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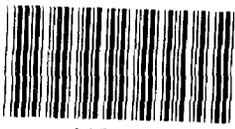
SUPPLEMENT TO A REPORT BY THE
Comptroller General
OF THE UNITED STATES

**Defense Continues To Subsidize Sales Of
Secondary Items To Foreign Governments
Because Of Poor Pricing Policies**

This report supplement contains GAO's analysis and response to the comments of the Department of Defense subsequent to the GAO report issued to the Congress on October 5, 1981.

GAO is responding to the comments at the request of the Chairman, House Committee on Government Operations, who was concerned about Defense's negative characterization of the report and its contention that GAO used unvalidated data to support its conclusions.

GAO has evaluated the Defense allegations and concludes that the report is accurate and the recommendations appropriate.



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

B-204400

The Honorable Jack Brooks
Chairman, Committee on
Government Operations
House of Representatives

Dear Mr. Chairman:

Your letter of December 7, 1981, expressed concern over Defense's negative characterization of two GAO reports dated September 10, 1981, and October 5, 1981, on pricing of foreign military sales inventory items. You asked us to evaluate the reasons for Defense's allegations that the reports were based on an erroneous application of the Arms Export Control Act and that unvalidated data were used to support our conclusions.

This report supplement is an integral part of our October 5, 1981, report entitled "Defense Continues to Subsidize Sales of Secondary Items to Foreign Governments Because of Poor Pricing Policies" (AFMD-81-105). It contains the Department of Defense comments on the report and our analysis and response to those comments. At the request of Senators Percy and Hollings, the October 5, 1981, report was issued without Defense comments as was the September 10, 1981, report entitled "Millions in Losses Continue on Defense Stock Fund Sales to Foreign Customers" (AFMD-81-62). We will address Defense's comments on the September 10, 1981, report in a separate supplemental report.

In our report on pricing of secondary items, we demonstrated that Defense continues to substantially subsidize the foreign military sales program by underpricing sales of secondary items to foreign customers.

Defense concurred in three of the five recommendations made, including our most important recommendation: That Defense should use more realistic inflation factors in determining the price to charge. For many years, Defense used inflation factors that were much too low to recover from foreign governments the estimated replacement cost of secondary items.

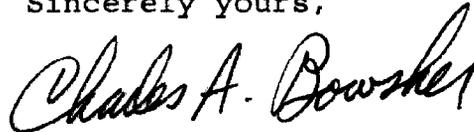
Even though it concurred in most of the recommendations, Defense stated that our report was unfair and harmful. Defense alleged that the data included in our sample contained errors

that cast serious doubt on the conclusions reached. We carefully examined the evidence and methodology used by Defense in support of its allegations and found them to be without substance and, in fact, based on erroneous information. Further, we found that even if Defense's facts had been correct, the statistical sample it used to review our work was too small to render statistically meaningful results. After examining Defense's reply, we conclude that our report accurately presents the events that took place and that our recommendations appropriately address the issues.

Your request is included as appendix I and the Defense response as appendix II. A detailed explanation of our position on this response is in chapter 2.

As arranged with your office, we are sending copies of this supplement to Senators Percy and Hollings. Unless you publicly announce its contents earlier, no further distribution of this supplement will be made until 7 days from its date.

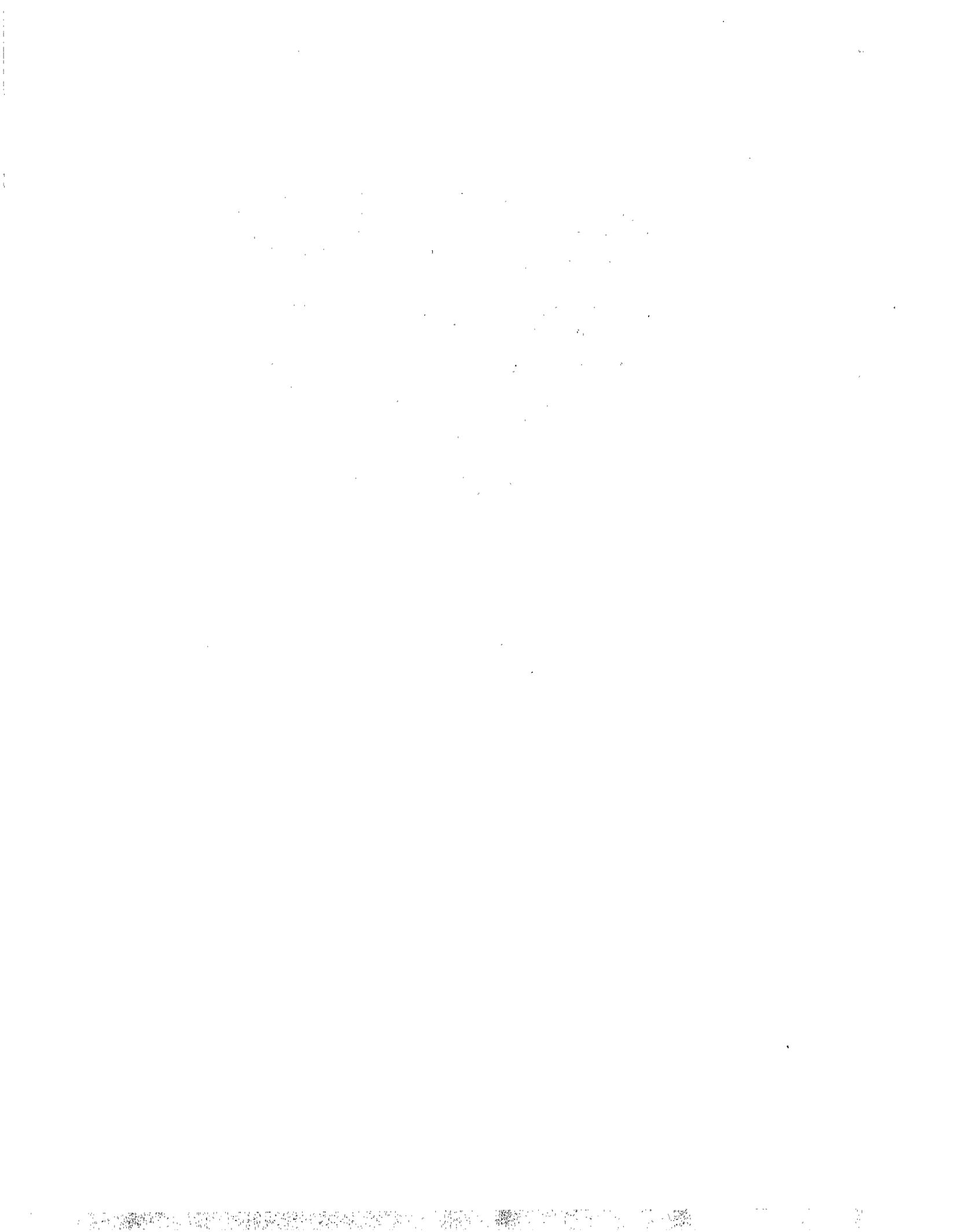
Sincerely yours,

A handwritten signature in black ink that reads "Charles A. Bowsher". The signature is written in a cursive style with a large, prominent initial "C".

Comptroller General
of the United States

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CHAPTER 1

REPORT BY THE
COMPTROLLER GENERAL
OF THE UNITED STATES

DEFENSE CONTINUES TO SUBSIDIZE
SALES OF SECONDARY ITEMS TO
FOREIGN GOVERNMENTS BECAUSE OF
POOR PRICING POLICIES

D I G E S T

Defense continues to make large subsidies to the foreign military sales program because prices charged for secondary items ^{1/} sold from Defense inventories are not sufficient to replace the items. Although GAO reported this situation 3 years ago, Defense has not taken adequate corrective actions.

Subsidies are also occurring because foreign customers are not charged an equitable share of normal inventory losses, as GAO stated in three earlier reports.

The Arms Export Control Act of 1976 requires that if items sold from inventory by the Department of Defense are intended to be replaced, the prices charged to foreign customers must cover replacement costs of those items.

At the request of Senators Percy and Hollings, GAO followed up on its previous reports to determine if Defense was still subsidizing the foreign military sales program.

REPLACEMENT COST NOT RECOVERED

Based on a random sample of fiscal 1979 sales of secondary items to foreign governments, GAO estimates that the foreign military sales program was subsidized through Defense appropriations by over \$8 million at the four inventory control points visited. Underbillings occurred primarily because (1) compound inflation factors were not applied and (2) the rate of inflation used to estimate replacement cost was unrealistically low.

^{1/}Secondary items are usually reparable and nonexpendable spare and repair parts bought with the military services' direct appropriations.

A similar study conducted by Defense personnel confirmed that billing prices were not adequate to cover replacement costs.

Inflation factors should be compounded

Many secondary items are procured infrequently; consequently the price at which items are carried in inventory may reflect a cost incurred 1 or more years before. GAO had previously recommended that, to adequately recover replacement cost when selling these items, the sales price should include compounded inflation factors from the time the items were last purchased to the selling date. Defense procedures, however, require only a single year's inflation rate to be added to the inventory price to recover estimated replacement cost. (See p. 8.)

For example, the Army purchased frequency converters in August 1977 at a unit price of \$3,314. In February 1979, the Army sold two of the items to foreign customers for \$3,539 each (\$3,314 plus a single year's inflation rate: the fiscal 1979 inflation factor of 6.8 percent). Eight months later the replacement price of the item was \$6,899. Thus the Army underbilled by \$3,360 per item. Although using compounded inflation factors as GAO recommended would not have covered the full replacement cost in this instance, it would have more closely approximated the replacement cost and reduced the amount of loss on the sale.

Defense inflation rate estimates are too low

GAO found that the inflation rates prescribed to the military services for estimating replacement prices are much too low. The rates Defense prescribed are based on those provided by the Office of Management and Budget for preparation of the President's budget. Historically, these rates have been shown to be a conservative forecast of price changes. A Department of Defense official told GAO that these official rates have proved to be too conservative in 10 of the last 11 years. (See p. 9.)

A recent Air Force Logistics Command study of contracts for 150 secondary items showed an average cost increase of 23 percent in fiscal 1980. These items were budgeted at an inflation rate of 7 percent. Also, the Pratt and Whitney

Aircraft Company, a major supplier of secondary items for the Air Force, recently advised the Air Force Logistics Command that secondary item prices in fiscal 1981 would be 25 to 30 percent higher than in fiscal 1980. The current procurement account inflation rate for fiscal 1981 is 9.7 percent.

ALL NORMAL INVENTORY LOSSES
ARE NOT REQUIRED TO BE RECOVERED

Additional subsidies to the foreign sales program occurred because some foreign customers who purchased secondary items from Defense inventories were not charged enough to cover normal inventory losses. For the four locations visited, GAO estimates that this subsidy amounts to about \$3.3 million each year.

In passing the Arms Export Control Act, the Congress intended that all indirect and direct costs be recovered so that the foreign military sales program would not be subsidized by Defense appropriations. Normal inventory losses--those caused by obsolescence, damage and deterioration, and pilferage--are indirect costs. However, the act, as amended in 1978, requires only that foreign governments be charged for normal inventory losses on sales from stock that is being stored at the expense of the purchaser.

Because participation in Defense inventories was believed to be limited to selected customers, the requirement for recovering normal inventory losses was not extended to all sales from inventory. Only certain foreign governments with long term contracts to purchase supply support from Defense bear the expenses of inventory storage. The reason for this is the theory that the other customers do not participate in or benefit from the Defense logistics system.

GAO found, however, that foreign governments who had not established long term contracts for supply support were participating in and benefiting from the Defense logistics system. All foreign governments have received benefits from the Defense inventory system. Accordingly, all should have paid an equitable portion of normal inventory losses. Allocating indirect costs such as inventory losses to all customers benefiting from the system that generated those costs is a standard accounting practice. (See pp. 10-12.)

SPECIAL DEFENSE UNIT
IS BEING ESTABLISHED
TO MONITOR PRICING PRACTICES

Over the past 6 years GAO has issued more than 30 reports that together cite hundreds of millions of dollars in unrecovered costs due to inadequate pricing policies and practices. Three years ago, GAO recommended that a special unit be created to ensure the adequacy of foreign military sales pricing (FGMSD-78-51). After some delay, the Department of Defense has recently established a quality assurance unit at the Security Assistance Accounting Center to monitor foreign sales pricing. With proper guidance and effective implementation, this unit should more adequately detect and resolve the type of pricing problems described in this report. (See p. 13.)

OPPORTUNITY EXISTS
TO RECOVER UNDERBILLINGS

The standard Defense foreign military sales contract provides that adjustments may be made to estimated costs that are not commensurate with actual costs up to and including final billing. Therefore, any costs that have not been recovered by the military services on those sales contracts for which final billing has not been made could and should be billed. As to undercharges that may be found after final billing, the Defense instruction 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 it will be to recover these amounts from foreign governments. Therefore, collection attempts should be initiated as soon as undercharges are discovered; if possible, this should be before the military services make final billings for contracts on which the undercharges occurred. (See p. 13.)

RECOMMENDATION TO THE CONGRESS

To ensure that all foreign governments are treated equitably and all indirect costs are charged, GAO recommends that the Congress amend the Arms Export Control Act to require that all sales from Defense inventories reflect the cost of normal inventory losses. (See p. 14.) (Suggested legislative language is in app. III.)

RECOMMENDATIONS TO THE
SECRETARY OF DEFENSE

To help ensure equitable and effective pricing of secondary items and avoid subsidies to foreign customers, GAO recommends that the Secretary of Defense:

- Instruct Defense components to use compound inflation factors when estimating replacement cost. (See p. 14.)
- Prescribe a more realistic inflation index. (See p. 14.)
- Use the quality assurance unit recently established at the Security Assistance Accounting Center to ensure that Defense components adequately and uniformly implement the revised estimation procedures. (See p. 14.)
- Direct the military services to make every reasonable effort to recover from foreign governments the past undercharges in sales of secondary items. (See p. 14.)

AGENCY COMMENTS

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

CHAPTER 2

GAO'S ANALYSIS AND RESPONSE TO COMMENTS

FROM THE DEPARTMENT OF DEFENSE

Although Defense does not agree with all of the report's recommendations, it does concur with three of the five recommendations we did make, including our main recommendation that Defense should use more realistic inflation factors in determining the price to charge. Defense should reconsider its position on our other recommendations. The concurrence and implementation by Defense of all of the report's recommendations would help preclude the improper subsidization of the foreign military sales program.

In addition, Defense took strong issue with our findings and indicated that because our sample of sales transactions contained errors, we lacked support for the conclusions drawn in our report. Defense checked our work on 40 of the 400 sales transactions we audited and alleges that 4 were in error. We reviewed the Defense allegations and disagree with their findings. (See pp. 9 and 10.)

We also analyzed the statistical sample used by Defense in reviewing our work and found that even if Defense's allegations about the quality of our work had been correct, its sample was too small to support any valid conclusions.

GAO'S EVALUATION OF DEFENSE'S COMMENTS ON OUR RECOMMENDATIONS TO DEFENSE

Our recommendations to the Secretary of Defense were designed to help ensure equitable and effective pricing of secondary items and avoid subsidies to foreign customers. Defense's comments on each of our recommendations and, where applicable, our evaluation, follow.

1. RECOMMENDATION: Prescribe a more realistic inflation factor for pricing secondary items.

Defense reply: Defense indicated that it concurred with our recommendation and that the Secretary of Defense had raised the issue to the Director of the Office of Management and Budget of how to improve methods of estimating and budgeting for inflation in Defense programs.

Defense advised that any changes resulting from this effort will be incorporated into its foreign military sales pricing policy.

GAO evaluation: If Defense proceeds to implement more realistic inflation factors, estimates of replacement cost should become more accurate and underpricing should be reduced.

2. RECOMMENDATION: Instruct Defense components to use compound inflation factors when estimating replacement cost for secondary items.

Defense reply: Defense does not agree with our recommendation. It said that its own studies and its review of our audit data indicate that the Defense policy of including an inflation factor on all sales, whether replacement of the item sold is required or not, results in full recoupment on an overall basis. Also, Defense said that price growth appears to be more dependent on source of supply and quantity procured than on time. Defense will make periodic studies to ensure that its pricing policy results in full recoupment and make changes where appropriate.

GAO evaluation: We disagree that Defense studies and the GAO data show that full recoupment of replacement cost is being accomplished. Defense could not furnish us with any valid studies demonstrating that its policy of adding a single year's inflation rate to an item's historical or standard price would be adequate to recover replacement cost.

Defense is using a draft study of sales transactions to support its claim that replacement cost is fully recouped. However, Defense used only 37 of the 214 transactions included in the sample to form the basis for its conclusions. To project results on only a small portion of the sample is statistically invalid. Also, we found that Defense's own analysis of the entire 214 sample transactions showed that its pricing policy would not recover replacement cost.

As shown on pages 9 and 10 of the basic report, two other Defense studies support the results of our work. Finally, our report clearly demonstrates that at the four locations visited, losses on sales would have been 30 percent lower using the inflation compounding procedures we recommended than they would have been under Defense's method.

Also, Defense has no evidence to support its statement that price growth appears to be more dependent on source of supply and quantity procured than on time. Our report clearly shows that in estimating replacement cost it is not adequate to apply a single year's inflation to items that have not been replaced for several years. We believe Defense should reconsider our recommendation.

3. RECOMMENDATION: Use the quality assurance unit recently established at the Security Assistance Accounting Center to ensure that Defense components adequately and uniformly implement the revised estimation procedures.

Defense reply: Defense concurred with our recommendation.

GAO evaluation: As indicated above, Defense did not agree to revise its estimation procedures in order to use compounded inflation factors. Concurrence with this recommendation, therefore, loses much of its significance.

4. RECOMMENDATION: Direct the military services to make every reasonable effort to recover from foreign governments the past undercharges in sales of secondary items.

Defense reply: While Defense concurred with the principle of this recommendation, we were advised that it will not attempt to recoup past undercharges because there is no convincing evidence of overall underrecoupment.

GAO evaluation: Our report demonstrates that there was an overall underrecoupment of replacement price for secondary item sales, even though Defense disagrees. The balance of this supplement shows that Defense's position is not supported by the evidence; therefore, Defense should reconsider its position.

GAO'S EVALUATION OF DEFENSE'S COMMENTS
ON OUR RECOMMENDATION TO THE CONGRESS

Defense also commented on our recommendation to the Congress that the Arms Export Control Act should be amended to require that all sales from Defense inventories reflect the cost of normal inventory losses. Defense says it would be inappropriate to charge customers for inventory losses when they do not benefit from the existence of an inventory system.

In passing the Arms Export Control Act, the Congress intended that all indirect and direct costs be recovered so that the foreign military sales program would not be subsidized by Defense appropriations. Normal inventory losses--those caused by obsolescence, damage and deterioration, and pilferage--are indirect costs. However, the act as amended in 1978, requires only that foreign governments be charged for normal inventory losses on sales from stock that is being stored at the expense of the purchaser.

Because participation in Defense inventories was believed to be limited to selected customers, the requirement for recovering normal inventory losses was not extended to all sales from inventory. Only certain foreign governments with long term contracts to purchase supply support from Defense bear the expenses of inventory storage. The reason for this is the theory that the other customers do not participate in or benefit from the Defense logistics system.

We found, however, that foreign governments who had not established long term contracts for supply support were participating in and benefiting from the Defense logistics system. Since all foreign governments have received benefits from the Defense inventory system, all should have paid an equitable portion of normal inventory losses. Allocating indirect costs such as inventory losses to all customers benefiting from the system that generated those costs is a standard accounting practice.

DEFENSE'S OBJECTIONS TO OUR FINDINGS

Defense reviewed 40 of the 400 sales transactions we audited and alleges that we erred on 4 of the transactions. Defense believes that, because of these errors, our sample results cannot be used to support our conclusion that Defense has substantially underpriced sales of secondary items to foreign countries. We reviewed the alleged errors and found that Defense had no basis for its conclusions. We also reviewed the methodology used by Defense in sampling the transactions we audited. We found that its sample was too small and thereby rendered the results statistically meaningless.

GAO errors alleged by Defense

Of the GAO errors alleged by Defense, by far the most significant allegation concerned a transaction for the sale of sixty 2-1/2-ton truck axles to a foreign customer. Our audit had disclosed that the axles were sold from inventory and therefore were subject to replacement pricing criteria set out by Section 21 of the Arms Export Control Act. Using these criteria, we found that the Army had substantially underpriced the axles. Defense officials told us that the Army researched the transaction in question and found the order had been satisfied from a new procurement rather than from inventory. Defense therefore argues that the price of the axles should have been the price stated in the contract, as prescribed by Section 22 of the Arms Export Control Act. Using these criteria, Defense contends that the sale of the axles resulted in a substantial overcharge to the foreign customer. We went back to the Army to find out if Defense was correct and found an apparent breakdown in communication between the two agencies. We found that in fact no contract for new procurement had been let by the Army to satisfy the sale of axles, and that we were correct in our determination that the transaction should be considered a sale from inventory. Defense's allegation that we made an error in this case is incorrect.

Another alleged GAO error, which occurred twice, involves two transactions we audited in which the Army sold diesel engines to foreign customers. Defense argues that since the type of engine sold will not be replaced, the actual value of the engines should have been recovered. Defense indicates that we erroneously used the price of a newer engine in estimating the replacement cost of the sale. Defense points out that had the actual value of the engines been used the sale would have resulted in a gain rather than the loss we reported.

We found that, as of the date of the sale, the Army records showed that the diesel engine sold was expected to be replaced. Given this fact at the date of the sale, the Army should have charged an estimated replacement price as required by law. The Defense argument that we erred in pricing the engines is incorrect.

With regard to the remaining alleged error, Defense argues that in estimating replacement cost for circuit card assemblies, we used a procurement contract for a lesser quantity of the assemblies than the quantity actually sold. This contract quantity, therefore, would not have been adequate to replace the amount shipped to the foreign customer. By using a contract in which a larger quantity was purchased to estimate replacement price, Defense arrived at a lower cost per unit. Defense admits, however, that even if the lower cost per unit had been used, a loss on the sale would still have been incurred.

We found that the Army records showed the smaller contract as a representative buy and therefore a good indication of what replacement cost would be. Generally, a procurement is considered representative if item managers or procurement specialists believe the contract price is indicative of the item price, regardless of the quantity. The Defense argument that we erred in using the contract for estimating replacement cost is incorrect.

Defense sample is statistically meaningless

We reviewed the methodology used by Defense to dispute our findings and found that its sample results are statistically meaningless. As indicated above, Defense alleges that it found errors in 4 of 40 sample transactions it took from our random statistical sample of 400 secondary item sales. We have demonstrated that Defense was wrong in its allegations, but even if Defense had been correct, the error range of its sample is so large that meaningful conclusions cannot be made. If all four of the transactions were in fact in error, Defense's sample mid-point projection would show a \$6.3 million gain on the sales of secondary items. However, because its sample size was so small, the sample error range at the 95-percent confidence level is quite large: + \$12.5 million. The effect of this is that the sample projections include losses and gains on sales, that is, a \$6.2 million loss and an \$18.8 million gain. Clearly, meaningful conclusions cannot be drawn from the Defense sample.

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NINETY-SEVENTH CONGRESS
Congress of the United States
House of Representatives
LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-373
WASHINGTON, D.C. 20515

December 7, 1981

The Honorable Charles A. Bowsher
Comptroller General of the United States
U.S. General Accounting Office
Washington, D. C. 20548

Dear General Bowsher:

By letter of November 25, 1981, the Secretary of Defense responded to me about the two recent GAO reports on the foreign military sales program as based on erroneous application of the Arms Export Control Act and the use of unvalidated data to support its conclusions. The two reports are entitled "Millions in Losses Continue on Defense Stock Fund Sales to Foreign Customers," AFMD-81-62, September 10, 1981, and "Defense Continues to Subsidize Sales of Secondary Items to Foreign Governments Because of Poor Pricing Policies," AFMD-81-105, October 5, 1981.

I am interested in these two reports and requested a response from DOD because of the seriousness of the apparent underpricing and the waste of millions of dollars in taxpayers' money. As you know, the Legislation and National Security Subcommittee held hearings on these matters and issued a report that was used by the Appropriations Committee to require notification of the Congress when costs are waived by DOD under the Arms Export Control Act.

I would appreciate it if you could evaluate the reasons for the Secretary's negative characterization of these recent GAO reports. A copy of Secretary Weinberger's letter is enclosed. An early response would be greatly appreciated. (See GAO note below.)

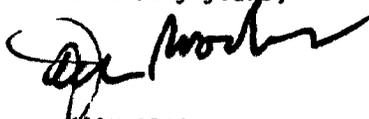
With all good wishes, I am,

GAO note:

We discussed this request with the Chairman's office and agreed to defer our response until Defense made final comments. (See app. II.)

Enclosure

Sincerely yours,


JACK BROOKS
Chairman



COMPTROLLER

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

20 JAN 1982

Honorable Charles A. Bowsher
Comptroller General of the
United States
Washington, D.C. 20548

Dear Mr. Chuck Bowsher:

This is in reply to your letter to the Secretary of Defense regarding your report dated October 5, 1981, entitled, "Defense Continues to Subsidize Sales of Secondary Items to Foreign Governments Because of Poor Pricing Policies," OSD Case #5807 (GAO AFMD-81-105).

Your report advised Senators Percy and Hollings that Defense continues to make large subsidies to the Foreign Military Sales (FMS) program because prices charged for secondary items sold from Defense inventories are not sufficient to replace the items. Your conclusion was predicated mainly on a random sample of Fiscal Year 1979 sales of secondary items to foreign governments. Due to erroneous data in your sample, we believe it cannot be used as support for your conclusion.

Your random sample indicated that DoD pricing procedures recouped only 87 percent of actual replacement cost. We requested, and were allowed access to, workpapers and the data underlying a random selection of 10 percent of the items included in your sample. The Military Departments were tasked to completely research these items. Their research has disclosed errors in the data included in the sample (see Enclosure 1 for details). The GAO data for the items selected for research produced a result showing a recoupment of 82 percent of the replacement cost. However, after correction of the errors, a recoupment of as much as 116 percent of the replacement cost could be indicated. This casts serious doubt on the validity of the conclusions you have drawn from your entire sample. Your allegation that Defense continues to make large subsidies to the Foreign Military Sales program in this area is not supported by your audit work.

The report further alleged that DoD subsidizes the Foreign Military Sales program by not charging a portion of inventory losses to all FMS customers purchasing secondary items. This is a position which GAO has taken in the past and to which DoD previously demurred. The difference of opinion was raised to the Congressional level resulting in a change to the Arms Export Control Act in 1979. The Act now clearly states (see para. 21(e)(1)(D)) that only those customers for whom defense articles are being stored will be charged inventory losses. Our position now is, as it was then, that it is inappropriate to charge customers for costs that they neither cause nor from which they benefit. We intend to continue with our current pricing policy.

Comments on your specific recommendations are:

1. Recommendation to the Congress: To ensure that all foreign governments are treated equitably and all indirect costs are properly charged, we recommend that the Congress amend the Arms Export Control Act to require that all sales from Defense inventories reflect the cost of normal inventory losses.

DoD Position: Nonconcur. It would be inappropriate to require FMS customers to pay for obsolete and excess inventory items when they do not benefit from the holding of inventory.

2. Recommendation to DoD: Instruct Defense Components to use compound inflation factors when estimating replacement cost.

DoD Position: Nonconcur. DoD studies and our review of the GAO data indicate that the DoD policy of including an inflation factor on all sales, whether replacement is required or not, results in full recoupment on an overall basis. Also, price growth appears to be more dependent on source of supply and quantity procured than on the time element. We will make periodic studies to ensure that our pricing policy results in full recoupment and make changes where found appropriate.

3. Recommendation to DoD: Prescribe a more realistic inflation index.

DoD Position: Concur. The Secretary of Defense has already raised the issue of how to improve our methods of estimating and budgeting for inflation in Defense programs to the Director of the Office of Management and Budget. Any changes resulting from this effort will be incorporated in our Foreign Military Sales pricing policy.

4. Recommendation to DoD: Use the quality assurance unit recently established at the Security Assistance Accounting Center to ensure that Defense Components adequately and uniformly implement the revised estimation procedures.

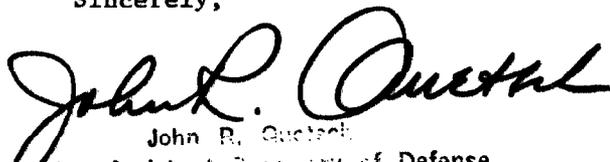
DoD Position: Concur. The duty of the quality control unit is to assure pricing is in compliance with DoD pricing policy.

5. Recommendation to DoD: Direct the Military Services to make every reasonable effort to recover from foreign governments the past undercharges in sales of secondary items.

DoD Position: Concur. It is DoD policy that, where pricing is not in accordance with DoD pricing guidance, adjustments in price must be made in customer's bills. However, in this case, there is no convincing evidence of overall underrecoupment. Since our aim is to strike a balance on overall sales, there is no basis for making additional charges on any individual sales.

Finally, we believe your report to be unfair and harmful. We continue to try to improve our operations, but the summary statement that "although GAO reported this situation three years ago, Defense has not taken adequate corrective actions" does harm to us since it conveys the impression of indifference, incompetence or inaction on our part. Neither is the case, but we may well be penalized because of your allegation. We believe that our pricing for secondary items is sufficient to replace items without subsidy to the foreign military sales program. Our approach may be different than you have recommended, but your audit fails to show that it is inadequate to the requirements of the law.

Sincerely,


John R. Quetch
Acting Assistant Secretary of Defense
(Comptroller)

Enclosure

GAO Audit Sample No	FMS Requisition No	Prescribed Selling Price	GAO Analysis		DoD Analysis		Explanation of Difference
			Replacement Cost/Actual Value ¹	Gain (loss) on Transaction	Replacement Cost/Actual Value ¹	Gain (loss) on Transaction	
A004	BIS0447201A075	\$5,615.50	\$4,578.20	\$1,037.30	\$4,578.20	\$1,037.30	
A020	BJOB446013A195	3,418.67	3,201.00	217.67	3,201.00	217.67	
A042	BJOB446016C340	941.78	868.00	73.78	868.00	73.78	
A053	BJUA846206B133	182.28	178.00	4.28	178.00	4.28	
A066	BPKN447143B017	4,446.08	4,789.50	(343.42)	4,789.50	(343.42)	
A077	BSPK656343B642	1,389.89	1,281.00	108.89	1,281.00	108.89	
A090	BSRD446329C176	4,516.86	4,790.00	(273.14)	4,790.00	(273.14)	
A105	BTWL647211B324	4,178.04	6,000.00	(1,821.96)	6,000.00	(1,821.96)	
A121	BJOB446014C453	12,518.03	7,644.00	4,874.03	7,644.00	4,874.03	
A135	BKSX2Z8054197L	112.84	119.00	(6.16)	119.00	(6.16)	
A149	BISA4482001102	4,440.73	4,057.97	382.76	4,057.97	382.76	
A159	BJOB446010B169	1,986.48	1,860.00	126.48	1,860.00	126.48	
A172	BJOB446013A179	692.06	513.00	179.06	513.00	179.06	
A186	BJOB446016B092	363.12	168.00	195.12	168.00	195.12	
A201	BKST447068D434	2,807.98	2,588.00	219.98	2,588.00	219.98	
A218	BMOA447250A146	6,504.12	21,000.00	(14,495.88)	12,819.00	(6,314.88)	Note 2
A233	BSPK657066A073	300.11	138.00	162.11	138.00	162.11	
A245	BSRG647042A990	472.06	462.00	10.06	462.00	10.06	
A257	BTU0648268B132	565.29	1,973.00	(1,407.71)	1,973.00	(1,407.71)	
B011	BTHW4Z7175D014	3,876.84	3,630.00	246.84	3,630.00	246.84	
B026	BKSJ4552960252	106,633.80	176,220.00	(69,586.20)	57,600.00	49,033.80	Note 3
B039	BSRG447052B113	104,272.88	114,705.04	(10,432.16)	96,104.00	8,168.88	Note 4
B050	BTHB4482740067	634.38	594.00	40.38	594.00	40.38	
B063	BGTA4492050063	2,567.12	2,366.00	201.12	2,366.00	201.12	
B076	BSRD4461759006	64,149.40	71,690.00	(7,540.60)	60,065.00	4,084.40	Note 4
C006	PTW54483253014	6,162.80	5,680.00	482.80	5,680.00	482.80	
C036	PKSE4491491099	2,213.40	2,040.00	173.40	2,040.00	173.40	
C051	PKSE4491761189	354.80	327.00	27.80	327.00	27.80	
C077	PGRQ4483240448	162.76	150.00	12.76	150.00	12.76	
C094	PNOX4490222522	1,204.35	1,110.00	94.35	1,110.00	94.35	
C106	PID04490532311	1,228.24	1,132.00	96.24	1,132.00	96.24	
C119	PKSE4491230309	2,213.40	2,040.00	173.40	2,040.00	173.40	
C140	PSPT4491645081	583.73	538.00	45.73	538.00	45.73	

GAO Audit Sample No	FMS Requisition No	Prescribed Selling Price	GAO Analysis		DoD Analysis		Explanation of Difference
			Replacement Cost/Actual Value ¹	Gain (loss on) Transaction	Replacement Cost/Actual Value ¹	Gain (loss) on Transaction	
C160	PGRP4591784951	742.14	684.00	58.14	684.00	58.14	
C172	PGRQ4592080051	1,848.84	1,704.00	144.84	1,704.00	144.84	
C190	PTW44492603274	21,548.10	19,860.00	1,688.10	19,860.00	1,688.10	
D031	DTH14490885809	960.66	2,175.60	(1,214.94)	2,175.60	(1,214.94)	
D046	DISA4590788108	31,389.05	31,389.05	0	31,389.05	0	
D067	DTH14490446189	11,691.96	13,923.84	(2,231.88)	13,923.84	(2,231.88)	
D088	DPIF4492360044	11,246.03	10,365.00	881.03	10,365.00	881.03	
Total		<u>\$431,136.60</u>	<u>\$528,532.20</u>	<u>(\$97,395.60)</u>	<u>\$371,505.16</u>	<u>\$59,631.44</u>	
				82%		116%	
Total less sample No. B026		<u>\$324,502.80</u>	<u>\$352,312.20</u>	<u>(\$27,809.40)</u>	<u>\$313,905.16</u>	<u>\$10,597.64</u>	Note 3
				92%		103%	

Notes:

¹For items which were replaced, replacement contract costs are used. For items which were not replaced and which are not excess, GAO and DoD agree that 100 percent of original acquisition cost represents actual value. DoD does not review individual secondary items sold to FMS customers to determine whether replacement is necessary. The standard price for all items is marked up a percentage inflation factor. Any excess collection on any sale realized from application of the percentage factor is used to cover any shortfall on other sales. Our aim is to reach a zero balance on total sales.

²GAO based replacement cost on a small business contract for a quantity of 2 which was smaller than the number shipped to the FMS customer. DoD cost is based on a non-small business contract for a quantity of 12 which was sufficient to cover the quantities shipped to the FMS customer.

³Error made by GAO. Sixty of this item were ordered by the FMS customer on October 23, 1975. The only contract to procure this item was awarded on September 16, 1977, for 361 at a unit price of \$960. Physical delivery of items on contract was completed in 1979 and ordered items were shipped to the FMS customer. There were no other contracts placed for the item from Fiscal Years 1975 through 1981. From

(903048)

this it must have been a new procurement covered under Section 22, AECA, and should not have been included as an inventory sale nor included in the sample. Since the item is in the sample, we carried through on the analysis. The loss indicated by GAO was based on a replacement unit cost of \$2,937 which is inadmissible since there was no replacement contract. The DoD gain was based on the difference between the price charged, \$1,638 (standard price in 1979) plus the 8.5% inflation factor and the \$960 unit cost which the customer should have been charged.

GAO error. This item, a diesel engine, was not and will not be replaced since it is no longer the preferred item. GAO based replacement cost on new engines which were capable of fitting in the engine compartment. The new engines incorporate product improvements and thus are more costly than the engine which was sold. DoD analysis used actual value of the engines sold since no replacement has taken place. The same item was sold on two of the requisitions randomly selected by GAO for audit examination.



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