



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

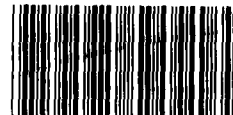
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ACCOUNTING AND FINANCIAL
MANAGEMENT DIVISION

DECEMBER 12, 1983

B-208256

The Honorable Caspar W. Weinberger
The Secretary of Defense



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Dear Mr. Secretary:

Subject: Improvements Needed in Pricing Overhaul and
Repair Services Performed for Foreign Coun-
tries (GAO/AFMD-84-12)

This summarizes the results of our review of the adequacy of billings by the military services to foreign countries for material, labor, and other costs incurred in overhauling and repairing foreign military equipment. The Department of Defense provides overhaul and repair services on a reimbursable basis for equipment it has sold to foreign governments. We found several instances in which the military had significantly underbilled foreign customers for these services. Details of our findings, conclusions and recommendations are in enclosure I. Our objectives, scope, and methodology are presented in enclosure II.

Fiscal year 1981 billings to foreign customers for repair and overhaul work amounted to \$30 million. This work is expected to increase dramatically due to the rapid growth in sales of military equipment to foreign governments. In the Air Force alone, foreign customer orders for repair and overhaul work to be performed over the next several years amount to about \$300 million.

For many years, the Congress has been interested in making sure that sales of military articles and services (including overhaul and repair) are made at no cost to the U.S. Government. This interest is expressed in the Arms Export Control Act of 1976, which contains specific provisions on costs of sales required to be recovered by Defense. Defense Manual 7290.3-M prescribes Defense's pricing policy which is intended to implement the cost recovery provisions of the act.

Our review disclosed the following instances which led to underbillings of about \$4.6 million during fiscal year 1982:

- The military services did not bill for all required costs of materials used in overhaul and repair work, undercharging by an estimated \$3.1 million. An October 1981 Defense policy

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change required that certain additional material costs be billed but the services did not effectively implement the policy.

--The Air Force underbilled West Germany an estimated \$456,000 for engine overhauls because one of its commands did not follow Defense's pricing policies. It did not include packing, handling, crating, and certain material and transportation costs in the sales price.

--The Air Force did not bill foreign customers an estimated \$1 million in civilian labor costs incurred in performing repair and overhaul work. These costs, which were the value of the government's contribution to the employees' retirement fund, were required by Defense directives to be charged to foreign customers. The Defense Audit Service reported this deficiency in 1980 but the Air Force did not take corrective action to include the charges in its billings.

So that future billings will be in accordance with the provisions of the law and Defense pricing policies, we recommend that you:

--Require the military services to examine their systems for collecting costs to ensure that all required costs of materials used in overhaul and repair of foreign countries' equipment are billed.

--Direct the Air Force to make sure that (1) all required costs of engine overhaul services are billed and (2) all civilian labor costs for retirement are included in foreign customer billings.

With regard to past undercharges, 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. For undercharges found after final billing, Defense directives provide that adjustments to final billings are permitted when there are unauthorized deviations from Defense pricing policies. Therefore, we also recommend that you direct the military services to make every reasonable attempt to bill for and collect the \$4.6 million in past undercharges for repair and overhaul work identified in this report.

As you know, 31 U.S.C. 720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations. You must send the statement to the House Committee on Government Operations and the Senate Committee on Governmental Affairs within 60 days of the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We discussed our findings and recommendations with Defense officials. They agreed with our recommendations and said that they

will take required corrective actions. Defense comments and our evaluation of them are in enclosure I.

We are sending copies of this report to the Director of the Office of Management and Budget and the Secretaries of the Army, Navy, and Air Force.

Sincerely yours,


W. D. Campbell
Acting Director

Enclosures - 2

FINDINGS AND RECOMMENDATIONSON THE NEED FOR IMPROVEMENTS IN PRICINGOVERHAUL AND REPAIR SERVICES FOR FOREIGN COUNTRIES

The military services did not bill foreign countries for all required material, labor, and other costs related to repair and overhaul work performed on foreign military equipment. As a result, the military services improperly used an estimated \$4.6 million in Department of Defense appropriations to subsidize this work for foreign countries. Our review disclosed that:

- The military services underbilled foreign customers an estimated \$3.1 million for stock fund materials used in repair and overhaul work during fiscal year 1982.
- The Air Force underbilled one foreign country an estimated \$456,000 for material and labor costs incurred in performing engine overhaul work. If we had not pointed this out and the Air Force had continued to bill in the same manner, additional underbillings estimated at \$18.4 million could have resulted over the next several years.
- The Air Force was not charging foreign customers for retirement benefit costs which are part of the civilian labor costs associated with repair and overhaul work, causing estimated underbillings of more than \$1 million for fiscal year 1982.

In each of these instances, the military services were not following Defense's pricing policy directives which are intended to implement the cost recovery provisions of the Arms Export Control Act.

BACKGROUND

Under the Department of Defense foreign military sales program, the military services overhaul and repair, on a reimbursable basis, military equipment previously sold to foreign governments. Fiscal year 1981 billings to foreign customers for such work totaled about \$30 million with dramatic increases anticipated. In the Air Force alone, foreign customer orders for work to be performed over the next several years amount to about \$300 million.

The military services provide this service under the authority of the Arms Export Control Act of 1976, which generally requires that the foreign military sales program be conducted on a cost-reimbursable basis (20 U.S.C. 2761 and 2762).

Defense's policies for pricing and billing goods and services sold to foreign customers are contained in Defense Manual 7290.3-M and related changes which are designed to implement the cost recovery provisions of the Arms Export Control Act. With regard to erroneous underbillings that may occur, Defense's standard foreign

military sales contract provides that, when customers are underbilled for goods and services, adjustments may be made if estimated costs are not commensurate with actual costs, up to and including final billing. Defense directives allow adjustments to final billings when there have been authorized deviations from Defense pricing policies.

Military services underbilled
foreign governments for material
used in overhaul and repair

The military services underbilled their foreign customers an estimated \$3.1 million for materials used in repair and overhaul work during fiscal year 1982. These underbillings occurred because the military services had not implemented Defense's policy for pricing stock fund materials when the materials were used in repair and overhaul work. Stock fund materials are mainly spare and repair parts maintained in Defense's inventory.

Defense amended its pricing policy in October 1981 to require the military services to add surcharges to the price of stock fund materials sold to foreign customers. These surcharges were generally intended to recover the cost of replacing the materials sold. When stock fund materials are used in repair and overhaul work for foreign customers, they are in effect sold to the customers since the cost of materials is included in the price of repairs. Defense officials agreed that, in accordance with the revised pricing policy, the prescribed surcharges should have been added to the price of stock fund materials used in repair and overhaul work for foreign customers. The Army, Navy, and Air Force did not add the surcharges in these cases; consequently the services underbilled their foreign customers an estimated \$3.1 million during fiscal year 1982. Our estimate of underbillings was based on information provided by the military services and later confirmed by the Office of the Assistant Secretary of Defense (Comptroller) in a letter to us dated August 24, 1982. The Assistant Secretary indicated that the services used approximately \$11.1 million in stock fund materials for repairing and overhauling items for foreign customers between October 1981 and May 1982. Assuming the same workload level for the remainder of the fiscal year, we estimate that total stock fund materials used for this purpose in fiscal year 1982 would be about \$14.8 million. By applying the applicable stock fund surcharges to the \$14.8 million, we estimate that 1982 underbillings for stock fund materials used in foreign customer repair and overhaul work were \$3.1 million. Military service officials could not explain, nor could we determine, why their billing systems for stock fund items had not been changed to include the appropriate surcharges.

Air Force underbilled foreign
customers for engine overhaul costs

The Air Force underbilled West Germany an estimated \$455,715 for the overhaul of aircraft engines because the San Antonio Air Logistics Command did not include all required costs in the price charged.

The San Antonio Air Logistics Command is responsible for pricing engine overhauls done for foreign customers at the San Antonio overhaul facility. We found that the Command did not include all costs required by Defense policy in billings to Germany for engine overhauls because it did not follow its local procedure, which was designed to ensure that all such costs are billed. Major costs not included were packing, handling, crating, and some transportation and material costs.

Under the Command's procedure, orders from foreign customers for engine overhauls were segregated from orders initiated by U.S. Air Force activities. The segregated orders were then sent to a control desk where they were checked to see that all required costs were included in foreign customer billings. This separate handling is necessary because certain substantial costs (e.g., costs of investment materials used in overhauling engines) are charged to foreign governments but are excluded from charges to U.S. Air Force activities.

An exception to the Command's usual procedure occurred in the case we mentioned involving Germany. In this case, the Air Training Command acted as an intermediary between Germany and the Air Logistics Command. Since the Training Command had submitted the orders, personnel at the Air Logistics Command treated them as though they were internal Air Force billings; they were not segregated and sent to the control desk.

Germany had purchased U.S. aircraft and had negotiated with the Air Training Command to train its pilots and overhaul 84 of its J-69-25 engines and 109 of its J-85-5 engines. At the time of our review, 37 of the former had been overhauled and bills sent. Because the orders for the 37 engines were not segregated and sent to the control desk, costs amounting to \$455,715 were not included in billings to Germany. Had future billings for the remaining engines to be overhauled been handled in the same way, total underbillings to Germany for overhauls would have been \$18.4 million. We informed Air Force officials of this problem and they agreed to take corrective action.

Air Force underbilled foreign customers
for labor costs applicable to overhaul
and repair work

Air Force activities did not bill foreign customers for all labor costs applicable to overhaul and repair work. We estimate that the Air Force underbilled foreign customers \$1 million in labor costs during fiscal year 1982.

The labor costs not billed by the Air Force consisted of the value of the government's contribution to the retirement fund for civilian personnel who did the overhaul and repair work. The government's contribution to the fund is commonly referred to as "unfunded civilian retirement costs" because the contributions are provided through separate budget appropriations and are not reflected in the operating expenses of the military services. They

are, however, part of the labor cost incurred by the government when the military services do overhaul and repair work. Defense regulations have required since 1978 that the military services bill foreign customers for these retirement costs and Defense has directed the services to apply a 13.4-percent acceleration factor to standard pay rates to recover these costs.

The Defense Audit Service reported in September 1980 that the military services were not applying the 13.4-percent acceleration factor, and that this resulted in substantial underbillings to foreign customers.¹ Again, in November 1980, the Defense Audit Service reported that the military services were not billing foreign customers for the unfunded portion of civilian retirement costs.² In response to these reports, the Army began applying the 13.4-percent factor to recover the retirement costs at the beginning of fiscal year 1981. The Navy directed its activities to apply the factor in January 1981.

In the Air Force, we found that two activities were not applying the factor to recover unfunded civilian retirement costs from foreign customers. We notified Air Force officials who told us this was an Air Force-wide problem and corrective action would be taken to require the retirement factor to be applied. We estimated that underbillings to foreign customers for unfunded civilian retirement costs amounted to \$1 million Air Force-wide in fiscal year 1982.

CONCLUSIONS

The military services have substantially underbilled foreign governments for overhaul and repair work. Although Defense's pricing policy directives required the services to bill foreign customers for the \$4.6 million in unbilled material and labor costs identified in this report, the military services had not fully implemented the directives. It is important that the military services comply with Defense directives and bill foreign customers for all required costs.

With regard to past undercharges identified in this report, 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. For those undercharges found after final billing, Defense directives allow adjustments to final billings when there are unauthorized deviations from Defense pricing policies. This means that the \$4.6 million in past undercharges may still be collectible.

¹"Report on the Review of Foreign Military Sales Case Management," Defense Audit Service No. 80-129, Sept. 2, 1980.

²"Report on the Review of Overhaul and Repair For Foreign Military Sales," Defense Audit Service No. 81-013, Nov. 3, 1980.

RECOMMENDATIONS

We recommend that the Secretary of Defense:

- Require that the military services examine their systems to ensure that all required costs of materials used in overhaul and repair of foreign countries' equipment are billed.
- Direct the Air Force to make sure that (1) all required costs of engine overhaul services are billed and (2) all civilian labor costs for retirement are included in foreign customer billings.
- Direct the military services to make every reasonable attempt to bill for and collect the \$4.6 million in past undercharges for repair and overhaul work identified in this report.

DEFENSE COMMENTS

In response to a draft of this report, Defense agreed with all of our recommendations and stated that the military services had been instructed to take the actions necessary to recover from foreign customers the costs recommended in our report. Defense pointed out that the military services had already initiated actions to recover those costs in future foreign military sales billings. Regarding the collection of past undercharges, Defense directed the military services to make every attempt to identify and bill for these costs on active repair cases and to keep track of collections made as a result of these billings.

GAO RESPONSE

If Defense's planned corrective actions are carried out effectively, the Department should recover the costs recommended in our report.

OBJECTIVES, SCOPE, AND METHODOLOGY

The overall objective of our review was to determine whether accounting systems and related administrative procedures and internal controls were adequate to recoup all applicable costs of overhaul and repair work performed for foreign countries under the foreign military sales program. Our review was limited to repair and overhaul work performed within the continental United States.

We reviewed applicable Department of Defense and military services directives, regulations, accounting procedures and reports, and other documents relating to pricing of overhaul and repair services performed for foreign countries. We also interviewed management personnel to discuss and clarify policies and procedures for determining prices to be charged for this work.

We conducted our review at the Department of Defense and at Headquarters, Departments of the Air Force, Army, and Navy, Washington, D.C.; Air Force Logistics Command, Dayton, Ohio; Headquarters, Air Training Command, Randolph Air Force Base, Texas; San Antonio Air Logistics Center, San Antonio, Texas; Oklahoma Air Logistics Center, Oklahoma City, Oklahoma; U.S. Army Armament Material Readiness Command, Rock Island, Illinois; U.S. Army Missile Command, Huntsville, Alabama; U.S. Army Depot System Command, Chambersburg, Pennsylvania; Letterkenny Army Depot, Chambersburg, Pennsylvania; U.S. Army Finance Center (Comptroller), Indianapolis, Indiana; Navy International Logistics Control Office, Philadelphia, Pennsylvania; Navy Aviation Supply Office, Philadelphia, Pennsylvania; Naval Aviation Logistics Center, Patuxent River, Maryland; and Navy Air Rework Facility, Norfolk, Virginia.

During the review, we obtained estimates from the military services on the amounts of stock fund materials used in repair and overhaul work for foreign customers. Our estimate of underbillings was derived by applying the applicable surcharge to these estimated amounts of stock fund materials. Information obtained in an August 24, 1982, memorandum to us from the Assistant Secretary of Defense (Comptroller) confirmed the data we had obtained from the military services.

Our estimates of future underbillings for engine overhauls assumed that the cost elements that were not included in past billings would not have been included in future billings. In our estimates we used information provided by the Air Force on the types and amounts of materials and labor that would be used and based them on costs in effect at the time of our review.

Our estimate of the unfunded civilian retirement costs that were excluded from billings for foreign customers was based on a 1:1 ratio that existed between total direct labor costs and total direct stock fund material costs in Air Force depot work. We applied this ratio to the stock fund material costs for foreign sales to obtain an estimated labor cost. The unfunded retirement cost

factor (13.4-percent) was applied to the estimated labor cost to arrive at the unfunded cost.

We performed our review in accordance with generally accepted government auditing standards.