DOCUMENT RESUME

05676 - [B1086045] RELEASED

Arms Sales Ceiling Based on Inconsistent and Erroneous Data. FGMSD-78-30; B-174901. April 12, 1978. Released April 19, 1978. 2 pp. + 2 appendices (8 pp.).

Report to Rep. Lee H. Hamilton; by Elmer B. Staats, Comptroller General.

Issue Area: Accounting and Financial Reporting: Government Operations and Useful Information (2811); International Economic and Military Programs: Foreign Military Sales (605).
Contact: Financial and General Management Studies Div.
Budget Function: Miscellaneous: Financial Management and Information Systems (1002).
Organization Concerned: Defense Security Assistance Agency.
Congressional Relevance: Rep. Lee H. Hamilton.

In November 1977, the Defense Security Assistance Agency disclosed that its previously reported estimate of $9.9 billion for fiscal year 1977 foreign military sales was understated by $1.4 billion. The President based the fiscal year 1978 arms sales ceiling of $8.6 billion on fiscal year 1977 sales. Findings/Conclusions: There were substantial accounting inconsistencies and errors relating to the $1.4 billion adjustment. As a result, fiscal year 1977 sales of weapons and weapons-related items subject to the ceiling were overstated by $594 million. Using the corrected sales figures, the ceiling now represents only a $66 million reduction from fiscal year sales rather than the $695 million reduction originally estimated. The Agency inconsistently accounted for price changes and made other accounting errors, and efforts to correct the accounting records at fiscal year end largely failed. Recommendations: The Secretary of Defense should have the Defense Security Assistance Agency: make its accounting practices consistent by requiring that all price changes be accounted for as an adjustment to sales totals for the fiscal year in which the original sales agreement was signed; correct its accounting records for 1977 sales, taking into account the errors found to date; formally report the revised sales totals to the President and the Congress; and review its accounting for arms sales, especially for scope and price changes, to assure that inconsistencies and errors were not made and correct the accounting records where necessary. (RRS)

0045

REPORT BY THE
Comptroller General
OF THE UNITED STATES

RESTRICTED — Not to be released outside the General Accounting Office except [illegible] approval by the [illegible] of Co[illegible]

RELEASED 4/19/78

Arms Sales Ceiling Based On Inconsistent and Erroneous Data

The dollar value of fiscal year 1977 arms sales reported by the Department of Defense was used as a basis in establishing $8.6 billion as the 1978 arms sales ceiling. The ceiling set by the President represented a $695 million, or a 7.5 percent, reduction in sales from fiscal year 1977.

GAO identified inconsistencies and errors in accounting which resulted in substantial overstatement of fiscal year 1977 sales. Using corrected sales figures, the ceiling now represents only a $66 million reduction from fiscal year 1977 sales. Further, had a 7.5 percent reduction been applied to the corrected sales figures, the fiscal year 1978 ceiling would have been set $584 million lower.

GAO is continuing its review of Defense's system of accounting for foreign military sales.

UNITED STATES GENERAL ACCOUNTING OFFICE

FGMSD-78-30
APRIL 12, 1978

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

B-174901

The Honorable Lee H. Hamilton
House of Representatives

Dear Mr. Hamilton:

Your letter of November 16, 1977, asked us to examine the procedures by which the Department of Defense accounts for the value of foreign military sales agreements and by which the yearly foreign military sales ceiling is established. You requested the review after the disclosure by the Defense Security Assistance Agency, in November 1977, that its previously reported estimate of $9.9 billion for fiscal year 1977 foreign military sales was understated by $1.4 billion. This matter received widespread attention since the President based the fiscal year 1978 arms sales ceiling on fiscal year 1977 sales. On February 1, 1978, the President established a ceiling of $8.6 billion which is a reduction of $695 million, or 7.5 percent, from fiscal year 1977 sales adjusted for inflation to fiscal year 1978 dollars.

As agreed with your office, our initial efforts were directed to reviewing the accuracy of the $1.4 billion adjustment. After briefing your office on March 3, 1978, it was agreed that we would prepare this interim report on our findings to date.

Our review disclosed substantial accounting inconsistencies and errors relating to the $1.4 billion adjustment. As a result, fiscal year 1977 sales of those weapons and weapons-related items that are subject to the ceiling were overstated by $594 million. The President, therefore, used erroneous sales information as a basis for establishing the arms sales ceiling for fiscal year 1978. Using corrected sales figures, the ceiling now represents only a $66 million reduction from fiscal year 1977 sales. Had a 7.5 percent reduction been applied to the corrected sales figures, the fiscal year 1978 ceiling would have been $584 million lower.

Details of our findings are included in appendix I. We informally discussed our findings with Defense Security Assistance and State Department officials and, where appropriate, their comments have been considered in preparing this report. The scope of our review to date is included in appendix II.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from the date of this letter. At that time we will send copies to interested parties and make copies available to others upon request.

Also, as arranged with your office, we will continue our review of Defense's system of accounting for foreign military sales and inform you of the results in a final report.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

FINDINGS AND RECOMMENDATIONS REGARDING DEFENSE'S ACCOUNTING FOR FOREIGN MILITARY SALES

BACKGROUND

The Defense Security Assistance Agency maintains an automated foreign military sales accounting system which, supplemented by manual records, provides detailed information on the value of foreign military sales. In September 1977, the Agency told the Congress that arms sales in fiscal year 1977 would approximate $9.9 billion. In November 1977, the Agency disclosed that its projections were understated by $1.4 billion. The understatement was attributed to a delay in applying a change in accounting policy whereby the dollar value of amendments increasing the scope of prior year sales agreements was to have been recorded as sales for the fiscal year in which the amendment was signed. Scope change increases cover additional quantities of items ordered, modifications to the configuration or design of items, and changes in the composition of services and training programs.

Defense Security Assistance Agency officials said that the $1.4 billion in accounting adjustments resulted because the Agency had erroneously followed superseded accounting practices and had recorded fiscal year 1977 scope increases as adjustments to prior year sales totals. They said that they were unaware of the magnitude of the error until the end of fiscal year 1977.

There are changes to sales agreements in addition to scope increases which have an important effect on the dollar value of sales reported. These changes are (1) scope decreases and (2) price changes. The accounting treatment prescribed by the Agency for the two types of changes follow.

Scope decreases. Where a change in a sales agreement results in a decrease in scope, Defense policies require it to be accounted for as a decrease to the sales total for the fiscal year in which the original sales agreement was signed. For instance, an amendment signed in fiscal year 1977, decreasing the scope of a fiscal year 1975 sales agreement, should have been accounted for as a decrease in the value of fiscal year 1975 sales.

Price changes. Price changes are generally the result of inflation, production delays, and/or poor price estimating. Defense policies require a price change to be accounted for in the same manner as a scope decrease. For instance, an amendment signed in fiscal year 1977 increasing or decreasing the price of an item or service included in a sales agreement signed in fiscal year 1975 should have been accounted for as an adjustment to the value of fiscal year 1975 sales.

Establishment of fiscal year 1978 sales ceiling

In a May 19, 1977, policy statement, President Carter said that the dollar volume of new commitments under the Foreign Military Sales and Military Assistance Programs for weapons and weapons-related items in fiscal year 1978 would be reduced from the fiscal year 1977 total. On February 1, 1978, the President placed an $8.6 billion ceiling on fiscal year 1978 sales.

In imposing the ceiling the President directed that the following sales be excluded: (1) sales to countries with which the United States has major defense treaties (North Atlantic Treaty Organization countries, Japan, Australia, and New Zealand), (2) sales of articles and services not considered to be weapons or weapons-related, such as most of the construction program in Saudi Arabia, and (3) commercial sales for which the U.S. Government must issue export licenses.

As shown below the fiscal year 1978 ceiling on sales was derived by inflating the value of fiscal year 1977 sales (less applicable exclusion as enumerated above) to constant fiscal year 1978 dollars and reducing the resultant figure by $695 million, or 7.5 percent, as directed by the President.

CALCULATION OF VALUE OF FISCAL YEAR 1978 ARMS SALES CEILINGS

		Amount (millions)
Total fiscal year 1977 sales reported by Defense Security Assistance Agency (including the $1.4 billion adjustment and applicable Military Assistance Program sales)		$11,469
Less exclusions:		
Sales to countries with treaties	($1,221)	
Sales of articles and services not considered as weapons or weapons related	(1,479)	(2,700)
Adjusted fiscal year 1977 sales		8,769
Add 6 percent inflation factor to equate to fiscal year 1978 constant dollars		526
Fiscal year 1977 sales in constant fiscal year 1978 dollars		9,295
Less reduction in sales set by the President (approximately 7.5 percent)		(695)
Fiscal year 1978 arms sales ceiling		$8,600

INCONSISTENT AND ERRONEOUS SALES DATA USED TO COMPUTE FISCAL YEAR 1978 ARMS SALES CEILING

The Defense Security Assistance Agency used inconsistent accounting practices and made substantial accounting errors in increasing its reported fiscal year 1977 sales by $1.4 billion in adjustments made in November 1977. The inconsistencies and errors resulted in an overstatement of $594 million for those 1977 sales which related to articles and services subject to the arms sales ceiling.

The accounting inconsistencies and errors included in the $1.4 billion adjustments, which affected the computation of the 1978 arms sales ceiling, follow:

--Although the Defense Security Assistance Agency reported that the entire $1.4 billion adjustment represented the value of sales scope increases, about $464 million of the adjustment pertained to price changes made to agreements signed prior to 1977. According to the Defense Security Assistance Agency's accounting procedures, price changes should be accounted for in the year the original sales agreement was signed.

--About $133 million of the sales adjustment was misclassified as pertaining to increases in scope for items and services subject to the arms sales ceiling. The $133 million pertained to construction work administered by the Army Corps of Engineers in Saudi Arabia and the transaction should have been accounted for as a nonceiling sale.

--About $11 million representing sales scope decreases pertaining to prior year sales agreements, were erroneously deducted from 1977 sales when the Agency made the $1.4 billion adjustment. As stated above, these decreases should have been accounted for as a decrease in sales for the year the sales agreement was originally signed.

--The cumulative effect of other miscellaneous accounting errors was an overstatement of sales of $8 million.

As indicated above, the largest accounting problem pertained to price changes. Many of the contract amendments which were used as support for the $1.4 billion adjustment included both scope changes and price changes. Rather than determining how much of the amendment amount related to scope changes and how much related to price changes, the Agency treated the entire amount as a scope increase and recorded it as a fiscal year 1977 sale. Responsible Agency officials said that although they did not have a written policy covering those cases where scope and price were combined on a contract amendment, it was their intention to treat the entire value of the combined amendment as a scope change. This practice is inconsistent with (1) the Agency's overall policy of accounting for price changes and (2) the Agency's disclosure that the $1.4 billion adjustment represented the value of scope increases. For example, included in the $1.4 billion was an amendment increasing the value of a fiscal year 1974 sales agreement for sale of Patrol Chaser Missiles to Saudi Arabia by $185.6 million. The entire amount was treated as a scope change and recorded as a fiscal year 1977 sale. We found, however, that only $21.2 million of the amount represented a change in scope. The remaining $164.4 million represented the net value of price increases and should have, therefore, been accounted for as an increase to fiscal year 1974 sales to be consistent with the Agency's accounting policies for recording price changes. In two other instances, amendments for $49.8 million and $19.4 million, although entirely for price changes, were erroneously recorded as fiscal year 1977 sales.

IMPACT OF ACCOUNTING INCONSISTENCIES AND ERRORS ON ARMS SALES CEILINGS

Considering the accounting inconsistencies and errors we identified, the calculation of the fiscal year 1978 arms sales ceiling as shown in the following table may have been overstated by about $584 million.

IMPACT OF ACCOUNTING INCONSISTENCIES AND ERRORS ON DEFENSE SECURITY ASSISTANCE AGENCY COMPUTATIONS OF FISCAL YEAR 1977 CEILING SALES AND THE EFFECT ON THE FISCAL YEAR 1978 ARMS SALES CEILING

	Defense Security Assistance Agency	Adjusted for accounting inconsistencies and errors found by GAO	Difference
		(millions)	
Value of fiscal year 1977 sales pertaining to items and services covered by the ceiling	$8,769	$8,175	$594
Sales adjusted for inflation from fiscal year 1977 to fiscal year 1978	9,295	8,666	629
Fiscal year 1978 arms sales ceiling	a/8,600	8,016	584

a/Set by the President, representing an approximate 7.5 percent reduction from fiscal year 1977 ceiling sales adjusted for inflation to fiscal year 1978.

The table shows that instead of reducing sales in fiscal year 1978 by $695 million ($9,295 million less $8,600 million), the ceiling set by the President will result in reducing sales by only $66 million ($8,666 million less $8,600 million).

The table also shows that, had a 7.5 percent reduction been applied to the corrected sales figures the sales ceiling would have been $8.016 billion or about $584 million less than the current fiscal year 1978 ceiling. This is not to say, however, that the President would have decided to reduce sales by 7.5 percent had he known the correct value of fiscal year 1977 sales.

OTHER ACCOUNTING INCONSISTENCIES AND ERRORS PERTAINING TO THE $1.4 BILLION ADJUSTMENT DID NOT AFFECT THE 1978 ARMS SALES CEILING

In addition to the accounting problems discussed above, the Agency in recording the $1.4 billion adjustment used inconsistent accounting practices and made accounting errors amounting to $82 million which did not affect the value of fiscal year 1977 sales related to items and services subject to the arms sales ceiling. For instance, price changes totaling $81 million relating to sales of items and services not subject to the ceiling and sales to countries exempt from the sales ceiling, were included in the $1.4 billion adjustment. These amounts, although having no impact on the establishment of the fiscal year 1978 arms sales ceiling, caused fiscal year 1977 total sales to be overstated.

CONCLUSIONS

There were serious weaknesses in the Defense Security Assistance Agency's accounting for the $1.4 billion adjustment in fiscal year 1977 arms sales because the Agency inconsistently accounted for price changes and made other accounting errors. Also, its efforts to correct the accounting records at fiscal year end largely failed. As a result, information on which the President based the fiscal year 1978 arms sales ceiling was substantially incorrect.

The Defense Security Assistance Agency should correct its accounting records for arms sales and should inform the President and the Congress of the revised sales totals.

RECOMMENDATIONS

We recommend that the Secretary of Defense have the Defense Security Assistance Agency:

--Make its accounting practices consistent by requiring that all price changes be accounted for as an adjustment to sales totals for the fiscal year in which the original sales agreement was signed.

--Correct its accounting records for fiscal year 1977 sales taking into account the errors found to date in our review.

--Formally report the revised sales totals to the President and the Congress.

--Review its accounting for arms sales, especially for scope and price changes in fiscal year 1978, to assure that inconsistencies and errors similar to the ones we found were not made and correct the accounting records where necessary.

SCOPE OF REVIEW

Our review of the $1.4 billion in accounting adjustments included an examination of policies, procedures, transactions, and reports dealing with accounting for the value of Foreign Military Sales and Military Assistance Program commitments. We interviewed responsible officials to discuss policies, procedures, and other matters. Our review of the remaining fiscal year 1977 sales and the system of accounting for foreign military sales is still underway.

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

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

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

--Security Assistance Accounting Center, Denver, Colorado.

--Army Corps of Engineers, Washington, D.C.

--Naval Material Command, Washington, D.C.

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

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

--Department of State, Washington, D.C.

(90377)