REPORT BY THE

Comptroller General

OF THE UNITED STATES

Efforts To Charge For Using Government-owned Assets For Foreign Military Sales: Marked Improvement But Additional Action Needed

Since 1970, GAO has been reporting that although Government-owned assets are used to produce items sold to other countries, these countries have not been charged for the use of those assets. The result has been millions of dollars of subsidies.

Although Defense has made a marked improvement in its efforts to recover these costs, certain problems remain. Roughly $10 million has not been recovered because the cost of using Government-owned assets on sales from inventory has not been assessed for foreign countries. Also, weaknesses in accounting and billing systems exist.

Defense needs to closely monitor actions to charge foreign governments for the use of Government-owned assets on inventory sales and to strengthen accounting and billing procedures. Defense also needs to assure that foreign customers are billed retroactively for unrecovered charges on inventory sales and for those asset-use charges identified in previous audit reports.

This report was prepared at the request of the Chairman of the Subcommittee on Investigations, House Armed Services Committee.

FGMSD-79-36

JUNE 1, 1979

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

B-174901

The Honorable Samuel S. Stratton
Chairman, Armed Services Investigations
Subcommittee
Committee on Armed Services
House of Representatives

HSE 00501

Dear Mr. Chairman:

This report, which was prepared pursuant to your request of July 28, 1978, discusses the Defense Department's efforts to charge for using Government-owned assets for foreign military sales. Although Defense has made a marked improvement, additional action is needed. The report identifies roughly $10 million in charges for the use of Government-owned assets on sales from inventory that have not been billed foreign governments since October 1, 1976. The report also discusses other accounting and billing weaknesses.

At the request of your office, we did not obtain written comments from the Department of Defense. However, the matters covered in the report were discussed with Defense officials and, where appropriate, their comments were considered.

As arranged with your office, we are sending copies of this report today to interested parties and will make copies available to others upon request.

Sincerely yours,

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE SUBCOMMITTEE ON ARMED SERVICES INVESTIGATIONS, HOUSE ARMED SERVICES COMMITTEE

EFFORTS TO CHARGE FOR USING GOVERNMENT-OWNED ASSETS FOR FOREIGN MILITARY SALES: MARKED IMPROVEMENT BUT ADDITIONAL ACTION NEEDED

D I G E S T

Since 1970, GAO has been reporting that although Government-owned assets are used to produce items sold to other countries, these countries have not been charged for the use of the assets as required by law and Defense policy. In April 1978, GAO reported that foreign governments had been subsidized by as much as $107 million for those sales reviewed because foreign governments were not being charged for the use of Government-owned assets.

Despite marked improvements in their efforts to charge foreign governments for use of U.S. assets for foreign military sales since the 1978 report, the Department of Defense needs to make certain additional improvements to assure that these costs are properly billed, collected, and deposited in the proper account. Millions of dollars of costs are still not being recovered because all accounting and other control weaknesses have not been fully corrected.

To comply with the requirements of the Arms Export Control Act, Defense must take positive action to assure that foreign governments are charged for the use of Government-owned assets.

GAO found that:

--Efforts to charge for using Government-owned assets for foreign military sales from new procurement have improved markedly. For 58 sales agreements valued at about $5.5 billion, about $43 million in asset-use and/or rental charges were included in sales prices. Amounts not included in sales prices were nominal. (See ch. 2.)

--Although Defense has required that other governments be assessed a 1-percent charge

for the use of Government-owned assets on sales from inventory since March 1977, the military departments and the Defense Logistics Agency have not been doing so. The charge was to be retroactive to October 1, 1976. As a result, roughly $10 million has not been billed foreign customers. Redesign of accounting systems to permit identification and billing of the 1-percent charge has been slow in coming. (See ch. 3.)

--Improvements are needed in accounting for charges for the use of Government-owned assets to assure that all such charges are collected and that the collections are deposited in Miscellaneous Receipts, U.S. Treasury, as required. For instance, at one organization, rental payments for use of Government-owned equipment for foreign military sales were not deposited in Miscellaneous Receipts, but were being offset against payments for current Defense costs which are to be paid with appropriated funds. We believe this practice is questionable and is inconsistent, in principle, with the Department's accounting policy for asset-use charges. (See pp. 6 and 7.)

--A better system for identifying items produced for foreign sales is needed so that charges applicable to the use of Government-owned assets are properly identified and billed. (See pp. 7 and 8.)

--Sufficient attention has not been given to recovering the unbilled costs for using Government-owned assets to produce items for foreign military sales that were identified in prior GAO and military department audit agency reports. As a result, foreign customers have been subsidized by millions of dollars. (See ch. 4.)

Defense has recognized the seriousness of not assessing other governments the required 1-percent charge on inventory sales and on September 8, 1978, directed the military departments and the Defense Logistics Agency

to bill foreign governments for these charges retroactive to October 1, 1976. (See pp. 9-11.)

Subsequent to the completion of GAO's field work on its review in February 1979, the Department directed on March 6, 1979, that the 1-percent charge be assessed on a current basis by the Security Assistance Accounting Center, the Department's centralized billing and collecting organization for the foreign military sales program. Charges are to be assessed beginning with the September 30, 1979, customer billings, which are to include deliveries from inventory since June 1, 1979.

The Center was also directed to compute the value and establish a basis for assessing the 1-percent charge retroactive to October 1, 1976. However, according to the March 6, 1979, directive, once this has been done, the Defense Security Assistance Agency plans to determine the reasonableness of asking the Congress to waive the retroactive charges.

The Arms Export Control Act provides that charges for the use of Government-owned assets can be reduced or waived, if the foreign sale would significantly advance U.S. interests in NATO standardization or foreign procurement in the United States under coproduction arrangements. In most cases, it is doubtful that the sales from inventory, requiring retroactive billing, would meet the cost waiver provisions of the act.

GAO does not believe these costs should be waived. Retroactive billing may prove embarrassing to Defense and could result in some customer dissatisfaction. However, any such problems were caused by Defense's lack of effective and timely action to assess the 1-percent charge and not by the reasonableness of the charge, the recovery of which is required by the act.

RECOMMENDATIONS

The Secretary of Defense should:

--Closely monitor efforts to implement the requirements of Defense Instruction 2140.1 concerning the application of the 1-percent, asset-use charge on sales from Defense inventories. He should assure that an adequate system for assessing these charges is developed without further delay and that charges from prior periods are billed.

--Require the military departments to take necessary actions to (1) improve their accounting procedures for asset-use and rental charges and (2) develop procedures for readily identifying foreign military sales items on contracts with U.S. contractors.

--Require that before a foreign sales agreement is closed, all charges for the use of Government-owned assets must be billed and collected, including those unbilled charges shown in GAO's April 11, 1978, report.

AGENCY COMMENTS

At the request of the Office of the Chairman, GAO did not ask the Defense Department for formal comments on this report. GAO discussed the report with Defense officials and, where appropriate, their comments are included.

Defense officials did not agree with GAO's recommendation to bill foreign governments for those unbilled charges identified in prior GAO and military department audit agency reports and reiterated the position taken in a June 5, 1978, letter commenting on GAO's April 1978 report (FGMSD-77-20). (See p. 18.)

Contents

CHAPTER 1

INTRODUCTION

Over the past decade, we have issued four reports 1/ pointing out that foreign military sales prices have not included appropriate charges for the use of Government-owned assets in producing items for foreign countries. In making, modifying, or repairing items sold to foreign governments, the military departments and private contractors use Government assets (that is, plant and production equipment) in facilities throughout the country. Although the cost of wear and tear of assets--depreciation--does not require current expenditure of funds, it is a real cost of the foreign sales program. Our most recent report on this problem, issued on April 11, 1978, showed that the Defense Department generally was not charging foreign governments for the use of Government-owned assets for foreign military sales and, as a result, as much as $107 million had been lost by the United States on just those foreign military sales we had reviewed (FGMSD-77-20).

Because of concern over the matters discussed in our April 11, 1978, report, Congressman Samuel S. Stratton, Chairman, Investigations Subcommittee, House Committee on Armed Services, asked the Defense Department for a listing of all weapons systems contracts with foreign governments that were signed between October 1, 1976, and April 30, 1978, together with the amounts of charges assessed for using Government-owned assets. On July 28, 1978, the Chairman asked us to review the listing to see that all appropriate charges for using Government-owned assets for foreign military sales were recovered. (See app. I.)

This report discusses the procedures by which the Department of Defense charges foreign governments for the use of Government-owned equipment that is used to produce items sold to them. It includes an evaluation of its efforts to charge foreign governments for these costs.

1/ "Action Needed to Recover Full Costs to the Government of Producing Weapons for Sale to Foreign Governments," Sept. 7, 1972, B-174901; "Recovery of Costs to the Government for Producing Weapons for Sale to Foreign Governments," Apr. 9, 1973, B-174901; "Recovery of Costs of Government-owned Plant and Equipment," Oct. 7, 1974, FGMSD-75-5; "The Department of Defense's Continued Failure to Charge for using Government-owned Plant and Equipment for Foreign Military Sales Costs Millions," Apr. 11, 1978, FGMSD-77-20.

COST RECOVERY REQUIREMENTS

Foreign military sales are transacted under authority of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2751, et seq.), which amended and renamed the Foreign Military Sales Act of 1968. The act expressly requires that foreign governments be charged for the cost of using Government-owned assets to produce items sold under the foreign military sales program. The legislative history of the act indicated that the Congress intended that direct as well as indirect costs of the foreign military sales program be recovered so that the program would not be subsidized by Defense appropriations.

Before passage of the Arms Export Control Act, the Foreign Military Sales Act of 1968 (22 U.S.C. 2761) provided that Defense items be sold to foreign countries at "not less than the value thereof." To accomplish this, Defense should have included all direct and indirect costs in sales prices, including the cost of using Government-owned assets to produce items for sale.

Relative to Department policy, Defense has long recognized its responsibility under foreign military sales legislation to recover from foreign buyers all direct and indirect costs associated with foreign military sales. In July 1973, Defense Instruction 2140.1, which covers pricing policy for foreign military sales, was amended, effective November 17, 1973, to require that foreign governments be charged for the use of Government-owned assets at Government-owned, contractor-operated facilities producing goods or rendering services for foreign military sales.

In June 1975, to facilitate recovering these indirect costs, the instruction was further modified to include an asset-use charge. The charge amounted to 4 percent of the direct costs incurred on foreign sales agreements that required the use of Government-owned assets in other than contractor facilities. The instruction also provided for rental rates to be charged for using Government-owned assets in contractor plants, as set forth in the Armed Services Procurement Regulation. (This regulation has been renamed the Defense Acquisition Regulation.)

Two years later, in March 1977, the instruction was further revised to include a 1-percent, asset-use charge on articles sold from Defense inventories. The instruction requires that the 1-percent factor be applied to the material base price for all articles sold under the foreign military sales program from Defense inventories. This charge is in lieu of the 4-percent, asset-use and/or rental charges which are assessed on sales from new procurement.

In implementing the Arms Export Control and the Foreign Military Sales acts, Defense included the following provisions in the standard sales contract:

--Prices of items shall be at their total cost to the U.S. Government.

--The Government will attempt to notify the foreign government of price increases affecting the total estimated contract price by more than 10 percent; but failure to do so will not alter the foreign government's obligations to reimburse the Government for the total cost incurred.

--The foreign government agrees to reimburse the Government if the final cost exceeds the amount estimated in the sales agreement.

CHAPTER 2

DEFENSE EFFORTS TO CHARGE FOR USING GOVERNMENT-OWNED ASSETS ON FOREIGN SALES FROM NEW PROCUREMENTS

The Department of Defense and the military departments have made noticeable improvements in their efforts to charge foreign governments for the cost of using Government-owned assets to produce new items sold to them. Sales agreements with foreign governments generally include a charge for the use of Government-owned assets and a system for collecting these amounts was in use. Certain additional action, however, is needed to assure that the charges are properly billed, collected, and accounted for as Miscellaneous Receipts.

ACCOUNTING, BILLING, AND COLLECTION PROCEDURES FOR ASSET-USE CHARGES

Defense Instruction 2140.1 requires that a 4-percent, asset-use charge be applied to direct costs on foreign military sales that require the use of Government-owned assets. The charge is to be applied for the use of facilities other than those for which rent is charged under the provisions of the Use and Charges section of the Armed Services Procurement Regulation (paragraph 7-702.12). The instruction requires that either charge be included in the unit price of the item or service so that neither sales agreements nor customer billings reflect the asset-use cost as a separate surcharge.

Asset-use charges included in the unit price of items are generally billed to foreign customers as deliveries are made. In cases involving a facilities rental charge, the Armed Services Procurement Regulation requires the contractor to compute and pay rental charges to the United States. The contractor forwards this payment each rental period to the responsible administrative contracting office in the military departments which then verifies and disposes of the payment. The contractor recoups the charge by including it in the base price of items delivered.

In its report on the fiscal 1976 Defense Appropriations Bill (H.R. Rep. No. 94-517), the House Committee on Appropriations stressed the importance of crediting reimbursements from foreign governments to the proper appropriation account. When a reimbursement cannot be identified as financed by any appropriation or fund, the amount collected should be deposited in Miscellaneous Receipts, U.S. Treasury. As required by

Instruction 2140.1, collections of charges for the use of Government-owned assets are to be deposited in Miscellaneous Receipts.

MILITARY DEPARTMENTS GENERALLY INCLUDE ASSET-USE CHARGES IN FOREIGN MILITARY SALES PRICES

Military department organizations we visited generally included applicable asset-use and/or rental charges in foreign military sales prices. This situation is a marked improvement over the situation at the time of our prior review (FGMSD-77-20, Apr. 11, 1978). At that time, only the Army was generally assessing the charge. The other services' awareness of the requirement to recover the cost of using Government-owned assets has increased.

The information the Defense Department furnished the Investigations Subcommittee listed the prices of 110 foreign military sales agreements signed between October 1, 1976, and April 30, 1978. Those prices supposedly included asset-use and/or rental charges totaling $39.7 million. We reviewed 58 foreign sales agreements, of which 39 were from the listing Defense provided the Subcommittee. Forty-seven of the 58 sales agreements, which were valued at $5.5 billion, included a total of $43.1 million in asset-use and/or rental charges. Similar charges were not included in the remaining 11 agreements as described below:

--No Government-owned equipment was used to produce the items sold under five sales agreements. Therefore, no charge was applied.

--Procurement contracts were still being negotiated for 3 of the 11 sales agreements. For two of the agreements, officials indicated that after prices are negotiated, appropriate asset-use and rental charges will be added. For the third agreement, current contracts for the same item indicate that a rental payment will be made after final delivery of the items.

--Two sales agreements were signed before Paragraph 13-406 of the Armed Services Procurement Regulation was revised in June 1976. The revision clarified the requirement to charge foreign countries for the use of Government-owned equipment on all foreign military sales. Defense contended that, previous to that date, Instruction 2140.1, which required the recovery of all costs of using Government-owned assets, conflicted with Paragraph 13-406 which permitted the rent-free use of Government-owned assets by private contractors to produce items for sale to foreign governments. The

Department contended that Paragraph 13-406 was the controlling regulation and precluded Defense from charging for the use of Government-owned assets when foreign governments purchased items produced at Government-owned, contractor-operated facilities. As discussed in our April 11, 1978, report, we disagreed with Defense on this matter. Before June 1976, Paragraph 13-406, by its terms, applied only to those cases where a foreign government was purchasing items directly from a private contractor under a commercial sales agreement and not to those sales agreements between a foreign government and Defense.

--Army officials responsible for one sales agreement were not aware of the requirement to charge for the use of Government-owned assets on sales of excess inventory items. The sale involved five excess helicopters priced at $244,760. Officials said that the appropriate asset-use charges would be added to the sales price.

ADDITIONAL IMPROVEMENTS ARE NEEDED IN DEFENSE'S EFFORTS TO CHARGE FOR USING GOVERNMENT-OWNED ASSETS

Despite noticeable improvements in Defense's efforts to recover the cost of using Government-owned assets for foreign military sales, accounting procedures need strengthening. The procedures must assure that asset-use and rental charges are properly billed, collected, and deposited in Miscellaneous Receipts as required by Defense Instruction 2140.1. The following examples show what can result when accounting procedures are not adequate.

--At one organization, rental payments for the use of Government-owned assets for foreign sales were being offset against monthly payments Defense made to the contractor for storage and maintenance of reserve production equipment. These storage and maintenance payments came from congressionally appropriated funds. During a 50-month period ended November 1978, $177,000 in rental payments were offset in this manner and, as a result, they were not deposited in Miscellaneous Receipts. Although there is no indication that rental payments were not properly collected, we believe the accounting practice of offsetting them is questionable. The Army contended that this accounting practice was correct because the contract constituted a lease under 10 U.S.C. 2667, and therefore, the type of offset involved here was permitted. However, the contractual documents we reviewed indicated that a facilities contract had been negotiated, pursuant to 10 U.S.C. 2304 (a)(10). The Army conceded that such a contract would

not permit offset. Without specific authority to the contrary, the Government must ordinarily deposit money it receives, such as the rental payments involved here, in the Treasury as Miscellaneous Receipts. (See 31 U.S.C. 484.) To allow an offset such as the one in this case, in effect, augments the funds appropriated by the Congress for storage and maintenance of reserve production equipment. Such a practice is neither proper absent specific authority (see 31 U.S.C. 628) nor consistent, in principle, with the Department's accounting policy for asset-use charges.

--At an Air Force organization, billing documents sent to the Security Assistance Accounting Center frequently did not separately identify asset-use charges. Therefore, the charges were not being credited to Miscellaneous Receipts.

--At an Army organization, asset-use charges were collected and deposited in the appropriation accounts instead of Miscellaneous Receipts because officials responsible for accounting were unaware of the requirement to so credit the asset-use charges.

--In one instance, rental payments made by a contractor could not be identified to a procurement contract (or sales agreement) because the contractor did not account for such costs on a contract-by-contract basis. In this situation, assuring that appropriate rental charges are being paid by the contractor is difficult if not impossible.

--Officials at one Army organization were not aware of a change to the Armed Services Procurement Regulation requiring contractors to compute and pay rental charges for the use of Government facilities. Rental payments were being made by the contractor, and the officials, unaware of these payments, applied the 4-percent, asset-use charge to the sales agreements. Foreign customers, therefore, would have been overcharged about $310,000 on the three sales we reviewed. Acting on our suggestion, the Army reduced the sales price accordingly.

--Military department contracting officials do not have a standard or consistent system for writing prime contracts that will readily identify items being produced for foreign customers. As a result, rental payments may not be collected or deposited to Miscellaneous Receipts because the administrative officials responsible for assuring that these actions are taken may not

be aware that foreign military sales items were involved in the procurement. As discussed in our March 22, 1979, report entitled "Improperly Subsidizing the Foreign Military Sales Program--A Continuing Problem" (FGMSD-79-16), the only way contract administrators can determine whether or to what extent foreign sales items are included in contracts is through a detailed and time-consuming review and analysis of the contracts. This problem is often compounded when primary contractors have subcontracts and purchase orders (referred to as second-level procurements) to obtain components and subassemblies to be used in producing the major items ordered. The subcontractors also often have subcontracts for some items (third-level procurements) and so on, down to sixth-level procurements. For the production of major items such as tanks, planes, or missiles, the contracts, subcontracts, and purchase orders may number in the thousands.

Defense has made a marked improvement in charging for the use of Government-owned assets for foreign military sales. Amounts are being included in foreign sales agreements, and a system exists for collecting the charges. However, as discussed above, certain procedures need strengthening to assure that charges for the use of Government-owned assets are properly accounted for and fully assessed, billed, and collected.

CHAPTER 3

FAILURE TO CHARGE FOR USING GOVERNMENT-OWNED ASSETS ON SALES FROM DEFENSE INVENTORIES

Foreign governments have not been charged for the use of Government-owned assets on sales from Defense inventories. The military departments and the Defense Logistics Agency have not implemented Defense's March 1977 requirement that a 1-percent, asset-use charge be assessed on these sales. As a result, based on estimates provided by Defense, foreign governments have been subsidized by roughly $10 million.

DEFENSE PRICING POLICIES HAVE NOT BEEN IMPLEMENTED

Although for over 2 years Defense pricing policies have required that a 1-percent, asset-use charge be applied on inventory sales, effort on the part of the military departments, the Defense Logistics Agency, and the Defense Department to insure that these charges were being assessed was generally lacking. Existing financial management systems were inadequate to properly assess the charges and timely action was not taken to redesign the systems.

Action by the Army to implement Defense pricing policies

The Army has not been charging foreign governments for the use of Government-owned assets on sales from inventories. At the time we began our review in September 1978, little had been done to implement the requirement.

In May 1978, the Army requested clarification from Defense on the procedures for assessing foreign governments for the 1-percent, asset-use charge. In a September 8, 1978, letter, Defense reiterated the requirements in Instruction 2140.1 and told the Army to develop the necessary changes to its financial systems as soon as possible so that selling prices for inventory items include the 1-percent, asset-use charge. The Department directed that the 1-percent asset-use charge be applied retroactively to inventory sales made after September 30, 1976, and asked for a milestone plan for corrective action by September 19, 1978.

The milestone plan submitted by the Army in November 1978 indicated that the charge would be assessed in two phases--(1) retroactive recovery of charges applicable to deliveries made under sales agreements offered after September 30, 1976, and

(2) recovery of charges on future deliveries. The plan stated that the Army's Commodity Command Standard System would be reprogrammed to combine the retroactive charges and the charges on current foreign customer bills. The Army established June 1979 as the target date for implementation of the plan.

Action by the Air Force to implement Defense pricing policies

The Air Force has not been charging foreign governments for the use of Government assets on sales from inventories. At the time we began our review, little had been done to recover these costs.

In a September 8, 1978, letter, the Department reminded the Air Force, Navy, and the Defense Logistics Agency of the requirement to assess a 1-percent, asset-use charge on inventory sales and asked that a status report and milestone plan for implementation be submitted by September 19, 1978. In a September 22, 1978, letter to the Department, the Air Force stated that an implementation plan was under consideration. It indicated that the charge could be implemented retroactively in approximately 70 days, and the existing financial system would be reprogrammed to permit applying the charge on current sales from inventory.

At the time we completed our review in February 1979, the Air Force was still working to implement the requirement. They had set a revised target date of April 1979, but subsequently found that they would not meet this date.

Action by the Navy to implement Defense pricing policies

The Navy also has not been charging foreign governments the 1-percent, asset-use charge on sales from Defense inventories. At the time we began our review, they had not yet implemented the requirement.

The Navy responded in a November 1, 1978, letter, to Defense's request for a status report on efforts to implement the requirement. The Navy stated that although it was including the 1-percent, asset-use charge in estimated prices shown on foreign sales agreements involving items from inventories, it had not begun assessing the charge because its financial system had not been redesigned to accommodate the charge. The Navy established an October 1979 target date for implementation of the requirement.

Action by Defense Logistics Agency to implement Defense pricing policies

Like the military departments, the Defense Logistics Agency has not implemented the requirement to charge foreign governments a 1-percent, asset-use charge on sales from inventories. At the time we began our review, the Agency had not acted to recover the charges.

Responding to Defense's September 8, 1978, letter of inquiry, the Agency said that it had not implemented the requirement because of the inconsistency of its application within the Defense Department and the Agency's belief that having the Security Assistance Accounting Center assess the charge for all sales from inventories would be more efficient. The Center, established in November 1976, is Defense's centralized billing and collecting organization for the foreign sales program.

In an October 16, 1978, letter, Defense told the Agency that its suggestion to have the Center assess the 1-percent, asset-use charge had been considered previously and was rejected for a variety of reasons. The Department admonished the Agency for its failure to bill the 1-percent charge and directed that the Agency immediately implement the requirement. At the time we completed field work on our review in February 1979, work was still underway to implement the requirement.

UNDERLYING CAUSE FOR THE FAILURE TO IMPLEMENT DEFENSE PRICING POLICIES

Pricing and selling of items and services to outsiders on a large scale is relatively new to Defense. Whereas Defense has developed sophisticated techniques over many years for purchasing items and services, it has had a relatively short time to develop pricing techniques for foreign military sales. Defense has, in large measure, failed to insure that the prices of items and services recover all of the costs required in accordance with the Arms Export Control Act, congressional intent, and its own pricing instructions. It has failed because of the

--rapid growth of the foreign military sales program,

--complexity involved in pricing items and services,

--general lack of effort on its part to insure that policies are properly implemented, and

--priority given to customer satisfaction instead of cost recovery.

Defense Instruction 2140.1 required that the 1-percent, asset-use charge be part of the unit price of material sold from inventory and not be identified on customer billings as a separate surcharge. In an August 25, 1978, report entitled "The Department of Defense Continues to Improperly Subsidize Foreign Military Sales" (FGMSD-78-51), we reported that Defense financial management systems were not designed to accommodate the phenomenal growth of the foreign military sales program. Sales for the program have grown from $953 million in fiscal 1970 to $13.5 billion in fiscal 1978. We reported that, because of time pressures, instead of designing and implementing separate systems to identify elements of costs to be included, Defense had to add foreign military costing requirements to existing financial systems. In several cases, because of a lack of pertinent cost data, Defense adopted a surcharge or rate methodology for recouping various costs.

In the case of the 1-percent, asset-use charge, requiring that the charge be part of the unit price of material sold from inventory, necessitated changes to the existing financial systems. Prompt action was not taken to redesign the systems, and the 1-percent, asset-use charge still has not been assessed--nearly 2 years after it was first required.

IMPACT OF NOT CHARGING 1-PERCENT, ASSET-USE CHARGE

Summary information on the value of sales to foreign governments from Defense inventories was not readily available. Defense officials, however, roughly estimated that $10 million in asset-use charges have not been billed foreign customers on sales from inventory. Because this information was not available until our field work had been completed, we did not have an opportunity to determine the reasonableness of this amount. Also, as Defense pointed out in an October 16, 1978, letter to the Defense Logistics Agency, failure to bill foreign countries for asset-use charges results in additional potential losses due to interest on borrowings that the Treasury might have avoided if collections had been made promptly. Interest on borrowings cannot be recouped and will continue until the requirement is implemented.

Recognizing that the Arms Export Control Act mandates the recovery of costs for the use of Government-owned assets on foreign military sales, Defense has directed that the 1-percent, asset-use charge be assessed retroactive to October 1, 1976. We agree with this action.

ACTIONS SUBSEQUENT TO THE COMPLETION OF OUR REVIEW

Subsequent to the completion of our field work in February 1979, the Defense Department changed its policy regarding the procedures for assessing foreign governments the 1-percent, asset-use charge on inventory sales and on recovering these charges retroactive to October 1, 1976.

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On March 6, 1979, the Security Assistance Accounting Center was directed to develop the capability to recover these charges on current billings beginning with the September 30, 1979, billing statement which is to include items delivered from inventory after June 1, 1979. Efforts by the military departments and the Defense Logistics Agency to develop their own systems for assessing the charge were abandoned. The Center will assess foreign countries a surcharge. The charge will not be part of the unit price of material sold from inventory but will be separately identified.

The Center was also directed to establish a basis for computing those asset-use charges applicable to sales from inventories retroactive to October 1, 1976. This is in line with Defense's previously established policy for recovering these charges. However, according to the March 6, 1979, directive, once the Center has computed these charges, the Defense Security Assistance Agency plans to determine the reasonableness of asking the Congress to waive the charges.

The Arms Export Control Act provides that charges for the use of Government-owned assets can be reduced or waived if the foreign sales would significantly advance

--U.S. interests in NATO standardization or

--foreign procurement in the United States under coproduction arrangements.

In most cases, it is doubtful that sales from inventory, which require retroactive billing to recover the asset-use charge, would meet the cost waiver provisions of the act.

CHAPTER 4

DEFENSE HAS NOT ACTED TO RECOVER UNBILLED CHARGES IDENTIFIED IN OUR AND DEPARTMENT AUDIT AGENCY REPORTS

Defense and the military departments have not given sufficient attention to recovering unbilled costs of using Government-owned assets for foreign military sales identified in prior reports issued by us and military department audit agencies. As a result, foreign customers have been subsidized by millions of dollars.

Recent audit reports by us and by the military department audit agencies identified over $100 million of costs which were not charged foreign governments for using Government-owned assets. Although the sales agreements were still open at the time of the audits, Defense and the military departments, for the most part, have not attempted to recoup the costs and efforts were not underway to do so.

In our April 11, 1978, report, we disclosed that Defense had not billed foreign governments as much as $107 million for the use of Government-owned assets for those foreign military sales agreements we reviewed. We recommended that the Secretary of Defense require the military departments to take action to recover the asset-use and rental charges which should have been billed foreign governments.

For instance, we reported that the Navy had not charged foreign customers about $18.4 million for using Government-owned assets on sales of the F-14 aircraft. Although the sales agreements involved were open, the Navy has made no effort nor does it have any plans to charge foreign governments for these amounts.

In another instance, the Army Audit Agency identified about $3.3 million in costs which were omitted from foreign sales agreements at the U.S. Army Missile Readiness Command. Although the sales involved were open at the time, the Command has not attempted to recoup some of the costs. In response to the Audit Agency's report, the Command said they would review foreign sales prices to assure compliance with regulatory requirements and would correct any pricing discrepancies. Although a June 1978 target date was set, at the time we completed our field work in February 1979, the Command had not corrected some of the pricing discrepancies.

In its report on the Defense Department's fiscal 1979 appropriation bill (H.R. Rep. No. 95-1398), the House Appropriations Committee expressed its concern with the Department's failure to charge foreign governments for the use of Government-owned assets. Citing our April 11, 1978, report, the Committee urged the Department to comply with the Arms Export Control Act and to bill foreign governments amounts that should have been charged for the use of Government-owned assets.

In recovering the costs up to and including final billing, the Department of Defense standard sales contract provides that adjustments may be made to estimated costs when they are not commensurate with actual costs incurred. Therefore, any costs that were not recovered by the military departments on those sales agreements for which a final billing has not been made could and should be billed.

As to undercharges that may be found subsequent to final billing, Instruction 2140.1 provides that adjustments to final billings are authorized when unauthorized deviations from Department pricing policies exist.

We discussed this matter with Defense officials who reiterated the position taken in their June 5, 1978, letter commenting on our April 1978 report (FGMSD-77-20). Defense contended that before June 1976, Defense policies concerning the recovery of charges for the use of Government-owned assets conflicted with Paragraph 13-406 of the Armed Services Procurement Regulation. Defense contended that at the time Paragraph 13-406 was the controlling regulation and precluded charging for use of Government-owned assets when foreign governments purchased items produced at Government-owned, contractor-operated facilities.

As discussed on pages 5 and 6, we disagree with Defense on this matter. Before June 1976, Paragraph 13-406, by its terms, applied only to those cases where a foreign government was purchasing items from a private contractor under a commercial sales agreement and not to those sales agreements entered into between a foreign government and Defense. As discussed in our April 1978 report, both the Air Force and the Navy recognized the free-use provisions of Paragraph 13-406 where applicable to direct sales.

Defense's June 5, 1978, letter also implies that before the Arms Export Control Act was passed on June 30, 1976, the Congress did not intend for foreign governments to be charged for the use of Government-owned assets nor did the Congress intend that these charges be assessed retroactively. We again disagree with Defense. We have been advising Defense

since 1970 that foreign military sales prices should include charges for the use of Government-owned assets. At that time they agreed with us in principle. As discussed in our April 11, 1978, report, before the Arms Export Control Act was passed, the Foreign Military Sales Act of 1968 (22 U.S.C. 2761) provided that Defense items be sold to foreign countries at "not less than the value thereof." To accomplish this, Defense should have included all direct and indirect costs in sales prices, such as the cost of using Government-owned assets to produce items for sale. Further, Defense's own pricing instructions required these charges beginning in July 1973.

CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

Although improvements have been made, the Defense Department continues to subsidize the foreign military sales program by not charging millions of dollars for the use of Government-owned assets on sales from Defense inventories. Further, improvements are needed in accounting for charges for the use of Government-owned assets and in identifying items subject to the charge.

Defense cannot assume that its policies are being effectively implemented and should closely monitor efforts to implement the policies. We agree with Defense's action directing the recovery of the 1-percent, asset-use charge on inventory sales retroactive to October 1, 1976, and believe it should closely monitor efforts to retroactively recover the costs.

We do not believe these costs should be waived. Any embarrassment to Defense or any customer dissatisfaction resulting from retroactive billings could have been avoided had Defense taken appropriate action to assess these charges promptly. The charges, which are required by law, are reasonable and should be assessed so that foreign governments are not subsidized by the foreign military sales program.

In those cases where recoverable costs should have been billed but were not, every reasonable effort should be made to recover such costs from the foreign countries involved.

The longer the Department delays in attempting to collect undercharges, the more difficult recovering these costs from foreign governments will be. Until action is taken to attempt to collect undercharges, the military departments and the Defense Logistics Agency should not make final billings for those sales agreements in which undercharges occurred.

RECOMMENDATIONS

We recommend that the Secretary of Defense:

--Closely monitor efforts to implement the requirements of Defense Instruction 2140.1 concerning application of the 1-percent, asset-use charge on sales from Defense inventories. He should assure that an adequate system for assessing these charges is developed without further delay and that charges from prior periods are billed.

--Require the military departments to take necessary action to (1) improve their accounting procedures for asset-use and rental charges and (2) develop procedures for readily identifying foreign military sales items on contracts with U.S. contractors.

--Require that before a sales agreement is closed, all charges for the use of Government-owned assets must be billed and collected, including those unbilled charges shown in our April 11, 1978, report.

AGENCY COMMENTS

As requested by the Chairman's office, we did not obtain written comments on the contents of this report, but we discussed our findings with Defense officials, and, where appropriate, their comments have been considered in preparing the report. Defense officials said that the Department intended to bill foreign governments for the use of Government-owned assets on sales from inventory retroactive to October 1, 1976. However, as discussed on page 13, the officials indicated that the Department was considering the reasonableness of asking the Congress to waive these charges.

They did not agree to bill foreign governments for those unbilled charges for use of Government-owned assets identified in prior reports issued by us and by military department audit agencies. In this regard, they reiterated the position taken in their reply commenting on our April 1978 report.
(See pp. 15 and 16.)

CHAPTER 6

SCOPE OF REVIEW

We reviewed the military departments' systems for pricing, accounting, billing, collecting, and depositing receipts for using Government-owned plant and equipment on foreign military sales.

Our review included an examination of legislation, policies, procedures, documents, and internal audit reports dealing with recovering the cost of using Government-owned assets on foreign sales. We reviewed selected foreign military sales cases and interviewed responsible officials to discuss these cases, policies, procedures, and other matters.

We performed our review at the following military departments and organizations and at several Government contractors.

--Headquarters, Departments of Army, Navy, and Air Force; Washington, D.C.

--Security Assistance Accounting Center; Denver, Colorado.

--Naval Material Command; Washington, D.C.

--Naval Air Systems Command; Washington, D.C.

--Naval Sea Systems Command; Washington, D.C.

--Naval International Logistics Control Office; Philadelphia, Pennsylvania.

--Air Force Logistics Command, Wright-Patterson Air Force Base; Dayton, Ohio.

--Aeronautical Systems Division, Wright-Patterson Air Force Base; Dayton, Ohio.

--U.S. Army Materiel Development and Readiness Command; Washington, D.C.

--U.S. Army Missile Readiness Command; Huntsville, Alabama.

--U.S. Army Tank-Automotive Readiness Command; Warren, Michigan.

--U.S. Troop Support and Aviation Materiel Readiness Command; St. Louis, Missouri.

--Defense Contract Administrative Services Region; Los Angeles, California.

--Defense Contract Administrative Services Management Area; Los Angeles, California.

--Defense Contract Administrative Services Management Area; Santa Anna, California.

--Defense Contract Adminsitrative Services Management Area; San Diego, California.

APPENDIX I

NINETY-FIFTH CONGRESS
U.S. House of Representatives
COMMITTEE ON ARMED SERVICES
ARMED SERVICES INVESTIGATIONS SUBCOMMITTEE
2339 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
225-4221, GOVERNMENT CODE 180, EXT. 4221

July 28, 1978

Dear Mr. Staats:

The Investigations Subcommittee is most concerned about the matters discussed in your April 11, 1978 report entitled "The Department of Defense's Continued Failure to Charge for Using Government-Owned Plant and Equipment for Foreign Military Sales Costs Millions." On May 25, 1978 I asked the Secretary of Defense to provide the Subcommittee with a listing by military service of all weapons systems contracts with foreign governments signed between October 1, 1976, and April 30, 1978, together with the amounts of charges assessed against those contracts for the use of Government-owned plant and equipment.

I would appreciate your staff reviewing the enclosed information provided by the Department of Defense in response to that request, as well as other records, to ensure that the Department is recovering all appropriate charges for the use of Government-owned plant and equipment on foreign military sales contracts signed since October 1, 1976.

The Subcommittee staff has discussed the proposed review with members of your office's Financial and General Management Studies Division, Systems in Operation group.

Sincerely,

Samuel S. Stratton
Chairman

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

Enclosure

(903830)

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