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REPORT TO THE CONGRESS

Contracts With Foreign Firms
Should Be Priced
In Local Currency B-146749

Department of Defense

B-146749

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

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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 our report entitled "Contracts with Foreign Firms
Should Be Priced in Local Currency "

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

We are sending copies of this report to the Director, Office
of Management and Budget the Secretary of Defense the Secretary
of the Treasury, the Secretaries of the Army, Navy, and Air Force
and the Director, Defense Supply Agency

James B. Stacks

Comptroller General
of the United States

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ABBREVIATIONS

DCAA Defense Contract Audit Agency

DOD Department of Defense

GAO General Accounting Office

D I G E S T

WHY THE REVIEW WAS MADE

GAO examined Department of Defense (DOD) policies and practices used in selecting the currency to price and pay foreign contracts

Because of the amounts involved, GAO wanted to find out whether existing DOD policies and practices adequately protect the U.S. Government and foreign contractors when currency fluctuations occur

Basic Information

The kind of currency used (the dollar, the currency of the contractor's country, or a combination of these currencies) is of little importance when the rate of exchange is stable. When the exchange rate has a history of significant fluctuation or is expected to change during the contract period, the kind of currency used becomes important (See p. 5)

Foreign contractors generally convert dollars to local currency to pay local obligations. When paid in dollars, contractors, as a result of exchange-rate fluctuations, may receive payments worth more or less in local currency than anticipated when the contracts were priced. When bidding for dollar-priced contracts, a foreign contractor may increase or decrease

its price depending on the gain or loss anticipated from exchange rate fluctuations before payment is received (See p 5)

GAO examined contracts at procurement offices overseas and in the United States that had awarded contracts for about \$800 million to foreign contractors during fiscal year 1971 (See app I)

GAO did not review contracts in countries where the Department of the Treasury held excess currency or near-excess currency (See p 6)

FINDINGS AND CONCLUSIONS

Lack of DOD policy

DOD has not formulated a uniform policy for determining whether to use local currency or dollars in pricing and paying contracts with foreign contractors (See p 7). DOD refrained from doing so on the basis that contracting officers need flexibility to insure that

--currency fluctuations do not result in unjust gain or loss to either the U.S. Government or the contractors and

--payment arrangements do not provide incentives for contractors to speculate on currency fluctuations (See p 8)

This approach has not accomplished the intended purpose, in fact, the opposite appears to have occurred in a number of instances

Because the selection of currency is left to the judgment of area or local commands or contracting officers, a number of different practices exist, sometimes within the same country or continent

For example, the U S. Army and the U S Air Force in Europe, in the absence of instructions from Headquarters, U S European Command, issued different instructions

The Army instructed its procurement offices to solicit and price procurements in the currency offering the maximum price advantage to the United States, however, it gave no guidance for making this determination. GAO found that implementing instructions issued by the four Army procurement offices visited varied (See p 12)

The Air Force instructed its offices to solicit proposals and to award contracts priced in the currency of the contractor's country (See p 13)

Results of diverse practices

The practice of paying some foreign contractors in dollars has resulted in inequities to both the United States and the contractors. For example

--In Korea, contractors have benefited or will benefit by about \$5.8 million on contracts GAO reviewed because the Korean won depreciated in value relative to the dollar (See p 8)

--In Japan, contractors could lose as much as \$4 million on open contracts as a result of the August 1971 devaluation of the dollar (See p 10)

--In Europe, contractors could lose an estimated \$1.6 million by accepting dollar-priced contracts for fiscal year 1972 milk requirements. These contracts were awarded only days before the value of the dollar dropped in Europe (See p 13)

Generally the area or local practices followed the contractors' wishes. In countries where the dollar tends to increase in value, contractors desire to contract in dollars. For example, in Korea the dollar began a steady climb from 276 won to a dollar in September 1968 to 381 won to a dollar in March 1972. In October 1972, when the U S Forces, Korea, attempted to price contracts in won, the Korean contractors refused to bid (See p 10)

In contrast, where the dollar has declined in value, contractors desire to contract in local currency. In Japan before July 1, 1971, military contracts awarded Japanese contractors were in dollars. After the August 1971 devaluation of the dollar, these contractors insisted on pricing in local currency (See pp 10 and 11)

Advantages of pricing and paying contracts in local currency

--The Air Force in Europe has generally priced its contracts in local currency. Its rationale has been that (1) fair and reasonable prices can best be obtained when unknowns, such as

international-currency fluctuations, have been eliminated, (2) contractors may try to make up losses resulting from exchange-rate fluctuations by poor performance or higher prices on future contracts, (3) it wants offers from contractors who are most capable, not those who are willing to assume the biggest risk, and (4) finance offices can handle international currency fluctuations better than procurement offices (See p 13)

--A Naval procurement office in the United States for the past 5 years has generally priced contracts with foreign contractors in local currency. It told GAO this practice has been followed to avoid problems which arise when dollar-priced contracts are affected by exchange-rate fluctuations (See p 14)

--Similarly the U.S. Embassy and Agency for International Development procurement activities generally have priced and paid contracts with Koreans in local currency (See p. 8)

It is extremely difficult to be fair to both the U.S. Government and foreign contractors when contracts are priced in dollars. With a few exceptions, notably in Korea, DOD activities are now pricing and paying foreign contracts in local currency.

Without formal DOD requirements to do so, however, local commands or procuring activities can revert to pricing and paying contracts in dollars as the monetary situation changes and the contractors can see an advantage in using dollars.

GAO believes DOD policy guidance now is critical because of

uncertainty in the international monetary market and changes likely in the near future.

RECOMMENDATIONS

The Secretary of Defense should establish a policy requiring that local currency be used to price and pay foreign contracts unless there is a compelling reason to use dollars, such as a requirement for significant purchases in the United States.

Justifications for pricing and paying contracts in dollars should be approved at a level above the contracting officer. Such policy would protect both the U.S. Government and the foreign contractors in the event of significant currency fluctuations.

A less preferable method would be to pay foreign contracts in dollars subject to provisions for an appropriate price adjustment if the exchange rate fluctuates significantly during the contract period (See p 19)

AGENCY ACTIONS AND UNRESOLVED ISSUES

DOD, although not agreeing to implement GAO's recommendations immediately, said the GAO report has stimulated procurement officials to review procurement and contracting arrangements with foreign contractors.

DOD said an interdepartmental working committee will be organized to study the need for Government-wide guidelines and procedures for pricing and paying foreign contracts overseas. DOD also said that this committee will give careful attention to GAO's comments and suggestions (See pp 19 to 22)

Any study group should develop a uniform policy equitable to both the United States Government and foreign contractors. Speculation on exchange-rate fluctuations should be minimized by establishing a single policy for pricing and paying, except for unusual circumstances, contracts in local currency. The devaluation of the dollar announced in February 1973 highlights the soundness of this

position

MATTERS FOR CONSIDERATION
BY THE CONGRESS

Because of the recent devaluation of the dollar, this report is to inform the Congress of DOD's need to minimize speculation on fluctuations in currency exchange rates in pricing contracts with foreign firms.

CHAPTER 1

INTRODUCTION

We examined the Department of Defense (DOD) policies and practices in selecting the currency to price and pay foreign contracts. Procurement activities awarded these contracts in the United States and overseas and priced them in U S. dollars, the currency of the contractors' country (local currency), or a combination of U S dollars and local currency. The kind of currency used is of little significance when the exchange rate between the dollar and the local currency is stable. When the exchange rate has a history of significant fluctuation or is expected to change significantly during the contract period, the currency used becomes important.

Foreign contractors generally convert dollars received to local currency to pay local obligations. When contractors are paid in dollars, they may receive payments worth more or less in local currency than anticipated when the contracts were priced. If the dollar increases in value, the contractor will be able to convert the dollars received to more local currency than originally anticipated, if the value of the dollar declines, the dollars received will convert to less local currency than originally anticipated.

In bidding on dollar-priced contracts, contractors may increase or decrease their bids depending on the amount of local currency they expect to receive because of exchange-rate fluctuations between the time a price is established and the date of payment. In contrast, if contracts are to be priced in local currency, bids should not be affected by anticipated exchange-rate fluctuations.

We wanted to find out whether DOD policies and practices adequately protect the U.S. Government and foreign contractors when exchange rates fluctuate. We made our review at (1) foreign DOD procurement activities responsible for procurement in Europe, Korea, Japan, Philippines, Okinawa, Taiwan, and Vietnam and (2) a number of DOD procurement activities in the continental United States which award contracts to foreign firms. At each activity visited, we inquired of command and procurement personnel whether contracts were denominated in dollars or foreign currency.

and the rationale for the selection of the currency used. We examined a selective sample of contracts to determine the effect of exchange-rate fluctuations on contract negotiations and the value of the currency received by the contractor as contract payments. We did not review any contracts awarded in countries in which the Department of the Treasury held excess currency or near-excess currency. The Armed Services Procurement Regulation adequately implements the Government's policy that U.S.-owned foreign currency be used when feasible in paying foreign contracts.

CHAPTER 2

LACK OF DOD POLICY RESULTS IN DIVERSE PRACTICES

DOD has not established a formal policy for determining whether defense contracts with foreign firms should be priced in dollars, local currency, or a combination of dollars and local currency. It delegated this responsibility to area or local commands or the contracting officers. As a result a number of different practices exist, sometimes within the same country or continent. In Europe the Army prices contracts in the currency offering the maximum price advantage to the United States, either dollars or local currency, but the Air Force generally prices its contracts in local currency.

The area and local practices generally follow the contractor's desires or are based on expediency. In countries where the dollar tends to increase in value, contractors desire to contract in dollars since the dollars they will receive at the time of payment will likely be worth more in local currency than at the time of award. In countries where the dollar has been declining in value, contractors generally insist on pricing contracts in local currency to avoid any decline in local purchasing power between the time of contract award and payment.

When contracts have been priced in dollars, the contractors have benefited from increases in the value of the dollar. In Germany and Japan however, where the dollar declined in value in August 1971 the contractors apparently lost or will lose substantial sums in converting dollars to local currency.

Although aware of the problems associated with pricing foreign contracts in dollars, DOD has not responded with policy guidance. In July 1971 the Defense Contract Audit Agency (DCAA) notified the Assistant Secretary of Defense (Installations and Logistics) that pricing and paying foreign contracts in dollars was, in some cases, resulting in contractors' receiving windfall profits. DCAA recommended that foreign contracts be priced in either (1) foreign currency or (2) U S dollars on the basis of a specified exchange rate.

DOD officials, however, chose not to implement either of DCAA's recommendations. DOD personnel advised DCAA that contracting officers are given much flexibility which, according to DOD, is needed to insure that currency fluctuations do not result in unjust gain or loss to the U S Government or the contractors and that the payment arrangements do not provide any incentive for contractors to speculate on currency fluctuations

PRICING CONTRACTS IN DOLLARS
BENEFITED KOREAN CONTRACTORS

DOD procurement activities in Korea generally have priced contracts with Korean firms in dollars. By so doing increases in the value of the dollar have been passed on to Korean contractors. In contrast, U S Embassy and Agency for International Development procurement activities generally have priced contracts in local currency (won) thereby accruing to the United States any benefits from increases in the value of the dollar without loss to the contractors.

According to Army Korea Procurement Agency and Air Force Korea Procurement Center commanding officers, pricing contracts with Korean contractors in dollars has been the accepted practice for several years. U S Government and contractor interests have not been analyzed to see whether contracts priced in won would be better.

Until recent years, the question of whether to price contracts in dollars or won has not been of great significance since the dollar/won exchange rate remained relatively stable. In September 1968 however, the Korean Government relaxed stringent monetary controls, the exchange rate began a steady climb from 276 won to a dollar to 381 won to a dollar in March 1972.

For contracts in effect at the time of our review, we estimated that Korean contractors have received or will receive an additional \$5.8 million because the dollar appreciated in value since the contracts were awarded. As shown below, we estimated that one contractor may receive the equivalent of an additional \$182,000 because of increases in the exchange rate for dollars.

	<u>Won value</u>
Contract price (note a) \$1,523,154	W502,640,820
Contract payments \$1,523,154	^b <u>W572,083,713</u>
Gain resulting from exchange- rate fluctuations	<u>W 69,442,893</u>
Dollar value of gain	^c <u>\$ 182,265</u>

^aContract amount was based on a rate of exchange of 330 won to a dollar

^bActual payments as of 2-29-72 were \$904,061 based on exchange rates ranging from 370 won to 377 won to a dollar. The remaining payments of \$619,093 were estimated on the won rate of exchange on 3-2-72 of 381 won to a dollar.

^cEstimated on the basis of the won rate of exchange on 3-2-72 of 381 won to a dollar

During contract negotiations the contractor refused the Army Korea Procurement Agency's request to negotiate the price on the basis of an exchange rate of 339 won to a dollar because it had no guarantee that the exchange rate would go that high. The contractor further stated that any devaluation in the won would drastically increase contract cost. The negotiation records showed, however, that the contractor's labor cost estimate, which accounted for about 90 percent of the contract cost, included a 15-percent wage increase for the majority of the work force. Also, the Commander of the Korea Procurement Agency told us that most Korean contractors arrange labor agreements before submitting proposals. In this way they fix their labor costs over the contract period.

Had this contract and others reviewed been paid in local currency, the United States, rather than the Korean contractors, would have benefited from the increase in value of the dollar. Further, the contractors would not have suffered any losses since they would have received the agreed amount of local currency.

After our fieldwork, we were informed that on August 2, 1972, Headquarters, U.S Forces, Korea, issued instructions, effective October 1, 1972, specifying that certain contracts with Koreans be priced in local currency. However, procurement halted when Korean contractors refused to bid in local currency. It did not resume until an interim measure was enacted providing for bidding in local currency and payment in dollars using exchange rates effective on payment dates.

EXCHANGE LOSSES OF
JAPANESE CONTRACTORS FORCED CHANGES

Before July 1, 1971, contracts awarded by the U S military in Japan were priced in dollars. As a result, the Japanese contractors bore the loss when the dollar was devalued in August 1971. From August to December 1971, the value of the dollar fell about 17 percent--from 360 to 308 yen to a dollar.

The U S Forces, Japan, Budget Office estimated that the Japanese contractors could lose about \$4 million as a result of the dollar devaluation. One Japanese contractor has appealed for relief to the U S Army Procurement Board, and at the time of our review the Board was considering whether the United States should make up the exchange rate losses.

As early as June 1970, minutes of a meeting of the Joint Procurement Coordinating Board, Japan,¹ indicated that Japanese contractors were starting to discuss the need for U S contracts to be priced in yen rather than dollars. During the following months the Board considered the following

- 1 Fifteen Japanese businessmen, representing the major contractors with whom the Army, Navy, and Air Force do business, submitted a petition to the U.S. Forces, Japan, requesting that U.S. contracts in Japan be written for payment in yen rather than dollars.

¹Members are the heads of the procuring activities of the Army, Navy, Air Force, Pacific Regional Exchange, Navy Exchange, and representation of U S Forces, Japan

- 2 There were indications that, if the contracts were not written in yen, some contractors might inflate their bids to guard against loss. This suspicion was reinforced when the Navy, after negotiating a contract in dollars convertible to yen, asked the contractor if it would give a lower price if the Navy wrote the contract using yen. The contractor said yes.
3. The Navy, in negotiating a contract with a Japanese firm, was advised in the final negotiations that the contractor would not sign a contract unless it was either written in terms of yen or at a specified rate of exchange. According to the contractor, it could not afford the risk of revaluation.
4. The Army Corps of Engineers asked for bids in dollars on construction projects in Okinawa but received two qualified bids that specified a rate of exchange of 360 yen to a dollar. When queried, the contractors indicated that the Government of Japan had recommended qualifying their bids.

The Board concluded that to continue contracting in dollars would strain relations with Japanese contractors, some contractors might (1) attempt to reduce their performance under existing contracts to hold their cost to the yen value received, (2) default because of the financial loss, and (3) pad their prices to avoid losses due to anticipated devaluation of the dollar. The Board, therefore, recommended that contracts with Japanese contractors be written in yen. As a result, U S Forces, Japan, regulations were revised effective July 1, 1971, to require that all contracts awarded by defense activities in Japan be priced and paid in yen. An exception to this requirement was made for the Navy Exchange, Corps of Engineers, and Pacific Regional Exchange contracts, which, in most instances, required the contractors to acquire much U S source material.

GAINS AND LOSSES OF EUROPEAN CONTRACTORS

European activities

Headquarters, U S European Command, has not issued instructions on the currency to be used for pricing contracts.

Separate instructions, however, have been issued by U.S. Army, Europe, and the U.S. Air Force, Europe.

U.S. Army, Europe, procurement instructions state that procurement offices should solicit and price procurements in the currency offering the maximum price advantage to the U.S. Government. No guidance, however, has been given as to how local installations are to implement these instructions. At the four Army procurement offices visited, the implementation of the instructions varied

At the U.S. Army Procurement Agency, for solicitations involving various countries, proposals are requested in local currency and the contractor is asked to give the exchange rate at which it is willing to convert the bid to dollars. On the date of award the official exchange rate available to the Government is compared with the contractor's exchange rate. If the contractor's exchange rate is below the official rate, the award is made in local currency. If the rate is above the official rate, making the relative dollar offer more advantageous to the Government, the contract is awarded in dollars. If both values are the same, the contract is awarded in dollars. In the past some countries offered exchange rates above the official rate to obtain dollar contracts.

At the Army Materiel Command, contracts for milk, variety meats, potato chips, and cookies are priced only in dollars. This practice was justified on the basis that

1. The administrative burden would be too great if proposals from contractors in six countries had to be evaluated using different currencies and exchange rates.
2. Selection of the exchange rate to be used would be complicated because of fluctuations during solicitation, negotiation, and award periods.
3. Money has been saved by denominating contracts in dollars rather than local currency.

Contracts for other items, such as those for fresh fruits and vegetables, are priced in either dollars or local currency. Some vendors of fresh fruits and vegetables will not accept dollar-priced contracts.

According to Army Materiel Command personnel, an estimated \$1.6 million was saved on fiscal year 1972 milk procurements by pricing the contracts in dollars. These contracts were awarded only days before the value of the dollar dropped throughout Europe. Had these contracts been priced in local currency, the United States would have lost rather than the contractors. Due to the devaluation, one contractor requested a price increase of \$97,000 but command officials said such an adjustment could not be made. After the devaluation, several contractors asked about submitting their fiscal year 1973 bids in local currency. Because of these requests, the fiscal year 1973 solicitation was amended to require proposals in dollars only and to show the exchange rate used to convert the local currency bid to U S dollar value.

The Army's practice conflicts with the Air Force's practice. The Air Force's procurement instructions state that the proposals will be solicited in the currency of the country concerned and the resultant contracts priced in the same currency. If, however, the foreign contractor refuses to submit a proposal in other than dollars, the procurement instructions state the contract will include a currency revaluation clause which provides for payment adjustments to offset the effects of currency revaluations.

For example, the Air Force obtained a downward price adjustment under the devaluation clause in a dollar-priced contract of about \$9 million because the Turkish lira was devalued in September 1970. Under the Army policy, the contract would not have contained a revaluation clause and the contractor, rather than the United States would have benefited.

The Air Force's rationale is that, in the long run, the Government obtains the lowest prices by pricing contracts in local currency because

- 1 Prices that are fair and reasonable can best be obtained when unknowns, such as international currency fluctuations, have been eliminated
- 2 If a contractor incurs a loss due to changes in exchange rates, he may try to make it up by poor performance or higher prices on future contracts

- 3 Offers are wanted from contractors who are most capable, not from those who are willing to assume the biggest risks.
- 4 Finance offices can handle international currency fluctuations better than procurement offices.

Continental U S activities

The Naval Regional Procurement Office, Philadelphia, normally prices foreign contracts in local currency. This practice usually has been followed, the Naval office said, to avoid problems which arise due to exchange-rate fluctuations when the U S dollar is used as a basis for pricing. Also, use of local currency aids payment to contractors.

Two of the nine contracts reviewed at this office were priced and paid in U S dollars. As a result of exchange-rate fluctuations, one of these contractors, a Norwegian, incurred an estimated loss of 38,000 Norwegian crowns equivalent to about \$5,700.

The Warner Robins Air Materiel Area, Robins AFB, Georgia, has not issued instructions governing the selection of the kind of currency to be used for pricing and paying its foreign contracts. An official stated, however, that when negotiating the price the contractor and the Government consider exchange rate fluctuations. All seven of the contracts reviewed at this office were priced in U S. dollars and paid in accordance with the contractors' preference.

Six of the contracts stated that payment could be made in U S dollars or local currency at the exchange rate in effect on the date of payment. In each case payment was made in local currency. The exchange rates were stable before award and did not change during the contract period.

The seventh contract, awarded to a Portuguese contractor on December 18, 1970, was priced and paid in U S dollars. Unlike U S Air Force, Europe, policy (see p 13) no currency revaluation clause was included in the contract. As a result of an increase in the value of the U S dollar, the contractor, as shown below, has received dollars worth more escudos than contemplated at negotiation.

	<u>Date</u>	Prevailling ex- change rate (escudo to dollar)	<u>Value in escudos</u>
Contract price			
\$71,700 (note a)	12-18-70	Esc.3.492 to \$1	Esc. <u>250,389</u>
Payments			
\$58,136	1- 3-72	3.640 to \$1	211,615
<u>13,564</u>	3- 6-72	3 660 to \$1	<u>49,644</u>
<u>\$71,700</u>			<u>261,259</u>
Gain due to exchange fluctuation			Esc <u>10,870</u>

^aThrough September 15, 1972, modifications have increased the value of this contract to \$164,680

CONTRACTS WITH PHILIPPINE CONTRACTORS
PRICED AND PAID IN DOLLARS OR LOCAL CURRENCY

Since the revaluation of the Philippine peso in February 1970, the Philippine Procurement Center, a central DOD procurement activity, has generally priced contracts and paid local contractors in pesos. Construction contracts requiring importation of U S -made goods and amendments to existing dollar-priced contracts, however, are priced and paid in dollars. Fluctuations in the exchange rate between the dollar and the peso make it difficult to establish the reasonableness of a price stated in dollars.

In auditing a proposal for a contract to be priced and paid in dollars, DCAA noted that the offeror converted its peso price to a dollar price by using a 4 65 peso to 1-dollar exchange rate. DCAA suggested that the then-current 6.1 peso to 1-dollar rate should have been used. The contracting officer disagreed, stating that use of the 6 1 rate would place the United States in a position of speculating for the services being procured, because the peso to dollar exchange rate floats and could drop to 5.0 or below. He further stated that awarding and paying the contract in pesos had been considered but that use of U S. dollars was more advantageous to the Government. He believed this would guarantee

contractor performance at a price determined to be fair and reasonable, thereby placing the risk on the contractor at the time it converts its U S. dollars to pesos

Notwithstanding the foregoing argument, the offeror was requested during negotiations to use a 6.0 exchange rate. The offeror finally agreed to accept a 5.5 exchange rate. On the date of award, June 15, 1970, the exchange rate had risen to 6.17 pesos, and by June 30, 1971, the scheduled date for contract completion, it was up to 6.44 pesos.

Obtaining the 5.5 rate, not the proposed 4.65 rate, saved the United States about \$65,000. Had the rate DCAA recommended been used or had the contract been priced in pesos, an even greater amount would have been saved without loss to the contractor

Price negotiations based on speculation of what will happen to exchange rates during contract performance cast serious doubt on the reasonableness of the negotiated dollar price. Although the offeror's price in pesos was determined to be fair and reasonable, the reasonableness of the dollar equivalent, based on a questionable exchange rate, was not established

The contracting officer justified the dollar payments on the basis that the risk of exchange fluctuation would be placed on the contractor. This risk, however, was recognized by the contractor and was compensated for by accepting a favorable exchange rate. In fact, the negotiated exchange rate of 5.5 was considerably below the market rate of 6.17 on the date of award

PRACTICE REVISED TO REQUIRE
CONTRACTS WITH VIETNAMESE CONTRACTORS
TO BE PRICED IN LOCAL CURRENCY

Effective May 31, 1972, the U S Military Assistance Command, Vietnam, directed that all contracts awarded to Vietnamese Nationals be priced in piasters without reference to the U S dollar. Before May 31, 1972, local national contracts were priced in both dollars and piasters. All contracts, however, were required to be paid in piasters

In February 1972 the U S military was administering 52 local national contracts with an equivalent value of \$18.5 million. Of this total, five contracts, valued at about \$2.7 million, were priced in dollars. The remainder were priced in piasters. In contrast, all contracts with local nationals awarded by the U S Embassy and Agency for International Development have been priced and paid in piasters.

Through March 31, 1972, the United States purchased the piasters needed for contract payments at the official, but artificially low,¹ exchange rate of 118 piasters to a dollar. On April 1, 1972, the Vietnamese Government agreed to allow the United States to buy piasters for all U S Government expenditures at the rate of 410 piasters to a dollar.

After we completed our fieldwork, the Military Assistance Command said four of the dollar-priced contracts were renegotiated, either to reflect pricing in piasters or the current exchange rate of 410 piasters to a dollar. Had these contracts originally been priced in local currency, renegotiation would have been unnecessary. The remaining dollar-priced contract already provided for payment at fixed rates in piasters, thus renegotiation was not necessary.

¹This was the subject of a report by the Committee on Government Operations, H Rept 92-760, Vietnam and the Hidden U S Subsidy, December 16, 1971.

CHAPTER 3

CONCLUSIONS, RECOMMENDATIONS, AND AGENCY

COMMENTS AND OUR EVALUATION

CONCLUSIONS

DOD has not formulated a uniform policy on the use of either local currency or dollars in pricing and paying contracts with foreign contractors, except in those countries where the Treasury holds excess currency or near-excess currency (See pp 5 and 6) DOD has refrained from doing so on the basis that contracting officers need flexibility in selecting the currency to be used to insure that currency fluctuations do not result in unjust gain or loss to either the U S Government or the contractors and that the payment arrangements do not provide incentive for the contractors to speculate on currency fluctuations.

The country-by-country situations discussed in this report show that this approach has not accomplished the intended purpose, in fact, the opposite appears to have occurred in a number of instances Fairness to both the U.S Government and foreign contractors is extremely difficult when contracts are priced in dollars Since the contractors must convert the dollars received to local currency to pay local obligations, any change in exchange rates after a dollar price has been agreed on may significantly affect the contractors' financial return. Exchange rates, which are not predictable and are beyond the contractors' influence, thus become an element of speculation which the contractors must consider in determining the dollar price they must receive for the work

This element of speculation can be removed if DOD would adopt a uniform policy to insure that foreign contractors receive value equivalent to the contract price This can best be insured by pricing and paying all such contracts in the currency of the contractor's country

With some exceptions, such as Korea, DOD activities are pricing and paying contracts with foreign contractors in local currency Without formal DOD requirements to do so, however, the local commands or procuring activities could revert to pricing and paying contracts in dollars as

the monetary situation changes or the contractors again see an advantage in receiving payment in dollars. DOD policy guidance at this time is critical because of the uncertainties which exist in the international monetary market and the changes which are likely to be forthcoming in the near future. These changes, and their effect on contract pricing, cannot be fully evaluated and fairly dealt with by the contractor or DOD activities at the command or procurement level.

RECOMMENDATIONS

We recommend that the Secretary of Defense establish a policy requiring that local currency be used to price and pay contracts with foreign contractors, unless there is a compelling reason to use dollars, such as a requirement for significant purchases in the United States. Justification for pricing and paying contracts in dollars should be approved at a level above the contracting officer. Such policy would protect both the U.S. Government and the foreign contractors in the event of significant currency fluctuations. A less preferable method would be to pay foreign contracts in dollars subject to provisions for an appropriate price adjustment in the event that the exchange rate fluctuates significantly during the contract's life

AGENCY COMMENTS AND OUR EVALUATION

DOD commented on our findings and recommendations by letter dated April 17, 1973. (See app. II.)

DOD said that its practice regarding the choice of U.S. dollars or foreign currencies for pricing and paying foreign contracts is based on a realization that the economics of international finance have an absolute influence over contracting in foreign countries. Inasmuch as the relative values of currencies and the economic status of foreign governments are constantly changing, it has not been considered to be in the best interests of the United States to direct a single over-all policy in this matter

We agree that international finance, including changes in the relative values of currencies and economic status of foreign governments, has influenced the pricing of contracts awarded in foreign countries. For this reason, action is

needed to establish a single overall policy. Such DOD policy is urgently needed because of the uncertainties which exist in the international monetary markets, the changes which are likely to be forthcoming, and the pressures of foreign contractors and governments to select the currency likely to benefit them the most.

DOD stated that many diverse and changing factors influence the determination of the procedure most beneficial to the United States for a specified country. These include (1) compliance with host country currency exchange control laws or binational agreements, (2) need to control black marketing and illegal transactions, (3) fringe benefits afforded local firms which generate foreign exchange for the host country, and (4) relative stability of the dollar versus local currency.

Payment in local currency, as we recommend, should eliminate problems involving host-country exchange laws, black market, and illegal transactions. If payments are made in local currency, dollars will not be available for illegal activities. As to binational agreements, DOD and our review did not disclose any country-to-country agreements which would affect the implementation of our recommendations. Further, payments to the contractors in local currency should not affect the generation of foreign exchange. The contractors will still be generating foreign business since DOD will be spending dollars to buy the local currency needed to make contract payments. Finally, the changes occurring in the stability of the dollar versus local currency form the basis for our recommendation.

DOD said the policy of pricing and paying defense contracts with local Korean firms in dollars has been in effect over 15 years, until recently this policy has been beneficial to the United States. This situation has changed in recent years, as noted in the GAO report Korea, Joint Procurement Coordinating Board, concluded that payments in won currency would be beneficial to the United States. However, effects to revise payment policy have been resisted by the Korean Government and local contractors. Discussions are continuing with the Korean Ministry of Commerce and Industry to secure host-country agreement for pricing and paying defense contracts in local currency

We believe DOD's implementation of our recommendation on a worldwide basis would influence the Korean Government and contractors to accept payments in local currency. It is understandable that, as long as the Korean contractors are benefiting from receiving payments in dollars (see p 8), the Korean Government will be reluctant to accept a change to payment in local currency when such change is not applied equally to all foreign contractors.

DOD said recent information indicates that the current procedure of pricing and paying contracts with Vietnamese firms in piasters may need revision. The highly inflationary trends in the Vietnamese economy and prospective losses of some local contractors is impairing capability for performance. A change in pricing policy may be beneficial to the United States.

We do not believe inflationary trends in foreign economies justify paying contracts in dollars in lieu of local currency. The contractor is responsible for establishing a price which will cover cost, including foreseeable price increases. If the contract period and fluctuations in the economy warrant, a price escalation clause may be needed. Our recommendation recognizes that some situations may justify deviation from an overall policy providing for payments in local currency.

DOD said the GAO audit report has, without question, stimulated procurement officials at many echelons of DOD to review procurement and contracting arrangements with foreign contractors, in discussing this matter with Treasury Department officials, it develops that there are no Government-wide policies on contracting with foreign contractors in foreign currencies or U S dollars. Since the Treasury has primary responsibility for establishing Government-wide policies concerning the acquisition, custody, and use of foreign currencies by U S departments and agencies, DOD is requesting the Treasury to participate in organizing an interdepartmental working committee to study the need for Government-wide guidelines and procedures for pricing and payment terms in procurement contracts overseas. The comments and suggestions made in the GAO report will be given careful attention by the interdepartmental committee mentioned above.

We inquired at the Departments of State and the Treasury to determine whether any U S policies exist concerning the use of dollars or local currency in pricing and paying contracts awarded foreign contractors. The only U S policy in this regard concerns situations in which the United States owns excess currency or near-excess foreign currency. The designation of such countries and the use of the excess currency or near-excess currency is under the authority of the Treasury. We did not include these countries in our review (See pp. 5 and 6.) Although DOD's action to coordinate with the Treasury seems desirable, DOD should recognize that, except for excess local currency, it is responsible for setting the policy for pricing and paying its contracts, whether with U S or foreign contractors.

Any organized study group should develop a uniform policy equitable to both the United States and foreign contractors. Speculation on exchange-rate fluctuations should be minimized by establishing a single policy for pricing and paying except for unusual circumstances, contracts in local currency.

The devaluation of the dollar, announced in February 1973, highlights the soundness of this position. Any foreign contractor holding a U S contract awarded before this devaluation, payable in dollars, will undoubtedly receive less value in terms of local currency than anticipated at the time of award.

Although the United States may benefit financially at the expense of these contractors, we believe such benefits should play no part in pricing contracts for goods and services. The primary concern is establishing a fair price reasonable to the United States and foreign contractors. The risk of exchange rate fluctuations makes it difficult to establish a fair price when contracts are priced and paid in dollars.

Further, contractors bidding in dollars for future contracts will no doubt include in bid prices contingencies for risks associated with exchange-rate fluctuations. The long-range effect may be awards to contractors which will take the greatest risks in this regard and not the ones which will furnish the best product at the lowest price. A contractor, losing money because of currency changes, may also be inclined to cut corners.

DOD FOREIGN CONTRACT PRICING PRACTICES
 FOLLOWED BY MAJOR PROCUREMENT ACTIVITIES GAO VISITED

<u>Contractors'</u> <u>country</u>	Approximate value of procurements in fiscal year 1971 (millions)	<u>Contract</u> <u>pricing</u> <u>practice</u>
Europe	<u>\$254</u>	Army contracts priced in dollars or foreign currency, whichever offers the maximum price advantage to the U S Air Force contracts are priced in foreign currency
Far East		
Japan	215	Through fiscal year 1971, contracts priced in U S dollars, fiscal year 1972 and after, contracts priced in yen
Korea	75	Most contracts priced in U S dollars
Philippines	7	Most contracts priced in pesos
Ryukyu Islands (Okinawa)	26	Contracts until May 15, 1972, were priced in U S dollars, after this date all contracts priced in yen
Taiwan	25	Air Force and Officer in Charge of Construction Contracts priced in New Taiwan dollars, Army contracts priced in U S dollars
Thailand	26	Most contracts priced in baht
Vietnam	<u>64</u>	Most contracts priced in piasters
	<u>438</u>	
Continental United States		
Naval Ship Systems Command, Washington, D C	1	Contracting officer's preference
Office of Naval Research, Arlington, Virginia	1	Contractor's preference
Naval Regional Procurement Office, Philadelphia	2	Foreign currency
Warner Robins Air Materiel Area, Robins AFB, Georgia	6	Contractor's preference
Defense Fuel Supply Center, Cameron Station, Virginia	83	U S dollars
Sacramento Air Materiel Area, McClellan AFB, California	<u>5</u>	Either U S dollars or foreign currency
	<u>98</u>	
Total value all locations	<u>\$790</u>	



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON D C 20301

17 APR 1973

INSTALLATIONS AND LOGISTICS

Mr James H Hammond
Deputy Director Procurement and
Systems Acquisition Division
United States General Accounting Office
Washington, D C 20548

Dear Mr. Hammond

This is in response to your letter of 15 February 1973 to the Secretary of Defense requesting comments on the draft report dated 15 February 1973, Subject "Contracts With Foreign Firms Should Be Priced in Local Currency", (OSD Case #3582)

Your report examined the policies and practices followed by the DoD in selecting the medium of exchange to price and pay foreign contracts to determine if existing DoD policies and practices adequately protect both the United States Government and the foreign contractors when currency fluctuations occur. GAO examined contracts at procurement offices overseas and in the U S that had awarded contracts valued at about \$800 million to foreign contractors during fiscal year 1971.

Your report found that (1) DoD has not formulated a uniform policy on the use of local currency versus dollars in pricing and paying contracts with foreign contractors, and (2) DoD has refrained from doing so on the basis that contracting officers need flexibility to assure that (a) currency fluctuations do not result in unjust enrichment or injury to either the U S Government or the contractors and (b) the payment arrangements do not provide incentives for contractors to speculate on currency fluctuations.

You suggest that the Secretary of Defense establish a policy requiring that local currency be used to price and pay contracts with foreign contractors, unless there is a compelling reason to use dollars, such as a requirement for significant purchases in the United States. Justification for pricing and paying contracts in dollars should be approved at a level above the contracting officer.

The practice of the Department of Defense regarding the choice of U S dollars or foreign currencies for pricing and paying foreign contracts is based upon a realization that the economics of international finance have an absolute influence over contracting in foreign countries. Inasmuch as the relative values of currencies and the economic status of foreign governments are constantly changing, it has not been considered to be in the best interests of the United States to direct a single overall policy in this matter.

In coordinating the subject audit report with the overseas military commands, the reactions received varied according to local conditions. It was pointed out that many diverse and changing factors influence the determination of the procedure most beneficial to USG for a specified country. These include (a) compliance with host country currency exchange control laws or bi-national agreements, (b) need to control black marketing and illegal transactions, (c) fringe benefits afforded local firms which generate foreign exchange for the host country, and (d) relative stability of the dollar versus local currency. In associating these factors to the comments in the audit report concerning Korea and Vietnam, the Pacific Unified Command (CINCPAC) stated:

"B Republic of Korea

"(1) The policy of pricing defense contracts with local ROK firms in dollars, with payment in dollars to the Bank of Korea has been in effect for a period exceeding 15 years. Until recently, this policy has been beneficial to USG. Fringe benefits were afforded by ROKG to ROK firms holding defense contracts (import licenses for the private sector) because these contracts generated foreign exchange. Thus, dollar payments on defense contracts encouraged more realistic prices free of contingencies.

"(2) This situation has changed in recent years, as noted in GAO report Korea, Joint Procurement Coordinating Board (JPCB) concluded that payments in won currency would be beneficial to USG. However, USFK actions to revise payments policy have been resisted by ROKG and local contractors. Defense purchasing offices in Korea, for a 30 day period in 1972, issued solicitations calling for payment in won currency. No offers were submitted by ROK firms during this period.

"(3) As a temporary measure, purchasing offices in Korea are using contract clause calling for payment in dollars at variable

APPENDIX II

rate to reflect dollar/won exchange rate at time of payment USFK is continuing discussions with ROK Ministry of Commerce and Industry with a view toward securing host country agreement for pricing and payment of defense contracts in local currency

"C Republic of Vietnam

"(1) MACV Directive 37-6 dated Sep 1969 and prior regulations provided definitive country team policy on the pricing and payment of contracts with local firms Contract pricing in dollars with payment in piasters at the fixed exchange rate of 118 piasters to the dollar was a fully coordinated USG position for several years

"(2) With the establishment of the MACV Economic Development Program use of the 275 1 piaster/dollar exchange rate was authorized by GVN for some contract categories to encourage Vietnamization of defense contracts Later, use of a 410 1 piaster/dollar exchange rate was authorized for new procurement for local RVN sources

"(3) Variations in contract pricing and payment procedures for RVN, as reported by GAO, reflects changes in unified command guidance during FY 72 time frame, rather than a lack of such guidance prior to 31 May 1972

"(4) Recent report of DAO Saigon indicates that current procedure to price and pay contracts with RVN firms in piasters may need revision The highly inflationary trends to the GVN economy and prospective losses of some RVN contractors is impairing capability for performance A change in pricing policy may be beneficial to USG "

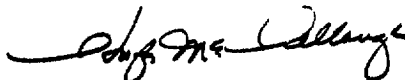
While the severity of the problem is known to vary according to the circumstances of individual countries or regions, the above comments concerning contracting in Korea and Vietnam are representative of contracting conditions in many countries and regions throughout the world

The audit report has, without question, stimulated procurement officials at many echelons of the Department of Defense to review procurement and contracting arrangements with foreign contractors The scope of this matter actually involves the several government departments and agencies that are engaged in procurement overseas However, in discussing this matter with Treasury Department officials, it develops that there are no government-wide policies with regard to contracting with foreign contractors

in foreign currencies or U S dollars Since the Treasury Department has primary responsibility for establishing government-wide policies concerning the acquisition, custody and use of foreign currencies by U S departments and agencies, the Department of Defense is requesting the Treasury Department to participate in organizing an interdepartmental working committee to study the need for government-wide guidelines and procedures for pricing and payment terms in procurement contracts overseas

The comments and suggestions made in the audit report will be given careful attention by the interdepartmental committee mentioned above

Sincerely,



HUC CUTTLOUGH
Acting Assistant Secretary of Defense
(Installations and Logistics)

APPENDIX III

PRINCIPAL OFFICIALS OF DOD
 RESPONSIBLE FOR ADMINISTERING
 ACTIVITIES DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF DEFENSE		
William P. Clements, Jr. (acting)	May 1973	Present
Elliot L. Richardson	Jan 1973	Apr 1973
Melvin R Laird	Jan 1969	Jan 1973
SECRETARY OF THE ARMY		
Howard H Callaway	May 1973	Present
Robert F Froehlke	July 1971	Apr 1973
Stanley R Resor	July 1966	June 1971
SECRETARY OF THE NAVY		
John W Warner	May 1972	Present
John H Chafee	Jan. 1969	May 1972
SECRETARY OF THE AIR FORCE		
Dr. John L. McLucas (acting)	May 1973	Present
Robert C Seamans, Jr.	Jan. 1969	Apr 1973

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