

DOCUMENT RESUME

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[Errors in Prices Charged Foreign Military Sales Customers].
LCD-77-449; B-183318. October 7, 1977. 8 pp. + enclosure (1 pp.).

Report to Secretary, Department of Defense; by Joseph Normile (for Fred J. Shafer, Director, Logistics and Communications Div.).

Issue Area: Facilities and Material Management: Supply and Maintenance Operations Reporting Systems (703).

Contact: Logistics and Communications Div.

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

Organization Concerned: Department of the Army; Department of the Army: Army Armament Materiel Readiness Command, Rock Island, IL.

Congressional Relevance: House Committee on Armed Services; Senate Committee on Armed Services.

Authority: Army Regulation 37-60. DCD Instruction 2140.1.

A review of free assets conducted at the Army Armament Command from June to August 1975 showed that the Armament Command had charged foreign military sales customers less than the market price for certain 50-caliber M2 machinegun orders. The prices charged for the machineguns should have been based on the prices in effect when the guns were dropped from inventory in accordance with Army policy. However, in spite of directions to recover replacement prices on the M2 machinegun sales, the Armament Command has repriced only five of these orders for an additional \$1.6 million. There are 22 other orders which are underpriced by about \$60.7 million on which similar action needs to be taken. Findings/Conclusions: The Armament Command's contention that they have a pricing exception regarding machinegun sales is incorrect. Assistant Secretary of Defense and Army Comptroller directives have clearly indicated that the collection of replacement prices for these orders is required. Adjustments should be made and replacement prices collected on all M2 machinegun sales for which items were delivered after the U.S. Army Armament and Materiel Readiness Command had initially identified the need for replacement in May 1974. The Army also had no basis on which to grant a 20% reduction on the sale of overhauled items to foreign customers, and those discount amounts should also be recouped. Recommendations: Since the ability of the United States to collect on these sales decreases with the passage of time, the Secretary of Defense should take immediate action to direct that the Army attempt collection of the underpricing on M2 machinegun sales and should closely monitor Army progress regarding these collections. (SC)

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UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

03850

LOGISTICS AND COMMUNICATIONS DIVISION

B-183318

OCT 7 1977

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

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

In our report to the Chairman of the House Armed Services Committee entitled "The Department of Defense Can Improve Its Free-Asset Management" (LCD-76-414, Mar. 3, 1976), we stated that the prices charged for the machineguns should have been based on the prices in effect when the guns were dropped from inventory in accordance with Army policy. Subsequent actions taken by the Army Comptroller's Office, and the Office of the Assistant Secretary of Defense, Comptroller, have substantiated our past position. However, in spite of direction to recover replacement prices on M2 machinegun sales, Armament Command has repriced only five of these orders for an additional \$1.6 million. We believe that similar action should be taken on 22 other orders which are underpriced approximately \$60.7 million.

ARMY PRICING AND CONTRACT PROVISIONS

Prior to June 11, 1974, Army regulations governing pricing policy for foreign military sales provided that " * * * if the procurement is planned for an item, the published price will continue to be used * * *." Standard prices based on the last procurement of the item; the M2 machinegun was last procured in 1945. These same Army regulations also stipulated that all charges for sales and issuance of items delivered from inventory would be made based on (1) standard prices in effect and (2) stock status at the time the items are dropped from inventory.

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Department of Defense instructions in force at the time allowed the option of either pricing sales at the date the items were dropped from inventory, or when the letter of offer was prepared, with a reasonable specified date set for customer acceptance. However, it must be remembered that prices quoted in the letter of offer (DD Form 1513) are only estimates, and the United States can revise these prices if the pricing considerations on which the original quotes were based change. Further support for this view is evidenced by the fact that the Department modified its instruction in June 1975 to state that if procurement of the item sold was intended within 12 months of its date of drop from inventory, replacement prices must be charged.

The prices for the subject M2 machinegun sales were quoted to foreign customers in the 1973 to 1974 time frame. At the time of quote no future procurement was planned for the item and the standard price was used. Shortly after the quotes were given, the Armament Command discovered that reprocurement of these items would be required to replenish stocks to authorized levels. In May of 1974 Armament Command advised the Army Materiel Command ^{1/} (the parent organization) that they had expected to buy the M2 machineguns. Armament Command realized that replacement prices for these items would be substantially higher than the prices quoted in the letter of offer. In June 1974, Armament Command requested Materiel Command's permission to increase M2 machinegun prices for foreign military sales orders that were not yet filled. They wanted to increase prices to reflect estimated replacement costs for reprocurement of the items sold. At this time no deliveries had yet taken place on the subject orders.

In August 1974, the Materiel Command denied the request to reprice M2 machinegun sales. In doing so it acknowledged that replacement of the weapons may be required but stated that since Armament Command had not established a funded procurement plan, they must charge the original price quoted in the letters of offer as a "one time exception." Item managers have since cited this exception as authority exempting these sales from repricing, even though the Assistant Secretary of Defense and Army Comptrollers have directed the collection of replacement prices for these sales.

^{1/}Now the United States Army Development and Readiness Command.

ONE TIME EXCEPTION
NOT OFFICIALLY AUTHORIZED

Once the Armament Command had notified the Materiel Command that replacement of the M2 machineguns was required, foreign sales contracts for these items should have been adjusted to reflect a more realistic sales price based on estimated replacement costs for the items. Department of Defense and Army regulations state explicitly the conditions under which pricing exceptions or deviations of any sort may be approved for foreign sales. Under these criteria all such requests must be forwarded for Army headquarters and ultimately Assistant Secretary of Defense, Comptroller approval.

During our followup work we questioned officials in the Office of the Secretary of Defense, Army headquarters, and the former Army Materiel Command regarding the authorization for directing a pricing exception for the subject M2 machinegun sales. None were able to provide any documentation supporting approval of the exception above its point of origin at the Materiel Command. A subsequent official attempt by the Materiel Command to obtain a pricing waiver on these same sales was denied by the Assistant Secretary of Defense, Comptroller. As such, the Armament Command position that a pricing exception exists exempting these sales from replacement pricing is incorrect.

Collection directed

Subsequent to our initial review in which we identified underpriced M2 sales, the Army Comptrollers Office directed the Materiel Command to collect replacement prices for these sales. This direction took place after Materiel Command's exception message, superceding it, and specifically referenced two of the sales that it had previously directed a pricing exception on. (The sales marked cases WDD and VYC, in enc. I.)

In an August 29, 1975, memorandum to the Materiel Command the Army Comptroller stated:

"At this time it appears that there is an intention to replace the M2 machine guns and this intention is contained in a programming document. Thus, the policy of replacement pricing as contained in DCDI (Department of Defense Instruction) 2140.1, is the guidance to be followed, for repricing."

Replacement prices were to be charged for all undelivered M2 machinegun orders and all those orders delivered for which a final accounting had not yet been completed (open order).

On September 26, 1975, the Materiel Command requested an exception from the Army Comptroller's directive that M2 machinegun sales be repriced. Unlike the earlier exception message it sent to Armament Command, this request was forwarded in writing through appropriate channels to the Assistant Secretary of Defense, Comptroller. This was the only official request for an exception to pricing policy concerning these sales, and was subsequently denied by the Defense Comptroller. In rejecting Materiel Command's exception request the Defense Comptroller stated to the Army Comptroller:

"We concur in your guidance to AMC [Materiel Command]. Foreign countries must be charged the replacement cost of the M2 machine guns now that a contractual action is in process. The DD 1513 should be amended to reflect the replacement price immediately."

The memorandum, dated January 23, 1976, also deleted authority to price items sold at the date of customer acceptance of the contract and required that items be priced at the date dropped from U.S. inventory.

The Army Comptroller notified the Materiel Command of the waiver denial on February 2, 1976, and included a copy of the Assistant Secretary of Defense, Comptroller decision as an appendix, and requested that repricing be undertaken. Coordinating copies were also sent to the Army's International Logistics branches.

HOW MUCH SHOULD BE COLLECTED?

Department of Defense and Army Comptroller officials state that collection of replacement prices should have been effected on all orders still being shipped as of June 1975. This is the date the Defense instruction was modified to emphasize the need to charge replacement prices if a requirement was anticipated within 12 months after the items are dropped from the inventory.

We concur in their direction to collect replacement prices on M2 machinegun sales. However, we feel that adjustments should be made and replacement prices collected on all M2 machinegun sales for which items were delivered after Armament Command had identified the need for replacement in May 1974. We believe there is ample support in Army regulations and the sales contract

itself to do so, particularly since they provide that foreign military sales items are to be priced at the date they are dropped from U.S. inventory. If a need to replace the items is expected within 12 months from the date of inventory drop, the regulation requires replacement prices to be charged.

The need to replace the subject items was identified in May 1974 and was reflected in the Army's Materiel Plan in January 1975. Although the letters of offer had been signed by the customer countries in the September 1973 through November 1974 timeframe, actual deliveries of the items did not commence until September 1974. This was 4 months after the original identification of replacement need. Furthermore, the January 1975 documentation in the Army Materiel Plan was well within the 12 month period following the delivery.

Army regulations also provide that when, through audit or review, overcharges or undercharges are uncovered in an amount greater than 5 percent of the foreign military sales case, the case will be reopened and adjusted. However, to reduce administrative processing, no adjustment will be made for less than \$1,000. This provision will be applied only within 2 years from the date of final accounting. Armament Command officials advised us that all 22 of the subject M2 machinegun foreign sales are still open.

In addition, the following purchase-agreement terms included in the offer and acceptance contracts are adequate to provide for collection of pricing adjustments:

- The prices of the items to be procured are to be their total cost to the Government.
- Purchasers are to reimburse the Government if the final costs exceed amounts estimated in the agreements.

ARMY SHOULD ALSO RECOUP DISCOUNTS
ALLOWED ON SALES OF OVERHAULED M2
MACHINEGUNS

When the initial sales contracts were offered for the M2 machinegun, the stockage of the item was more than adequate to meet Army needs. Because of this, and to meet customer delivery requirements that were too short to be satisfied through new procurement, the M2 was sold from U.S. inventories. Some of the items had to be overhauled before they were shipped. The Army policy was to reduce the price of overhauled items by 20 percent.

On July 1, 1974, the Office of Assistant Secretary of Defense, Comptroller, challenged the Army's discount policy regarding overhauled items. In a memorandum responding to a newly proposed Army regulation containing the discount and other policies, the Comptroller stated:

"It is our understanding that many overhauled items (rebuilt) are superior to new items. A serviceable-used item would be suitable for issue to Army or other users in lieu of a new item. We see no basis for this proposed 20 percent price reduction."

The Army has since discontinued this discount policy.

We concur with the Comptroller's observation that since these items are delivered in "as good or better than new condition" there is no logical basis for these discounts. We, therefore, feel that in repricing M2 machinegun sales the Army should assure that the full replacement costs are collected on all machineguns sold, including those that were supplied from overhauled stocks.

INACTION ON REPRICING DIRECTIVE

Subsequent to denial of its request for a pricing exception regarding M2 machinegun sales, the Materiel Command sent pricing guidance to its commands. In an April 1976 foreign military sales pricing guidance letter to its commands, the Materiel Command directed that all orders delivered on or after June 17, 1975, would be repriced according to provisions of Army Regulation 37-60. This regulation implemented the new revisions to Department of Defense Instruction 2140.1 of June 1975 which require replacement pricing of all items sold for which an intent exists to replace the item within 12 months of the date of sale, and emphasizes that such pricing determination be made at the date that items are dropped from U.S. inventory.

In spite of this guidance, Armament Command has acted to reprice and collect on only five of the subject M2 machinegun orders. Item managers at the command continue to cite the superceded August 1974 Materiel Command exception message as authority exempting other M2 sales from repricing.

Pending purchase of M2 machineguns

In October 1976, Armament Command initiated action to procure additional M2s to replace the depleted stocks.

Currently they plan to procure 13,092 machineguns. The anticipated price is about \$9,954 each for machineguns with supplemental parts and tools and \$9,439 without such equipment. The total contract value will be over \$123 million. The need for this procurement originated because customer requirements were satisfied from U.S. stocks rather than from new procurement. These items were sold from U.S. stocks at unit prices ranging from a low of \$546 to a high of about \$1,500 (see enc. I). Had these requirements been satisfied from procurement, the customers would have paid the higher cost. Collection on the subject M2 sales would provide \$60.7 million which could be applied toward the planned \$123 million procurement.

Army officials have in the past commented that it would be embarrassing to adjust these orders. We believe that it is not only embarrassing but inequitable to have sold items for about \$1,500 or less per unit, and now have to use taxpayers' dollars to buy back identical stock at \$9,439 per unit.

CONCLUSIONS

The Armament Command's contention that they have a pricing exception regarding the subject M2 machinegun sales is incorrect. Assistant Secretary of Defense and Army Comptroller directives have clearly indicated that the collection of replacement prices for these orders is required. Although Comptroller officials have indicated an effective date of June 17, 1975, for the repricing requirement, we feel that adjustments should be made and replacement prices collected on all M2 machinegun sales for which items were delivered after the United States Army Armament and Materiel Readiness Command had initially identified the need for replacement in May 1974.

We also agree with the Office of the Assistant Secretary of Defense's position that the Army had no basis on which to grant a 20-percent reduction on the sale of overhauled items to foreign customers. Accordingly, such discounted amounts granted on M2 machinegun sales should also be recouped.

We believe there is ample support in Army regulations and the sales contract itself to do so. We also believe that the underpriced M2 orders should have been adjusted long before now.

RECOMMENDATIONS

The ability of the United States to collect on these sales decreases with the passage of time. Therefore, the Secretary of Defense should take immediate action to direct that the Army

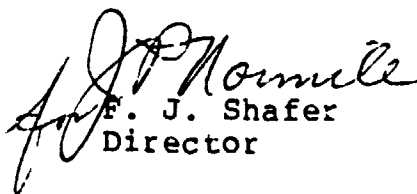
attempt collection of the underpricing on the subject M2 machinegun sales. In view of past confusion at the command level to collect on these sales, the Secretary should closely monitor Army progress regarding these collections.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Chairmen of the Senate Committees on Appropriations, Armed Services, and Governmental Affairs; Chairmen of the House Committees on Appropriations, Armed Services, and Government Operations; and to the Director, Office of Management and Budget.

We would appreciate being advised of actions taken on the matters discussed in this letter.

Sincerely yours,


F. J. Shafer
Director

Enclosure

FOREIGN MILITARY SALES
ANALYSIS OF CASES ELIGIBLE FOR ADJUSTMENT
AS OF JULY 31, 1977

Country	Case	Quantity	Date order accepted	Date order established	Dates delivered	Dates collected	Unit Price charged	Unit price based on GAO computations (note a)	GAO computed underpricing (note a)	Total by country (note a)
Israel	IS-VXE	39	3/74	12/74	10/74	4/75	\$1,555.40	\$9,439.00	\$ 307,460.40	\$31,095,001.40
	IS-VYC	70	11/74	7/76	3/75-6/75	1/77	1,550.00	9,439.00	552,230.00	
	IS-VZJ	650	1/74	7/76	2/75-5/75	1/75-6/75	1,060.00	9,439.00	5,446,350.00	
	IS-WCS	680	5/74	10/76	5/76-5/76	Open	1,414.00	9,439.00	5,457,000.00	
	IS-WDA	630	5/74	9/74	8/76-5/77	11/76-5/77	1,063.00	9,439.00	5,276,880.00	
	IS-WDB	306	5/74	9/74	10/76	4/77	1,063.00	9,439.00	2,563,056.00	
	IS-WDC	239	5/74	9/74	10/76	10/75	1,063.00	9,439.00	2,001,864.00	
	IS-WDO	1,145	5/74	9/74	1/76-3/76	4/76-5/77	1,414.00	9,439.00	9,188,625.00	
	IS-XV4	36	5/74	6/74	10/74	4/75	1,063.00	9,439.00	301,536.00	
	IR-		11	12/73	1/74	3/76	6/76	791.00	9,439.00	
Iran	IR-V	944	6/74	11/74	9/75-10/75	10/75-7/76	1,436.00	9,954.00	8,040,782.00	11,076,362.00
	IR-V2	250	6/74	10/74	6/76	Open	988.00	9,439.00	2,112,750.00	
	IR-UYA	150	12/73	6/74	2/75	8/75	1,414.00	9,439.00	1,203,750.00	
	IR-UXE	60	12/73	1/74	4/75	7/75	791.00	9,439.00	518,880.00	
	SR-UIE	1,000	9/73	7/75	12/74	6/76	1,436.00	9,954.00	8,518,000.00	
Jordan	JO-ULP	130	7/74	6/76	9/74	Open	1,604.00	9,954.00	1,085,500.00	6,055,363.00
	JO-ULM	621	8/74	8/74	12/74-12/75	Not fully collected	1,436.00	9,439.00	4,969,863.00	
Peru	PE-UPK	155	11/73	1/76	3/75	1/76	1,063.00	9,439.00	1,298,280.00	1,298,280.00
Greece	GR-UXP	65	11/73	12/76	10/74	7/75	990.00	9,954.00	582,660.00	582,660.00
Lebanon	LE-UJG	60	3/74	10/74	5/76	Open	545.79	9,439.00	533,592.60	533,592.60
Yemen	YE-UAA	50	7/74	10/74	11/74	3/76	1,428.00	9,954.00	426,700.00	426,700.00
Norway	NO-UXE	39	4/74	10/74	10/75	12/75	2,454.93	9,439.00	311,378.73	311,378.73
Total underpricing										\$60,697,337.73

2/Unit prices were based on the following: New machinegun issued from stock: \$9,439 (estimated replacement costs); new machinegun issued from stock with supplemental spare parts and tools: \$9,954 (estimated replacement costs); in accordance with Assistant Secretary of Defense position figures are not discounted 20% for overhauled items.