

September 1978

SUMMARY OF
EFFORTS TO
RECOVER U.S.
GOVERNMENT
COSTS IN FOREIGN
MILITARY SALES

On April 29, 2008, this GAO report was reposted with a cover page added to the original product to provide the following clarifying information. The correct product number for this report is ID-78-56. References to ID-77-56 are incorrect. No content was revised in the original document.



G A O

Accountability * Integrity * Reliability

DOCUMENT RESUME

97439 - [C2727827]

Summary of Efforts To Recover U.S. Government Costs in Foreign Military Sales. ID-78-56; B-165731. September 27, 1978. 36 pp. + 2 appendices (4 pp.).

Report to the Congress; by Elmor B. Staats, Comptroller General.

Issue Area: International Economic and Military Programs:
Foreign Military Sales (605).

Contact: International Div.

Budget Function: National Defense; Department of Defense -
Military (except procurement & contracts) (051).

Organization Concerned: Department of Defense; Department of the
Air Force; Department of the Army; Department of the Navy;
Department of State.

Congressional Relevance: House Committee on International
Relations; Senate Committee on Foreign Relations; Congress.

Authority: Mutual Defense Assistance Act of 1949 (63 Stat. 720).

Mutual Security Act of 1954 (68 Stat. 836). Foreign
Assistance Act of 1961 (75 Stat. 437). Foreign Military
Sales Act of 1968 (82 Stat. 1320). International Security
Assistance and Arms Export Control Act of 1976. Foreign
Assistance Act of 1962. Arms Export Control Act of 1976. 90
Stat. 729. 76 Stat. 259. DOD Instruction 2140.1.

U.S. foreign military sales (FMS) have increased significantly in the past decade. Under the International Security Assistance and Arms Export Control Act of 1976, the Government is required to recover its costs in FMS. The Secretary of State, under the President's direction, is responsible for supervising and providing general direction for the conduct of U.S. military export sales, and the Department of Defense (DOD) is responsible for program administration.

Findings/Conclusions: DOD has recognized its responsibility to recoup from foreign buyers all Government costs associated with sales. Pricing guidance has been established and cost recoupment criteria have been expanded and strengthened, thus increasing cost recoupments. DOD believes that current FMS pricing instructions and practices of the military services adequately implement requirements. Although DOD has taken considerable corrective actions based on earlier GAO reports, ineffective implementation of pricing policy is still a primary cause of inadequate recoupment. The chief problem is in inadequate implementation of policy by the military departments and insufficient followup of cost recovery practices by DOD policymakers. (HTW)

7827

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Summary Of Efforts To Recover U.S. Government Costs In Foreign Military Sales

The Department of Defense has failed to operate the foreign military sales program at no loss to the Government as required by law. The Government, therefore, has absorbed many millions of dollars in cost which should have been recovered from foreign customers.

Over the past decade, considerable effort has been devoted to improving the adequacy of foreign military sales cost recoupment. This effort has led to improved pricing policies and better recoupment from foreign governments. However, more effort is needed to recover all costs.





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

B-165731

To the President of the Senate and the
Speaker of the House of Representatives

Over the years, we have focused considerable audit attention on the adequacy of U.S. Government cost recoupments in foreign military sales, and many reports have been issued to the Congress and to the Secretary of Defense on the subject. This report discusses certain of these past efforts, provides an overall perspective of progress made toward selling arms abroad at no loss to the Government, and identifies remaining barriers.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Office of Management and Budget; Secretary of Defense; Secretaries of the Army, Navy, and Air Force; and appropriate congressional committees.

A handwritten signature in black ink, reading "Luther B. Starks".

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

SUMMARY OF EFFORTS TO
RECOVER U.S. GOVERNMENT
COSTS IN FOREIGN
MILITARY SALES

D I G E S T

Recovering the full cost of U.S. Government involvement in foreign military sales has been a continuing concern of the Congress. Increased U.S. arms sales abroad have served to heighten this interest.

Over the years, GAO has focused considerable audit attention on the adequacy of U.S. Government cost recoupments in foreign military sales, and many reports have been issued to the Congress and to the Secretary of Defense on the subject. This report discusses certain of these past efforts, provides an overall perspective of progress made toward selling arms abroad at no loss to the Government, and identifies remaining barriers.

The International Security Assistance and Arms Export Control Act of 1976 authorizes the U.S. Government to sell defense articles and defense services to friendly countries having the ability to pay to equip their military forces at adequate strength without undue burden to their economies. Under the direction of the President, the act charges the Secretary of State with responsibility for supervising and providing general direction for the conduct of U.S. military export sales, including but not limited to determining whether there will be a sale and the amount thereof. The Department of Defense has been given overall responsibility for administering the program, including the pricing of defense articles and defense services.

As a matter of policy, Defense has long recognized its responsibility under foreign military sales legislation to recoup from foreign buyers all direct and indirect U.S. Government costs associated with sales.

ID-77-56

Pricing guidance to this effect has been established and cost recoupment criteria have been expanded and strengthened over the years. Increased foreign military sales cost recoupments have therefore been made possible.

The Department of Defense informed GAO that it believed that current foreign military sales pricing instructions and practices of the military departments adequately implement congressional and Defense requirements. Defense considers that various actions taken by the Department since June 1975 have overcome the problem of inadequate policy implementation by the military departments.

Although Defense has taken considerable corrective action based on our earlier reports, our recent and ongoing work in the cost recovery area continues to show that ineffective implementation of pricing policy remains a primary cause of inadequate recoupment. It should be emphasized that we believe Defense has done a good job in prescribing adequate policy; the problem lies in inadequate implementation of policy by the military departments and, in our opinion, insufficient followup or monitoring of actual cost recovery practices by Defense policymakers.

A summary of GAO's past reviews and Defense Department responses to them is intended to provide important background information and a current perspective for use by the Congress in considering Defense Department proposals and requests related to foreign military sales.

C o n t e n t s

		<u>Page</u>
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Background	1
	Scope of review	3
2	COST RECOVERY REQUIREMENTS	4
	Statutory requirements	4
	Pricing policies and cost criteria improved	6
	Policy implementation--a system weakness	8
3	FOREIGN MILITARY SALES COSTS NOT FULLY RECOVERED BY GOVERNMENT	11
	Contract administration costs	11
	Government-owned asset costs	15
	Transportation and other ac- cessorial costs	18
	Training of foreign military students	20
	Technical assistance and training services	23
	Recovery of normal inventory losses	24
	Inventory replacement costs	26
	Nonrecurring costs	31
	Waivers of nonrecurring costs	33
	Agency comments and our evaluation	36
APPENDIX		
I	Listing of our reports concerning foreign military sales cost recovery	37
II	February 24, 1978, letter from the Assistant Secretary of Defense (Comptroller)	39

ABBREVIATIONS

DOD	Department of Defense
DSAA	Defense Security Assistance Agency
FMS	foreign military sales
GAO	General Accounting Office

CHAPTER 1

INTRODUCTION

Over the past decade, increased public and congressional awareness has focused upon the rather dramatic increases in the dollar volume of U.S. foreign military sales (FMS). From a comparatively modest billion dollar program in fiscal year 1967, foreign sales orders exceeded \$10 billion in fiscal year 1975 and totaled \$11.2 billion in fiscal year 1977. This growth has sparked considerable controversy over the program's operation and direction both inside and outside the Congress. The executive departments have continued to provide the Congress with details of the program's operation and explanations of its growth. Many people, however, have remained concerned over a variety of issues.

An issue that has received much attention over the years is whether the U.S. Government recovers its costs in FMS. Continuing interest in this area has in large part been prompted by various cost recoupment provisions contained in the International Security Assistance and Arms Export Control Act of 1976 (Arms Export Control Act) and earlier legislation. It has long been the express position of the Congress that the Government recover full value for all U.S. military equipment and services sold to others. Concern in the Congress over cost recovery aspects of U.S. military sales has heightened in recent years due to increased sales to the Middle East.

Over the past several years, we devoted considerable attention to the subject of cost recovery in FMS. As a result of our work, a number of reports have been issued to the Congress outlining a variety of weaknesses in U.S. Government cost recoupment practices. We have examined and issued separate reports on various cost factors, such as administration, training, and transportation. This report discusses certain of our past efforts and Department of Defense (DOD) procedural changes in order to provide an overall perspective of progress made toward selling U.S. arms abroad at no loss to the Government.

BACKGROUND

Since World War II, the United States has been assisting friendly nations in establishing and maintaining adequate defense postures for internal security and resisting external aggression. This assistance has been provided because it is believed that the security and economic well-being of ally nations is essential to the security of the United States.

The United States has rendered this assistance in a variety of ways, including sale or grant aid of defense articles and services, financial aid, and commodity grants. The Congress, over the years, has enacted considerable military assistance legislation to achieve its goals in this area. The Mutual Defense Assistance Act of 1949, Mutual Security Act of 1954, Foreign Assistance Act of 1961, Foreign Military Sales Act of 1968, and Arms Export Control Act of 1976 are legislative milestones representing congressional concern and interest.

The Foreign Military Sales Act of 1968 consolidated and revised provisions of the Foreign Assistance Act of 1961 concerning reimbursable military exports. The 1968 act brought together previous legislation dealing with military sales by the U.S. Government for either cash or credit terms. It sought to combine the administrative and the general legislative authorities to meet the growing demand of the expanding sales program.

The Foreign Military Sales Act was amended by the Arms Export Control Act on June 30, 1976. The new act, while materially altering certain provisions of the old legislation, retains the same basic objective:

"To facilitate the common defense by entering into international arrangements with friendly countries which further the objective of applying agreed resources of each country to programs and projects of cooperative exchange of data, research, development, production, procurement, and logistics support to achieve specific national defense requirements and objectives of mutual concern."

To this end, the Arms Export Control Act authorizes the U.S. Government to sell defense articles and services to friendly countries having the ability to pay to equip their military forces without undue burden to their economies.

Benefits of FMS that are often mentioned as accruing to the United States and that are not specifically addressed in the act include:

--Foreign military sales are an important instrument of U.S. foreign policy.

- U.S. balance of payments is aided, and there are closer relations, cooperation, and partnership with other nations.
- The standardization of equipment, doctrine, and training is increased.
- Research and development costs can be shared.
- Unit costs to the U.S. military services are reduced.
- Forward material support is facilitated.
- U.S. employment is increased and U.S. military production bases kept active.

Under the direction of the President, the act makes the Secretary of State responsible for supervising and providing general direction for the conduct of U.S. military export sales, including but not limited to determining whether there will be a sale and the amount thereof. The Secretary also ensures that sales are integrated with other U.S. international activities and are consistent with U.S. foreign policy. By Executive order, the Secretary of Defense has been given overall responsibility for administering FMS, including pricing defense goods and services.

SCOPE OF REVIEW

We made our review at DOD headquarters. Our objective was to see what progress DOD had made toward fully recovering the cost of Government involvement in FMS and to surface major problems found. We examined DOD's pricing policies and procedures on FMS and considered information from a number of our reviews dealing with cost recoupment on military sales.

CHAPTER 2

COST RECOVERY REQUIREMENTS

STATUTORY REQUIREMENTS

The statutory language pertaining to FMS cost recovery has changed a number of times over the years. Authority to sell defense articles and defense services stems from section 408(e) of the Mutual Defense Assistance Act of 1949 (63 Stat. 720). This provision authorizes such sales "without cost to the United States" and specifically requires the recovery of "full cost, actual or estimated," of defense articles and services. It should be noted that the 1949 act was aimed primarily at furnishing military assistance to foreign nations. Government agencies that furnished such assistance were to be reimbursed from funds available under the act in an amount equal to the value of the articles or services.

In 1950, section 408(e) was amended. The phrase "full cost, actual or estimated" was deleted and inserted was the language "fair value, as determined by the President," but "not * * * less * * * than the 'value' thereof as defined in subsection 403 of the 1949 act" (64 Stat. 373). "Value" was defined as follows:

- Excess equipment or materials: the gross cost of repairing, rehabilitating, or modifying.
- Nonexcess equipment or materials: the actual or projected cost of procuring for replacement or, if replacement is not necessary, the gross cost or replacement cost, whichever the Secretary of Defense may specify.
- Procurement of equipment or materials for sale: the gross cost.

During the next 18 years the language concerning FMS cost recovery remained substantially unchanged. Section 408(e) of the 1949 act, as amended, was superseded by section 106 of the Mutual Security Act of 1954 (68 Stat. 836). This legislation deleted the phrase "at no cost to the United States" but otherwise read the same as its predecessor. Section 106 was in turn replaced by section 507 of the Foreign Assistance Act of 1961 (75 Stat. 437), with the general cost recovery standard of "fair value" being changed to "value." The Foreign Assistance Act of 1962 (76 Stat. 259) inserted the language "not less than" before "the value."

The enactment of the Foreign Military Sales Act of 1968 (82 Stat. 1320) represented the first time the foreign military sales program was authorized under legislation separate from the foreign assistance program. The new act was intended to consolidate and revise prior legislation relating to sales. It contained three sections pertaining to sales: cash sales from stock (sec. 21), procurement for cash sales (sec. 22), and credit sales (sec. 23). These sections state in part:

"Sec. 21. Cash Sales From Stock.--The President may sell defense articles from the stocks of the Department of Defense and defense services of the Department of Defense to any friendly country or international organization if such country or international organization agrees to pay not less than the value thereof in United States dollars. * * *

"Sec. 22. Procurement for Cash Sales.--The President may, without requirement for charge to any appropriation or contract authorization otherwise provided, enter into contracts for the procurement of defense articles or defense services for sale for United States dollars to any friendly country or international organization if such country or international organization provides the United States Government with a dependable undertaking (1) to pay the full amount of such contract which will assure the United States against any loss on the contract. * * *

"Sec. 23. Credit Sales.--The President is hereby authorized to finance procurements of defense articles and defense services by friendly countries and international organizations on terms of repayment to the United States Government of not less than the value thereof in United States dollars within a period not to exceed ten years after the delivery of the defense articles or the rendering of the defense services." (Underscoring supplied.)

With the separation of the Foreign Military Sales Act from the Foreign Assistance Act of 1961, as amended, the definition of value in the latter act was no longer applicable to foreign military sales. Legislative history indicated that the definition was omitted with the understanding

that the traditional cost recovery requirements under the definition of value would continue in effect.

With enactment of the International Security Assistance and Arms Export Control Act of 1976 (90 Stat. 729), the Congress clarified and strengthened cost recovery requirements of FMS as a matter of law. Present cost recovery requirements as contained in the 1976 legislation may be summarized as follows:

- Defense article not intended to be replaced--not less than the actual value thereof.
- Defense article intended to be replaced--estimated cost of replacement of such article, including the contract or production costs less any depreciation in the value of such article.
- Defense service--the full cost to the United States in furnishing such service.
- Procurement for cash sales of defense articles or defense service--the full amount of the contract which will assure the United States against any loss on the contract.

All of the above sales shall include appropriate charges for

- administrative services, calculated on an average percentage basis to recover the full estimated costs of administration of the sales;
- any use of plant and production equipment in connection therewith; and
- a proportionate amount of any nonrecurring costs of research, development, and production of major defense equipment.

The legislative purpose of these latter charges was to ensure that all sales prices include a fair share of all indirect costs so that there were no longer any elements of subsidy in the sales program.

PRICING POLICIES AND COST CRITERIA IMPROVED

DOD has overall responsibility for administering FMS, including responsibility for pricing defense articles and defense services sold in conformance with statutory cost

recovery requirements. Accordingly, DOD has established basic policy guidance in the form of DOD directives and instructions to govern the pricing of military sales. The military departments are responsible for implementing this policy guidance.

In general, DOD pricing policies for FMS provide for the recoupment of all identifiable DOD direct and indirect costs of each sale. Current guidance to the military departments covers the pricing of defense personnel services (including training), defense articles sold from stock, and defense articles sold from new procurement. This guidance specifies (1) charges to be included in FMS pricing to recover accessorial costs (for example, packing, handling, crating, transporting, port handling, and pre-positioning), (2) administrative costs, (3) use of Government-owned equipment and/or facilities (asset use), (4) nonrecurring costs (that is, research, development, and nonrecurring production), and (5) certain other allocable costs.

On the basis of DOD's established pricing policies, there has been basic agreement during the past decade that FMS legislation generally requires the recovery of all costs that may be identified with a given sale of a defense article or a defense service (that is, the full cost). We first took this position concerning defense services in 1969 in a report to the Congress entitled "Omission of Significant Costs From Changes to the Federal Republic of Germany for Pilot Training" (B-167363), where we stated:

"Although neither the FAA [Foreign Assistance Act] nor its legislative history defines value as it relates to defense services, we believe that the FAA contemplates recovery of full costs for defense services which are sold to foreign customers. We believe therefore that the selling prices for defense services should be established on the basis of the full cost pricing method and that failure to adopt that method provides DOD with many options for pricing training services. Pricing under the full cost pricing method, in our opinion, would establish a selling price for defense services that recovers all costs incurred, whether of a direct or an indirect nature."
(Underscoring supplied.)

There has been some disagreement with DOD, however, as to which specific elements of cost, particularly indirect costs, constitute the "full cost" of the sale of a defense article

or service. Our judgments have also differed on occasion as to how costs for materials should be determined and applied. Resolving these matters over the years has strengthened FMS pricing policy and therefore improved the potential for recoupment. For example, DOD, since program inception, excluded from FMS pricing any charge for use of Government-owned plant and equipment by contractors in the production of articles for sale to foreign buyers. Omitting such an important cost factor from FMS pricing costs the Government millions of dollars annually in possible recoupment. After bringing this matter to DOD's attention on a number of occasions and after some delay, DOD finally established a policy requiring such a charge in future FMS pricing. (The details are discussed starting on p. 15.)

Within the general bounds of recovering all costs, legislation authorizing FMS before enactment of the Arms Export Control Act left to DOD's discretion the development of essential cost recovery criteria. Which cost factors were appropriately included in FMS pricing thus became a matter of DOD interpretation and accounting judgment. Developing complete and understandable FMS pricing guidance has proved to be no small undertaking. Over the years, DOD has focused considerable management attention on improving its FMS pricing policies and cost recovery criteria, and others have contributed to the effort. FMS pricing guidance, which earlier tended to be vague and incomplete, has been greatly improved. FMS cost criteria have been expanded and pricing policies strengthened through clarification. The process, while lengthy and thus costly in terms of lost recoupment, has nonetheless established a stronger pricing policy framework. Greater cost recoupments have therefore been made possible.

Improved policy guidance has led to increased FMS cost recoupment. Recoupment, however, still remains well below where it should be if the FMS program is to operate at no loss to the Government. We believe the problem in large part stems from ineffective implementation of DOD pricing policy.

POLICY IMPLEMENTATION--A SYSTEM WEAKNESS

A prime objective of DOD's pricing policies is that the military departments apply uniform criteria for FMS pricing. This, however, has not been achieved. Our work has continued to demonstrate that wide variances exist in the cost recovery practices of the military departments. For example, defense guidance in effect in fiscal year 1975 required that FMS

training course costs include all direct and indirect costs related to training. The guidance, however, did not specify the procedures to be used for determining these costs. The military departments, therefore, independently established prices according to how each interpreted the cost recovery requirements of the law. Because of the different interpretations, charges to foreign governments differed greatly for basically similar instruction. Estimated undercharges for training provided by the military departments during fiscal year 1975 was in excess of \$30 million. (See pp. 20-23.)

Congressional concern over pricing of FMS training prompted DOD to issue new pricing guidelines for training in late 1975. The new guidance included detailed procedures for determining the costs to be recovered through tuition rates. However, this guidance was modified in September 1976 because DOD was concerned over the possible impact on foreign military training. Congressional concern over DOD's action finally resulted in issuing new pricing guidance in May 1977.

A similar situation exists in the pricing of defense articles sold from stock. Our recent work on pricing of secondary items sold to foreign governments demonstrated that the statutory requirement to charge replacement cost for defense articles intended to be replaced was not being uniformly applied by the military departments. As a result, all three services are recovering less than replacement cost on stock fund and nonstock fund items sold to foreign governments. In the Air Force, alone, we estimated that fiscal year 1976 stock fund sales to foreign governments may have been underpriced by as much as \$32.5 million. For nonstock fund sales, we found that the military services were allowed to develop their own pricing policies and procedures for recovering replacement cost on foreign sales. The methods used varied and resulted in inconsistent and inadequate pricing.

DOD has taken actions to revise certain of its pricing policies for secondary items as a result of our findings. However, the methods to be used in pricing stock fund and nonstock fund items will not recover replacement cost in all cases. (See pp. 28-31.)

The foregoing indicates a fundamental system weakness in FMS pricing: DOD has failed to ensure military department compliance with the intent of its various FMS pricing policies. Under the present system, developing the detailed pricing procedures necessary to implement DOD policy is the individual responsibility of each service. Accordingly,

separate detailed pricing procedures representing each department's interpretation of basic policy have been developed. These procedures, which guide the actual day to day pricing of FMS transactions, are often inconsistent with established policy. Such inconsistencies frequently go unnoticed until brought to DOD's attention by question or audit. Even then, however, DOD's corrective action is limited to improving policy guidance, which must again be translated into procedures by the military departments. Such an approach for implementing policy guidance has resulted in the unnecessary loss of many millions of dollars in possible FMS recoupment.

Beginning with our 1969 report, we have issued a number of reports critical of DOD for failing to adequately recover costs of FMS. These reports are discussed in chapter 3.

CHAPTER 3

FOREIGN MILITARY SALES COSTS NOT FULLY RECOVERED BY GOVERNMENT

During the past decade, we have issued numerous reports to the Congress and to the Secretary of Defense concerning inadequate recoupment of cost from sales of defense articles and defense services abroad. Our reports have continued to identify a variety of program weaknesses relating to FMS policy, accounting, billing, collecting, and depositing of receipts which have, in total, cost the Government hundreds of millions of dollars in potential recoupment.

Corrective action has been taken by the Defense Department on many of the problems noted in our reports. This action, however, has usually been slow in coming, narrowly confined, and passively implemented. Moreover, DOD's attention to the overall problem of inadequate FMS recoupment has been limited to little beyond the policy formulation stage. As a result, cost recoupment remains inadequate.

Our previous reports have identified various FMS cost factors, both direct and indirect, that have not been included in FMS pricing and have therefore escaped recoupment from foreign governments. Major cost factors that have been addressed in our reports include (1) contract administration costs, (2) Government-owned asset costs, (3) transportation costs, (4) foreign national training costs, (5) technical assistance and training service costs, (6) normal inventory losses, (7) inventory replacement costs, and (8) research, development, and nonrecurring production costs.

CONTRACT ADMINISTRATION COSTS

According to DOD estimates, FMS administrative costs for fiscal years 1970 through 1975 were \$425 million. Approximately one-fourth of this cost was incurred in fiscal year 1975 alone. The fiscal year 1975 figure includes 4,868 military and civilian staff-years of effort and over \$10 million in other costs (including printing, supplies, communication, travel, etc.).

To recover these costs, DOD established a policy of applying an administrative surcharge to the price of contractual services and materials sold to foreign governments. The rate of surcharge is dependent on the contractual arrangement. In supply support agreements, an administrative charge

of 5 percent is added to the base sales price of the initial agreement. A 5-percent surcharge is also added to all FMS purchases of nonstandard articles. In all other FMS orders (including training), an administrative charge of 2 percent 1/ is added. However, if a supplying military department determines that the rate is either insufficient or in excess of the actual administrative expenses, the actual cost may be charged.

In a report issued February 26, 1973, entitled "Opportunity To Recover Certain Foreign Military Sales--Administrative Expenses" (B-165731), we noted that the United States was not being reimbursed for administrative costs amounting to about \$19 million in fiscal year 1972 alone on sales to the Federal Republic of Germany. We recommended that appropriate Department of State officials discuss the payment of FMS administrative expenses with Germany and that they obtain a cost analysis of the administrative expenses for processing sales orders from Germany.

The Department of State said that Germany desired a detailed analysis of the administrative costs and did not want to be charged on a flat percentage rate basis. However, Germany had agreed in principle to pay a fair assessment of the administrative cost to process its military sales orders.

In 1973 the Defense Security Assistance Agency (DSAA) performed a DOD-wide study to determine the adequacy of the 2-percent administrative surcharge. The study concluded that (1) the 2-percent rate was sufficient to recover current FMS administrative costs, provided it was applied to all sales, and (2) it would be administratively infeasible to develop a system to account for the cost of administering each individual sale.

Through fiscal year 1975, however, the 2-percent surcharge was still not being applied to foreign national training cases and all military sales to Germany and Canada. For fiscal years 1950 through 1975, German and Canadian orders for U.S. military equipment and services totaled roughly 24 percent of the total FMS orders.

1/Revised from 2 to 3 percent, effective Oct. 1, 1977.

In an October 21, 1974, report entitled "Issues Related to U.S. Military Sales and Assistance to Iran" (B-133258), we reported that administrative costs of about \$11 million annually were not being recovered on FMS to Iran. We recommended that DOD ensure that sales prices include all pertinent costs, including administrative time of military advisory groups and any other personnel not normally considered part of the logistics system. In March 1975 the Departments of State and Defense reached agreement with Iran on reimbursing the U.S. Government for costs of maintaining a U.S. military mission in Iran. Under the FMS agreement, Iran would pay for 80 percent of annual operating, personnel, and support costs of the U.S. military mission in Iran; the remaining cost was considered an appropriate burden of the U.S. Government. The agreement has increased U.S. Government cost recoupments by an estimated \$22 million annually. Authorizing legislation now requires that administrative costs be fully reimbursed by foreign governments.

In a May 1975 report, "The U.S. Should Recover Full Costs of Reimbursable Satellite Launches" (LCD-74-107), we found that the 2-percent administrative charges to the United Kingdom and the North Atlantic Treaty Organization for satellite launches would not recover DOD's costs of administering and managing the 1970 and 1971 launch programs.

Air Force officials believed that the 2-percent administrative surcharge was adequate. In addition, they contended that the cost of managing and administering the 1970 and 1971 launches did not involve additional Air Force overhead expenses. They argued that no additional overhead expenses were incurred because Air Force command and staff elements and facilities would still be required even if not used to support foreign programs.

The Air Force did agree to charge direct personnel costs as a separate element of program cost. We believe that this will aid in recovering a greater share of administrative costs but will still not sufficiently recover all such costs.

DOD has taken steps to increase the effectiveness of administrative cost recoupments. In March 1974 DOD revised its pricing policy to require that the military services charge a 2-percent administrative surcharge on FMS training cases, previously exempt from the administrative charge. In addition DOD in June 1975 revised its pricing instructions to provide that, on stock level sales cases, an administrative surcharge of 5 percent will be applied to

replacement costs for the articles, rather than on the most recent purchase price. This surcharge could increase administrative cost recoupment since replacement cost is normally greater than the last purchase price.

Another DOD-wide study was initiated in July 1975 to determine the adequacy of the 2-percent administrative charge in view of the sharp increase in sales activity since the first study. The new study, completed in May 1976, concluded that (1) the 2-percent surcharge rate is adequate to recover FMS administrative costs, (2) the rate should be applied to all countries including Germany and Canada, (3) military surcharge collections have not been timely, and (4) centralized management of the FMS administrative surcharge is needed to provide a uniform system of policy and budget control. DOD officials have informed us that centralized management is being implemented.

In a Senate Committee on Armed Services report, the Committee expressed concern over the (1) increases in military and civilian personnel devoted to the FMS program, (2) lack of standardized and precisely defined accounting for personnel and associated costs, and (3) adequacy of the 2-percent administrative charge. At the Committee's request, we reviewed the accounting and reimbursement for all military and civilian personnel involved in FMS.

Our report, "Inadequate Methods Used To Account for and Recover Personnel Costs of the Foreign Military Sales Program" (B-165731), was issued to the Committee on October 21, 1977. In the report, we pointed out that:

- There are no adequate systems for accounting and reporting the actual number of personnel involved in FMS to use in determining personnel costs.
- Recent one-time DOD studies of FMS personnel strengths have been perfunctory and inexact and therefore of little value for use in congressional or defense management decisionmaking.
- DOD has no assurance that the 2-percent administrative surcharge on FMS is adequate to recover the full cost of administering the FMS program because (1) the system used to account for personnel is not adequate and (2) retirement cost factors are not high enough to recover the full cost of these benefits.

--A review of sales records at the U.S. Army International Logistics Command disclosed that there were 66 FMS cases wrongly recorded as being exempt from the 2-percent administrative surcharge. As a result, foreign countries were undercharged by \$940,000.

We recommended that the Secretary of Defense prescribe standard procedures for identifying and reporting estimated and actual staff-years of effort devoted to FMS. In commenting on the report, DOD agreed in general with our findings and has promised corrective action.

GOVERNMENT-OWNED ASSET COSTS

Since 1970, we have been advising the Secretary of Defense that FMS prices have not always included a charge for using Government-owned assets. DOD's actions on our findings have been gradual, as shown below.

Our effort

Early 1970--We advised DOD that the military services were not recovering costs of using Government assets to produce items sold to foreign governments.

Defense action

June 1970--DOD reminded the military services that its instructions required recovering depreciation costs for Government-owned assets at Government-owned and operated facilities.

April 1971--DOD agreed to look into the legal and accounting aspects of charging foreign countries for the use of Government-owned assets in Government-owned, contractor-operated facilities and in contractor-owned, contractor-operated facilities.

Our effort

September 1972--We issued a report citing the military services' continued failure to recover charges for using Government-owned assets at Government-owned and operated facilities. The report also noted that foreign sales prices did not include the cost of Government assets used in either Government-owned, contractor-operated or contractor-owned, contractor-operated facilities.

April 1973--We issued a follow-up report on the failure of the subordinate commands of the Army Materiel Command (now named the Development and Readiness Command) to charge foreign governments for the use of Government-owned assets at Government-owned and operated facilities.

October 1974--We reported that the Government continued to sustain losses because the military services failed to recover the costs of using assets at Government-owned facilities to produce items sold foreign governments. The report also noted that DOD had not charged foreign governments for a fair share of the cost of Government-owned assets used in contractor-owned and operated facilities.

Defense action

July 1973--DOD Instruction 2140.1, "Pricing of Sales of Defense Articles and Defense Services to Foreign Governments and International Organizations," was revised, effective November 17, 1973, to require that sales prices include the cost of using Government-owned, contractor-operated facilities.

March 1974--DOD auditors performed a followup review to evaluate actions taken to improve operations. The review confirmed our findings regarding the Army Materiel Command and identified similar problems within the Navy and the Air Force. DOD auditors also concluded that \$3.6 million had not been recovered in fiscal years 1973 and 1974.

June 1975--DOD Instruction 2140.1 was further revised to require the application of an asset-use charge (computed at 4 percent of direct costs billed) to recover the costs of using assets at Government-owned facilities. The instruction also required that the cost of using Government assets in contractor-owned and operated plants be recovered.

In an April 1978 report to the Congress entitled "The Department of Defense's Continued Failure To Charge for Using Government-Owned Plant and Equipment for Foreign Military

Sales Costs Millions" (B-174901), we identified \$107 million that DOD has failed to recoup from foreign governments for use of Government-owned assets in FMS transactions. The report pointed out that:

- Although DOD has required that foreign governments be charged for the use of Government-owned assets in Government-owned, contractor-operated facilities since November 1973, and specified in its guidance the application of an asset-use charge for this purpose since June 1975, it has not made sure that these requirements are being implemented.
- The Air Force and Navy ignored DOD policies on these matters and did not try to resolve uncertainties about how the asset-use charge should be applied. Naval Air Systems Command officials did not attempt to have DOD policy clarified although they were unsure how to implement it. About \$36 million in charges for using Government-owned assets have not been recovered by this command on sales of four weapons systems alone.
- The Air Force and Navy took no action on reports by their service audit agencies dealing with the failure to charge for using Government-owned assets. Even though the Naval Audit Service reported in June 1976 that about \$2.6 million had not been included in charges on four sales cases, no attempt has been made to recover this amount.
- DOD did not formulate a policy until June 1975 for recovering the cost of using Government-owned assets located in contractors' facilities.

Because of this inaction the military services did not recover over \$30 million in three instances involving Government-owned assets located in contractors' facilities. We recommended that the Secretary of Defense:

- Form a task force, consisting of representatives from DOD and the military services, to evaluate whether responsible commands are computing foreign military sales asset-use charges completely and accurately. Where necessary, the task force should assist the commands in applying and collecting asset-use charges. Further, the team should report to the Secretary whether corrective action is taken on the recommendations in this report.

- Require that in the future, DOD officials make sure that new or revised foreign military sales pricing policies are understood by the services and are properly implemented.
- Make every reasonable effort to recover from other governments undercharges which resulted from omitting charges for the use of Government assets since November 1973 including amounts (1) identified by us and the military services' audit agencies and (2) related to the use of assets in contractor-owned, contractor-operated facilities and Government-owned, contractor-operated facilities.

TRANSPORTATION AND OTHER ACCESSORIAL COSTS

DOD's general policy is to charge foreign customers for all accessorial services, provided these costs are incident to the sale of defense articles and are therefore not included in the standard price or contract cost of an item. Accessorial costs include packing, handling, crating, transportation, port loading and unloading, and pre-positioning.

To recover the cost of these accessorial services, DOD uses various formulas and procedures to establish standard rates or surcharges to be applied to the cost of the item sold. While it remains DOD's objective that the charges to foreign governments be sufficient to fully recover accessorial costs incurred, we have found that costs are not recovered for a number of reasons.

In an April 16, 1975, report entitled "Airlift Operations of the Military Airlift Command During the 1973 Middle East War" (B-180332), we reported that the Military Airlift Command and/or the Air Force may have used improper billing rates to charge Israel for airlift services. The billing did not include all flying hours involved, used outdated flying-hour costs, and excluded certain other cost factors.

Our report noted that if current costs had been used and all other pertinent costs were included, the airlift billing to Israel would have been increased by about \$45 million.

Both the Air Force and the airlift command recognized that the rates used would not recover the cost of the services provided. At our request, in September 1974, the Air Force recomputed the billing rates and determined that Israel had been underbilled \$14 million. This computation,

however, excluded about \$10 million in interest on Government investment and about \$21 million in proper depreciation charges.

In a report issued to the Secretary of Defense on August 19, 1977 (B-165731), we detailed the results of our review of FMS transportation and handling costs. The report pointed out that accessorial costs had not been fully recovered from foreign governments because of problems in identifying and billing customers for such services. More specifically, we found that:

- Foreign customers had been undercharged about \$17 million for air shipment of their items.
- Defense had been applying unrealistic percentage factors under the surcharge billing methods. We estimated that Defense had been recovering only about one-half the cost it incurred in packing and handling charges on FMS shipments and that undercharges for this service alone may exceed \$71 million a year.
- Over \$7 million in ocean transportation costs had not been billed to customers on FMS items withdrawn and shipped from depots in Germany, and the future costs of shipping replacement items overseas had not been considered.
- Defense generally had not obtained delivery receipts for FMS shipments; consequently, it had no basis for challenging or establishing responsibility for thousands of loss and damage claims received and processed under the FMS program each year.

We believe Defense could solve many of its problems by using actual cost data to bill customers for the transportation and port handling services it has provided on FMS shipments. Although this would require modifying procedures, it should not present considerable management problems.

To improve the program, we recommended that the Secretary of Defense direct the following actions.

- Discontinue using standard surcharges to recover transportation and port handling costs and modify FMS documentation and billing procedures so customers are billed for the actual cost of transportation and port handling services.

- Increase the surcharge rate used to determine packing, handling, and crating costs to cover actual costs.
- Ensure that FMS sales agreements provide for reimbursement of the future transportation and handling costs required to ship items from the continental United States to replace those withdrawn from overseas depots.
- Establish procedures to obtain proof of delivery documentation on FMS shipments to aid personnel responsible for processing loss and damage claims.
- Review all previous shipments made from overseas installations and attempt to recover any costs that have not been billed, including the cost of shipping replacement items from the continental United States.
- Review previous air shipments, recompute customer billings using the correct nongovernment shipper rates, and attempt to collect amounts underbilled.
- Require, as a control procedure, the Defense Audit Service to periodically review and report on how effective directed improvements are and if the costs of accessorial services provided by DOD are fully recovered.

TRAINING OF FOREIGN MILITARY STUDENTS

Foreign nations ordered almost \$1.5 billion worth of training under the FMS program during fiscal years 1950 through 1976. In addition, almost \$1.9 billion in military training was provided over the same period to foreign nations on a grant aid basis. Hundreds of thousands of foreign students have received U.S. military training as a result.

FMS training has historically averaged about 2.6 percent of the dollar volume of FMS orders. In fiscal year 1976, FMS training orders totaled \$252 million, or about 3 percent of total sales orders received.

Legislation authorizing FMS training requires that the Government be reimbursed by foreign countries for the cost of training foreign students. In recent work on pricing FMS training, we found that DOD has failed to recover certain Government costs.

In an April 11, 1975, report to the House Committee on Appropriations entitled "Pilot and Navigator Training Rates" (FPCD-75-151), we reported that the military services were not recovering all costs associated with pilot training under the Foreign Military Sales Act. Also, the military services used different methods in developing reimbursement rates, resulting in a wide variance in the reimbursements for training foreign pilots. Navy prices were based on full average costs incurred, while Air Force prices included only variable costs. As a result, the Navy charged \$282,000 for undergraduate jet pilot training while the Air Force charged only \$81,000.

Flight training is the most costly training the services provide. We recommended that in reviewing the Defense appropriation request for fiscal year 1976, the Committee may wish to consider whether the services should use the same methodology in computing charges for training foreign pilots.

In a December 14, 1976, report to the Congress entitled "Millions of Dollars of Costs Incurred in Training Foreign Military Students Have Not Been Recovered" (FGMSD-76-91), we reported that:

--Although the law and the contracts with foreign governments in effect during our review provided, respectively, that the value and total cost be recovered, Air Force and Army procedures omitted certain costs. As a result, these services did not recover millions of dollars incurred in training foreign students. In the Army, estimated undercharges totaled \$18.7 million in fiscal year 1975. In the Air Force, at one of eight undergraduate pilot training installations alone, about \$11.7 million in foreign training costs incurred during fiscal year 1975 was not recovered.

--Although the Navy's pricing policy provided for recovering the full cost of training foreign students, about \$2.7 million in costs incurred during fiscal year 1975 was not charged.

--The Marine Corps had a policy of not charging for training provided to foreign students. For example, during the 6-month period ended December 31, 1975, foreign governments received, at no charge, training valued at \$252,000.

We recommended that the Secretary of Defense direct the Army, Navy, and Air Force to attempt recovering those

amounts which should have been included in tuition rates billed to foreign countries. Also, in a report to the Director of DSAA (B-165731, July 15, 1976), we recommended that the Marine Corps attempt to recover the costs of all training provided foreign countries without charge during fiscal years 1974 through 1976.

The pricing problems identified were in large part caused by inadequate DOD pricing guidance. The absence of detailed instructions for pricing FMS training resulted in each military department establishing pricing procedures based on its own interpretation of the law. Differing judgments, therefore, led to differing charges for basically similar instruction.

On November 5, 1975, DOD, reacting to congressional concern over the pricing of foreign training, specified which cost elements were to be included when establishing prices for training courses. This guidance generally resulted in improved pricing of training courses.

On August 12, 1976, however, DOD notified the Chairman of the House and Senate Committees on Appropriations that the sudden and substantial increase in prices resulting from the November 5, 1975, guidelines had a drastic impact on foreign training and that DOD was going to make substantial reductions in tuition rates.

Both Committees informed DOD that they objected to reducing tuition rates and that DOD appropriations would be reduced by amounts equal to reimbursements lost through failure to make appropriate charges to foreign governments. Despite the objections and possible consequences, on September 28, 1976, DOD issued new guidance to reduce tuition rates effective October 1, 1976. DOD's action appeared to have been contrary to the Arms Export Control Act, which required that the Government be reimbursed for the full cost of providing foreign training. Therefore, we recommended that the Secretary of Defense rescind his decision to reduce tuition rates.

On February 23, 1977, we issued a followup report entitled "Defense Action To Reduce Charges for Foreign Military Training Will Result in the Loss of Millions of Dollars" (B-159835). We reported that DOD's action to reduce training charges to foreign military students would cost the United States at least \$40.4 million in fiscal year 1977. We also found that over three-fourths of the price reduction would benefit the countries of Iran, Germany, and Saudi Arabia.

On May 3, 1977, DOD finalized planned revisions to its pricing policy for FMS training, which included training under the International Military Education and Training Program as well as FMS training. DOD estimated that the revisions would increase reimbursements to military services appropriations by about \$24.3 million during fiscal year 1978. In addition the Air Force determined that for FMS training alone, the revised guidance would result in \$11.8 million in additional reimbursements that would be credited to miscellaneous receipts of the Treasury.

In a May 6, 1977, report (B-159835) issued to the Chairman of the House Committee on Appropriations, we reported that, based on limited review, DOD's estimates of increased reimbursements resulting from the revised pricing policy appeared reasonable. We also pointed out that, while DOD's revisions were a major step toward providing for recovering the full cost of training foreign students, certain issues remained to be resolved. Factors for computing military retirement pay, the cost of other civilian benefits, and the cost of aircraft use and attrition remained too low in the revised instructions. DOD officials said that these cost factors would be reevaluated.

TECHNICAL ASSISTANCE AND TRAINING SERVICES

A foreign country purchasing military equipment from the United States may also purchase the services of U.S. military and civilian technicians. Such personnel provide technical assistance and train members of the purchasing country's armed forces to operate, maintain, and support equipment purchased.

DOD provides such services to foreign governments under authority granted in the Arms Export Control Act. The act provides that the President may sell services of DOD to any eligible country or international organization if such country or organization agrees to pay the full cost of the Government's furnishing such service.

During fiscal year 1976 the Government of Iran was the major purchaser of U.S. technical assistance and training. Contracts with Iran for the sale of these services totaled \$93.4 million. However, in February 1976 DOD auditors found that of the costs that would be incurred by the U.S. Government for providing technical assistance and training in Iran during fiscal 1976, roughly \$28.5 million was not included in sales contracts with Iran. DOD auditors recommended, and DOD officials agreed, that (1) a study be made to ensure

that all costs of providing services to the Iranian Armed Force are identified and (2) reimbursement for such costs be obtained.

In a July 13, 1976, report (B-159835) to the Secretary of Defense, we pointed out that DOD had neither acted nor planned to act on the DOD auditors' recommendations. We informed the Secretary that we had reviewed the work of DOD auditors and found sufficient basis to warrant implementing their recommendations. Accordingly, we recommended that he direct the Director, DSAA, to:

- Initiate and complete the study recommended by DOD auditors before fiscal year 1976 contracts expire for identifying the costs which had not been included in contracts with Iran or billed and which should be reimbursed to the U.S. Government.
- Attempt to recover from the Government of Iran the amount determined to be reimbursable.
- Include in future FMS contracts any additional estimated costs identified during the study as being associated with providing technical assistance and training services to Iran.

We also recommended that the procedures and criteria used for identifying costs that should be reimbursed by Iran be reevaluated to ensure that all costs to the U.S. Government for providing that country with technical assistance and training are recovered.

As a result of the recommended study, DSAA identified \$17.4 million in technical assistance and training costs incurred by the U.S. Government that had not been included in fiscal year 1976 sales contracts with Iran. The identified undercharges were brought to Iran's attention, and on August 7, 1977, Iran formally agreed to reimburse the U.S. Government for the additional \$17.4 million in costs.

RECOVERY OF NORMAL INVENTORY LOSSES

Sales of defense articles to foreign governments are authorized by the Arms Export Control Act, which provides that DOD may sell articles from its stocks (inventories). For articles which DOD does not intend to replace, the act requires that a foreign government pay "not less than the actual value thereof." The act further provides that for articles which DOD intends to replace, the foreign government

must agree to pay the estimated replacement cost of the article.

In addition to selling major defense articles, such as tanks and aircraft, DOD sells articles to foreign governments that are commonly referred to as secondary items. Secondary items fall into two categories: (1) stock fund items and (2) other DOD inventory items called nonstock fund items. Stock fund items are generally low-cost, expendable and nonexpendable items, such as gears, bearings, and gaskets. Nonstock fund or other inventory items are generally reparable and nonexpendable items, such as engine motors, manifolds, and generators.

Secondary items may be purchased by foreign governments through supply support arrangements or other sales agreements. Supply support arrangements set forth the terms and conditions for providing articles, in effect, on a prepaid basis through the DOD supply system. These arrangements require investing foreign government money in DOD inventories. Other sales agreements generally do not require foreign government investment.

In maintaining secondary item inventories, DOD incurs normal inventory losses, such as damage, deterioration, obsolescence, and pilferage. Since these losses are normal costs of maintaining DOD inventories, the pricing of items sold to foreign governments should include a factor for recovering the losses. Including these losses in determining total cost is consistent with congressional intent that DOD appropriations should not subsidize FMS.

DOD's problems in recovering normal inventory losses on sales to foreign governments was the subject of a September 8, 1977, report (B-174901) to the Secretary of Defense. In the report we expressed concern over inconsistency found between charges for normal inventory losses on sales of stock fund and nonstock fund inventory items. We pointed out that the military services, as required by DOD directive, attempt to recover normal inventory losses on sales of stock fund items by applying surcharges to the standard price of the article being sold. For sales of nonstock fund items, however, we found that no attempt to recover the cost of normal inventory losses was being made by the military services. We noted that this inconsistency in pricing resulted from a failure of

--the military services to implement a longstanding DOD requirement to recover normal inventory losses

on all nonstock fund items sold under supply support agreements and

--DOD pricing instructions to require this same recoupment on sales of nonstock fund items sold through other agreements (that is, sales agreements other than supply support arrangements).

We estimated that in the Air Force alone, \$30 million in normal inventory losses associated with foreign sales of nonstock fund items was not charged to foreign governments.

We recommended to the Secretary of Defense that he direct:

--DOD to change its pricing policy for FMS, requiring the inclusion of normal inventory losses in charges to foreign governments for all nonstock fund items sold from DOD inventories.

--The military services to implement DOD policies on the recovery of these losses.

--The military services to attempt to recover previously unbilled costs for normal inventory losses on sales of nonstock fund inventory items for (1) all sales agreements for which a final billing has not been made and (2) supply support arrangements for which a final billing has been made.

INVENTORY REPLACEMENT COSTS

In a review of free assets ^{1/} conducted at the Army Armament Command (now the United States Army Armament and Materiel Readiness Command) from June to August 1975, we noted that the command had charged FMS customers less than the market price for certain 50-caliber M2 machinegun orders. These sales were also the subject of an Army Audit Agency price finding.

Before June 11, 1974, Army regulations governing pricing policy for FMS provided that " * * * if no future procurement is planned for an item, the published standard price will

^{1/}DOD generates funds from the sale of equipment for which there is no requirement for replacement in its inventory. Receipts from such sales are termed "free assets."

continue to be used * * *." Standard prices are based on the last procurement of the item; the M2 machinegun was last procured in 1945.

The prices for these M2 machinegun sales were quoted to foreign customers in the 1973 to 1974 time frame. At this time no future procurement was planned for the item and the standard price was used. Shortly after the quotes were given, Armament Command discovered that reprourement of these items would be required to replenish stocks to authorized levels. In May of 1974 Armament Command advised the Army Materiel Command (now the United States Army Development and Readiness Command) that they expected to buy M2 machineguns. Armament Command realized that replacement prices for these items would be substantially higher than the prices quoted to foreign customers. In June 1974 Armament Command requested Materiel Command's permission to increase M2 machinegun prices for unfilled FMS orders. Armament Command wanted to increase prices to reflect estimated replacement costs for reprourement of the items sold. No deliveries had yet taken place on the subject orders.

Materiel Command denied the request to reprice M2 machinegun sales. In doing so it acknowledged that replacing the weapons may be required but stated that since Armament Command had not established a funded procurement plan, it must charge the original price quoted to foreign customers as a "one time exception."

DOD instructions in effect at the time allowed the option of either pricing sales at the date the items were dropped from inventory or when the letter of offer was prepared, with a reasonable specified date set for customer acceptance. However, prices quoted in the letter of offer (DOD Form 1513) are only estimates, and the United States can revise these prices if the pricing considerations, on which the original quotes were based, change. In June 1975 DOD revised its instructions to state that if procurement of the item sold was intended within 12 months of its date of drop from inventory, replacement prices must be charged.

In a report to the Chairman, House Armed Services Committee, entitled "The Department of Defense Can Improve Its Free-Asset Management" (LCD-76-414, Mar. 3, 1976), we stated that the prices charged for the machineguns should have been based on the prices in effect when the guns were dropped from inventory in accordance with Army policy. Later actions of the Army Comptroller's Office and the Office of the Assistant Secretary of Defense, Comptroller,

have substantiated our position. However, we noted in a followup report to the Secretary of Defense, dated October 7, 1977 (B-183318), that in spite of direction to recover replacement prices on the machinegun sales, Armament Command has repriced only 5 of the 27 FMS orders for \$1.6 million. We, therefore, recommended that the Secretary direct the Army to attempt collection on the remaining 22 FMS orders which we estimated were underpriced by approximately \$60.7 million. 1/

The results of a comprehensive examination of replacement pricing practices within DOD were included in an August 25, 1978, report to the Congress entitled "The Department of Defense Continues to Improperly Subsidize Foreign Military Sales," (B-174901). The report covered both stock fund and nonstock fund pricing of secondary items sold from DOD inventories.

The report points out that DOD is not charging foreign governments the replacement cost of items sold from its inventories as required by law. Because the cost of replacing items sold has generally been much higher than the price charged to foreign governments, Defense appropriations continue to subsidize foreign sales each year.

DOD's failure to charge replacement cost is the result of:

- Pricing policies that are ambiguous, conflicting, and difficult to apply.
- An unworkable system of identifying item replacement cost.
- Inadequate actions to change pricing policies.

DOD policy governing stock fund operations, including pricing, requires that each stock fund item have a standard price to be used for both inventory accounting and sales reimbursement. The standard price is to include:

- the procurement cost of the item (last known purchase price),
- transportation cost incurred by the fund, and
- a surcharge to compensate the fund for normal operating losses.

1/DOD subsequently questioned this recommendation, which we are presently reconsidering.

During an inflationary period, these standard item prices will not recover replacement cost. In fiscal year 1974, the Defense stock fund's cash and working capital began to deteriorate because pricing policies were based on latest procurement cost and did not consider replacement cost. In December 1974, as a stop-gap measure, the Secretary of Defense approved a plan to improve the stock fund's financial position and stabilize prices to customers. The plan, implemented in fiscal year 1976, required that a surcharge be added to the standard prices. Under the plan, prices, including the surcharge, were to be computed once annually and were to remain in effect until the following fiscal year. For fiscal year 1976 the prescribed surcharge was 15 percent; in fiscal year 1977 the surcharge was reduced to 7 percent.

The stock fund stabilization pricing policy, we found, was developed by DOD officials who were not familiar with foreign sales pricing requirements. In March 1977 we discussed the pricing policy with a Department of Defense policy-making official. The official stated that pricing policies were not designed nor intended to recover replacement cost on an item-for-item basis. Instead, the pricing policy was to achieve the basic objective of the stock fund; that is, generate sufficient cash on sales to purchase and stock needed inventory items. The official explained that an item sold today will not be replaced until sometime in the future. The cash proceeds from today's sale are used to restock items sold in the past. When the item sold today requires replacement, the needed cash will come from future sales.

The primary stock fund objective and the pricing policy, we believe, are incompatible with the Arms Export Control Act which requires replacement pricing.

The military services began implementing the stock fund stabilization pricing policy in fiscal year 1976. Shortly thereafter, military officials who were responsible for stock fund operations voiced their concern that prices computed under DOD policy did not recover replacement cost on sales to foreign governments. The services, however, did not take any corrective action and the practice of subsidized pricing on foreign sales from the stock fund continued.

Based on a statistical sample, we estimated that use of the stabilization pricing policy by the Air Force during fiscal year 1976 resulted in sales to foreign governments that were underpriced by as much as \$32.5 million. Limited review of the Army and the Navy provided additional evidence of stock fund underpricing on fiscal year 1977 sales to foreign governments.

For nonstock fund sales, the military services were allowed to develop their own pricing policies and procedures for recovering replacement cost on foreign sales. Each service and components within each service interpreted the replacement cost provisions of DOD policy differently. The methods used therefore varied and resulted in inconsistent and inadequate pricing. For example:

- The Army, at the commands we visited, applied inflation factors to the historical cost of nonstock fund items in an attempt to recover replacement cost.
- The Air Force attempted to manually analyze each nonstock fund item to determine if replacement was expected and what the replacement cost would be.
- The Navy did not attempt to charge replacement cost for nonstock fund items.

DOD has taken action to change its pricing policies for secondary items. However, the methods to be used in pricing items sold from inventories will not recover the replacement cost in all cases.

To comply with the intent of the Congress that DOD not subsidize foreign military sales, DOD must devise systems to insure that the full replacement cost is charged for items sold from inventories that are to be replaced. Further, DOD must revise its policy to require that replacement pricing be applied to sales from the stock fund, as well as nonstock fund items.

We therefore recommended to the Secretary of Defense that:

- The method for determining and charging replacement cost for items sold foreign governments from DOD inventories be revised. When items are purchased in years previous to the year of sale, compounded inflation factors, similar to those developed by the Army commodity commands, should be used.
- Defense instructions be revised to require that replacement pricing be used for items sold from the stock fund.
- The military services be directed to make a reasonable attempt to recover from foreign governments the undercharges in sales from inventory resulting from the failure to charge replacement pricing where required by law and Defense regulations.

Other pricing problems discussed in the report included:

- Inadequate foreign government investment in supply support arrangements.
- Failure to properly account and bill for such costs as Government-furnished material, transportation, and contractor assistance.
- Failure to provide pricing guidance for items replaced through repair.

NONRECURRING COSTS

As a matter of longstanding policy, DOD has directed that foreign purchasers of defense equipment be charged an equitable share of nonrecurring costs incurred by the U.S. Government in developing and producing such equipment. Nonrecurring costs include research, development, test, and evaluation costs as well as nonrecurring production costs.

Until passage of the Arms Export Control Act on June 30, 1976, legislation authorizing FMS did not specifically address the need for recouping nonrecurring costs for FMS. Recovering these costs was implied in prior legislation under the general provision of recovering all costs. The Arms Export Control Act requires that now DOD include in its FMS pricing an appropriate charge for "a proportionate amount of any nonrecurring costs of research, development, and production of major defense equipment." Waiving or reducing this charge for certain sales is permitted but not mandatory under the act if the sales "would, if made, significantly advance United States Government interests in North Atlantic Treaty Organization standardization or foreign procurement in the United States under coproduction arrangements."

In January 1977 DOD revised its nonrecurring cost recoupment policy to conform to the new legislative language. The new guidance now requires that nonrecurring costs be applied on a proportionate basis to recover the equitable portion applicable to the sale. A proportionate share is to be determined by prorating nonrecurring costs as pools against total estimated quantities of the sale model, past and projected.

DOD policy further provides that deviations from the above practice may be granted when such action is considered in the best interest of the United States to (1) satisfy a right of the manufacturer or the purchaser or (2) obtain advantage to DOD.

Before DOD's new guidance on nonrecurring costs, non-recurring research and development costs for major defense articles were normally applied in an amount not greater than 4 percent of the total FMS price. Larger recoveries of research and development costs were permitted when considered appropriate on major defense articles which had been in production for less than 5 years. Nonrecurring production costs, which include such items as special tooling and start-up costs, were recovered by applying a prorata share of these costs to the individual FMS case.

In a report issued to the Secretary of Defense on December 18, 1975 (B-164912), we identified certain weaknesses found in DOD's research and development recoupment program. The major problem was the absence of centralized responsibility and focus for the total recoupment program. DOD's written instructions were primarily devoted to responsibilities and actions to be taken regarding sale under the FMS program. However, prescribed procedures were not as specific for sales made by contractors to foreign buyers. As a result, inconsistent recoupment actions were taken by the military departments. The fact that two sets of guidance--the Armed Services Procurement Regulations and DOD's recoupment policy directive--provide information on applying DOD's recoupment policy intensifies the problem. We noted inconsistencies between the two sets of instructions as well as instances where the instructions were unclear and subject to different interpretation.

We observed that it may be desirable to centralize responsibility for DOD's research and development recoupment programs and to establish a single body of uniform instructions for consistent application by all components. In commenting on the report, DOD said that it was in the process of revising its research and development cost recoupment policy and strengthening administrative control over the program. In addition, the Armed Services Procurement Regulations Committee was to determine after publication of the new policy what revisions were necessary to its contracting procedures.

The Air Force Audit Agency, in a June 1976 summary report of its review of FMS within the Air Force Systems Command, found that \$38.3 million in nonrecurring costs had been omitted from FMS pricing. Air Force auditors concluded that cost identifying and accumulating procedures were not comprehensive enough to ensure that all applicable costs were included in foreign sales. They therefore recommended that pricing procedures be improved for FMS.

Air Force headquarters concurred in the recommendation and took action to revise the pricing manual. We, however, have been informed that the Air Force does not intend to go back and rebill the sales cases that were reportedly under-priced.

Waivers of nonrecurring costs

For years DOD has interpreted FMS legislation to permit the waiving of nonrecurring research and development costs when such action is considered to be in the Government's best interests. In addition, exceptions to established DOD pricing policies have been granted when deemed appropriate. Such action before enactment of the Arms Export Control Act of 1976 resulted in considerable pricing concessions to foreign buyers.

In a classified report to the Congress entitled "Cost Waivers Under The Foreign Military Sales Program: More Attention and Control Needed" (FGMSD-78-48, Sept. 26, 1978), we reported the results of our review of FMS cost waivers granted and under consideration since passage of the Arms Export Control Act. In addition, we identified other actions where DOD and military department officials knowingly undercharged foreign governments on FMS.

We found that during the 15 months following passage of the act, DOD authorized or considered cost waivers of about \$500 million. The Congress has not been informed of the amounts being waived and the specific reasons for granting waivers although the information would improve its oversight and control of the program.

The Arms Export Control Act provides that DOD may waive or reduce charges for nonrecurring research, development, and production costs and for the use of the Government-owned assets if a sale would significantly advance either (1) U.S. interests in North Atlantic Treaty Organization standardization or (2) foreign procurement in the United States under coproduction arrangements. The legislative history of the act, however, does not explain what is meant by the term "significantly advance" leaving this interpretation to DOD.

In the largest cost waiver case reviewed (the proposed sale of the Airborne Warning and Control System to the North Atlantic Treaty Organization), the planned waiver will no doubt comply with congressional intent and result in standardization. In other cases, it is difficult to measure whether the sale would significantly advance standardization.

For example, without demonstrating that the sale significantly advanced standardization, DOD officials used the cost waiver provision to justify waiving \$21.8 million in nonrecurring research and development costs on the proposed sale of the Sub-Harpoon missile to a North Atlantic Treaty Organization country. The waiver was authorized after the foreign country balked at paying the charge. Because of the precedent set in granting the waiver, the same country received a similar type waiver on its proposed purchase of the Harpoon missile.

We also found that some of the cost waivers authorized were on sales to non-North Atlantic Treaty Organization countries that did not involve coproduction. Such waivers are not permitted by the act.

DOD has not developed specific criteria for granting cost waivers because it believes that this would place the Secretary of Defense at a disadvantage in negotiating with officials of other countries who would be aware of but not bound by such criteria. We agree that publication of criteria for cost waivers would be disadvantageous to the United States. However, because of the large sums involved in waivers granted, authorized, and under consideration, we believe that the Congress should be informed of the amounts being waived and the specific reasons for granting waivers. Such information would allow the Congress to measure whether DOD is acting within the intent of the law and would improve congressional oversight.

We recommended that the Congress amend the Arms Export Control Act to require that DOD include the value of and explanation for cost waivers in required congressional notification reports on FMS.

In commenting on this recommendation, the Director, DSAA, said that if it becomes public knowledge that certain countries have already been granted waivers, it would be more difficult to use the granting or withholding of waivers as leverage to help achieve North Atlantic Treaty Organization standardization objectives with other countries. The director added that DOD could, if required by the Congress, provide such additional information on a classified basis.

The report also pointed out that DOD has authorized waivers of millions of dollars in royalty fees. 1/ Although recovery of royalty fees would be consistent with one of the primary purposes of the Arms Export Control Act that foreign governments not be subsidized through FMS, the act does not require that the fees be charged.

We therefore recommended that the Congress amend the Arms Export Control Act to require that royalty fees be charged on FMS and that the Congress decide under what circumstances, if any, DOD would be permitted to waive the charges.

Concerning other actions where foreign governments were knowingly undercharged, we reported that:

- High-level DOD and State Department officials directed that the military services not charge for administrative and other costs which should have been recovered.
- An Army depot, with the knowledge of its higher headquarters, intentionally failed to charge a foreign country for costs incurred on work for that country and improperly transferred the costs to work done for U.S. Forces.
- The Navy failed to charge foreign governments for \$10 million in costs incurred in selected sales cases. These costs which were required to be recovered by law and Defense regulations were identified in a Navy study. The study concluded that for all open cases there was a potential for recovery of an additional \$100 million to \$200 million in incurred costs and applicable charges. Naval Air Systems Command stopped the review and did not attempt collection of the \$10 million in undercharges.
- The military services have not attempted to recover \$65 million in costs which their auditors have shown were omitted from sales contracts with foreign governments.

We recommended that the Secretary of Defense direct that:

1/Defense regulations define a royalty fee as a technology charge when DOD sells a production technical data package to a foreign government for use in its manufacture of items.

- The military services make every reasonable effort to recover those amounts identified by their internal auditors as not being charged to foreign governments and in the case of the Navy those amounts identified during their study of open FMS cases.
- The military services review all open FMS cases to ensure that all proper charges are included. In particular, the Navy should reinstate its earlier study.
- The Army take necessary actions to (1) improve its depot accounting systems to make sure that costs incurred on work for foreign governments are charged only to foreign governments, (2) attempt to recover the amount of undercharges from the foreign government involved, and (3) determine whether other similar improper cost transfers have taken place and, if so, attempt to bill foreign governments for the undercharges.

DOD has advised us that it will request the military departments to review our findings and take corrective action where DOD policies were not followed.

AGENCY COMMENTS AND OUR EVALUATION

In a February 24, 1978, letter commenting on our report (see app. II), the Assistant Secretary of Defense (Comptroller) implied that inadequate policy implementation is no longer a problem because of various safeguard actions taken by DOD since June 1975. In making this comment, he said that our analysis of current implementation was based for the most part on transactions that took place in fiscal year 1975 and prior. Conversely, our recital of fiscal year 1975 and prior years transactions was to place this matter in historical perspective. Although DOD has taken considerable corrective action based on our earlier reports, our recent report entitled "The Department of Defense continues to Improperly Subsidize Foreign Military Sales" (FGMSD-78-51, Aug. 25, 1978), which included analysis of fiscal year 1976 and 1977 transactions, and our other ongoing work in the cost recovery area continue to evidence the fact that ineffective implementation of pricing policy remains a primary cause of inadequate recoupment. It should be emphasized that we believe DOD has done a good job in prescribing adequate policy; the problem lies in inadequate implementation of policy by the military departments and, in our opinion, insufficient followup or monitoring of actual cost recovery practices by DOD policymakers.

LISTING OF OUR REPORTS
CONCERNING FOREIGN MILITARY
SALES COST RECOVERY

Congressional reports

1. "Omission of Significant Costs From Charges to the Federal Republic of Germany for Pilot Training," B-167363, Nov. 19, 1969
2. "Opportunity To Reccover Certain Foreign Military Sales-- Administrative Expenses," B-165731, Feb. 26, 1973
3. "Reimbursements From Foreign Governments for Military Personnel Services Provided Under the Foreign Military Sales Act," ID-75-6, Aug. 16, 1974
4. "Issues Related to U.S. Military Sales and Assistance to Iran," B-133258, Oct. 21, 1974
5. "Pilot and Navigator Training Rates," FPCD-75-151, Apr. 11, 1975
6. "Airlift Operations of the Military Airlift Command During the 1973 Middle East War," B-180332, Apr. 16, 1975
7. "The U.S. Should Recover Full Costs of Reimbursable Satellite Launches," B-168707, May 6, 1975
8. "The Department of Defense Can Improve Its Free-Asset Management," LCD-76-414, Mar. 3, 1976
9. "Millions of Dollars of Costs Incurred in Training Foreign Military Students Have Not Been Recovered," FGMSD-76-91, Dec. 14, 1976
10. "Defense Action To Reduce Charges for Foreign Military Training Will Result in the Loss of Millions of Dollars," B-159835, Mar. 3, 1977
11. A report on DOD's estimates of increased reimbursements resulting from revision of pricing policy, B-159835, May 6, 1977
12. "Inadequate Methods Used To Account for and Recover Personnel Costs of the Foreign Military Sales Program," B-165731, Oct. 21, 1977

13. "The Department of Defense's Continued Failure To Charge for Using Government-owned Plant and Equipment for Foreign Military Sales Costs Millions," B-174901, Apr. 11, 1978
14. "The Department of Defense Continues To Improperly Subsidize Foreign Military Sales," FGMSD-78-51, Aug. 25, 1978.
15. "Cost Waivers Under the Foreign Military Sales Program: More Attention and Control Needed," FGMSD-78-48, Sept. 26, 1978.

Reports to the Secretary of Defense

1. "Action Needed To Recover Full Costs to the Government of Producing Weapons for Sale to Foreign Governments," B-174901, Sept. 7, 1972
2. "Recovery of Costs to the Government for Producing Weapons for Sale to Foreign Governments," B-174901, Apr. 9, 1973
3. "Recovery of Costs on Government-owned Plant and Equipment," B-174901, Oct. 7, 1974
4. "Reimbursement for Foreign Military Student Training," FGMSD-76-21, Dec. 1, 1975
5. A report on weaknesses in DOD's research and development recoupment program, B-164912, Dec. 18, 1975
6. "Recovery of Costs Incurred by the Defense Department in Providing Technical Assistance and Training in Iran," B-159835, July 13, 1976
7. "Improvements are Needed To Fully Recover Transportation and Other Delivery Costs Under the Foreign Military Sales Program," B-165731, Aug. 19, 1977
8. A report on DOD recoupment of normal inventory losses on FMS, B-174901, Sept. 8, 1977
9. A report on underpricing of M2 machinegun sales to foreign customers, B-183318, Oct. 7, 1977



COMPTROLLER

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

24 FEB 1978

Mr. J. F. Fasick
 Director, International Division
 U.S. General Accounting Office
 Washington, D.C. 20548

Dear Mr. Fasick:

This is in reply to your letter to the Secretary of Defense regarding your draft report dated January 10, 1978, on "Recovering U.S. Government Costs in Foreign Military Sales - More Effort Needed," OSD Case #4795, CAO Code Number 46329.

Your draft report indicates that there has been improvement in DoD's pricing policy during the past few years but that Service actions to implement this policy have been lacking. Your findings basically cover transactions which took place prior to the issuance of the revised policy. To properly evaluate Service implementation, you should consider current transactions in support of your conclusions and recommendations which purport to reflect the situation as it exists at the present.

Starting with the June 17, 1975, reissuance of DoDI 2140.1, "Pricing of Sales of Defense Articles and Defense Services to Foreign Countries and International Organizations," all of the DoD policy documents on pricing and billing for FMS transactions have been reissued or revised to clarify and strengthen them. All changes in law have been incorporated in a timely manner. As mentioned in your transmittal, all of the 23 reports listed in Appendix I have been previously provided DoD for comments. In fact, many of the findings in these reports have been repeated in reports four or five times.

(See GAO note, p. 34.)

The advance copy of the report on secondary items mentioned on page 13 includes FY 1976 and FY 1977 transactions in a few cases. However, most of the findings involve actions prior to FY 1976. The other reports are a compendium of transactions which occurred prior to the update of the DoD policy in June 1975 and the subsequent issuances and restates the facts as if they still exist. It does not seem appropriate to evaluate the Services' implementation of DoD policy which was issued in FY 1976 and FY 1977 by citing actions that were taken in FY 1975 and prior.




In the Services' implementation of DoD policy, the OSD staff works closely with the Service personnel to insure proper implementation. In most instances, the Services publish guidance which incorporates the DoD Instruction plus amplification to accommodate Service peculiar requirements. Copies of all implementing instructions are required to be submitted to OSD for review. Also, since June 1975 there has been a requirement that all Letters of Offer of \$5 million or more, plus certain other cases, be submitted to the Comptroller, Defense Security Assistance Agency for review of adequacy of pricing before being forwarded to the foreign government. It is my opinion that current pricing instructions and practices of the Services adequately implement Congressional and DoD requirements and that your report overstates the magnitude of the problem. In view of all the above, I recommend that the report not be issued.

The DoD has taken conscious steps to correct those situations where abuses of policy were pointed out by GAO, to revise the policy to more adequately implement the intent of the Congress, and to work with GAO to reach a policy which is mutually acceptable. We would like to keep working in that direction, still recognizing our national objectives.

As we indicated in our letter of January 25, 1978, on your report "Continued Failure to Charge for the Use of Government-Owned Plant and Equipment for Foreign Military Sales" (OSD Case #4760), I believe that GAO assistance, as well as DoD effort, can be more beneficial and productive in working with the current FMS program. We will be glad to discuss this further with your staff if you desire.

Sincerely,



Fred P. Wacker
Assistant Secretary of Defense

GAO note: The deleted comments relate to matters which have been revised in this report.

(46329)