BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

The Department Of Defense Continues To Improperly Subsidize Foreign Military Sales

During the past several years, GAO has issued numerous reports on Defense's continued failure to properly price and bill for foreign military sales. This failure has resulted in large subsidies to the sales program--a practice which the Congress wants Defense to avoid.

This report, which covers Defense's pricing policies and practices in the sale of equipment and spare parts, identifies an estimated $69 million in direct and indirect costs which was not charged to foreign governments on selected sales cases. GAO recommends ways to improve Defense's pricing policies and practices.

FGMSD-78-51
AUGUST 25, 1978

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

B-174901

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

During the past several years we have issued numerous reports on the Defense Department's continued failure to properly price and bill for foreign military sales. The Department has not given this matter the priority necessary to recover all costs as required by law. This report addresses Defense pricing policies and practices in the sale of equipment and spare parts and points out that $69 million of direct and indirect costs were not charged to foreign governments on selected sales cases.

Our review was made 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; the Secretary of Defense; and the Secretaries of the Army, Navy, and Air Force.

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

THE DEPARTMENT OF DEFENSE CONTINUES TO IMPROPERLY SUBSIDIZE FOREIGN MILITARY SALES

DIGEST

The Department of Defense is making large subsidies--in the millions--in the foreign military sales program, a practice which the Congress wants it to avoid. By not charging foreign governments enough for equipment and spare parts--items which made up a large portion of the $11.2 billion in sales during fiscal year 1977--the Department is, in effect, subsidizing the sales.

According to the International Security Assistance and Arms Export Control Act of 1976, there should be a charge for items which are sold to foreign governments and which must be replaced in the Defense inventory. The act requires that, for sales in which Defense procures the item for a foreign government, the full contract cost be charged. The Congress intended that direct as well as indirect costs be recovered so that the foreign military sales program would not be subsidized by Defense appropriations.

GAO estimated that, because of weaknesses in pricing policies and practices, $69 million of direct and indirect costs for selected sales cases had not been charged to foreign governments. For example:

--The military services did not charge replacement costs for items sold from certain inventories. In the Air Force and at one Army command, subsidies estimated at $35 million may have been provided to foreign governments. (See p. 3.)

--Costs of normal inventory operating stock losses (an indirect cost) are not allocated to sales of nonstock fund items; therefore, foreign sales prices did not

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include millions of dollars in recoverable cost. In one military service alone, subsidies amounted to about $30 million in fiscal year 1976. (See p. 31.)

--A serious breakdown in the Air Force's accounting system led to unrecovered costs on items procured for foreign countries.

A considerable amount of equipment and spare parts sold comes under supply support arrangements with foreign countries. Although these arrangements can be beneficial, Defense needs to make sure that foreign country purchases from stock will not deplete critical inventory items.

Not charging the right amount for equipment and spare parts is part of the overall problem Defense has experienced in pricing foreign sales. During the past few years, GAO has issued numerous reports covering a wide range of pricing problems regarding the recovery of such costs as those for

--training foreign students,

--using U.S. Government-owned plant and equipment, and

--transporting items.

The Secretary of Defense should assign specific responsibility for administering pricing policy and monitoring pricing systems to a new organization or an existing organization that can be sufficiently freed from other work to provide careful surveillance over the pricing function.

GAO is also making specific recommendations for improving Defense's pricing policy and the military services' pricing systems.

AGENCY COMMENTS

Advance written comments from the Department of Defense were not received in time to be considered in preparing this final report. Informal comments from Defense officials were obtained and incorporated as appropriate.

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CHAPTER 1

INTRODUCTION

AUTHORITY FOR FOREIGN MILITARY SALES

Foreign military sales are transacted under authority of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2151), which amended and renamed the Foreign Military Sales Act of 1968.

The legislative history of the Arms Export Control Act indicates the Congress intended that indirect as well as direct costs of goods and services sold to foreign governments be recovered so that the foreign military sales program would not be subsidized by the Department of Defense appropriations.

The Foreign Military Sales Act provided that the sales of Defense items to foreign countries be priced at not less than the actual value thereof.

Phenomenal growth of the foreign military sales program

Department of Defense sales of articles and services to foreign governments have grown from fiscal year 1970 sales of $953 million to $11.2 billion in fiscal year 1977. This report focuses on Defense's policies, procedures, and accounting systems used to price and bill sales of secondary equipment and spare parts to foreign countries. Secondary items include those which are not primary items--that is they are not major and complete weapon systems such as airplanes, tanks, and ships. Generally, two classes of equipment and spare parts--stock fund and nonstock fund--make up the secondary items.

Each military service maintains a stock fund to finance commodities that are generally low cost, expendable, and nonreparable. Each stock fund is subdivided by the types of commodities managed. For example, the Bulk Fuel and Petroleum Stock Fund finances all fuel and petroleum products; the Military Clothing Stock Fund finances clothing; and the Systems Support Stock Fund finances spare parts needed to support weapon systems and special equipment. Stock funds are set up as self-sustaining revolving funds and are financed by selling commodities to military service organizations that pay with appropriated funds.

Nonstock fund items are bought with the military services' direct appropriations and are furnished to their operating organizations without reimbursement. Nonstock fund equipment items and spare parts are reparable, nonexpendable items, such as test benches, manifolds, actuators, and generators.

Foreign governments purchase secondary items through contractual agreements with the Department of Defense. In some cases, sales are made on an item-by-item basis to fill the current needs of the foreign government. In other cases, sales are based on supply support arrangements which allow foreign governments to invest and participate in the Defense logistics system and obtain long-term support for an entire weapon system.

Sales of secondary items in fiscal year 1976 amounted to $2.4 billion, or 28 percent of total foreign military sales. As sales of major weapons systems continue, sales of follow-on spares will grow in support of both old and new systems. It is widely recognized by Defense officials that costs of follow-on support, including spare parts, can eventually exceed a weapon system's initial cost.

CHAPTER 2

FOREIGN GOVERNMENTS NOT CHARGED

REPLACEMENT COSTS FOR ITEMS SOLD FROM INVENTORY

The Department of Defense is not charging foreign governments the replacement cost of items sold from its inventories although required by law to do so. Over the past few years, the cost of replacing items sold generally has been much higher than the price charged. Consequently, Defense appropriations are subsidizing foreign sales by millions of dollars each year. We found that:

--Pricing policies were ambiguous, conflicting, and difficult to apply.

--Defense had not developed a workable system to identify item replacement cost so that foreign countries could be charged the proper sales price.

--Actions to change pricing policies were inadequate.

The Air Force and one Army command may have subsidized foreign sales by an estimated $35 million by not charging replacement cost on items sold from the stock fund.

For nonstock fund sales, 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. 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.

REQUIREMENTS FOR RECOVERING REPLACEMENT COST

The Arms Export Control Act of 1976 requires that articles sold from Defense inventories to foreign governments be priced at either

--actual value, when the article is not intended to be replaced in the Defense inventory, or

--replacement cost, when the article is to be replaced.

The act also requires that the price of articles sold from Defense inventories include administrative cost, the cost for using plant and production equipment, and other indirect costs. These cost recovery provisions were intended to insure that foreign sales prices include a fair share of all indirect costs so that there would be no elements of subsidy in the foreign sales program.

Before passage of the Arms Export Control Act, the provisions of the Foreign Military Sales Act of 1968 required that foreign countries be charged the value of stock items purchased. To satisfy this requirement, Defense should have included all direct and indirect costs in sales prices.

A Defense instruction of January 29, 1970, pertaining to pricing of articles sold to foreign governments (Defense Instruction 2140.1), required Defense components to, in effect, use replacement cost for pricing nonexcess articles sold from stock which required replacement, other than stock fund items.

On June 17, 1975, the instruction was revised. Although the instruction still required replacement cost pricing for nonexcess items sold from stock which were to be replaced, the revision required Defense components to price items financed by stock funds in accordance with the directive pertaining to stock fund pricing (that is, Defense Directive 7420.1). Since the stock fund pricing directive did not require recovery of replacement cost, the new requirement resulted in ambiguous and conflicting pricing policy. This problem is discussed below in more detail.

STOCK FUND PRICING POLICY

Defense Directive 7420.1 governs stock fund operations, including pricing procedures. The directive requires that each item financed under a stock fund have a standard price to be used for both inventory accounting and sales reimbursements. Each item's price was 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.

However, standard prices, based on historical cost, were not adequate to recover replacement cost during an inflationary period. 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 Department of Defense officials who were not familiar with foreign sales pricing requirements. In March 1977 we discussed the pricing policy with a Department of Defense policymaking 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 some time 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 Defense official did not believe that the Congress wanted replacement cost recovered on stock fund sales to foreign governments. He emphasized that recovering replacement cost would result in a tremendous increase in available cash, and the Congress might criticize the stock fund for apparently profiting on sales. He noted that to recover replacement cost, the Congress would have to acknowledge that the resulting increase in cash balances was not profit but was cash on hand to replace items sold to foreign governments.

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

Military services concerned about stock fund pricing policy

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 became concerned because prices computed under the Defense policy did not recover replacement cost on sales to foreign governments. In a letter to his next higher command, an Air Force official reported that:

> "Losses, gains, and adjustments resulting from sales within the Department of Defense (DOD) which although not financially or logically sound can be morally and technically understood and accepted. However, this ALC (Air Logistics Center) is firmly committed and obligated to support programs such as Foreign Military Sales (FMS) and Military Assistance Programs (MAP) and the existing moratorium for price changes totally restricts the recoupment of our investments, simply because we procure at inflated costs and bill at antiquated standard prices. This restriction creates a condition that is totally and grossly unfair to our taxpayers and detrimental to sound management.
>
> "Considering the current pricing policy was directed by DOD, this ALC comprehends your limitations. We solicit your consideration in obtaining and providing flexible procedures that will give us the capability to react when surveillance isolates large disparities in price variances caused by cost escalations."

The higher command replied that the price stabilization policy for fiscal year 1976 was Defense directed and that the Office of the Secretary of Defense continued to believe that the policy was in the best interest of the United States and the Air Force. Corrective action was not taken, and the practice of subsidized pricing on foreign sales from the stock fund continued.

Similar concern over the Defense pricing policy was expressed by the Army. As early as October 1975, Army headquarters officials recognized that the Defense stock fund stabilization pricing policy would not recover replacement cost and should not be used to price items sold to foreign countries. In early 1976 officials at a major Army command requested removal of the yearly price freeze to avoid further stock fund cash drain and enable the Army to collect the most recent cost from foreign customers.

In February 1976 the Army's Director of Supply and Maintenance, in a memorandum to the Army's Director of Finance and Accounting, stated:

> "There is a real possibility of criticism for noncompliance with OSD and/or Congressional intent, should it come to light by way of stock fund cash degradation to the point of a R.S. 3679 violation (the Antideficiency Act), or the need for appropriation request. In view of the foregoing, it is recommended that your office * * * provide guidance as appropriate regarding implementation of FMS pricing policy * * *."

The Army official's recommendation was not accepted, and the Army continued to use the stock fund stabilization pricing policy for foreign sales.

REPLACEMENT COST NOT RECOVERED ON DEFENSE STOCK FUND SALES

Because of the pricing policies, replacement cost was not recovered on stock fund sales to foreign governments. All three services have continued to subsidize the sale of these items. The subsidies have cost the U.S. taxpayer millions of dollars.

Subsidies through Air Force stock fund sales

Because the Air Force used the Defense stock fund stabilization pricing policy for items sold to foreign governments, replacement cost was not recovered and fiscal year 1976 sales to foreign governments may have been underpriced by as much as $32.5 million.

In fiscal year 1976 Air Force stock fund sales for systems support totaled $468.5 million. Of this amount, $112 million, about 24 percent, were sales to foreign governments.

A statistical sample from $22.7 million of the sales revealed that 74 percent of the items reviewed were priced below replacement cost. On the basis of the statistical sample, we estimate that these sales were underpriced by $6.5 million, 1/ about 29 percent. If this ratio is representative of all fiscal year 1976 Air Force stock fund sales to foreign governments, the subsidies may have amounted to as much as $32.5 million. The example below shows how subsidies result when replacement cost is not recovered.

In July 1975 the Air Force established the price for compressor blades for the J-85 Engine. Using the Defense stock fund stabilization pricing policy, the Air Force determined the fiscal year 1976 price should be $3.22 each. Between July 1, 1975, and September 30, 1976, foreign governments purchased 97,922 of the compressor blades at that price and the Air Force recovered $315,518.

Within 3 months after the 1976 price had been established, the Air Force had to replenish its inventory. Procurements were made for 215,465 compressor blades at a contract price of $3.84 each. Had the Air Force updated the stock fund price for compressor blades to the replacement cost for fiscal year 1976, the selling price to foreign governments would have been $4.92 each ($3.84 plus a surcharge to cover administrative costs and inflation) and the Air Force would have recovered $482,121. The stock fund stabilization pricing policy, however, does not allow prices to be changed until the next fiscal year unless initial computations were in error. Consequently, the Air Force subsidized foreign governments $166,603 on the sale of compressor blades in fiscal year 1976.

Using the compressor blades as an example, we advised Air Force officials in February 1977 that replacement costs were not being recovered on stock fund sales. They agreed and cited the stock fund stabilization pricing policy as the cause. As for recovering the fiscal year 1976 subsidies, officials said they did not have authority to deviate from the pricing policy and could not recover these costs.

1/Statistical analysis based on 90 percent confidence level with an error range of ± $3.7 million.

Subsidies through Army stock fund sales

Like the Air Force, the Army used the stock fund stabilization pricing policy. At the Missile Readiness Command alone, the resulting foreign sales subsidies may have amounted to as much as $2.5 million in fiscal year 1977. We analyzed the command's fiscal year 1977 stock fund prices as computed under the stabilization pricing policy criteria. We compared that price to the actual replacement cost of the items. Without considering expected inflation for fiscal year 1977, the fiscal year 1977 prices were understated by 8.7 percent. If foreign sales of stock fund items in fiscal year 1977 equal fiscal year 1976 sales of $28.8 million, this one Army command may undercharge foreign governments by as much as $2.5 million.

At the other Army organization we visited--the Army Tank-Automotive Readiness Command--information was not readily available to determine the overall dollar effect of not charging replacement cost. As shown below, however, we did obtain specific examples of subsidies on stock fund sales to foreign governments.

Examples of Subsidies on Stock Fund Sales to Foreign Governments

Item	Replacement price	Stock fund price	Difference	Number of items sold	Subsidy
Propeller	$388.82	$192.00	$196.82	561	$110,416.02
Boot, St.	4.04	3.00	1.04	36,991	38,470.64
Battery	19.29	15.00	4.29	980	4,204.20

Considering that the four other commodity commands are not charging replacement costs, the amount of the Army's foreign sales subsidies is substantial.

Subsidies through Navy stock fund sales

The Navy also failed to recover replacement cost for items sold from the stock fund. In December 1975 Navy headquarters instructed the Aviation Supply Office and the Ships Parts Control Center to implement a manual system that would, to the extent feasible, insure that foreign governments were charged replacement cost for articles sold from stock.

The Naval Audit Service found in June 1976 that such a system had not been implemented and reported that the Supply Office and the Control Center undercharged foreign governments about $148,000 on 34 of 110 requisitions.

In our limited review during 1977 at the Supply Office and the Control Center, we found that a system still had not been implemented to insure that replacement cost was recovered. For 11 of 88 selected requisitions, foreign governments were not billed the correct price--the replacement cost had not been charged.

MILITARY SERVICES' PRICING POLICIES FOR NONSTOCK FUND ITEMS ARE INCONSISTENT

Because each military service has been allowed to develop its own procedures for pricing nonstock fund items, pricing has been varied and inconsistent. Each military service interpreted the replacement cost provisions of Defense Instruction 2140.1 differently. As a result, not all replacement costs are being recovered.

Army nonstock fund sales

Army commodity commands used different techniques to determine replacement costs of nonstock fund items sold to foreign governments. While their techniques differed, the two commands we reviewed did attempt to implement an automated replacement cost system for foreign sales and recovered over an additional $15 million.

Army regulations, which implemented foreign sales pricing policies of Defense Instruction 2140.1, required nonstock fund inventory items to be priced at the higher of standard or replacement costs for foreign sales. When the replacement cost exceeded the standard cost by 5 percent, the replacement cost was to be used as the billing price.

Different commands interpreted the regulations differently. One command decided that all nonstock fund items would be replaced and determined that a 19.86-percent factor should be added to the standard price of items sold to foreign governments.

After applying the standard factor for 9 months, the command was advised by higher headquarters to change its procedures for replacement pricing. The command was directed to analyze each item individually at the time of sale to determine

--if replacement was necessary and

--the actual replacement cost.

The command advised heaquarters that over 75 percent of nonstock fund sales were foreign sales. Since the command managed over 4,700 different items, it estimated that 500 additional people would be needed to make the required analyses for individual item replacement pricing. Headquarters decided to allow the command to continue using its own pricing procedures. The command estimates that $9 million in additional replacement costs will be recovered from foreign governments because of its procedures.

The second command, which manages about 500 nonstock fund items, decided to determine, on an item-by-item basis, which items were to be replaced. The command found that about 100 of the 500 items were subject to replacement, and prices for these 100 items were increased by using inflation indexes. The revised price became the billing price to foreign governments. The command also decided that items shipped to foreign governments during fiscal year 1976 should be rebilled at the newly devised replacement cost. The command estimates that recoveries of about $6 million in replacement costs will result.

Air Force nonstock fund sales

The Air Force, like the other services, found it difficult to determine replacement cost for nonstock fund inventories. The Air Force decided to manually determine the price of each item sold to a foreign government.

Standard inventory prices were initially charged to the foreign government. Later, a price verification was required to determine the actual or replacement value of the items sold. If variances were discovered, the price was corrected through an adjusted final billing. The process did not always work because

--thousands of individual transactions were involved and often prices were not verified and

--the Air Force's accounting systems frequently contained erroneous and outdated pricing data.

The following example typifies the problems in the Air Force's verification process.

The Air Force sold 12 jet engine test stands to foreign governments between March 1974 and February 1976. Prices to the Air Force ranged from $90,737 to $102,164 for each of these test stands. As test stands were shipped, billings were made to the foreign governments. On 6 of the 12 sales, the recorded inventory price of $80,000 was initially charged. However, the recorded inventory price was outdated, and the initial billings had not been corrected.

We informed Air Force officials of the erroneous standard price and resulting undercharges on sales of the jet engine test stands. The officials agreed with our finding and recovered an additional $75,468.

Sale of Navy nonstock fund items

The Navy has no system to insure that replacement costs are charged to foreign governments for nonstock fund items. In a limited test at the Aviation Supply Office and the Ships Parts Control Center, we found that 22 of 35 sales requisitions were billed at incorrect prices and resulted in underbillings totaling $44,000.

Some of the undercharges that occurred because replacement pricing had not been used are shown below.

Number of items sold	Price charged	Replacement price	Undercharge
10	$ 25	$ 105	$ 800
1	187	1,401	1,214
2	356	1,306	1,900
3	50	252	606

Because the Navy has not taken action to implement replacement cost pricing, it has incurred and will continue to incur losses on the sale of nonstock fund inventory items to foreign governments.

DEFENSE ACTION TO CHANGE
ITS PRICING POLICIES

After we had completed our review and advised Defense officials of our findings, Defense revised certain of its pricing policies on items sold from inventories.

These changes do not correct the problems noted during our review, nor do they comply with the intent of the Congress that Defense not subsidize foreign governments through the foreign military sales program.

Stock fund sales

The revised pricing policy in Defense Instruction 2140.1 of April 13, 1978, stated that stock fund items were to be sold to foreign governments at their established standard price in accordance with Defense Directive 7420.1. As discussed on pages 4 through 10, standard prices developed under Directive 7420.1 do not represent replacement cost. Recovery of replacement cost on sales to foreign governments is expressly required by the Arms Export Control Act when the item is intended to be replaced.

Nonstock fund sales

The revised Instruction 2140.1 provides that all nonexcess secondary items sold from Defense inventories to foreign governments must be replaced and requires that inflation factors be added to the inventory price. The instruction further provides that, as a new inflation factor is added to the inventory price each year, the prior year's factor will be eliminated.

This policy is inadequate to insure that replacement cost is recovered. Although we believe the use of rates or factors to be the most practicable means of establishing the replacement cost, Defense's method does not provide for the recovery of the replacement cost in those cases where secondary items are purchased prior to the year in which they are sold. For example, assuming an average annual inflation rate of 7 percent, an item last purchased in 1975, sold in 1978 and replaced in 1979, would cost 28 percent more to replace than its inventory price (4 years at 7 percent a year). However, under Defense's methodology only a 7-percent inflation factor would be added to the inventory price since prior year inflation factors would be eliminated. Thus, the item would be sold at the 1975 price plus 7 percent, which would not provide for the replacement of the item. Inflation or replacement factors must be compounded where items were last purchased during earlier fiscal years.

CONCLUSIONS

Defense has taken action to change its pricing policies for secondary items. However, the methods to be used in pricing stock fund and nonstock fund items will not recover the replacement cost in all cases.

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

The Army commodity commands' methods of using compounded additive factors to cover replacement costs on nonstock fund sales appears to be the most effective and least costly method for charging replacement cost. Defense's policy of adding only the current year's inflation rate is not adequate.

In recovering costs of foreign sales up to and including final billing, the Department of Defense standard sales contract provides that adjustments may be made to estimated costs which are not commensurate with actual costs. Therefore, any costs which have not been recovered by the military services on those sales contracts for which final billing has not been made could and should be subsequently billed.

As to undercharges which may be found after final billing, Instruction 2140.1 provides that adjustments to final billings are permitted when there are unauthorized deviations from Department pricing policies.

The longer the Defense Department takes to attempt to collect undercharges, the more difficult it will be to recover these amounts from foreign governments. Until action is taken to attempt to collect undercharges, the military services should not make final billings for contracts in which undercharges occurred.

RECOMMENDATIONS

We recommend that the Secretary of Defense take action to:

--Revise the method for determining and charging replacement cost for items sold foreign governments from Defense inventories. 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.

--Revise Defense Instruction 2140.1 to require that replacement pricing be used for items sold from the stock fund.

--Direct the military services 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.

CHAPTER 3

MANAGEMENT OF SUPPLY SUPPORT

ARRANGEMENTS NEEDS IMPROVEMENT

Under supply support arrangements, intended to improve Defense logistics management, foreign governments

--ordered $308 million of parts without paying required investment funds of $90.6 million and

--obtained at standard prices parts which had been purchased for Air Force needs and had to be replaced at higher costs to the Air Force.

Further, the lack of control over requisitions from foreign governments under supply support arrangements might have an adverse effect on logistics management. Foreign governments can, under the present system, obtain parts potentially critical to the United States.

Also, according to the Air Force Audit Agency, the Air Force unnecessarily purchased about $38 million of spare parts for foreign governments because supply support requirements established for a 17-month period were computed according to a system designed to compute Air Force requirements for 30-month periods.

The Army and Navy also have entered into supply support arrangements, but we did not review these arrangements.

NATURE OF SUPPLY SUPPORT ARRANGEMENTS

Supply support arrangements are agreements between the United States and various foreign governments. The intent is to provide foreign governments with continuous and timely spare parts support by allowing them to invest and participate in our defense logistics system. The foreign governments are required to put up advance equity funds equal to a stated portion of the inventory items to be purchased for their needs. If the foreign governments do not put up the required equity or if they subsequently draw out more items than their investment represents, the United States will have to cover the investment with its own funds.

We believe the concept of the supply support arrangement is good. If properly implemented, such arrangements can be beneficial to both the United States and the foreign countries involved. In our September 2, 1977, report to the Congress, "Foreign Military Sales--A Potential Drain on the U.S. Defense Posture" (LCD-77-440), we recommended to the Secretary of Defense that supply support arrangements be made a part of any sale when it is feasible to do so, so that Defense can program and fund future support without adversely affecting U.S. defense capabilities.

Before March 1977 Defense Instruction 2140.1 required supply support arrangements to be based on a list of specific items and quantities that would be needed by the foreign government during a 17-month period. The total value of the listed items became the basis for determining the amount of funds the foreign government was required to deposit with the United States as an equity investment. The foreign governments were required to deposit 5/17ths of the value of the specified requirements.

In March 1977 Defense Instruction 2140.1 was revised to eliminate the list of specific items to be furnished. Instead, supply support arrangements were to be made for a total dollar value of support over a 17-month period. The new concept became effective October 1, 1977. We evaluated agreements that had been formalized when the specific items and quantities were identified in the arrangement.

REQUIRED EQUITY FUNDS NOT PAID

Foreign governments requisitioned $308 million of spare parts above the amount agreed to in supply support arrangements without increasing their equity investment in the Air Force Logistics System. As a result, Air Force funds were being used to finance procurement for foreign sales.

Defense Instruction 2140.1 requires foreign governments to establish an equity investment in the Defense inventory to qualify for supply support. As noted above the foreign government should place on deposit with the United States an amount equal to 5/17ths of the total value called for in the agreement to achieve an equity investment. Once the foreign government deposits the funds and completes the supply support arrangement, items may be requisitioned. Theoretically, items subsequently shipped to the foreign government should be priced at standard inventory cost, rather than replacement cost, because the foreign government has put up an equitable share to purchase from inventory.

However, quantities requisitioned by foreign governments frequently were greater than agreed upon in the supply support arrangements. When this occurred, the foreign government should have been required to deposit additional funds of 5/17ths of the value of overrequisitioned material to maintain its equity investment in Defense inventories. The Air Force, however, did not require additional deposits. The chart below shows several examples where foreign countries requisitioned quantities exceeding those provided for in the supply support arrangement.

Schedule of Quantities Requisitioned in Excess of Supply Support Arrangement

Item included in supply support arrangement	Number of foreign customers reviewed	Quantity agreed to under supply support arrangement for 17-month period	Actual quantity requisitioned during a 12- to 15-month period (note a)	Quantity over-requisitioned
J-85 engine fuel control	9	177	320	143
J-85 engine amplifier	1	18	67	49
J-85 engine exciter	3	46	145	99
F-5 and T-38 indicator	2	6	16	10

a/Data was not readily available for some of the 17 months.

We did not attempt to determine the quantities requisitioned which exceeded amounts shown on the supply support arrangement because, after discussions with Air Force officials, the Air Force Audit Agency agreed to make a detailed review. The auditors reviewed requisitions for a 12-month period and found that foreign governments requisitioned quantities valued at $308 million more than agreed upon in the supply support arrangements. If the agreed upon 5/17ths of inventory value had been deposited, the foreign governments would have had to advance an additional $90.6 million to maintain their required equity in the Defense inventories.

REPLACEMENT COST NOT CHARGED

Significant subsidies to foreign governments are occurring on supply support arrangements because Defense Instruction 2140.1 does not provide for replacement cost to be charged on excessive quantities obtained. The pricing policy for items purchased under the arrangements requires that standard cost be charged because the items provided to foreign governments were obtained from inventory purchased specifically for the foreign governments with funds provided by the foreign customer.

As noted above, however, foreign governments are requisitioning items in quantities above the amounts planned for. These requisitions are filled from inventory that was purchased to meet Air Force needs; so the Air Force must replace the items to support its own operations. Since the foreign governments are charged standard cost in lieu of replacement cost for items ordered in excess of the agreed quantities, the Air Force subsidizes the foreign government, as shown below.

Examples of Subsidies Resulting from Charging Standard Cost in Lieu of Replacement Cost

Item requisitioned	Excess quantity requisitioned	Standard billing price		Replacement cost		Net subsidy
		Unit	Total	Unit	Total	
Fuel control	143	$7,498	$1,072,214	$9,491	$1,357,213	$284,999
Engine amplifier	49	3,681	180,369	3,948	193,452	13,083
			$1,252,583		$1,550,665	$298,082

In June 1977 Air Force officials agreed with us that replacement cost should be charged for the fuel controls. As a result the Air Force should recover an additional $683,469 for those sold and on order. Fuel controls, however, are but one of many items purchased by foreign governments, under supply support arrangements, in excess of agreed quantities. Corrective action should, therefore, be taken on all items which were sold in excess of agreed quantities.

The Air Force was also subsidizing foreign governments in those cases where foreign governments were requisitioning items before the Air Force had time to achieve required inventory levels. The Air Force Audit Agency found that supply support arrangements were allowing some foreign governments to obtain items which had been procured to support Air Force requirements. New customers are authorized to requisition items immediately after the arrangement is implemented. Within 2 months after signing a supply support arrangement, one foreign government had submitted 2,250 requisitions valued at $2.1 million. The inventory items on hand at the time had been procured to supply other requirements.

Department of Defense officials recognized that, until proper inventory levels were achieved, requisitions should be priced at replacement cost. In March 1977 Defense Instruction 2140.1 was revised to require that

> "Requisitions in advance of achieving required inventory levels are not to be treated as Supply Support Arrangement requisitions and are, therefore, subject to replacement pricing."

At the conclusion of our review, the Air Force had not implemented this change to pricing policy.

UNNECESSARY PURCHASES DUE TO ERROR IN FORECASTING REQUIREMENTS

Supply support arrangements are designed to provide foreign governments continuous spare parts support for a 17-month period. With the requirements data for a 17-month period, the military services could forecast, purchase, and have on hand the needed items when the foreign government requisitioned them.

The Air Force requirements system, however, was not designed to limit inventory levels to the negotiated 17 months. Air Force inventory levels were projected on lead time and economic order quantities. The Air Force Audit Agency found that these factors resulted in at least a 30-month supply for stock fund items required in supply support arrangements. This caused an overinvestment in support arrangement stock fund inventories of at least $37.9 million. Whether these items can be used or whether they will become excess remains to be seen.

The Air Force Logistics Command informed the Air Force Audit Agency that action was underway to correct the forecasting system deficiency.

BETTER CONTROL OVER SUPPLY SUPPORT REQUISITIONS NEEDED

Under supply support arrangements, foreign countries are obtaining unauthorized items and in some instances depleting inventories of items needed to operate U.S. aircraft and equipment.

Foreign governments are requisitioning spare parts for aircraft they do not own. One foreign government requisitioned and obtained items peculiar to the C-5A aircraft, a firstline defense system unique to the United States. The supply support arrangement did not specify that C-5A parts could be obtained. We also identified 12 other foreign governments that had established stock levels for parts peculiar to the C-5A aircraft. We did not attempt to determine why the foreign governments were obtaining these parts.

We found in some cases that foreign governments' requirements have depleted Defense stocks of needed items. In a 12-month period, 2 foreign governments requisitioned and obtained 10 indicators used on F-5 and T-38 aircraft above the level provided in the supply support arrangements. During 1 month of this period, 85 T-38A aircraft in the U.S. Air Force inventory were not operational because indicators were not available.

In another case spare J-85 engines, used on T-38 aircraft, were reported as "not operationally ready" during fiscal year 1976 because foreign government requisitions had depleted Air Force inventories of engine exciters. We found that foreign countries had requisitioned engine exciters in quantities exceeding levels cited in the arrangement. One foreign government, for example, ordered 30 exciters or 28 more than the number provided in the supply support arrangement.

Although the F-5 is not one of our frontline aircraft and the T-38 is a training aircraft, the above examples show there is a need to better control foreign requisitions. As new weapon systems, such as the F-15 and F-16 aircraft, are delivered to foreign countries, control over requisitions will become even more critical.

As noted on page 17 effective October 1, 1977, a list of specific items to be furnished was no longer to be a part of the supply support arrangement. Instead, only a total dollar value of support was to be specified in the arrangement. Without a list of items to be furnished it will be nearly impossible to track what was purchased under the arrangements and to determine whether items requisitioned by the foreign governments were purchased for U.S. defense needs. Therefore Defense should reconsider its decision to eliminate item listings.

CONCLUSIONS

The Air Force must devise controls to insure that it does not subsidize foreign government purchases of items through supply support arrangements. Further, there is a need to make sure that foreign country requisitions of supplies do not result in (1) depleting inventories of items needed to operate U.S. aircraft and equipment and (2) foreign governments obtaining unauthorized items.

Also we think it is a mistake to eliminate the item list because the absence of a list may impede Defense's ability to program and fund supply support to foreign countries without adversely affecting U.S. defense capabilities.

RECOMMENDATIONS

We recommend that the Secretary of Defense require the Air Force to institute necessary controls so that:

--For items covered by supply support arrangements made prior to October 1, 1977, foreign governments are billed replacement cost when quantities above the amount planned in the arrangement are requisitioned and when items are requisitioned before the Air Force has achieved proper inventory levels.

--Requisitions for unauthorized items are not honored.

--Foreign country requisitions that will deplete critical inventory items will not be filled.

We further recommend that the Secretary of Defense consider revising Defense Instruction 2140.1 to require that supply support arrangements be based on a list of specific items and quantities that would be needed during the term of the arrangement.

We recommend also that the Secretary of Defense require that the Army and Navy internal auditors conduct reviews to determine whether the two services have problems with supply support arrangements similar to those experienced by the Air Force.

CHAPTER 4

FOREIGN GOVERNMENTS NOT CHARGED

ACTUAL COST FOR ITEMS PURCHASED

DIRECTLY FROM CONTRACTORS

Millions of dollars in subsidies to foreign governments resulted from a serious breakdown in the Air Force's accounting system. Controls were inadequate to insure that all costs related to procuring items for foreign countries were accounted for and recovered.

In a limited test of Army transactions, we found that in one instance the Army had used $330,000 in Government-owned spare parts in a sale of trucks but had not included this amount in billing the foreign government.

PRICING REQUIREMENTS ON SALES OF ARTICLES PURCHASED DIRECTLY FROM CONTRACTORS

The Arms Export Control Act of 1976 requires that foreign governments pay the full amount of contracts for new procurement to insure the United States against any loss.

Defense Instruction 2140.1 requires that full contract cost plus appropriate surcharges for administrative, transportation, packing and crating, and other indirect cost be recovered from foreign governments on items sold from new procurement. The Instruction also requires that the cost of Government-furnished material, contract services, and other recurring support be recovered.

SERIOUS BREAKDOWN IN AIR FORCE CONTROL

In reviewing selected sales we found that the Air Force was making substantial errors and cost exclusions in accounting and billing for costs relating to procuring items for foreign countries.

- --In one case involving sales of test benches, a variety of errors and cost exclusions resulted in underbillings of $1.2 million.

- --In another case involving sales of F-5 spare parts, weaknesses in the Air Force accounting system resulted in failure to charge the final contract price; and in many instances no billings were made for items shipped.

--In a third case involving the sales of contractor services relating to jet engine test stands, the Air Force accounting system did not provide for accumulating the cost of the services for billing purposes.

Sale of test benches

Our review of sales of 67 test benches showed that the Air Force underbilled foreign governments $1.2 million. A large portion of the underbilling was due to not accounting for and billing the cost of Government-owned materials. Government-owned materials are frequently provided to contractors for use in manufacturing or overhauling items for the Defense Department. This material, known as Government-furnished material, is provided free of charge to the contractor and is not part of the contract price for the items being made or repaired. The Government-owned material used for each test bench cost approximately $6,000. In many instances this amount was excluded in billings.

Other causes for the underbilling included failure to account and bill for transportation costs, lack of control in correcting a major key punch error, and failure to bill for any of the costs of procuring four of the test benches.

We notified Air Force officials of our findings, and they took action to correct earlier billings. By the end of our review, $1.08 million of the underbilling had been collected.

We have been advised by Air Force officials that action is being taken to redesign accounting systems to identify charges for Government-furnished materials applicable to foreign sales. Further, the Air Force Audit Agency was requested to make a detailed audit of foreign sales involving Government-furnished materials. To date, the Air Force Audit Agency at two locations has identified $5.8 million in undercharges to foreign governments for Government-furnished material. Air Force auditors told us that the $5.8 million was later billed and collected from foreign governments.

Sales of F-5 spare parts

In reviewing sales of F-5 aircraft spare parts, we found that foreign governments were being routinely charged erroneous prices for items purchased through contracted procurements because Air Force accounting systems were not designed to account for and bill the final contract price. In many instances no billings were made for items shipped.

When new weapon systems are introduced into Defense Department inventories, spare parts needed for support are normally concurrently procured through initial provisioning contracts. Under these contracts, the manufacturer of the weapon system provides the needed support equipment and spare parts peculiar to the weapon system. The quantities of support equipment and spare parts ultimately procured through initial provisioning are normally based on Air Force and contractors' estimates.

The F-5 aircraft system was purchased predominately for sale to foreign governments. Multimillion-dollar contracts for initial provisioning of equipment and related spare parts peculiar to F-5 aircraft were awarded to the aircraft manufacturer. For the contract we reviewed, the contractor provided the estimated cost of items to be procured by the Air Force. Final prices were later negotiated between the contractor and Air Force officials. As prices were finalized, a formal modification was made to the basic contract. To recover actual cost, the Air Force had to charge the foreign government the final price of the articles purchased from the contractor.

The Air Force system which provides pricing data to foreign sales billing systems was not designed to record and bill price modifications resulting from contract negotiations. Consequently, the actual cost to the Air Force for most of the items purchased for foreign governments was not the same as the price charged.

For example, the United States agreed to sell F-5E fuel tanks to one foreign government. The tanks were procured from the aircraft manufacturer under an initial provisioning contract dated November 1970. The contractor shipped the fuel tanks directly to the foreign government in February and March 1976. Upon shipment, the Air Force billed the foreign government $5,962 each which was the initial estimated cost of the fuel tanks.

In July 1976, the contractor negotiated with the Air Force for a final price of $9,246 for each fuel tank. The Air Force's system used to price items sold to foreign governments did not record and bill the change in price; consequently, over $62,000 of contract cost incurred by the Air Force was not recovered.

We reviewed 381 shipments to a foreign government consisting of 267 line items valued at $1.5 million which were procured from the F-5 manufacturer. As shown below, 281 of the 381 shipments (74 percent) were billed at erroneous prices. Also, 65 shipments (17 percent) were not billed at all.

Extent of Erroneous Billings to One Foreign Government

Number of shipments	Billing results	Percent of total shipments	Net value of overbilling and underbilling(-)
9	Recently shipped	2	(a)
26	Correctly billed	7	-
143	Overbilled	38	$346,744
138	Underbilled	36	-165,274
65	Not billed	17	-315,778
381		100	-$134,308

a/Since the shipments were made within a short time of our review no billings had been rendered.

Using the sale of the fuel tanks as an example, we informed Air Force officials of the mischarges that were occurring and of the billings that were not made. The officials acknowledged that a problem existed in identifying and updating contract prices and in insuring that billings were made for all items shipped. The Air Force was studying ways to correct the system's problem.

Sale of contractor services relating to jet engine test stands

Air Force accounting systems do not include the cost of contractor assistance with the cost to be recovered in the sale of articles. Consequently, in the case we reviewed, these costs were not recovered from foreign governments.

A contract for jet engine test stands which were sold to foreign governments included a requirement for the contractor to set up and calibrate the stands. The contractor was to receive a fee of $1,687 for each test stand calibrated, plus transportation and incidental costs. The contractor assistance fee was a separate charge in the contract and independent of the basic price of the test stands. The

Air Force accounting system did not provide for identifying these costs so that they could be included in billing the foreign governments.

We informed the Air Force of the subsidies being provided to foreign governments on the test stand sales. It agreed with our findings and implemented corrective changes to the accounting system to identify and recover contractor assistance cost. We estimate that about $90,000 will be recovered. In the future recoveries should be made as a result of changes to the system in identifying and billing for such cost.

COST OF GOVERNMENT-PROVIDED SPARE PARTS NOT RECOVERED BY ARMY

In overhauling trucks for sale to a foreign country, an Army depot used Government-provided spare parts valued at $330,000. These spare parts were part of an inventory valued at $8.4 million which had been transferred without charge to the depot from another Army installation. Because the depot did not pay for the spare parts, the accounting system did not include the cost of the spares as a charge to the foreign government.

After we questioned this transaction, the Army took action to recover the cost of the spares and indicated that, in the future, the cost of the material that had been provided free of charge to the depot would be accounted for and recovered from foreign governments.

CONCLUSIONS

To insure that foreign governments do not receive subsidies through the foreign military sales program, the Air Force must improve its system for new procurement sales to properly account and bill for such costs as Government-furnished material, transportation, and contractor assistance. Further, the Air Force must improve its controls so that (1) the final contract price is charged for items sold to foreign governments and (2) billings are made for all items shipped.

For recovering costs up to and including final billing, the Defense standard sales contract provides that estimated costs may be adjusted when they are not commensurate with actual costs incurred. Therefore, any costs which were not recovered by the Air Force on those sales contracts for which final billing had not been made could and should be subsequently billed.

As to undercharges which may be found after final billing, Instruction 2140.1 provides that adjustments to final billings are permitted when there are unauthorized deviations from Defense pricing policies.

The longer the Air Force takes to attempt to collect undercharges, the more difficult it will be to recover these amounts. Until action is taken to attempt to collect the undercharges, it should not make final billings for contracts in which undercharges occurred.

RECOMMENDATIONS

We recommend that the Secretary of Defense have the Air Force

--make a comprehensive review of its system for accounting and billing for contractual procurement sales and institute controls necessary to insure that all applicable costs are recovered and

--make a reasonable effort to collect from foreign governments for underbillings related to contractual procurement sales.

CHAPTER 5

OTHER PROBLEMS AFFECTING COST RECOVERY

ON ITEMS SOLD TO FOREIGN GOVERNMENTS

Foreign governments are also being subsidized because:

--The Defense Department's pricing policy does not contain criteria for pricing articles that are replaced through repair rather than procurement.

--The military services do not charge foreign governments a proportionate share of normal inventory operating stock losses on sales of nonstock fund items.

FAILURE TO PROVIDE PRICING GUIDANCE FOR ITEMS REPLACED THROUGH REPAIR

Because the Department of Defense does not prescribe a pricing policy for nonstock fund items which are replaced through repair, the Air Force, at one location alone, subsidizes foreign sales by over $1 million annually.

Air Force nonstock fund inventories contain items which have not been purchased in many years because there is no readily available procurement source. To maintain satisfactory inventory levels and provide support to the Defense Department and foreign governments, these items are continuously repaired in lieu of procuring new items. Over a period of time, repair and related cost for each repair can exceed the price originally paid for the items by the Air Force.

Defense pricing policy does not provide guidance for determining the sales price of items replaced through repair. Instead the policies provide for prices to be based on either standard cost (last known procurement cost) or replacement cost (estimated future procurement cost). The Air Force charges foreign governments standard cost for items which are repaired instead of replaced through procurement. As a result, it takes the loss for a large part of repair and the related cost as indicated below.

Comparison of Standard Cost and the Cost To Repair Items Sold to Foreign Governments

Item sold	Quantity sold	Air Force standard cost	Amount recovered	Actual repair cost per item	Total cost incurred	Repair cost not recovered by Air Force
Valve	24	$ 88.00	$ 2,112.00	$ 230.00	$ 5,520.00	$ 3,408.00
Valve	41	86.01	3,526.41	146.04	5,987.64	2,461.23
Start generator	39	551.00	21,489.00	1,116.89	43,558.71	22,069.71
			$27,127.41		$55,066.35	$27,938.94

In February 1976 and again in April 1977, we advised Air Force officials of the problems in recovering the repair cost of items sold to foreign governments. In April 1977 one Air Logistics Center changed its method of pricing items which are frequently repaired in one of its divisions. The division manages about 5,000 of the 35,954 nonstock fund items at the Center. The new pricing method compared repair cost to the standard cost of items shipped to foreign governments. In those instances where repair cost exceeded standard cost, the higher repair cost was charged to the foreign government. During 1 month, the Air Logistics Center recovered about $89,000 more than would have been recovered using standard cost. Over a 1-year period, such additional recoveries will amount to over $1 million.

We suggested that the Center advise the Air Force Logistics Command of the results of the pricing method so that a consistent pricing policy could be formulated to recover the cost of items being replaced through repair programs. We also advised Defense officials of the need to provide a pricing policy for items which are replaced through repair.

INVENTORY OPERATING STOCK LOSSES NOT RECOVERED

The Department's pricing policies and the pricing and billing systems used by military services to recover normal inventory losses were inadequate. We estimate that in the Air Force alone, $30 million in normal inventory losses are not recovered each year.

Inventory operating stock losses, such as pilferage, damage, obsolescence, and other losses, are a normal cost of operating the Defense inventory system, and to the extent that foreign governments purchase articles from this system, they should share in these losses. This is consistent with the congressional intent of the Arms Export Control Act of 1976 that the foreign military sales program not be subsidized by Defense appropriations.

On September 8, 1977, in a letter to the Secretary of Defense, we pointed out that for at least 8 years, Defense instructions have required that the military services recover normal inventory losses under supply support arrangements and that the military services have never implemented this requirement as it relates to sales of nonstock fund items (FGMSD-77-43).

We also pointed out that, for nonstock fund items sold through sales agreements other than supply support arrangements, Defense instructions do not require, nor do the military services attempt, recouping for normal inventory losses.

We recommended that the Department require that normal inventory losses be included in charges to foreign governments for all nonstock fund items sold from Defense inventories, that the military services implement the Defense requirements, and that the military services attempt to recover previously unbilled costs for normal inventory losses.

In a letter dated November 17, 1977, the Assistant Secretary of Defense (Comptroller) did not concur in our recommendations. He indicated that, for items sold under supply support arrangements, separate records must be kept of actual losses of items being stored for a foreign customer and that, since GAO did not disclose any evidence of charges being assessed by the military services to customers, it could mean that no inventory shortages had been found.

The military services do not account for actual losses of nonstock fund items held for foreign customers. No separate records are maintained which show normal inventory losses for items originally purchased for sales to foreign customers. Such an accounting would be impractical, if not impossible. Even though items are purchased in anticipation of foreign sales, once the items are in inventory, they are commingled with like items purchased for Defense needs. Consequently, when shortages are found during inventory, the losses are charged to the Defense inventory without considering the intended or eventual owner of inventory items.

As to charging inventory losses for items purchased through other than supply support arrangements, the Assistant Secretary said that such charges are not made because under these agreements the buyer is not entitled to the benefits associated with maintaining the inventory. He said that requisitions under these other agreements are placed in a "back order" status unless stocks are above the approved level for the item being requisitioned.

It is our view that, when a foreign government's requisitions are filled from a Defense inventory, the foreign government is receiving the benefits of the Department's maintaining the inventory and therefore (as we have noted above) the foreign government should share in the total cost of maintaining the inventory--including the cost of inventory operating stock losses.

Military service officials have also expressed concern over the failure to recover normal inventory losses in the sale of nonstock fund items. In a May 1976 memorandum to a higher command, the comptroller of a major Army command said that 75 percent of nonstock fund issues were to foreign governments and therefore a charge for normal inventory losses appeared appropriate. In an April 1977 message to Air Force headquarters, the Air Force Logistics Command said that, when purchasing nonstock fund items from inventory, the customer should share in the cost of normal inventory losses.

CONCLUSIONS

Contrary to the intent of the Congress, foreign countries are receiving large subsidies through the foreign military sales program because of poor pricing policies and practices for items sold from inventory.

RECOMMENDATIONS

We are therefore recommending that the Secretary of Defense require that:

--A pricing policy be formulated for items replaced through repair. Pricing criteria should require that the higher of standard cost or repair cost be charged to foreign governments.

--The military services identify all items which are routinely repaired in lieu of repurchase. The military services should reprice these items and attempt to recover previous undercharges from foreign governments.

We are also recommending that the Secretary of Defense reconsider the recommendations we made in our September 8, 1977, report in which we said that the Secretary should direct:

--The Department to change its pricing policy for foreign military sales, requiring the inclusion of normal inventory losses in charges to foreign governments for all nonstock fund items sold from Defense inventories.

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

--The military services to make every reasonable 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.

CHAPTER 6

NEED FOR IMPROVED ADMINISTRATION OF FOREIGN MILITARY SALES PRICING POLICIES AND IMPLEMENTING SYSTEMS

The failure to charge the right amount for equipment and spare parts is symptomatic of the overall problem Defense has experienced in pricing foreign military sales. As shown in appendix I during the past few years we have issued over 15 reports covering a wide range of pricing problems on the recovery of such costs as those for

--training foreign students,

--using U.S. Government-owned plant and equipment, and

--transporting items.

Large-scale pricing and selling of items and services to outsiders is relatively new to Defense. Whereas Defense has developed sophisticated techniques over many years for purchasing items and services, it has had a relatively short time to develop pricing techniques for foreign military sales. Defense has, in large measure, failed to insure that prices of items and services recover all of the costs required in accordance with the law and the intent of the Congress. It has failed because of the

--rapid growth of the foreign military sales program,

--complexity involved in pricing items and services,

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

--priority given to customer satisfaction.

Defense financial management systems were not designed to accommodate the phenomenal growth of the foreign military sales program. Sales for the program grew from less than $1 billion in fiscal year 1970 to an average of over $9 billion a year for fiscal years 1974 through 1977. Because of time pressures, instead of designing and implementing separate systems to identify elements of costs to be included in pricing of items and services, Defense had to add foreign military sales costing requirements to existing financial systems. In several cases, because of a lack of pertinent cost data, Defense had to adopt a surcharge or rate methodology for recouping various costs.

Defense has taken certain actions to improve the administration of foreign military sales. One of the more significant measures has been the creation of a central billing and collection agency--the Security Assistance Accounting Center. We have been informed by Defense officials that this specialized organization has brought a marked improvement in the functions of billing and collecting for foreign sales. Considering the recurring problems Defense has had over the years in the area of pricing and implementing systems, establishment is also warranted of an organization specifically charged with pricing policies and insuring that the military services effectively and consistently apply the pricing policies.

RECOMMENDATION

We recommend that the Secretary of Defense assign specific responsibility for administering pricing policy and monitoring pricing systems to a new organization or some existing organization that can be sufficiently freed from other work to provide careful surveillance over the pricing function.

CHAPTER 7

SCOPE OF REVIEW

We reviewed the military services' accounting systems used for pricing secondary items sold to foreign governments.

Our review included an examination of legislative policies, procedures, documents, transactions, and reports dealing with secondary item sales to foreign governments. We interviewed responsible officials to discuss policies and operating procedures and other related matters.

Our review was made at the following departments and organizations.

- --Departments of Defense and the Army, Navy, and Air Force, Washington, D.C.
- --Air Force Logistics Command, Dayton, Ohio
- --Air Force Systems Division, Dayton, Ohio
- --San Antonio Air Logistics Center, San Antonio, Texas
- --Warner Robins Air Logistics Center, Warner Robins, Georgia
- --U.S. Army Materiel Development Readiness Command, Washington, D.C.
- --U.S. Army Tank-Automotive Readiness Command, Warren, Michigan
- --U.S. Army Missile Readiness Command, Redstone Arsenal, Alabama
- --Red River Army Depot, Texarkana, Texas
- --Corpus Christi Army Depot, Corpus Christi, Texas
- --Navy International Logistics Control Office, Philadelphia, Pennsylvania
- --Navy Aviation Supply Office, Philadelphia, Pennsylvania
- --Navy Ships Parts Control Center, Mechanicsburg, Pennsylvania

PREVIOUS GAO REPORTS ON RECOVERY OF SALES COSTS

The inadequacies of Defense accounting systems for pricing foreign military sales have been a continuous concern to the Congress and the General Accounting Office. Following is a list of the reports we have issued through the years.

--"The Department of Defense's Continued Failure to Charge for Using Government-owned Plant and Equipment for Foreign Military Sales Costs Millions" Report to the Congress. April 11, 1978, FGMSD-77-20.

--"Sales of Inventory Items to Foreign Governments Do Not Recover Normal Inventory Losses" Report to the Secretary of Defense. September 8, 1977, FGMSD-77-43.

--"Inadequate Methods Used to Account for and Recover Personnel Costs of the Foreign Military Sales Program" Report to the Senate Committee on Armed Services. October 21, 1977, FGMSD-77-22.

--"Improvements Are Needed to Fully Recover Transportation and Other Delivery Costs Under the Foreign Military Sales Program" Report to the Secretary of Defense. August 19, 1977, LCD-77-210.

--"Millions of Dollars of Costs Incurred in Training Foreign Military Students Have Not Been Recovered" Report to the Congress. December 14, 1976, FGMSD-76-91.

--"Defense's Reexamination of Its Fiscal Year 1978 Budget Related to Reimbursements for Foreign Military Sales" Report to the Chairman, House Appropriations Committee. May 6, 1977, FGMSD-77-40.

--"Defense Action to Reduce Charges for Foreign Military Sales Training Will Result in the Loss of Millions of Dollars" Report to Congressman Clarence D. Long. February 23, 1977, FGMSD-77-17.

--"Reimbursement to the Marine Corps for Costs Incurred in the Training of Foreign Military Students" Report to Lt. Gen. H. M. Fish, Director, Defense Security Assistance Agency and Deputy Assistant Secretary (ISA), Security Assistance. July 15, 1976, B-165731.

--"Reimbursement for Technical Assistance and Training Services Provided to Foreign Governments by the Department of Defense" Report to the Secretary of Defense. July 13, 1976, FGMSD-76-64.

--"Reimbursement for Foreign Military Student Training" Report to the Secretary of Defense. December 1, 1975, FGMSD-76-21.

--"Pilot and Navigator Training Rates" Report to the House Committee on Appropriations. April 11, 1975, FPCD-75-151.

--"Reimbursements from Foreign Governments for Military Personnel Services Provided Under the Foreign Military Sales Act" Representative Les Aspin. August 16, 1974, ID-75-6.

--"Recovery of Costs to the Government for Producing Weapons for Sale to Foreign Governments" Report to the Secretary of Defense. April 9, 1973.

--"Recovery of Costs of Government-owned Plant and Equipment" Report to the Secretary of Defense. October 7, 1974, FGMSD-75-5.

--"Airlift Operations of the Military Airlift Command During the 1973 Middle East War" Report to the Congress. April 16, 1975, LCD-75-204.

--"Action Needed to Recover Full Costs to the Government of Producing Weapons for Sale to Foreign Governments" Report to the Secretary of Defense. September 7, 1972, B-174901.

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