BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Cost Waivers Under The Foreign Military Sales Program: More Attention And Control Needed

After the Arms Export Control Act was passed on June 30, 1976, Defense authorized or considered cost waivers totaling over $500 million on sales to foreign countries. The act provides that under certain conditions nonrecurring research and development costs and other costs associated with a sale may be waived (i.e., not charged to the foreign country) by Defense.

Defense is not required to report to the Congress on the values of and reasons for cost waivers. Such information would strengthen congressional oversight and control of the sales program.

GAO also noted many instances where millions of dollars in costs were intentionally not charged by Defense.

GAO is recommending that the Congress be informed of cost waivers and that Defense make every reasonable effort to recover from foreign governments certain costs which should not have been waived.

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

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

This is the unclassified version of our classified report that discusses the need for more attention and control of waivers granted by the Department of Defense under the Foreign Military Sales program.

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 Director, Office of Management and Budget; the Secretary of Defense; and the Secretaries of the Army, Navy, and Air Force.

James B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

COST WAIVERS UNDER THE FOREIGN MILITARY SALES PROGRAM: MORE ATTENTION AND CONTROL NEEDED

D I G E S T

The Congress, in passing the International Security Assistance and Arms Export Control Act of June 30, 1976, for the first time specified the circumstances in which the Department of Defense could waive certain costs under the foreign military sales program. Over the next 15 months, the Department 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 this information would improve its oversight and control of the program.

Further, GAO found that Defense and military service officials were intentionally undercharging foreign governments millions of dollars. The actions were not in accordance with pricing requirements specified in Defense regulations and intended by law.

NEED FOR THE CONGRESS TO BE INFORMED OF COST WAIVERS

The Arms Export Control Act provides that charges for nonrecurring research, development, and production costs and for the use of Government-owned assets can be waived or reduced if the sale would significantly advance either (1) U.S. interests in North Atlantic Treaty Organization (NATO) 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 determination to the Defense Department.

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The Department is not required to get congressional approval before authorizing waivers, nor is it required to report to the Congress on the reasons for and amounts of waivers. Furthermore, the value of waivers is not included in sales figures under the President's arms sales ceiling.

In the largest cost waiver case GAO reviewed (the anticipated sale of the Airborne Warning and Control System to NATO countries), the planned waiver will no doubt comply with congressional intent and result in NATO 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 U.S. interests in NATO standardization, Defense officials used the cost waiver provision to justify waiving millions in nonrecurring research and development costs on the proposed sale of a missile to a NATO country. The waiver was authorized after the foreign country balked at paying the charge. The Department authorized the waiver of additional millions in nonrecurring research and development costs on a second proposed missile sale to the same country because of the precedent set in granting the first waiver. (See pp. 4 and 5.)

The Congress has made it clear that the foreign military sales program should not be used to subsidize foreign governments. It is, therefore, important that costs be waived only in accordance with congressional intent.

The Defense Department has not developed specific criteria for granting cost waivers because it believes 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. GAO agrees 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, GAO believes that the Congress should be informed of the amounts being waived and the specific reasons for granting the waivers. This would afford the Congress a means to measure whether Defense is acting within the intent of the law and would strengthen congressional oversight.

GAO is recommending that the Congress amend the Arms Export Control Act to require that Defense include the value of and explanation for cost waivers in the required notification reports on foreign military sales.

GAO is also recommending that, until the Congress has had an opportunity to consider legislative changes, the Secretary of Defense include the value of and explanations for cost waivers when he submits to the Congress those notification reports on foreign military sales required by the Export Control Act. Defense told GAO that it could, if required by the Congress, provide additional information on a classified basis.

RECOVERY OF ROYALTY FEES

Defense authorized the waiver of millions in royalty fees for use of a U.S.-developed technical data package. 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 foreign military sales, the act does not require that the fees be charged. GAO believes foreign governments are being subsidized, to the extent they receive a benefit, where they are given free use of a technical data package.

GAO is recommending that the Congress amend the act to require that royalty fees be charged on foreign military sales. GAO is also recommending that the Congress decide under what circumstances, if any, Defense

would be permitted to waive the charges. (See ch. 3.)

FOREIGN GOVERNMENTS INTENTIONALLY UNDERCHARGED ON CERTAIN SALES

In addition to cost waivers, GAO noted other instances which have resulted in foreign governments being knowingly undercharged, and thus subsidized, by millions of dollars. As stated previously, the Congress has made it clear that foreign governments should not be subsidized through the foreign military sales program. GAO found, however, that:

--After various foreign governments complained about high prices, Defense and State Department officials directed the military services to charge prices which did not include all costs. On four sales cases the military services were directed to omit about $7.9 million. For instance, although Defense officials told a foreign country that the Department was required by law to recover the cost of administering the foreign military sales program, the foreign country persisted in its efforts to have the charge reduced. Eventually, the charge was reduced from $3.8 million to $2.1 million. In another instance, because a sales price was directed by high-level officials, military officials did not charge a foreign government $2 million of the costs which should have been reimbursed to the United States.

--The Army intentionally did not charge a foreign country appreciable costs incurred to overhaul equipment. Overhaul costs were greater than originally anticipated. Instead of charging the foreign country for these costs as intended by law and required by Defense pricing policies, the Army improperly transferred the costs to an Army overhaul project, thereby subsidizing the foreign country.

--Although being told by its internal audit agencies and military service study teams that $75 million in applicable costs had not been charged foreign governments, the military services did not bill for these costs.

GAO is recommending that the Secretary of Defense direct that:

--The military services make every reasonable effort to recover applicable costs identified by their internal auditors and other service personnel as not being charged to foreign governments.

--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 government accounts, (2) determine whether similar improper cost transfers have taken place and, if so, attempt to bill foreign governments for the undercharges.

The Defense Department said it is concerned about any failure to comply with its policies and will request that the military departments review the GAO findings and take corrective action where its policies were not followed.

Tear Sheet

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CHAPTER 1

INTRODUCTION

The foreign military sales program grew from about $1 billion in fiscal year 1970 to over $11 billion in fiscal year 1977. The rapid growth has caused considerable congressional concern over the program's cost, operation, direction, and control. To strengthen its oversight of the program, the Congress passed the International Security Assistance and Arms Export Control Act (22 U.S.C. 2151) on June 30, 1976, which amended the Foreign Military Sales Act of 1968. The Arms Export Control Act placed stringent reporting requirements on the executive branch, clarified and strengthened cost recovery requirements, and specified the types of charges that could be reduced or waived by the President.

The act requires that, before an offer is made to sell Defense articles or services valued at $25 million or more or any major Defense equipment valued at $7 million or more, the President must submit a notification to the Congress which shows

--the foreign country or international organization to which the offer is being made,

--the dollar amount of the offer and the number of articles or the extent of services involved,

--a description of the article or service being offered, and

--the military service or other agency making the sales offer.

The act sets forth the following cost recovery requirements for four general categories of sales.

1. For articles from Defense stocks (inventories) not intended to be replaced--not less than the actual value.

2. For articles intended to be replaced--the estimated replacement cost of the article.

3. For Defense services--the full cost of furnishing such services.

4. For procurements for cash sales--the full amount of contract without any loss to the United States.

The act further requires that sales prices include the cost of administering the foreign military sales program; the cost of using Government-owned plant and production equipment; and a proportionate amount of any related nonrecurring research, development, and production costs. The legislative history of the act indicates that the Congress intended that indirect as well as direct costs be recovered so that the foreign military sales program would not be subsidized by Department of Defense appropriations.

The act does allow some leeway. The President is permitted to reduce or waive charges for nonrecurring research, development, and production costs and for the use of Government-owned plant and production equipment if the sale would "significantly advance" either U.S. interests in North Atlantic Treaty Organization (NATO) standardization or foreign procurement in the United States under coproduction arrangements.

We undertook this review to determine if there is a need to strengthen congressional control and oversight over the waiving of costs by Defense.

CHAPTER 2

CONGRESSIONAL OVERSIGHT AND CONTROL NEEDED FOR COST WAIVERS

Oversight and control is needed over cost waivers to ensure compliance with the congressional intent that foreign governments not be subsidized through foreign military sales.

The Arms Export Control Act does not explain what is meant by the term "significantly advance," leaving this determination to the Defense Department. Congressional approval is not required for cost waivers, nor is the Department required to report to the Congress on the reasons for and amounts of waivers. We found that it is difficult to determine whether a sale would significantly advance standardization or coproduction.

CRITERIA FOR COST WAIVERS

As discussed on page 2, the Arms Export Control Act provides that nonrecurring research, development, and production costs and charges for the use of Government-owned plant and production equipment can be reduced or waived, if the foreign sale would significantly advance

--U.S. interests in NATO standardization or

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

The Arms Export Control Act and its legislative history, however, do not indicate what the Congress meant by the term "significantly advance," leaving this determination, which by its nature is largely subjective, to the Defense Department. Also, although the Arms Export Control Act requires the President to (1) report to the Congress on the amount of sales to each foreign government and (2) submit to the Congress a notification on all sales valued at $25 million or more and on sales of major Defense equipment valued at $7 million or more (see p. 1), the President is not required to get congressional approval or report to the Congress on the reasons for and amounts of waivers. In addition, the value of waivers is not included in sales figures under the President's arms sales ceiling.

After passage of the Arms Export Control Act, Defense revised its Directive 2140.2 which contains pricing policy

on the recovery of nonrecurring costs on sales to foreign governments. The revised instruction, dated January 5, 1977, provided that foreign governments be charged a proportionate amount of nonrecurring research, development, and production costs and cited the specific cost waiver provisions of the act. However, Defense did not develop criteria for applying cost waivers so as to ensure that foreign governments would not be subsidized through the sales program.

COST WAIVERS AUTHORIZED BY DEFENSE

The following cases show Defense's application of cost waiver provisions of the Arms Export Control Act and the magnitude of cost waivers.

Sale of the Deleted

In a November 17, 1976, memorandum, the Director, Defense Security Assistance Agency, recommended that the Deputy Secretary of Defense waive all nonrecurring research and development costs and asset-use charges on the sale of the Deleted Deleted to the Deleted because the sale offered an excellent opportunity to implement provisions of the Arms Export Control Act regarding the reduction or waiver of certain applicable costs. The memorandum did not demonstrate the extent to which the waiver would advance NATO standardization but merely stated that the sale would increase standardization while enhancing the capability of the Deleted force.

On November 19, 1976, the Deputy Secretary of Defense authorized a reduction in the amount of nonrecurring research and development costs to be charged the [Deleted] The Deputy Secretary approved the inclusion of a 4-percent surcharge, or [Deleted] The proportionate amount (i.e., the total nonrecurring research and development costs divided by the number of missiles to be produced) of such costs equals [Deleted] Since the proposed sale is for [Deleted] missiles, the total price reduction could amount [Deleted]

Sale of [Deleted] missile

The [Deleted] requested price estimates for the proposed acquisition of [Deleted] missiles. In response the acting Director, Defense Security Assistance Agency, in a January 19, 1977, memorandum to the Deputy Secretary of Defense, recommended a 4-percent surcharge for the recovery of nonrecurring research and development costs. The 4-percent surcharge was being recommended to cover the research and development cost in the sales price and to insure consistency with the Department's cost recovery policy on the sale of the [Deleted] missile discussed above. The Director did not address the impact of the sale on NATO standardization or demonstrate that the sale significantly advanced standardization. The Deputy Secretary nevertheless approved the waiver.

In January 1977 the Director informed the Navy's Director, Security Assistance Division, that in accordance with the Department of Defense Directive 2140.2, the research and development charge for the sale of the [Deleted] missile to the [Deleted] was to be 4 percent of the missile unit price. Thus [Deleted] million in nonrecurring research and development cost will be waived if the [Deleted] buys [Deleted] missiles and about [Deleted] million will be waived if [Deleted] missiles are purchased.

Sale of the [Deleted] missile

In an October 1, 1976, memorandum, the Director, Defense Security Assistance Agency, advised the Deputy Secretary of Defense that negotiations with the [Deleted] were in process concerning the production and purchase of the [Deleted] expressed interest in purchasing [Deleted]

and in entering into a coproduction arrangement for an additional [Deleted] The memorandum noted

[Deleted] In recommending that all nonrecurring research and development costs associated with production of the [Deleted] missile be excluded from the proposed sales agreement with [Deleted] and on future sales of the missile to NATO nations, the Director stated:

[Deleted]

The Director told the Deputy Secretary that this sale offered an excellent opportunity to implement the provisions in the Arms Export Control Act to waive or reduce certain costs if such action would significantly advance standardization with NATO countries or foreign procurement in the United States under a coproduction arrangement. Although this may very well be, the Director's memorandum did not demonstrate the significance of the advancement to standardization or to coproduction.

On October 4, 1976, the Deputy Secretary approved the waiver of all research and development cost on the sale and on all further sales to NATO nations. The waiver to [Deleted] alone amounts to over [Deleted] million.

Cost waivers were approved by Defense on sales to non-NATO nations

On October 4, 1976, the Deputy Secretary of Defense approved the use of a 4-percent surcharge to recover the cost of nonrecurring research and development on sales of the [Deleted] to countries which were not members of NATO. Use of a 4-percent surcharge had been recommended by the Director, Defense Security Assistance Agency, who, in a memorandum dated October 1, 1976, stated that the 4-percent charge was

acceptable under previous criteria and had some acceptance in the foreign market.

The memorandum made no mention of the specific cost waiver provisions of the Arms Export Control Act that were effective October 1, 1976. As discussed previously, the act requires that foreign sales prices include a proportionate amount of any nonrecurring research and development costs and that such charges may be waived or reduced only if the particular sale would significantly advance (1) United States interests in NATO standardization or (2) foreign procurement in the United States under coproduction arrangements. Therefore, the blanket authorization to reduce charges on future sales to non-NATO countries, without regard to whether coproduction was involved, was not permitted by the act.

We discussed this matter on December 1, 1977, with Defense Security Assistance Agency officials. On December 7, 1977, the Director of the Agency, in a memorandum to the military services, stated that the authorization to grant the waivers was no longer in effect.

Sale of the Airborne Warning and Control System

Defense has been negotiating for the sale of [Deleted] [Deleted] Airborne Warning and Control System aircraft to NATO nations. In the interest of standardization, Defense had decided to charge a total of [Deleted] [Deleted] million for the recovery of nonrecurring research and development costs as opposed to the proportionate amount of about [Deleted] million. This planned waiver of about [Deleted] million, which is the largest we reviewed, will no doubt comply with congressional intent regarding NATO standardization.

Difficulties in developing and applying cost waiver criteria

In an April 7, 1978, letter the Director, Defense Security Assistance Agency, said that developing specific criteria for implementing the waiver provisions of the Arms Export Control Act would place the Department 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 specific criteria for cost waivers could be disadvantageous to the United States. However, because of the large sums involved in waivers granted, authorized, and under consideration, the Congress should be informed of the amounts being waived and the specific reasons for granting waivers. This would give the Congress the means to ensure that Defense is acting within the intent of the law and would strengthen its oversight of the program.

CONCLUSIONS

The Congress has made clear its intention that the foreign military sales program should not be subsidized by Department of Defense appropriations. The only exceptions to this are those cases where the Arms Export Control Act authorized cost waivers. It is, therefore, important that the cost waiver provisions of the act are properly carried out.

To help ensure that the program is not subsidized and to strengthen congressional oversight and control, Defense should report to the Congress on the values of and reasons for cost waivers.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress amend the Arms Export Control Act to require that Defense include the values of and explanations for cost waivers in the required notification reports on foreign military sales. This can best be accomplished by adding an additional reporting requirement to section 36(b)(1) of the act. We will provide specific legislative language if the Congress so desires.

RECOMMENDATION TO THE SECRETARY OF DEFENSE

We recommend that, until the Congress has had an opportunity to consider legislative changes, the Secretary of Defense include the value of and explanations for cost waivers when submitting notification reports on sales required by the Arms Export Control Act.

AGENCY ACTIONS

In his April 7, 1978, letter, the Director of the Defense Security Assistance Agency 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 NATO standardization objectives with other countries. The Director said that, if the Congress required additional information, the Department could provide it on a classified basis.

In a February 9, 1978, letter (see app. II), the Deputy Assistant Secretary of State for Budget and Finance said that the State Department had no substantive objections to the matters discussed in this report.

CHAPTER 3

RECOVERY OF ROYALTY FEES

The Deputy Secretary of Defense authorized the waiver of about [Deleted] million in royalty fees on a coproduction arrangement with [Deleted] pertaining to the [Deleted] missile. 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 foreign military sales, the act does not require that the fees be charged.

Department of Defense Instruction 2140.1 defines royalty fees as a payment to the United States for the use of a technical data package in the production of Defense articles outside the United States by a foreign government. Under the coproduction arrangement, the [Deleted] will be produced in [Deleted] and, therefore, meets the criteria under which charges for royalty fees are required. The Instruction further specifies that royalty fees are a technology charge and should not be confused with the recoupment of research and development costs.

Under the Instruction, foreign governments are to be assessed a fee of 5 percent of the United States' unit price for each item produced by the foreign government for its own use and 8 percent of the United States' sales price for items produced for sale to a third country. On the basis of data contained in the coproduction arrangement, we computed the royalty fee on the sale of the [Deleted] to [Deleted] to be about [Deleted] million.

The Director, Defense Security Assistance Agency, in his April 7, 1978, letter said that, since the act does not specifically require that royalty fees be charged foreign governments and since the fees represent a charge for the benefits to be derived from the use of the data package rather than a recovery of the costs of developing the package, the Department can make an administrative determination as to whether the fees will be charged.

We recognize that the act in addressing the recovery of costs does not provide for the establishment or recovery of royalty fees. The legislative history of the act also is silent on such fees. However, the history indicates that the Congress intended that foreign governments would not be

subsidized through the sales program. In this context, we believe foreign governments are being subsidized, to the extent they receive a benefit, where they are given free use of a U.S.-developed technical data package. Defense recognized this by including royalty fees as a recoverable charge in its Instruction 2140.1. Because of this and the significant amounts of money involved, we believe clarifying legislation is in order.

RECOMMENDATIONS

We recommend that the Congress amend the Arms Export Control Act to require that royalty fees be charged on foreign military sales. We also recommend that the Congress decide under what circumstances, if any, Defense would be permitted to waive the charges. We will provide specific legislative language if the Congress so desires.

CHAPTER 4

COSTS INCURRED ON SALES TO FOREIGN GOVERNMENTS WERE INTENTIONALLY NOT CHARGED

Because pricing requirements specified in Defense pricing instructions and intended by law were not followed, applicable costs were omitted from foreign sales prices. These actions were intentional and resulted in foreign governments' being subsidized by about $8 million in cases we reviewed and another $75 million on selected cases reviewed by the military services' internal auditors and a Navy study team. We found that:

--High-level Defense 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 did not 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 did not 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 additional substantial costs would not be recovered on those sales cases the study team had not reviewed.

--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.

COST RECOVERY REQUIREMENTS

The Foreign Military Sales Act of 1968, as amended (22 U.S.C. 2761), which was in effect at the time the foreign sales cases we reviewed were signed, stated that articles and services may be provided to foreign governments if the foreign governments agree to pay not less than the

value thereof. We believe that this requirement supports a charge commensurate with the cost of the article sold or service rendered. The Congress has long held that the foreign military sales program should not be used to subsidize foreign governments. This intent was reinforced with the passage of the Arms Export Control Act in June 1976 (as discussed on p. 2); its legislative history indicates that the Congress intended that indirect as well as direct costs be recovered.

In implementing the Foreign Military Sales Act and the Arms Export Control Act, the Defense Department has generally required that all direct and indirect costs be recovered on sales to foreign governments, including the cost of administering the sales program and the cost of using Government-owned assets to produce the items. The Department included the following provisions in the standard contract used for sales to foreign governments.

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

--The U.S. Government will attempt to notify the foreign government of price increases which will affect the total estimated contract price by more than 10 percent; but failure to so advise does not alter the foreign government's obligation to reimburse the U.S. Government for the total costs incurred.

--The foreign government will reimburse the U.S. Government if the final cost exceeds the amount estimated in the sales agreement.

DIRECTED PRICING BY GOVERNMENT OFFICIALS RESULTED IN COSTS NOT BEING CHARGED

Defense Department officials directed the military services to charge foreign governments prices which did not cover almost $8 million of recoverable costs on sales we reviewed. Their actions were intentional and resulted in the subsidization of foreign governments through the foreign military sales program.

Administrative costs
not recovered

The Secretary of Defense directed that the administrative charge be reduced by about $1 million on the sale of [Deleted] [Deleted] aircraft to [Deleted] On a sale of this aircraft to [Deleted] Defense and State Department officials directed that the administrative charge be reduced by about $1.7 million.

During negotiations for the purchase of the [Deleted] [Deleted] representatives of the [Deleted] Government vigorously expressed the need to keep costs to an absolute minimum because of their country's poor financial condition. These representatives believed there were many areas where cost could be reduced--particularly by eliminating the administrative charge.

In a [Deleted] memorandum to the Secretary of the Air Force, the Secretary of Defense said that the purchase of [Deleted] would significantly contribute to the NATO alliance. The Secretary of Defense further emphasized that strong, well-trained, and well-equipped [Deleted] The Secretary authorized a reduction in the administrative charge if the Director, Defense Security Assistance Agency, considered the reduction essential to making the sale.

On [Deleted] signed a sales agreement to purchase [Deleted] A fixed charge of $2 million for administrative expenses was included in the agreement. According to the pricing criteria in Defense Department Instruction 2140.1, the administrative charge on this sale should have been about $3 million, or $1 million more than actually charged.

In [Deleted] during negotiations for the sale of [Deleted] aircraft to [Deleted] representatives of the [Deleted] Government also requested that the administrative charge be reduced. Defense and State Department officials stated that the provisions of the Foreign Military Sales Act required the United States to recover all costs of administering the foreign military sales program. Nevertheless, representatives from [Deleted] persisted in their efforts to obtain a reduced charge, and U.S. officials

agreed to reexamine their position. Subsequently, authority was granted to reduce the administrative charge.

On [Deleted] agreed to purchase the [ ] aircraft from the Air Force when informed the administrative charge was being reduced from $3.8 million to $2.1 million.

Full cost of [Deleted] not recovered

Because the price that the Deputy Secretary of Defense directed on a sale of [Deleted] to the [Deleted] Government was too low, the Army could incur costs of about $1.5 million which will not be recouped. The amount recovered was not enough to replace these [Deleted] in the Army inventory.

In [Deleted] signed a contract to purchase [Deleted] at a unit price of [Deleted] The Army Materiel Development and Readiness Command instructed the Army Tank-Automotive Readiness Command--the manager of the [Deleted] to expedite the processing of the sales offer. As a result, Tank Command personnel did not have adequate time to determine whether the price shown on its accounting records--which represented the value of the item for inventory purposes--was sufficient to purchase replacements. As it turned out, the price was not sufficient.

In a July 1974 memorandum, the Director, International Logistics, Army Materiel Development and Readiness Command, was advised that the contractor could produce the [Deleted] for a unit price of [Deleted] if the order was received in time for production to start in August 1974. The memorandum stated that the [Deleted] representatives were aware the price had escalated but refused to pay the increase because they [Deleted]

Subsequently, the Deputy Secretary of Defense sent a memorandum to the Secretary of the Army stating that to reduce the U.S. cost for the sale, a new contract should be prepared. The old unit price of [Deleted] would be charged for [Deleted] to be taken from Army stock, and the contract price of [Deleted] would be charged for [Deleted] to be obtained from the contractor. This was acceptable to [Deleted]

In [Deleted] the [Deleted] were shipped from Army organizations in Europe. Because these organizations were active, the [Deleted] had to be replaced. Proceeds from the sale of the [Deleted] however, were sufficient to replace only [Deleted] because by then the price had escalated to [Deleted].

Consequently, in March 1976 the Tank Command prepared a proposed amendment to the sales contract with [Deleted]. The amendment would have increased the price of the [Deleted] to cover the cost of replacing the [Deleted] in Army stock. While acknowledging an appreciable loss on the sale, the Army Materiel Development and Readiness Command would not amend the contract nor pass the proposed amendment to higher authority for approval or disapproval because the price of [Deleted] had been directed by the Deputy Secretary of Defense. At the time of our review, the loss was estimated to be about $1.5 million.

Overhaul costs not recovered

Defense and State Department officials directed that a price be charged for [Deleted] to be overhauled for sale to [Deleted] which was about [Deleted] lower than the Army's estimated cost of overhauling the [Deleted].

In October 1975 [Deleted] agreed to purchase [Deleted] to be overhauled by the Army for [Deleted]. An Army memorandum said the price directed by Defense and State for overhauling the [Deleted] was too low and would result in a shortfall of [Deleted], or about [Deleted] for the sale. We were unable to determine the actual amount underbilled before completing our review.

IMPROPER COST TRANSFERS AT ARMY DEPOT

Because costs were transferred to other overhaul projects, the Army did not recover about [Deleted] of costs incurred to overhaul trucks for [Deleted].

In [Deleted] the Army offered to sell [Deleted] for [Deleted] [Deleted] signed the contract in [Deleted].

which called for the trucks to be overhauled to U.S. Army standards. Subsequently, the Red River Army Depot discovered the trucks had to be overhauled to foreign military sales standards.

These standards are much more stringent than Army standards. According to a depot official, the vehicles have to be overhauled to a new or like-new condition. Each truck has to be completely disassembled and reassembled, and 270 parts have to be replaced. For the 40 trucks this additional work resulted in a 74-percent increase in labor hours.

The depot accounting system recorded costs of [Deleted] to overhaul the 40 trucks. [Deleted] was billed [Deleted] (the amount of the sales agreement), or [Deleted] less than the recorded costs. By direction of the Army Materiel Development and Readiness Command, the [Deleted] overrun was transferred to other overhaul programs for U.S. forces which were experiencing cost underruns.

We also found that about $123,000 of other applicable costs were not charged to the [Deleted] sale but to programs for U.S. forces and to overhead accounts. The costs not recorded included

--$42,469 for parts charged to 6 other depot programs,

--$42,938 for labor charged to the depot's 5-ton truck engine overhaul program, and

--$37,647 for labor and material for minor maintenance and assembling items shipped with the trucks, i.e., jacks, wrenches, etc., which were charged to the depot supply account.

This made a total of about [Deleted] the Army did not bill [Deleted]

Depot officials told us that transferring costs from a program experiencing overruns to one with underruns is a normal practice. Although the practice may be normal at the depot, it is, in our opinion, clearly improper. First, the practice is not in compliance with the Foreign Military Sales Act which required that foreign governments be charged an amount commensurate with the cost of the article

sold or the service rendered. Secondly, the action to transfer costs to overhaul work for U.S. forces distorted the cost of the services sold and resulted in improperly subsidizing the foreign country with appropriated funds to the extent such funds were used to pay for the overhaul work.

NO PLANS TO RECOVER COSTS IDENTIFIED BY DEFENSE AUDITORS

The military services' internal audit agencies indentified about $65 million in costs which were omitted from sales contracts with foreign governments. Although the sales cases involved were open at the time, the military services did not attempt to recoup the costs. Further, the Navy stopped an internal study of foreign sales pricing and took no corrective action after the study team identified $10 million in unrecovered costs on 6 sales.

Naval Audit Service and Navy study team

In June 1976 the Naval Audit Service reported that the Naval Air Systems Command had not billed for about $2.6 million that should have been recovered on 4 foreign military sales cases. The audit service recommended that the command review all open cases to determine whether all recoverable costs were being charged the foreign governments.

The command agreed to the recommendation and contracted with the Naval Weapons Engineering Support Activity to make the review. In June 1977 the Support Activity had completed its review of 6 of the 409 open foreign sales cases. The 6 cases reviewed were valued at $250 million, whereas the total value of the 409 cases was almost $5 billion. The Support Activity study team identified over $10 million of costs which would not be recovered by the Navy: For instance, $1.6 million for Government-furnished equipment, $2.4 million for training, and $4.7 million in asset-use charges. The study team concluded that for all open cases there was a potential for a recovery of an additional $100 million to $200 million in incurred costs and applicable charges. The team recommended that the remaining open sales cases be reviewed and that the unrecovered costs identified be recovered.

The Naval Air Systems Command, although it did not disagree with the study team's findings, stopped the review and did not attempt to charge foreign governments the $10 million in costs identified for the six cases.

Command officials stated that they had not billed for the costs because of possible international repercussions. They said that higher headquarters would have to approve any such action. However, they provided no evidence to show they had advised higher headquarters of the situation. The command's lack of action will cost the United States $10 million for six sales cases and probably many millions of dollars for those open cases not reviewed.

Air Force Audit Agency

In June 1976 the Air Force Audit Agency reported that the Air Force Systems Command had not included $41 million in recoverable costs in prices to be charged foreign governments for selected sales, as follows:

--Nonrecurring production costs of over $31 million were not included in sales prices.

--Foreign governments' share of costs for the J85-21 engine component improvement program exceeded their cost contributions by $7.3 million. Foreign governments' share of the total costs was $27.1 million although they contributed only $19.8 million.

--Air Force negotiators excluded $2.5 million of costs for six foreign military sales cases valued at $6.4 million, excluding the $2.5 million.

--Recoverable engineering support costs of $363,000 were not included in foreign military sales cases.

--Quality assurance costs of $238,000 were omitted.

The auditors also found that Air Force cost accounting systems were not adequate to make sure that all recoverable costs were included in sales prices. They recommended that pricing procedures be improved for foreign military sales.

Air Force headquarters concurred in the recommendation and took action to revise the pricing manual. The official in charge of followup action on the audit report told us that the Air Force does not plan to go back and reprice the sales cases which were reportedly underpriced unless so directed by the Defense Department.

Army Audit Agency

In November 1975 the Agency reported the pricing procedures used by commands under the Army Materiel Development and Readiness Command were not adequate to ensure that all costs were recovered on sales to foreign governments. The auditors identified over $20 million of costs that had been excluded from the sales prices as shown below:

--Sales of M2 machine guns were underpriced by $19 million because standard inventory prices were not updated to show the current cost. (In a separate review of pricing for the sales of M2 machine guns that included additional sales of the machine guns, we found that sales were underpriced by additional millions.) (LCD-76-414, Mar. 3, 1976, and LCD-77-449, Oct. 7, 1977.)

--Appropriated funds of about $600,000 had to be used in purchasing 2,315 radio sets sold to a foreign government because the price quoted and billed the country was understated.

--Iran was underbilled over $900,000 for certain personnel services because inaccurate reimbursement factors were used in computing the cost.

Although the Army promised to improve its pricing procedures, officials said they do not plan to take any action to recover cost excluded from sales contracts.

CONCLUSIONS

Defense and military service officials have knowingly subsidized foreign governments by not charging them for the costs required under the foreign military sales program.

Defense and military service personnel responsible for pricing foreign military sales should adhere to cost recovery provisions of the law and of implementing Defense regulations.

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

In recovering the costs up to and including final billing, the Department of Defense standard sales contract

provides that adjustments may be made to estimated costs when they are not commensurate with actual costs incurred. Therefore, any costs that were not recovered by the military services on those sales contracts for which a final billing has not been made could and should be billed.

As to undercharges that may be found subsequent to final billing, Instruction 2140.1 provides that adjustments to final billings are authorized when 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 costs from foreign governments. Until action is taken to attempt to collect undercharges, the military services should not make final billings for those contracts in which undercharges occurred.

RECOMMENDATIONS

We recommend that the Secretary of Defense direct that:

--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 foreign military sales.

--The military services review all open foreign military sales cases to ensure that all proper charges are included. In particular, the Navy should reinstitute 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 is charged only to foreign government accounts, and (2) determine whether other similar improper cost transfers have taken place and, if so, attempt to bill foreign governments for the undercharges.

AGENCY ACTIONS AND UNRESOLVED ISSUES

In his April 7, 1978, letter the Director, Defense Security Assistance Agency, said that the Defense Department is concerned about any failure to comply with its policies on pricing and accounting practices and that the

Defense Department Comptroller will request the military departments to review the findings and will take corrective action in those cases where the directives were not followed.

CHAPTER 5

SCOPE OF REVIEW

We reviewed the Department of Defense and military services systems for authorizing, accounting for, and reporting significant costs waived for foreign military sales and the pricing of these sales.

Our review included an examination of legislation, policies, procedures, documents, transactions, and reports dealing with the waiving of costs and the pricing of foreign military sales. We interviewed responsible officials to discuss policies, procedures, and other matters.

We made our review at the following military departments and organizations:

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

--Defense Security Assistance Agency, Washington, D.C.

--Director, Defense Research and Engineering, Washington, D.C.

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

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

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

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

--Red River Army Depot, Texarkana, Texas

--Aeronautical Systems Division, Air Force Systems Command, Wright-Patterson Air Force Base, Ohio

DEFENSE SECURITY ASSISTANCE AGENCY
WASHINGTON, D. C. 20301

7 APR 1978

In reply refer to:
I-1228/78

Mr. D. L. Scantlebury
Director, Division of Financial
and General Management Studies
United States General Accounting
Office
Washington, D.C. 20548

Dear Mr. Scantlebury:

This is in reply to your letter to the Secretary of Defense regarding your draft report dated 29 December 1977 on waivers granted by the Department of Defense under the Foreign Military Sales Program, OSD Case #4789, FGMSD-78-1.

The principal concern of the Department of Defense is that the draft report fails to adequately recognize why Congress authorizes waivers and why the Secretary of Defense exercises waiver authority; namely, to facilitate negotiations for greater standardization and interoperability among NATO countries. Such negotiations involve major expenditures plus sensitive and complex economic, political, and military issues (for more details, see Dewey F. Bartlett, "Standardizing Military Excellence, the Key to NATO's Survival", AEI Defense Review December 1977; also see Comptroller General Report, "Improving the Effectiveness and Economy of Mutual Defense Efforts", 19 January 1978). The draft report, however, proposes the promulgation of detailed reports without indicating how they will contribute to NATO standardization and interoperability and without recognizing how such reports might impede U.S. efforts. Because of this, the Department of Defense objects to the main thrust of the report and opposes the recommendations concerning the use of the waiver authority.

(See GAO note, p. 28.)

In addition, in discussing the non-imposition of surcharges on Foreign Military Sales prices, the report refers to "cost waivers" and implies that these charges are those covered in Section 21(a) of the Arms Export Control Act. Section 21(e) of the AECA provides guidance on the recovery of administrative and nonrecurring "sunk costs," as distinct from current expenditures covered in Section 21(a). Section 21(e)

APPENDIX I

further permits waiver of the recovery of "sunk costs" under certain conditions. In the interests of clarity, the Department of Defense suggests that the GAO draft report be modified to reflect the distinction which the Congress itself has made on this point. Our comments on the GAO draft recommendations follow.

(See GAO note, p. 28.)

The recommendation proposes that the Secretary of Defense include the value of any cost waiver granted when he submits the formal reports required by the Arms Export Control Act. If it becomes public knowledge that certain countries have already been granted waivers, then it would be more difficult to use the granting or withholding of waivers as leverage to help achieve U.S. NATO standardization objectives when dealing with other countries. However, the Department of Defense, could, if required by the Congress, provide additional information on a classified basic.

(See GAO note, p. 28.)

The Department of Defense is concerned about any failures to comply with its policies and the Defense Department Comptroller will request the military departments to review the findings and will take corrective action in those instances where the directives were not followed.

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(See GAO note, p. 28.)

Royalty fees are not a cost; rather they are charges made in addition to those for the recovery of the costs of developing a technical data package. In other words, the fees represent a charge for the benefits to be derived from the use of the data package rather than a recovery of the costs of developing it. It is this distinction that DODI 2140.1 makes. In recognition of the nature of royalty fees, proceeds therefrom are deposited as Miscellaneous Receipts to the Treasury. If they were construed as a recovery of costs, it would be permissible to credit them to Department of Defense appropriation accounts. Because royalty fees are not required to be collected by law, it is our opinion that collection of fees may be waived.

(See GAO note, p. 28.)

The opportunity to review and comment upon the draft report is appreciated. It is requested that this letter be incorporated into the final report as an appendix.

The requested security review is underway and the results will be furnished separately.

Sincerely,

Ernest Graves

ERNEST GRAVES
LIEUTENANT GENERAL, USA
DIRECTOR
DEFENSE SECURITY ASSISTANCE AGENCY

DEPARTMENT OF STATE

Washington D.C. 20520

February 9, 1978

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

Dear Mr. Fasick:

I am replying to your letter of December 29, 1977, which forwarded copies of the draft report: "Cost Waivers Granted By Defense Department Under The Foreign Military Sales Program: More Attention and Control Needed."

The enclosed comments were prepared by the Acting Director of the Bureau of Politico-Military Affairs.

We appreciate having had the opportunity to review and comment on the draft report. If I may be of further assistance, I trust you will let me know.

Sincerely,

Daniel L. Williamson, Jr.
Deputy Assistant Secretary
for Budget and Finance

Enclosure: As stated

GAO DRAFT REPORT: "COST WAIVERS GRANTED BY DEFENSE DEPARTMENT UNDER THE FOREIGN MILITARY SALES PROGRAM: MORE ATTENTION AND CONTROL NEEDED"

The Department of State has no substantive objection to the report as drafted. With respect to the security classification, we believe the classification is proper and concur in the release of the classified information to authorized persons on a need to know basis. It is important that the United Kingdom Sub-Harpoon sale remain classified as to the number of missiles involved (Page 6). This information was never made public and was classified in the formal notification of the sale to the Congress under section 36(b) of the Arms Export Control Act.

(See GAO note below.)

Richard A. Ericson
Acting Director
Bureau of Politico-
Military Affairs

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

(90354)