates and in reimbursing the Defense activities for the costs incurred. Recovery of costs is based on the amounts budgeted. Therefore, even if a 3-percent surcharge is sufficient to cover all costs, the costs will not be recovered if they are not billed through the budgets. (See p. 2.)

In 1977 and 1978, GAO reported that inadequate methods were used to account for and recover personnel costs of administering the foreign military sales program. The budgeting policies and procedures used provided no assurance that Defense was recovering the full cost of administration.

Although Defense officials generally agreed with both these reports and have made improvements, problems still exist and Defense is continuing to subsidize the foreign military sales program. Specifically, GAO's latest study showed that:

--Defense is still unable to adequately estimate the full costs incurred by the military services in administering the program because (1) the Defense Security Assistance Agency directed the military services to exclude certain valid costs from their budget submissions and (2) the military services, in preparing their budgets, made inaccurate and incomplete estimates of other administrative costs to the program. (See p. 7.)

--Actual costs incurred by Defense activities in administering the sales program exceeded budgeted amounts, but the amount billed the surcharge account was to be limited to the budgeted amount. As a result, Defense funds absorbed the costs incurred in excess of the original budgeted amount. (See p. 10.)

--Defense made improper transfers of over \$5 million to the administrative surcharge account

during fiscal 1980. These transfers were made in an attempt to adjust for earlier billing errors made by the Air Force. However, GAO's review showed that these adjustments were not warranted and Defense funds were again used to subsidize the foreign military sales program. (See p. 12.)

- The accounting procedures used did not always accumulate actual cost or workload data for administering the program. As a result, Defense had not accumulated the data needed to make an adequate and meaningful analysis of the adequacy of surcharge fees collected from foreign customers. Without an adequate surcharge rate, the administrative support costs will not be recouped. (See p. 13.)

Although GAO could not determine the total amount by which the military sales appropriations are subsidizing the foreign military sales program, the amount is known to be in the millions of dollars. For example, an Air Force activity estimated that its fiscal 1981 budget was reduced by about \$21 million because of the budget guidance restricting cost recovery. Also, an Army activity estimated that it was necessary to use appropriated funds to absorb about \$2 million of overhead costs incurred during fiscal 1981 in administering the program. GAO's examination at activities with about \$96 million in fiscal 1980 billings identified about \$5 million in unrecovered costs. (See p. 10.)

#### RECOMMENDATIONS

GAO recommends that the Secretary of Defense take the following actions to improve the financial management of the administrative surcharge fund:

- Direct the Defense Security Assistance Agency to revise its existing budget guidance to Defense activities to clearly identify the costs to be included in the budget submissions and to require recovery of the full administrative costs of foreign military sales.
- Require all commands and activities to develop accurate and timely personnel and other cost data for use in preparing budget submissions and obtaining reimbursement for expenses incurred.

- Direct each military service to periodically adjust its budget estimates to reflect actual costs incurred and report these adjustments to the Defense Security Assistance Agency.
- Direct the Air Force to reverse the improper transfers made to the administrative surcharge account.
- Require the Defense Security Assistance Agency to monitor the adequacy of the administrative surcharge rate and make periodic adjustments when warranted to ensure full recovery of costs.

**AGENCY COMMENTS**

As requested by the Offices of the Senators requesting this review, GAO did not obtain official comments from the Department of Defense.



C o n t e n t s

	<u>Page</u>
DIGEST	i
CHAPTER	
1 INTRODUCTION	1
Growth of program	1
Requirement to recover full administrative costs	2
Budget and reimbursement procedures	2
Earlier audit reports	3
Objectives, scope, and methodology	4
2 IMPROVEMENTS STILL NEEDED IN PROCEDURES USED TO RECOVER ADMINISTRATIVE COSTS OF PROGRAM	6
Military services' budgets were not based on full costs	7
Allocation method was prohibited for indirect costs	7
All direct labor costs may not be recovered	9
Military services' budget submissions were not reliable	10
Transfers to administrative surcharge account were improper	12
Adequacy of surcharge rate is not known	13
Conclusions	13
Recommendations	13
APPENDIX	
I May 27, 1980, letter from Senators Charles H. Percy and Ernest F. Hollings	15
II Legal opinion on the statutory requirements for recovering administrative costs of the foreign military sales program	16



## CHAPTER 1

### INTRODUCTION

In a May 27, 1980, letter (app. I), Senators Percy and Hollings expressed concern that General Accounting Office recommendations to improve accounting and financial management of the foreign military sales program had not been implemented by the Department of Defense. They also asked us to evaluate recent Defense actions to improve its financial management of the foreign military sales program and reduce its budget by eliminating subsidies to that program.

In accordance with the Senators' request, we have made a followup review of Defense's system to reimburse the military services for appropriated funds expended in administratively supporting the foreign military sales program. In 1977 and 1978, 1/ we reported that inadequate methods were used to account for and recover personnel costs of administering the program. These methods were inadequate because they gave the Department of Defense no real basis for determining if all administrative costs of the program were recovered, as required by law, from foreign purchasers of U.S. military equipment and services.

This report, the third in a recent series, 2/ focuses on actions needed to improve Defense's accounting and financial management of the foreign military sales program. Specifically, we discuss whether the procedures now used by the military services to estimate and recover the full cost of administering the program are adequate.

#### GROWTH OF PROGRAM

In recent years, increased congressional interest has focused on the tremendous growth of the foreign military sales program and on accounting and financial management problems encountered by Defense in executing the program. Foreign military sales agreements have grown from about \$1 billion in fiscal 1970 to over \$15 billion in fiscal 1980.

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1/"Inadequate Methods Used to Account for and Recover Personnel Costs of the Foreign Military Sales Program," FGMSD-77-22, Oct. 21, 1977, and "Inadequate Methods Still Used to Account for and Recover Personnel Costs of the Foreign Military Sales Program," FGMSD-78-47, July 25, 1978.

2/"Millions in Losses Continue on Defense Stock Fund Sales to Foreign Customers," AFMD-81-62, Sept. 10, 1981; and "Defense Continues to Subsidize Sales of Secondary Items to Foreign Governments Because of Poor Pricing Policies," AFMD-81-105, Oct. 5, 1981.

As the total sales volume of this program has expanded, the efforts required by the military services to administer the program have also expanded. The budgets approved for administrative support of the foreign military sales program are shown in the following chart.

<u>Military activity</u>	<u>Approved budgets</u>	
	<u>Fiscal 1980</u>	<u>Fiscal 1981</u>
	------(millions)-----	
Army	\$ 91.6	\$ 88.3
Navy	52.1	56.5
Air Force	118.9	121.7
Other Defense activities	<u>40.9</u>	<u>37.7</u>
Total	<u>\$303.5</u>	<u>\$304.2</u>

#### REQUIREMENT TO RECOVER FULL ADMINISTRATIVE COSTS

The Arms Export Control Act of 1976 gives the Department of Defense authority to sell Defense articles and services to foreign countries at no cost to the U.S. Government. To recover the indirect costs of these sales, the act requires that foreign customers be charged an appropriate amount, calculated on an average percentage basis, to recover the full estimated costs of administrative services. The legislative purpose of this charge is to ensure that all sales include "a fair share of all indirect costs so that there are no longer any elements of subsidy in the sales program."

The Defense instructions implementing the act require that sales agreements include an administrative surcharge sufficient to recover from the foreign customers the costs of administering these sales. The costs are incurred primarily for personnel who operate the Defense logistical, supply, and procurement services. These personnel handle sales negotiations, case implementation, procurement, resolution of discrepancy reports, contract administration, program control, accounting, and budgeting. In addition, the costs of utilities, office supplies, travel, rent, and other overhead to support these functions are considered part of the administrative or indirect costs of the program.

#### BUDGET AND REIMBURSEMENT PROCEDURES

The Defense Security Assistance Agency and the Assistant Secretary of Defense (Comptroller) are responsible for ensuring that the U.S. Government receives full payment under the foreign military sales program. Defense is required to recover these administrative costs by applying an administrative surcharge to foreign

military sales orders. A 3-percent surcharge is normally applied to sales orders signed since October 1, 1977.

Revenues generated from this administrative surcharge on sales are deposited into a separate trust fund account called the administrative surcharge account. To obtain reimbursements from this account, the Defense activities prepare annual budgets which must be approved by the Defense Security Assistance Agency. As costs are incurred, the Defense activities receive reimbursements by obtaining funds based on their approved budgets. That is, the appropriations accounts, initially used to fund the indirect costs of administering the foreign military sales program, are reimbursed from the administrative surcharge account for expenses incurred up to the amount of the approved budgets. Full cost recovery depends upon the adequacy and accuracy of these budgets since recovery of administrative costs for the program is limited to the amounts budgeted.

#### EARLIER AUDIT REPORTS

As indicated on page 1, we have issued other reports on the accounting system used to obtain reimbursement for administration of the foreign military sales program. The Defense Audit Service also has recently reported on this matter.

We pointed out in our October 21, 1977, report to the Chairman of the Senate Committee on Armed Services that Defense used inadequate methods to estimate the number of foreign military sales administrative personnel in fiscal 1977 and that amounts included in the administrative surcharge for retirement benefits for these personnel were not high enough to recover full costs. Although Defense officials agreed with this report and revised the factors for personnel retirement benefits, the improvements that were implemented did not ensure the development of accurate and adequate budget estimates.

Because Defense officials had difficulty in obtaining reliable data on the cost of administering the foreign military sales program, a new Security Assistance Manpower Accounting Report was developed. However, the procedures used to develop data for the report did not define administrative personnel adequately, did not provide for controls over the gathering of data, and permitted inconsistent methods to be used to develop the data.

In our July 25, 1978, report to the Senate Appropriations Committee, we pointed out that Defense policies and systems used to estimate the administrative costs of the foreign military sales program still did not adequately account for the number of personnel who administered the program or provide for the full recovery of costs to the U.S. Government for retirement and other employee benefits. As a result, Defense had no assurance that the prices of military equipment and services sold under the program were sufficient to recover the full administrative costs.

During 1979 and 1980, the Defense Audit Service issued several reports on its reviews of Army, Navy, and Air Force administrative budgets. These reports point to many of the same deficiencies that are discussed in this report. The Defense Audit Service found that the administrative budgets reviewed contained invalid costs and unsupported estimates. It also concluded in its report on the Air Force that directives and regulations were ambiguous about what costs could be included in the budgets and noted that, until costs were more clearly defined, the budget process would be subject to varying interpretations.

#### OBJECTIVES, SCOPE, AND METHODOLOGY

The overall objective of our review, in accordance with the request from Senators Percy and Hollings, was to determine if the Department of Defense was obtaining adequate reimbursement from foreign customers for the cost of administering the foreign military sales program. Our specific job objectives were to

- determine the adequacy of the Defense accounting system used to identify and budget for administrative costs incurred and
- determine the propriety of deposits into and disbursements from the administrative surcharge trust fund account.

We analyzed applicable Department of Defense and military service regulations, accounting procedures and reports, computer printouts, and other documents relating to recovery of the cost of administering the foreign military sales program, and held discussions with responsible program officials. We reviewed accounting and financial management records used to recover administrative support costs for the foreign military sales program at the Defense Security Assistance Agency and Headquarters, Departments of the Army, Navy, and Air Force, Washington, D.C.; the Defense Security Assistance Accounting Center, Denver, Colorado; Air Force Logistics Command, Wright-Patterson Air Force Base, Dayton, Ohio; Army Tank-Automotive Command, Warren, Michigan; and the Naval Air Systems Command and Naval Sea Systems Command, Arlington, Virginia. We also discussed earlier audit coverage with senior management personnel at the Defense Audit Service in Arlington, Virginia.

Using documents and other information supplied by the above officials, we (1) tested the reasonableness of fiscal 1980 reimbursements for administrative expenses, (2) tested the adequacy of fiscal 1981 administrative budgets, and (3) evaluated the propriety of all deposits into and disbursements from the administrative surcharge account during fiscal 1980. Our review included the following:

- An examination of the procedures used by four major military commands in preparing data on costs incurred to administratively support the foreign military sales program

in fiscal 1980. These four activities were reimbursed about \$96 million--more than 30 percent of the total reimbursements for administrative support of the program.

--An analysis of the policies and procedures used by these four commands in preparing their fiscal 1981 administrative budgets for the foreign military sales program. The budgets prepared by the four activities totaled \$104.3 million--about 40 percent of the total budgets of the three military departments approved by the Defense Security Assistance Agency for reimbursement of administrative support costs.

--An evaluation of all deposits to and disbursements from the administrative surcharge account during fiscal 1980.

Since our selected review of fiscal 1980 reimbursements and fiscal 1981 administrative budgets was not based on statistical sampling, the results of our review cannot be projected to other activities or considered to be an all-inclusive review of the activities visited. We believe, however, that procedural problems similar to those discussed in this report may exist at other Defense activities not included in this review because all activities operate under standard budget guidelines issued by the Defense Security Assistance Agency.

The audit was carried out in accordance with generally accepted government auditing standards except that the financial information in the report is based mainly on Department of Defense accounting records and information provided by Defense officials. It was not always feasible to verify this information because the accounting systems involved are highly complex and the foreign military sales financial data is voluminous, including thousands of individual cases.

## CHAPTER 2

### IMPROVEMENTS STILL NEEDED IN PROCEDURES USED

#### TO RECOVER ADMINISTRATIVE COSTS OF PROGRAM

Defense still does not have adequate procedures to estimate the full costs incurred by the military services in administering the foreign military sales program. Therefore, Defense has no assurance that the 3-percent surcharge on sales to foreign customers is sufficient to recover, as required by law, the full costs of administering the program.

The 3-percent surcharge collected by Defense is deposited into a trust fund account and used to reimburse the military services for administering the program. The military services prepare annual budgets for these administrative costs and submit the budgets to the Defense Security Assistance Agency for approval. As costs are incurred, the military services bill for reimbursement from the trust fund. The total billings are limited to the approved budget amounts. Thus, it is essential that all applicable costs be identified and included in these budgets; otherwise, such costs will be absorbed by the military services' appropriations rather than being passed on as part of the cost to the foreign country.

The military services' budgets, however, were not adequate to provide for the recovery of all costs for two reasons. First, to reduce surcharge expenditures, the Defense Security Assistance Agency directed the military services to exclude certain valid costs from their budgets. Examples of these excluded costs were overhead costs which could not be proven to vary with fluctuation in the foreign sales program, and direct personnel costs for individuals spending less than 10 percent of their time on foreign sales functions. Secondly, in preparing their budget submissions, the military services made inaccurate and incomplete estimates of other administrative costs of the program.

Failure to recover all costs of administratively supporting the foreign sales program has been a longstanding problem in Defense. We reported on this problem in October 1977 and July 1978. (See p. 1.) Although Defense Department officials agreed with the recommendations in these reports and have made some improvements, they still have not developed adequate methods of accounting for and recovering all costs of administering the program. Until this problem is corrected, Defense will not be able to determine the adequacy of the 3-percent surcharge and the military services' appropriations will continue to subsidize the foreign military sales program.

Although we could not determine the exact amount by which the military services' appropriations were used to subsidize the foreign military sales program, we know it to be in the millions of



dollars. For example, an Air Force activity estimated that its fiscal 1981 budget submission was reduced by about \$21 million because of the budget guidance requiring the exclusion of certain items of valid cost. An Army activity estimated that it was necessary to use appropriated funds to absorb about \$2 million in overhead costs incurred in administering the program. Over \$5 million more of appropriated funds were improperly transferred to the administrative surcharge account during fiscal 1980 because of inaccurate and incomplete data. Finally, our review at a limited number of locations identified about \$5 million in costs that were not reimbursed during fiscal 1980.

MILITARY SERVICES' BUDGETS  
WERE NOT BASED ON FULL COSTS

The budget guidance issued by the Defense Security Assistance Agency did not permit the military services to include all costs expected to be incurred in supporting the foreign military sales program when they prepared their budgets. The guidance restricted the recovery of support costs in two ways. First, only those indirect or overhead costs of the activity that could be proven to vary with fluctuations in the foreign military sales program were valid costs unless the activity was dedicated primarily to the foreign military sales program. Secondly, the recovery of direct personnel costs for individuals who spent less than 10 percent of their time on foreign military sales functions was disallowed.

Because of these restrictions, the budgets were understated. Since the reimbursements were limited to the approved budgets, the military services were continuing to incur costs in excess of the reimbursements. Thus, Defense appropriations were used to pay for costs that were required by law to be recovered from foreign customers.

Allocation method was prohibited  
for indirect costs

The budget guidance issued by the Defense Security Assistance Agency on June 2, 1980, was restrictive in that it required the services to provide supporting documentation showing that costs were incurred primarily for the benefit of a foreign country. It prohibited the use of allocation methods for determining certain indirect or overhead costs that are normally established in this manner. This guidance was based on a policy of allowing only incremental or variable costs to be recovered by the military services.

The Defense Security Assistance Agency policy of allowing only incremental or variable costs resulted from its interpretation of the Arms Export Control Act. This interpretation was based on the belief that the Congress intended for Defense to recover only those administrative expenses that were incurred primarily for the benefit of the foreign customer. By analogy, the Agency reasoned that only expenses that varied directly with fluctuations in the foreign

military sales program should be charged. Appendix II discusses why we believe that the Defense Security Assistance Agency's decision to adopt a variable cost method was legally improper, since the Arms Export Control Act clearly requires the charging of Administrative expenses on a full cost basis. (See p. 16.)

Shortly after this guidance was issued, we met with key personnel from the Defense Security Assistance Agency and the Office of the Assistant Secretary of Defense (Comptroller) to discuss the policy on inclusion of costs in foreign military sales administrative budgets. On July 7, 1980, the Defense Security Assistance Agency revised the transmittal letter for the budget guidance to delete the term "incremental cost" and to allow inclusion of all costs in the foreign military sales administrative budgets that "were incurred primarily for the benefit of foreign customers." However, this revised guidance did not eliminate the restrictions on full cost recovery by the military services.

The revised guidance required the service activities to prove that overhead costs were primarily for the benefit of a foreign military customer by demonstrating that a cost was being incurred that would not be incurred if the foreign military sales program were abolished. If this could not be demonstrated, the cost was not to be considered primarily for the benefit of the foreign military sales customer. Thus, since many indirect or overhead costs do not vary directly with the level of workload activity, this restriction did not allow the services to allocate overhead charges to determine the total cost of administering the program.

These restrictions severely constrained the services in preparing their budget submissions. The primary overhead costs that were not included in the budget submissions and were not expected to be fully recovered from foreign customers included facility rental, operating supplies, communication expenses, indirect or supervisory personnel costs, equipment rental, and base operating support. For example:

--When both Defense and foreign military sales work are performed in the same facility, allocation of the facility rental cost would normally be based on the percentage of the activity's overall workload that is made up of foreign military sales. The foreign military sales program would share an equivalent percentage of the cost of the facility housing the workspace. However, the budget guidance did not permit charges for facility rental unless the service activity could show that the rent would not be incurred if the foreign military sales workload were abolished. Since the foreign military sales program does not constitute the primary workload at most service activities, rental charges for the workspace could not be allocated to the foreign military sales program under the Defense policy.

--When managers are supervising persons working on both Defense and foreign military sales functions, the supervisory

personnel costs would normally be allocated to these functions on the basis of direct labor hours. However, under the budget guidance provided, the service activities were required to document that the number of supervisory personnel would be decreased if the foreign military sales program were eliminated. Otherwise, the service activities could not prove that the supervisory personnel performed work primarily for the benefit of the foreign customers and the supervisory personnel costs were not an allowable charge.

Because of these Defense Security Assistance Agency restrictions, costs that should have been recouped from the surcharge trust fund had to be absorbed by the military services' appropriations. For example:

- Army Missile Command budget personnel estimated that it was necessary to use appropriated funds to absorb about \$2 million in overhead costs which, under normal cost allocation methods, would have been charged to the foreign military sales program. This represented about 20 percent of the command's total support costs for that program. These costs had to be excluded because the command could not prove the costs would not exist if the foreign military sales program were eliminated.
  
- An Air Force general wrote to the Defense Security Assistance Agency regarding the Air Force Logistics Command's fiscal 1981 administrative budget submission. Commenting on the restriction, the general said, "This budget estimate was computed by using Defense Security Assistance Agency's interpretation of full costing. However, if we had used the GAO interpretation, the estimate would be 750 man-years or \$21 million higher."

While we recognize that elimination of a small percentage of a direct labor force might not change the indirect or overhead costs, elimination of a program as large as the foreign military sales program would reduce these costs. Also, it is a generally accepted accounting principle that in determining the full cost of a function or product, the cost of overhead must be included. Further, good business practice calls for estimates of the cost of sales to include the full cost of providing the goods or services to the customers, including indirect or overhead costs.

#### All direct labor costs may not be recovered

The military services were not allowed to budget for and recover direct costs for persons who spent less than 10 percent of their time working on the foreign military sales program. This disallowance was based on a restriction contained in Department of Defense Instruction 2140.1 (replaced in June 1981 by Department of Defense Manual 7290.3-M). As a result, the military services' budget estimates did not include all direct labor costs incurred

in performing support functions. We believe that the exclusion of these costs is inconsistent with the statutory requirement that the full administrative costs of the foreign military sales program be recovered.

We could not readily determine the amount of costs absorbed by the military services because of this budget restriction on the recovery of direct costs. However, because of the size and complexity of the foreign military sales program, we know the amount is significant.

This restriction could be justified from a management standpoint only if it served to establish a lower limit beyond which it was not worth the effort to accumulate the cost and charge the program. That is, it is not worthwhile to spend more than a dollar to collect a dollar. However, as many military service activities have standard systems for accumulating time charges, they should have been permitted to recover direct costs for the individuals working part time on foreign military sales.

#### MILITARY SERVICES' BUDGET SUBMISSIONS WERE NOT RELIABLE

In addition to excluding some costs in preparing the fiscal 1981 budget submissions, as directed by the Defense Security Assistance Agency, the military services did not prepare accurate and reliable budgets for other costs expected to be incurred in administering the foreign military sales program. The military services' personnel accounting systems did not provide current and accurate data to support the budget submissions and a number of clerical errors were made in compiling the budget data.

Similar problems in preparing the fiscal 1980 budget resulted in Defense appropriations being used to subsidize the foreign military sales program. Our examination of about \$96 million in fiscal 1980 billings identified about \$5 million in unrecovered costs. Although the restrictions in the budget guidance contributed to the failure to recover full costs as required, the restrictions were only part of the problem. The inaccuracy and unreliability of data contributed significantly to the inadequacy of the budgets.

Many of the problems noted in our previous reviews still existed during preparation of the fiscal 1981 administrative budget. We pointed out in our reports of 1977 and 1978 that Defense did not have an adequate accounting or reporting system for determining the actual number of foreign military sales program personnel and could not accurately estimate personnel costs. We recommended that Defense revise its guidelines for determining personnel requirements and estimating costs of administering the program.

At that time, Defense agreed that an adequate system was needed and initiated development of a standard personnel accounting system for use in identifying the effort that supported the foreign military sales program. This system, the Security

Assistance Manpower Accounting System--which Defense began developing in 1977--was intended to provide staffing data to support budget estimates and justifications as well as meet congressional reporting requirements. The Defense plan was to use administrative personnel data from this accounting system in preparing the administrative budget. However, this system still does not provide accurate data on the number of personnel required to administer the program.

Defense guidance stated that personnel data for the accounting system reports should be consistent with that used in compiling the administrative budget estimates; however, the accounting system reports we reviewed showed different staff-year requirements than those included in the fiscal 1981 budget submissions. We also found reporting errors in the administrative budgets caused by inadequate estimating techniques.

For example, the fiscal 1981 budget, submitted by the Air Force Logistics Command for Defense Security Assistance Agency approval, erroneously omitted 41 staff-years with an estimated cost of \$1.5 million. This omission occurred because the personnel data used in compiling the budget were 3 years old. A manpower study completed after submission of the budget request showed the foreign military sales workload required 41 additional staff-years. Because these costs were not included in the administrative budget, the Air Force Logistics Command was not reimbursed for them.

The Army also did not prepare accurate and reliable budget submissions for costs expected to be incurred in administering the program. For example, the Army Tank-Automotive Command's fiscal 1981 budget submission omitted about \$700,000 in administrative costs because of clerical errors made in determining the number of support personnel required for foreign military sales functions. Because the reimbursements collected from the trust fund were based on the budget rather than on actual workload data, the foreign military sales program was subsidized by this amount.

Our review of the Navy activities also disclosed errors in compiling the budget submissions for fiscal 1981. For example, the Navy obtained reimbursements of over \$200,000 for personnel costs although it actually incurred the costs for rent, supplies, communications, printing, and data processing expenses. Because these expenses were erroneously classified as personnel costs, a 24.2-percent factor was added to cover fringe benefits and retirement costs. This erroneous classification caused the Navy to be overreimbursed by about \$50,000.

The use of outdated personnel data was not a one-time problem. Similar budget preparation problems coupled with a number of clerical errors resulted in Defense appropriations subsidizing the foreign military sales program by about \$5 million in fiscal 1980. For example, in the absence of an adequate cost accounting system, the Air Force Logistics Command prepared cost estimates for fiscal

1980 by relying on an outdated study prepared in fiscal 1977. Although a later Air Force study (August 1980) disclosed that the fiscal 1980 budget was understated by \$2.4 million, no action was taken to adjust the budget and the Air Force did not obtain full reimbursement. Since only \$475,029 of the \$2.4 million remained unspent at that time, only this amount was billed and collected from the administrative surcharge. The remaining \$1.9 million was not recovered because the Air Force did not believe the Defense Security Assistance Agency would approve the billing.

TRANSFERS TO ADMINISTRATIVE SURCHARGE ACCOUNT  
WERE IMPROPER

Defense made improper transfers of over \$5 million to the administrative surcharge account during fiscal 1980. These transfers were made to adjust Air Force billings for earlier fiscal years. However, our review showed that the transfers were incorrect and Defense funds were improperly used to subsidize the foreign military sales program.

In fiscal 1980, the Air Force processed adjustments to correct what it considered to be improper charges to the administrative surcharge account in earlier years. However, our review of these adjustments, which totaled \$8.3 million, showed that only \$2.9 million of them were valid corrections. The other adjustments, totaling \$5.4 million, were improper as discussed below.

The Air Force improperly transferred \$4,849,000 to the administrative surcharge account because of overhead allocation restrictions imposed by the Defense Security Assistance Agency. Before fiscal 1980, proportionate overhead costs were allocated to the foreign military sales program. When the Defense Security Assistance Agency restricted recoupment of overhead costs in fiscal 1980, the Air Force applied this restriction to earlier years. However, since this restriction was legally improper (see app. II), the adjustment to previous charges resulted in an improper transfer.

Another \$552,000 was improperly transferred to the administrative surcharge account. This transfer by the Air Force was made to correct a prior year billing to allow for staff vacancies at an Air Force activity. However, we found that the activity had used actual payroll data and the initial billing to the administrative surcharge account had been correct. Therefore, the billing reversal was in error.

These improper transfers increased the balance in the administrative surcharge account and resulted in the use of appropriated funds to subsidize the foreign military sales program. Since these transfers were based on the application of the variable cost recovery method, which we believe is legally improper, the applicable appropriation accounts must be credited.

## ADEQUACY OF SURCHARGE RATE IS NOT KNOWN

Although Defense has attempted to evaluate the adequacy of the surcharge rate periodically, these evaluations have not been based on complete and adequate data. As discussed previously (p. 7), all costs incurred in administering the foreign military sales program are not being accumulated and charged to the trust fund. As a result, Defense has no assurance that the 3-percent charge added to the sales price of equipment and services sold under the program is sufficient to recover, as intended by law, the full costs of administering the program.

The foreign military sales administrative surcharge rate was increased from 2 to 3 percent in October 1977 because Defense officials did not believe 2 percent was adequate. In May 1979, the Defense Security Assistance Agency reexamined the 3-percent rate. The review was made in accordance with the existing Defense cost recovery concept and essentially consisted of comparing surcharge receipts with past and anticipated expenditures. Although Defense concluded that the rate was adequate, the conclusion may have been incorrect. As shown in this report, the full cost of administering the foreign military sales program is not being budgeted for and billed to the administrative surcharge account. Thus, it is impossible for Defense to accurately compare the full cost of administering the foreign military sales program with the surcharge revenue.

## CONCLUSIONS

As a result of limitations imposed by current guidance, the military services' budget submissions for the administrative costs of the foreign military sales program do not include all appropriate costs. Also, the Defense accounting systems do not provide accurate data on use of Defense personnel to support that program. Without complete and accurate budgets, the Defense Department has no assurance that the military services are being reimbursed as required by law for the full cost of administering the foreign military sales program.

Furthermore, Defense has not made an accurate and meaningful determination of the adequacy of the administrative surcharge rate. Until such determination is made, using the full cost concept prescribed by the Congress, the solvency of the administrative surcharge fund will remain a matter for concern.

## RECOMMENDATIONS

We recommend that the Secretary of Defense take the following actions to improve the financial management of the administrative surcharge fund:

- Direct the Defense Security Assistance Agency to revise its existing budget guidance to Defense activities to clearly

identify the costs to be included in the budget submissions and to require recovery of the full administrative costs of foreign military sales.

- Require all commands and activities to develop accurate and timely personnel and other cost data for use in preparing budget submissions and obtaining reimbursement for expenses incurred.
- Direct each military service to periodically adjust its budget estimates to reflect actual costs incurred and report these adjustments to the Defense Security Assistance Agency.
- Direct the Air Force to reverse the improper transfers made to the administrative surcharge account.
- Require the Defense Security Assistance Agency to monitor the adequacy of the administrative surcharge rate and make periodic adjustments when warranted to ensure full recovery of costs.



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## United States Senate

COMMITTEE ON  
GOVERNMENTAL AFFAIRS  
WASHINGTON, D.C. 20510

May 27, 1980

The Honorable Elmer B. Staats  
Comptroller General  
of the United States  
Washington, D.C. 20548

Dear Elmer:

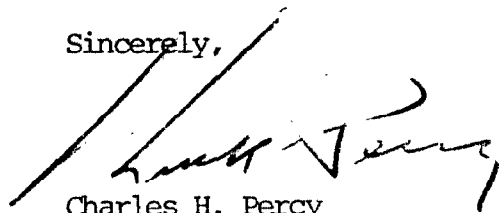
During the past several years, the General Accounting Office has issued a number of reports on the accounting and financial management of the Foreign Military Sales Program by the Department of Defense. These reports have resulted in budget reductions in the past and indicate that a potential exists for further budget reductions in the future.

As several of the recommendations have not been implemented, the Defense appropriations are apparently being used to subsidize the Foreign Military Sales Program. This has been a continuing problem within Defense and it appears that Defense needs to devote additional attention to this area to bring about budget reductions.

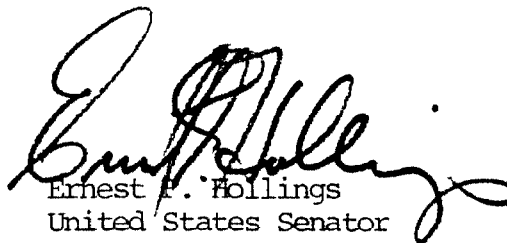
In this regard, we would appreciate your staff reviewing recent actions by Defense to implement the recommendations in your reports and other actions taken by Defense to improve its management of the program. We would appreciate your office developing questions for use by the Committee during hearings on the fiscal 1982 Defense budget. In addition, we would appreciate a detailed report on this matter by June 30, 1981.

Senator Percy's staff has discussed this review with members of your Financial and General Management and Studies Division, Systems in Operation group.

Sincerely,



Charles H. Percy  
United States Senator



Ernest P. Hollings  
United States Senator

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LEGAL OPINION ON THE STATUTORY REQUIREMENTS FOR  
RECOVERING ADMINISTRATIVE COSTS OF THE  
FOREIGN MILITARY SALES PROGRAM

As part of a review of the accounting systems used to recover overhead costs of administering the foreign military sales (FMS) program, we examined the legal propriety of (1) a decision by the Defense Security Assistance Agency to charge foreign customers the variable versus the full costs of administering the program and (2) a related transfer of funds from prior year Air Force appropriations to the administrative surcharge account.

We concluded that the Defense Security Assistance Agency's decision to charge only the variable costs of the foreign military sales program was legally improper since the Arms Export Control Act clearly requires charging the full administrative costs of the program. Given this conclusion, it follows that the Air Force could not legally transfer prior years' expired appropriations to the administrative surcharge account. A detailed analysis appears below.

BACKGROUND

The Arms Export Control Act (22 U.S.C. 2751 et seq.) authorizes the sale of defense articles and services to eligible foreign countries on a cost-reimbursement basis. As a means of recovering the indirect costs of these sales, subsection 2761(e)(1) requires that appropriate charges be included for "administrative services, calculated on an average percentage basis, to recover the full estimated costs of administration of the sales \* \* \* to all purchasers."

Department of Defense (DOD) implementing instructions (formerly DOD Instruction 2140.1, now FMS Financial Management Manual 7290.3-M) require that an administrative surcharge be imposed on all sales (e.g., 3 percent of the contract price). The instructions also require that the military departments prepare annual budgets for their anticipated administrative expenses in support of the foreign military sales program. Revenues generated from the administrative surcharge are deposited into a separate account within the Foreign Military Sales Trust Fund, a general fund DOD established to facilitate the financing of foreign military sales. The Defense Security Assistance Agency (DSAA), which is responsible for administering the trust fund, allocates the surcharge revenue to the military departments in accordance with their approved budgets for FMS administrative expenses.

The DOD instructions do not require the use of any one cost method (e.g., full cost vs. variable cost) in calculating the administrative expenses of the FMS program. Until recently the

Air Force used the so-called full cost method. Under this method, the Air Force included various administrative costs that, while remaining substantially unchanged irrespective of the level of FMS program activities, were indirectly supporting such a program.

DSAA believes that the military departments should use the so-called variable (incremental) cost method in calculating their FMS administrative expenses. That is, the departments should include only those administrative costs that clearly vary with the level of FMS program activities. Applying the variable cost method has resulted in excluding certain indirect overhead costs (e.g., base operating support, facility rental, communications, operating supplies).

The Air Force and DSAA apparently agreed to use DSAA's variable cost method for fiscal 1980 and thereafter. In addition, DSAA invited the Air Force to recalculate its prior year charges (fiscal 1977, 1978, and 1979) to FMS administrative funds, using the variable cost method. To the extent "erroneous charges" were identified (approximately \$8.3 million), funds were returned to the administrative surcharge account on the theory that Air Force appropriated funds improperly obtained reimbursement from that account. The transfer of \$3.4 million is acceptable since this amount reflects errors in prior billings to foreign countries. However, we question the transfer of the remaining \$4.9 million (representing mostly "fixed" base operating support costs) on the grounds that the underlying cost items are required to be charged under the Arms Export Control Act. We understand that the specific source of these funds was the unobligated balance of expired Operation and Maintenance (O&M) accounts.

#### LEGAL QUESTIONS

QUESTION 1: Which cost method (variable vs. full) does the Arms Export Control Act require to be applied in determining military departments' administrative costs that are to be charged to the FMS program?

QUESTION 2: Could the Department of the Air Force legally transfer \$4.9 million from the unobligated balances of prior year O&M accounts to the FMS administrative surcharge account on the grounds that the O&M funds had been improperly reimbursed from that account through the use of the full cost method for calculating administrative expense?

ANSWER: The Arms Export Control Act clearly requires that the full cost method be applied in charging for the administrative costs of the FMS program. Given this conclusion, we do not believe that the Air Force could legally transfer prior year expired appropriations on the grounds that the variable cost method should have been used in those prior years.

DISCUSSION

Section 21(e)(1) of the Arms Export Control Act, as amended, (22 U.S.C. 2761(e)(1)), requires that certain charges be imposed, including charges for administrative services, in connection with FMS transactions as follows:

"After September 30, 1976, letters of offer for the sale of defense articles or for the sale of defense services that are issued pursuant to this section or pursuant to section 22 of this Act shall include appropriate charges for--

"(A) administrative services, calculated on an average percentage basis to recover the full estimated costs of administration of sales made under this Act to all purchasers of such articles and services;

"(B) any use of plant and production equipment in connection with such defense articles;

"(C) a proportionate amount of any nonrecurring costs of research, development, and production of major defense equipment; and

"(D) the recovery of ordinary inventory losses associated with the sale from stock of defense articles that are being stored at the expense of the purchaser of such articles." (Emphasis added.)

Thus, administrative services are to be charged on the basis of "full estimated cost." The act does not define this term; however, it is clear that the Congress intended to apply the traditional concept of full costing for administrative services. The Senate Foreign Relations Committee report on its version of the legislation (Public Law 94-329) that enacted this cost-recovery requirement states:

"The new subsection (e) is designed to insure that all government-to-government sales shall include a fair share of all indirect costs so that there are no longer any elements of subsidy in the program \* \* \*." 1/

While differences may arise over the treatment of particular cost items, there is a clear and fundamental difference between the accounting concepts of full and variable cost recovery. For

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1/S. Rep. 94-876, p. 29 (1976).

example, these concepts are contrasted by Kieso and Weygandt in "Intermediate Accounting." 1/.

"Fixed manufacturing overhead costs present a special problem in costing inventories because two concepts exist relative to the costs that attach to the product as it flows through the manufacturing process. These two concepts are variable costing, frequently called direct costing, and absorption costing, also called full costing.

"In a variable cost system all cost must be classified as variable or fixed. Variable costs are those that fluctuate in direct proportion to changes in output, and fixed costs are those that remain constant in spite of changes in output. Under variable costing only costs that vary directly with the volume of production are charged to products as manufacturing takes place. Only direct material, direct labor, and the variable costs in manufacturing overhead are charged to work in process and finished goods inventories and appear as cost of goods sold. \* \* \*

"Under absorption costing, all manufacturing costs, variable and fixed, direct and indirect, incurred in the factory or production process attach to the product and are included in the cost of inventory. Direct material, direct labor, and all manufacturing overhead--fixed as well as variable--are charged to output and inventories." 2/

Clearly the Defense Department also recognizes the distinction between full and variable costing. Thus, the Defense Audit Service's "Report on the Review of Foreign Military Sales Administrative Budget at Selected Air Force Activities" (No. 80-115, June 20, 1980), notes on page 1:

"The Air Force budget estimates were prepared under full costing concepts. We used variable costing concepts. Current directives and regulations are sufficiently ambiguous to support an argument for either concept. However, the 3-percent surcharge rate is not sufficient to provide funding for full costing. \* \* \*"

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1/Third edition, 1980, p. 342.

2/See also Anthony, "Management Accounting" (4th ed., 1970), pp. 376-377.

In summary, section 21(e) of the Arms Export Control Act requires that the full estimated costs of administrative services be recovered. Both the legislative history of section 21(e) and generally recognized accounting concepts suggest that this language was meant to require the application of full costing rather than variable costing.

The only statutory language that might be read to support variable costing is section 43(b) of the Arms Export Control Act, as amended, (22 U.S.C. 2792(b)), which provides that:

"Charges for administrative services calculated under section 21(e)(1)(A) of this Act shall include recovery of administrative expenses incurred by any department or agency of the United States Government, including any mission or group thereof, in carrying out functions under this act when--

"(1) such functions are primarily for the benefit of any foreign country; and

"(2) such expenses are not directly and fully charged to, and reimbursed from amounts received for, sale of defense services under section 21(a) of this Act." (Emphasis added.)

It could be argued that the phrase emphasized above qualifies and limits the recovery of administrative expenses by requiring that each individual cost element be included only if it is incurred "primarily for the benefit of" the foreign military sales customer.

The legislative history of section 43(b) does not elaborate on the "primarily for the benefit" phrase. However, it is not tenable, in our view, to conclude that this phrase, or anything else in section 43, was intended to reject or limit application of the full cost method for recovery of administrative services under section 21(e). First, the language of section 43(b) itself suggests a design to complement, not qualify, section 21(e)(1)(A). Both the original versions of section 21 and 43(b) were enacted at the same time by Public Law 94-329. Secondly, the legislative history of section 43(b) indicates (as does the history of section 21(e), discussed previously) a basic intent to maximize, rather than limit, cost recovery. Thus, the House International Relations Committee report on the legislation enacted as Public Law 94-329 states that the purpose of section 43(b) "is to make sales and export control operations self-supporting to the maximum extent possible." 1/

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1/H. Rept. 94-1144 (1976), p. 39; see also, S. Rept. 94-876 (1976), p. 45.

Given the above considerations, we do not read section 43(b) as limiting or qualifying in any way the cost recovery method applicable under section 21(e)(1)(A). On the contrary, it seems most likely that section 43 is concerned with identifying administrative functions which might not otherwise be reimbursable under section 21(e) (e.g., functions carried out under the act that are not part of sales transactions, but nevertheless are primarily for the benefit of foreign countries).

Thus, section 43 does not establish or otherwise affect the method by which individual cost components of such functions are to be calculated under section 21. In other words, once it is established that any Federal agency incurs administrative costs in carrying out functions under the Arms Export Control Act primarily for the benefit of any foreign country, section 43 requires that the costs of such functions be recovered. The calculation of how much to recover, and what specific cost elements to include, is made by applying full costing under section 21(e).

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