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Action Needed To Recover Full Costs
To The Government Of Producing
Weapons For Sale
To Foreign Governments

B-174901

Department of Defense

**UNITED STATES
GENERAL ACCOUNTING OFFICE**

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SEPT. 7, 1972



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

DIVISION OF FINANCIAL AND
GENERAL MANAGEMENT STUDIES

B-174901

BEST DOCUMENT AVAILABLE

Dear Mr. Secretary:

This is our report on actions needed to recover the full costs to the Government of producing weapons for sale to foreign governments.

We have been informed that, as a result of our review, Army and Navy industrial funds have begun charging unfunded costs to orders for foreign governments. We would like to be advised of the total amount of unfunded costs billed to foreign governments by Department of Defense industrial funds during fiscal years 1971 and 1972. Further, we suggest that action be taken to insure that Air Force industrial fund policies and procedures regarding recovery of unfunded costs are consistent with Department of Defense regulations.

Copies of this report are being sent today to the Director, Office of Management and Budget; the Secretary of the Army; the Secretary of the Navy; the Chairmen, House and Senate Committees on Appropriations; the Chairmen, House and Senate Committees on Government Operations; and the Chairmen, House and Senate Committees on Armed Services.

Sincerely yours,

D. I. Scantlebury

D. I. Scantlebury
Director

The Honorable
The Secretary of Defense

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ABBREVIATIONS

DOD	Department of Defense
GAO	General Accounting Office

GENERAL ACCOUNTING OFFICE
 REPORT NO. THP
 SECRETARY OF DEFENSE

ACTION NEEDED TO RECOVER FULL
 COSTS TO THE GOVERNMENT OF
 PRODUCING WEAPONS FOR SALE TO
 FOREIGN GOVERNMENTS
 Department of Defense: R-1740-1

D I G E S T

WHY THE REVIEW WAS MADE

During fiscal years 1967 through 1971, the Department of Defense (DOD) sold over \$6.5 billion worth of weapons and related items to foreign governments. These sales are estimated to exceed \$2.8 billion per year for fiscal years 1972 and 1973. Government-owned plant and equipment were used by DOD industrial activities and contractors in producing many of these weapons. The General Accounting Office (GAO) made this review to find out if DOD was recovering a fair share of the cost of Government-owned plant and equipment used in producing weapons for sale to foreign governments.

FINDINGS AND CONCLUSIONS

GAO reviewed the charges for work performed for foreign governments by two of DOD's many industrial activities: the Army Arsenal at Rock Island, Illinois, and the Navy Ammunition Depot at Crane, Indiana.

DOD regulations require these industrial activities to charge non-Federal Government customers, including foreign governments, for the use of plant and equipment and other so-called unfunded costs applicable to the work performed. Neither activity was complying with these regulations.

As a result they did not recover about \$396,000 of unfunded costs on

work orders for foreign governments completed during fiscal years 1969 and 1970. The activities attributed the failure to comply with DOD regulations to a lack of clear and specific instructions from their higher headquarters. (See p. 4.)

GAO also noted that foreign governments were not being charged for the cost of Government-owned equipment used by contractors to produce weapons for sale to such governments. For example, the contractor-operated Cleveland Army Tank-Automotive Plant, in which the Government has invested about \$99 million in plant and equipment, has applied \$92 million worth of work to about 1,600 M109 self-propelled howitzers ordered by foreign governments without a charge for the use of the Government-owned plant and equipment. (See p. 7.)

DOD regulations on this matter are inconsistent. While regulations do not require a charge to foreign governments for the use of Government-owned equipment used by contractors, the regulations do require such a charge when the producer is a Government industrial fund activity.

Failure to include a fair share of the costs of Government-owned plant and equipment in the prices of weapons sold to foreign governments may result not only in an undisclosed loss to the Government but also in a subsidy to the purchaser. DOD recognizes this principle in its own

industrial activities but has not applied it to Government-owned plant and equipment used by contractors.

RECOMMENDATIONS OR SUGGESTIONS

- DOD internal review organizations should periodically examine prices charged to non-Federal Government customers for work performed by DOD industrial activities to insure that DOD regulations are being properly implemented. (See p. 5.)
- DOD should take action to recover for the Government a fair share of the cost of Government-owned plant and equipment used by contractors in the production of equipment for sale to foreign governments and should submit appropriate detailed reports to the Congress when a fair share is not recovered. (See p. 9.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

DOD has (1) taken action to correct the deficiencies revealed in this report concerning DOD industrial activities, (2) agreed with GAO's recommendation that a fair share of the cost of Government-owned plant and equipment should be recovered when defense equipment is produced in Government-owned, contractor-operated plants, and (3) agreed in principle that the Government should recover a fair share of the cost of Government-owned equipment used rent free in contractor-owned plants to produce equipment for sale to foreign governments and said that a study would be made to determine the best way to implement GAO's recommendation.

CHAPTER 1

INTRODUCTION

The General Accounting Office has reviewed the policies and practices of the Department of Defense (DOD) in charging for the use of Government-owned plant and equipment used to manufacture weapons for sale to foreign governments. These weapons are produced, in whole or in part, by:

- Government owned and operated industrial fund activities.
- Contractors using Government-owned plant and/or equipment.

We reviewed the prices charged during fiscal years 1969 and 1970 for weapons produced or worked on for foreign governments by the Army Weapons Command's Rock Island Arsenal and the Naval Ordnance System Command's Crane Ammunition Depot industrial fund activities. We reviewed also the prices charged to foreign governments for weapons produced by (1) the Government-owned, contractor-operated Cleveland Army Tank-Automotive Plant and (2) another contractor using Government-owned equipment.

CHAPTER 2NEED FOR SURVEILLANCE OFPRICES CHARGED BY DOD INDUSTRIAL FUND ACTIVITIES

DOD regulations¹ require industrial fund activities to charge foreign governments and other non-Federal Government customers for both funded and unfunded costs. Funded costs are those paid from the activities' working capital funds. Unfunded costs are those paid from appropriations and include the cost of depreciation of plant and equipment, the pay and allowances of military personnel, and certain other costs.

We reviewed the prices charged for \$9.8 million worth of orders for foreign governments and other non-Federal Government customers completed during fiscal years 1969 and 1970 by the Army's Rock Island Arsenal and by the Navy's Crane Ammunition Depot, and we found that neither activity had included unfunded costs in the prices charged for this work. As a result we estimate that about \$396,000 in unfunded costs were not recovered by the Government.

ROCK ISLAND ARSENAL

During fiscal years 1969 and 1970, the arsenal completed about \$8.3 million worth of orders placed by the Army in behalf of foreign governments. Unfunded costs amounting to an estimated \$336,000 were not charged to these orders.

Arsenal officials informed us that unfunded costs had not been charged because specific instructions that unfunded costs be included in the prices charged for orders placed by the Army in behalf of foreign governments had not been received.

We brought this matter to the attention of the Assistant Secretary of Defense (Comptroller) who, on June 30, 1970, issued a memorandum advising the Army to issue instructions

¹DOD Directive 7410.4, "Regulations Governing Industrial Fund Operations."

to comply with DOD regulations. We were advised that information copies were being sent to the Navy and the Air Force. On October 6, 1970, the Army directed the Army Materiel Command to include unfunded costs in all prices offered to foreign governments after November 1, 1970. The command implemented these procedures on December 18, 1970.

In June 1972 officials at the Rock Island Arsenal informed us that approximately \$326,000 has been added to prices charged to foreign governments for unfunded costs on orders completed by Rock Island Arsenal since January 1, 1971.

CRANE AMMUNITION DEPOT

In February 1970 we observed that the depot was not charging unfunded costs for work performed for foreign customers even though the Naval Ordnance Systems Command had issued instructions to all its components, including Crane, in December 1969, requiring them to comply with DOD regulations. We estimate that the depot failed to recover for the Government about \$60,000 in unfunded costs on \$1.5 million worth of orders completed during fiscal years 1969 and 1970 for foreign governments.

When we brought this matter to the attention of depot officials, they informed us that the instructions were not clear and they requested clarification. The Naval Ordnance Systems Command issued clarified instructions which stated that unfunded costs should be included in the prices charged for work performed on orders for foreign governments, and Crane took action to comply.

CONCLUSION

Because of the significant amounts of money involved and the lack of compliance with DOD regulations indicated by our review, we believe that DOD internal review organizations should periodically examine the prices charged by its industrial fund activities for work performed for foreign governments and other non-Federal Government customers.

RECOMMENDATION

Accordingly we recommend that the appropriate DOD internal review organizations be required to make periodic

examinations of the prices charged to non-Federal Government customers for work performed by industrial fund activities to insure proper implementation of DOD regulations that require the recovery of all costs, including unfunded costs, applicable to the performance of such work.

CHAPTER 3NEED TO INCLUDE CHARGE FOR GOVERNMENT-OWNED PLANT AND
EQUIPMENT USED BY CONTRACTORS IN PRICES OF WEAPONS
PRODUCED FOR SALE TO FOREIGN GOVERNMENTS

Records at Army Weapons Command Headquarters showed that the prices charged for weapons produced for foreign governments in Government-owned, contractor-operated plants did not include a charge for the use of the Government-owned plant and equipment. According to the records, the Cleveland Army-Tank Automotive Plant, which represents a Government investment of about \$99 million in plant and equipment, had performed and billed about \$92 million worth of work on about 1,600 M109 self-propelled howitzers ordered by foreign governments without charging for the use of Government-owned plant and equipment. The records showed also that the prices charged for weapons ordered by foreign governments and produced with Government-owned equipment located in a contractor-owned plant did not include a charge for the use of the Government-owned equipment.

The cost of the use of plant and equipment is a significant element of the cost of production. Although the total amount that is not being recovered from foreign governments for the cost of using Government-owned plant and equipment is not known, it is believed to be substantial.

Foreign governments may place orders for weapons with DOD under the provisions of section 22 of the Foreign Military Sales Act of 1968 (Public Law 90-629). The act provides that the President may enter into contracts for the procurement of defense articles for sale to any friendly country which insures the U.S. Government against any loss on the contract. The act also authorized the President to fix prices to be paid by the purchasing countries and states that (1) prices fixed shall, to the maximum extent possible, be sufficient to reimburse the United States for the cost of the articles ordered and (2) the President shall promptly submit to the Congress a detailed report concerning any fixed-price sales agreement under which the cost to the

United States exceeds the aggregate amount required to be paid by the purchasing country. If the producer is a Government industrial fund activity, the cost of using U.S. Government-owned plant and equipment is required by DOD regulations to be charged to the foreign government. If, however, the producer is a contractor, DOD does not require that the cost of using Government-owned plant and equipment be charged to the foreign government.

We believe the latter practice is inconsistent with DOD industrial fund regulations, the Foreign Military Sales Act of 1968, and the general DOD policy regarding the pricing of sales of defense articles to foreign countries. The DOD policy is that pricing policies and procedures must provide for the charging of all DOD direct and indirect costs.¹ Moreover the prescribed form² for offer and acceptance agreements with foreign governments for such sales advises that the price of the items to be procured shall be at their total cost to the U.S. Government.

Foreign governments also may contract for weapons directly with contractors employing Government-owned equipment. In these cases, DOD procurement directives authorize the rent-free use of Government-owned equipment by the contractors and therefore the cost of the use of such equipment is not charged to the foreign government or otherwise recovered by the United States.³

Another DOD directive,⁴ however, requires that foreign buyers of major defense equipment pay a fair share of such

¹DOD Instruction 2140.1, "Pricing of Sales of Defense Articles and Defense Services to Foreign Countries and International Organizations."

²DD Form 1513.

³Armed Services Procurement Regulation 13-406, April 30, 1971.

⁴DOD Directive 2140.2, "Recovery of Nonrecurring Costs Applicable to Foreign Sales."

nonrecurring costs as rent-free facilities associated with the equipment, regardless of whether the equipment is sold from DOD inventories or is produced by a U.S. producer for sale to a foreign buyer directly or indirectly through DOD. Major defense equipment includes equipment or systems having a total cumulative DOD research, development, test, and evaluation investment in excess of \$50 million or having a total production investment (both recurring and nonrecurring) in excess of \$200 million.

CONCLUSION

In our view, the intent of the Foreign Military Sales Act of 1968 and of general DOD policy is that the full costs to the Government, including a fair share of the cost of Government-owned facilities used in production, should be charged to foreign governments, regardless of whether the items are produced by the U.S. Government, are ordered by the U.S. Government from commercial sources in behalf of foreign governments, or are purchased by foreign governments directly from commercial sources. The failure to include these costs in the prices of weapons sold to foreign governments results in an undisclosed loss to the Government and in a corresponding subsidy to the purchaser. Moreover it is inconsistent to charge foreign governments for Government-owned equipment used by DOD industrial fund activities and not to charge them for Government-owned equipment used by contractors.

RECOMMENDATION

Accordingly we recommend that DOD take action to recover for the Government a fair share of the cost of Government-owned plant and equipment used in the production of defense equipment for sale to foreign governments. We further recommend that DOD submit appropriate detailed reports to the Congress concerning any fixed-price sale made under section 22 of the Foreign Military Sales Act of 1968 in which the aggregate cost to the United States exceeds the amount required to be paid by the purchasing country.

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AGENCY ACTION

The Assistant General Counsel (Fiscal Matters), Office of the Secretary of Defense, agreed that a fair share of the cost of Government-owned plant and equipment should be recovered in the sale to foreign buyers of defense equipment produced in Government-owned, contractor-operated plants. He agreed in principle that a fair share of the cost of Government-owned equipment used rent free by contractors should be recovered when used in the production of equipment for non-Federal Government customers and said that a study would be made to determine the most feasible manner of implementing the recommendation. He stated that DOD would inform us of the results of this study and of the actions taken to implement our recommendations.

Copies of this report are available from the U. S. General Accounting Office, Room 6417, 441 G Street, N W., Washington, D.C., 20548.

Copies are provided without charge to Members of Congress, congressional committee staff members, Government officials, members of the press, college libraries, faculty members and students. The price to the general public is \$1.00 a copy. Orders should be accompanied by cash or check.