



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

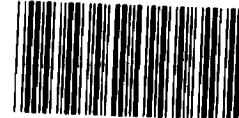
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HENSE

DIVISION OF FINANCIAL AND
GENERAL MANAGEMENT STUDIES

DECEMBER 3, 1979

B-165731

Title on Form 115



110987

The Honorable Harold Brown
The Secretary of Defense

Dear Mr. Secretary:

Subject: Response to Defense Comptroller's Comments
on GAO's Report Entitled "Improperly
Subsidizing the Foreign Military Sales
Program--A Continuing Problem" (FGMSD-79-16,
Mar. 22, 1979)

previous report #

In a June 15, 1979, letter (OSD Case #5125), the Assistant Secretary of Defense (Comptroller) responded to our report cited above. In his response, the Assistant Secretary took exception to our recommendations. (See encl. I.) My purpose in this report is to respond to the Assistant Secretary's objections and to reiterate the merits of our recommendations and the importance of your implementing them.

In our subject March 1979 report, we (disclosed that during the past 6 fiscal years the Defense Department had not charged up to an estimated \$370 million for quality assurance services provided on items sold to foreign countries, even though recovery of costs for these services had been required since at least 1970.) The problems encountered in not recovering these costs were indicative of Defense's continued failure to recover all costs for foreign military sales.

(Failure to recover these costs has largely resulted from inadequate implementation of Defense's pricing policies by the military departments and Defense agencies, and insufficient followup or monitoring of the departments' and agencies' actions by Defense policymakers. Our main recommendation was to assign to a new or existing organization the specific responsibility for insuring effective and consistent implementation of foreign military sales pricing policies. That organization should be sufficiently freed from other work to carefully follow up and monitor implementation of foreign military sales pricing policies.

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007949

FGMSD-80-2
(903680)

The Assistant Secretary does not accept ^{this} our recommendation because (1) followup to assure compliance with Defense policies should be the responsibility of internal audit staffs, inspector general teams, and financial quality assurance organizations and (2) he believed that a new foreign military sales "audit/inspection" organization would not be the most efficient use of available personnel. Further, he questions ^{the} our estimate of up to \$370 million in costs not recovered for quality assurance services, but advises that corrective action has been initiated to recover those costs and to avoid incurring future deficits.

We have considered the Assistant Secretary's comments carefully, but we believe our position is sound and merits further consideration by your Department. ^(b) Regarding whether additional effort would be warranted to police compliance with Defense policies, ^(b) cumulative foreign military sales since 1972 have totaled about \$70.2 billion, and during that time we have issued 30 reports on deficient accounting, billing, and collecting on foreign military sales. Since 1976, we have identified ^(b) over \$1 billion in unrecovered costs on selected sales cases. ^{has been done} The total of such unrecovered costs is undoubtedly substantially more. Considering the size of the program and the cost of not administering the program properly, we believe that our recommendation is cost effective and should be implemented.

^(b) The Assistant Secretary believes that ^{is} our estimate of up to \$370 million in unrecovered quality assurance services costs may be significantly overstated. He said that Defense is attempting "to develop a more accurate estimate of the total underrecoupment (if any)." However, as noted in our report, Defense has no statistics to show the amount of quality assurance spent on foreign military sales items, ^(b) that lack of information strongly indicates a deficient accounting system. To obtain a rough approximation of the quality assurance costs incurred by contract administration services regions, we determined the ratio of the dollar values of foreign military sales acceptances to Defense procurement appropriations and multiplied that by the cost of the regions' quality assurance for fiscal 1973 through 1978. The resulting estimate of \$370 million represents an average of 0.57 cent for each sales dollar.

^(b) Defense, in attempting "to develop a more accurate estimate," ^(b) examined a random sample of 100 contracts, ^(b) and found that quality assurance costs 0.48 cent per sales dollar. ^(b) Although the Defense Logistics Agency concluded that the sample was too small and not statistically valid (see encl. II), it is interesting to note that our estimate and the results of Defense's sample ^(b) are not appreciably different.

of the amount that

A brief review of the facts leaves no doubt that the amount of the underrecoupment for quality assurance is substantial. Since fiscal 1976, the Defense Logistics Agency has identified (but not collected) \$16 million in quality assurance costs on foreign military sales items. The \$16 million represents only 2 percent of the Defense Logistics Agency's quality assurance efforts. Since foreign military sales orders represent approximately a third of Defense's purchasing authority, substantial costs obviously have not been identified or recouped.)

Also, in a report on quality assurance activities in Defense contract administration organizations (No. 79-085, May 9, 1979), the Defense Audit Service identified reimbursables of \$20 million for fiscal 1977--most of which, according to Defense auditors, was for quality assurance provided by the military services. (Since the military services are responsible for quality assurance at only 36 of about 20,000 Defense contractor plants, 1/ the Defense Logistics Agency's share of quality assurance costs should be many times greater than that incurred by the services.)

The Assistant Secretary also indicated that actions have been taken to correct the problems in reimbursing the Defense Logistics Agency for quality assurance. In an October 25, 1978, memo, the military departments were notified to honor the Defense Logistics Agency billings for quality assurance provided on foreign military sales items. However, as of July 1979, the Defense Logistics Agency has received cumulative reimbursements (i.e., reimbursements for all fiscal years) totaling only about \$2 million.)

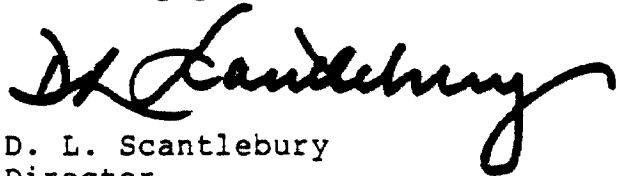
The Assistant Secretary also stated that (foreign military sales cases written or amended since June 1978) have included a 1-percent factor for quality assurance costs, and that ample funds will have been billed and collected from foreign military sales customers. The inclusion of the 1-percent factor in the the sales cases is a step in the right direction. However, as shown by the small amounts being billed and collected, there is still no assurance that the costs will be billed and collected. To ensure billing and collecting of quality assurance costs, Defense must first establish a system to identify when such costs are incurred for foreign military sales.)

1/The Defense Contract Administration Services regions provided quality assurance, as required, at the rest of the contractor plants.

Almost 10 years after requiring that quality assurance costs be reimbursed, Defense has not, for the most part, recovered those costs. The problem of noncompliance or long delays in implementing Defense policies has been disclosed in the 30 reports we have issued in the past several years on deficient pricing practices. We think that basic corrective action is long overdue and that Defense should provide sufficient resources to ensure that its pricing policies are effectively implemented.

Copies of this report are being sent to the Director, Office of Management and Budget and to the House Committee on Government Operations, the Senate Committee on Governmental Affairs, and the House and Senate Committees on Appropriations.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. L. Scantlebury". The signature is written in a cursive style with a large, sweeping flourish at the end.

D. L. Scantlebury
Director

Enclosures



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

15 JUN 1979

CONFIDENTIAL

Honorable Elmer B. Staats
Comptroller General of the
United States
Washington, D.C. 20548

Dear Mr. Staats:

This is in reply to your letter to the Secretary of Defense regarding your report dated March 22, 1979, on "Improperly Subsidizing the Foreign Military Sales Program — A Continuing Problem" (OSD Case #5125) (FGMSD-79-16).

The above report stated that since 1973 up to \$370 million worth of quality assurance services had not been properly recouped from Foreign Military Sales (FMS) customers. We believe this estimate may be significantly overstated and are investigating the condition. Each of the Military Departments has been requested to identify the dollar value of FMS contracts forwarded to the Defense Logistics Agency (DLA) for quality assurance support. Also, a random sample of quality assurance cost expended on foreign commercial contracts has been taken. The sample discloses that the quality assurance effort averages .48% of contract cost. Quality assurance cost for the sampled contracts ranges from a high of 37.1% on a \$748 contract to a low of .2% on a \$40,898 contract. The sample is now being evaluated by DLA statisticians to determine if it can be used to project the quality assurance costs related to the total universe. If it is validated, we will apply the percentage to the dollar value of contracts forwarded to DLA for quality assurance support and thus be in a position to develop a more accurate estimate of the total under-recoupment (if any).

The necessity to include provision for recoupment of quality assurance support in the estimated FMS case cost was stressed in the June 1978 FMS pricing workshops. These workshops were conducted in response to recommendations contained in previous GAO reports. Cases written or amended since that date have included a 1% factor for quality assurance cost. Therefore, if the sample percentage of .48% is representative of the universe, ample funds will have been billed and collected from FMS customers. The major remaining effort then will be to assure that Military Department contracts provide sufficient FMS identification so that all quality assurance support costs are recouped. This identification problem is the reason that there is a possibility all FMS support costs have not been recouped. However, it should be emphasized that in most

cases FMS customer funds have been obtained for these services and are on deposit in the FMS trust fund, a non-interest bearing Treasury account. The problem associated with reimbursing DLA was resolved by an Assistant Secretary of Defense (Comptroller) memorandum dated October 25, 1978, which notified Military Departments to honor DLA billings for quality assurance hours that are supported by applicable FMS country, case, contract and requisition number. Now that this information is being provided, funds are being transferred to reimburse the DLA appropriation accounts.

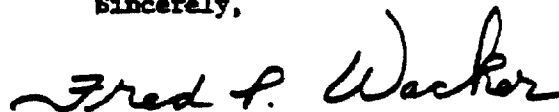
The first recommendation to the Secretary was to reconsider previous GAO recommendations to assign specific responsibility for ensuring effective and consistent implementation of Foreign Military Sales pricing policies to a new or existing organization that can be sufficiently freed from other work to carefully follow up and monitor implementation of FMS pricing policies. Our position that follow-up at the installation level to assure compliance with DoD policies should be the responsibility of our internal audit staffs, inspector general teams, and financial quality assurance organizations remains unchanged. We believe that establishment of a new FMS "audit/inspection" organization would not be the most efficient use of available manpower resources.

The second recommendation was to develop and implement practical procedures to recover the cost of Government-provided quality assurance. Our current procedures provide for accumulating quality assurance support hours expended on contracts awarded to meet FMS customer requirements. We are presently developing simplified procedures for accumulating man-hours for support of FMS customers. The system provides for determining average man-hours per \$1,000 on the basis of the type of commodity and complexity of quality assurance support required. This action will effectively implement the GAO recommendation and result in a savings of administrative man-hours for quality assurance personnel.

Your final recommendation was to direct responsible organizations to make a reasonable attempt to identify and recoup undercharges for quality assurance. As you point out in the report, a case cannot be closed until costs have been recouped in accordance with DoD Instruction 2140.1. A new procedure will be implemented shortly to assure that a final review of case pricing is made prior to case closure. Additional documentation will be placed in each case file to show the cost elements included in the case price and the appropriation accounts which have been reimbursed. This improved audit trail will reinforce our pricing policies and help assure that all costs are properly recouped. Under this procedure any under-recoupments would be identified so that appropriate billings can be made.

We appreciate the opportunity to comment on your report.

Sincerely,



Fred P. Wacker
Assistant Secretary of Defense

8 JUN 1979

DLA-CFC

MEMORANDUM FOR DEPUTY ASSISTANT SECRETARY OF DEFENSE (MANAGEMENT SYSTEMS)

SUBJECT: QA Costs Incurred in Support of Foreign Country District Commercial Contracts

Reference: OASD(MS) memorandum, 1 May 1979, subject as above.

The enclosure displays the results of a regression analysis performed on the referenced data. Of the 100 random sample contracts within the reference, only 35 sample contracts were input to the regression analysis. We excluded 15 contracts because they were highly skewed in respect to the rest of the sample. Because this sample is from a population of 10,000 contracts, the results of our regression analysis are not reliable. A random sample of 1,000 contracts will provide more meaningful results. The need for a large sample becomes quite apparent when the Correlation Coefficient is reviewed (see subparagraph c below).

The enclosure does not show that QA hours incurred within the subject area can be estimated from the Dollar Value of the contract, i.e., QA hours being the dependent variables and the Dollar Values of each contract being the independent variables. Both the low Correlation Coefficient and the high Standard Error of the Estimate bears this out. The following is an explanation of the enclosure's figures.

a. The Intercept and the Regression Coefficient yield the following equation:

$$y_c = 4.79185 + .0000763325 (x)$$

yc = calculated QA hours
x = Dollar Value of a contract

b. Because the Computed T-value is greater than three, there may be a mathematical relationship between QA hours and the Dollar Value of the contract.

c. The Correlation Coefficient indicates that only 34.3% of the variations of the Y Estimated values from the Y Observed values are explained by estimate (see Table of Residuals). That is 65.7% of this variation is not accounted for by the sample.

DLA-CFC

SUBJECT: QA Costs Incurred in Support of Foreign Country District Commercial Contracts

d. The Standard Error of Estimate indicates that, on the average, a Yc calculated from a Dollar Value in the sample will come within ± 4.189 hours of the actual QA hours associated with that contract.

e. The Table of Residuals shows the Yc for each of the 85 Dollar Values in the sample:

Y Observed = actual QA hours billed

Y Estimated = QA hours calculated with $Yc = 4.79183 + .0000763325 (x)$

Residual = Y Observed - Y Estimated

FOR THE DIRECTOR:

(signed) R. G. BORDLEY

Encl

R. G. BORDLEY
Chief, Accounting and Finance Division
Office of the Comptroller

Mr. Swanson/46217/shs/7 Jun 79 *shs*Mr. Coffee *CFC*LTC Resa *res*

J.F.R.: Mr. Melkurn submitted this data to refute
o GAU report that states DoD has
undercharged over \$370 million for QA
services rendered. A larger sample could
prove to be helpful to his cause,

COMPUTED T-VALUE..... **3.331**
 CORRELATION COEFFICIENT..... **.313**
 STANDARD ERROR OF ESTIMATE... **4.189**

TABLE OF RESIDUALS

CASE NO	Actual Q T OBSERVED	Estimated T ESTIMATED	RESIDUAL
1	2.822	4.883	-2.063
2	8.822	6.141	1.859
3	6.822	4.896	1.104
4	4.822	5.822	-1.822
5	2.822	6.311	-4.311
6	3.822	4.969	-1.969
7	3.822	4.929	-1.929
8	2.822	5.855	-3.855
9	3.822	4.818	-1.818
10	15.822	9.473	5.527
11	5.822	5.296	-.296
12	7.822	6.758	.758
13	10.822	9.264	.736
14	6.822	6.913	-.913
15	5.822	7.317	-2.317
16	5.822	7.312	-2.312
17	4.822	4.871	-.871
18	4.822	5.117	-1.117
19	2.822	4.985	-2.985
20	3.822	4.819	-1.819
21	4.822	14.335	-10.335
22	2.822	4.873	-2.873
23	5.822	5.669	-.669
24	7.822	4.865	2.135
25	3.822	6.854	-3.854
26	4.822	6.911	-2.911
27	2.822	4.861	-2.861
28	19.822	5.658	13.342
29	1.822	4.927	-3.927
30	12.822	6.887	5.913
31	8.822	5.195	2.895
32	3.822	4.811	-1.811
33	8.822	4.953	3.847
34	3.822	5.725	-2.725
35	1.822	4.834	-3.834
36	4.822	7.932	-3.932
37	3.822	4.958	-1.958
38	5.822	4.843	.157
39	4.822	5.826	-1.826
40	6.822	5.677	.323
41	4.822	5.867	-1.867
42	3.822	4.951	-1.951

43	2.828	5.479	-3.479
44	5.828	5.269	-.269
45	15.828	5.963	9.837
46	16.828	6.615	9.385
47	5.828	7.914	-2.914
48	7.828	5.883	1.483
49	11.828	8.993	5.818
50	3.828	5.857	-2.457
51	9.828	5.156	3.844
52	18.828	5.873	4.927
53	2.828	5.274	-3.274
54	9.828	5.139	3.661
55	16.828	6.193	9.818
56	6.828	5.258	.758
57	4.828	4.925	-.925
58	9.828	5.112	3.888
59	7.828	4.849	2.151
60	8.828	4.824	3.176
61	16.828	5.845	18.155
62	4.828	4.827	-.827
63	2.828	4.895	-2.825
64	5.828	4.888	.128
65	2.828	-4.828	-2.828
66	4.828	5.981	-1.981
67	4.828	4.896	-.896
68	16.828	11.388	4.692
69	5.828	5.894	-.494
70	4.828	4.882	-.882
71	4.828	5.238	-1.238
72	21.828	5.662	15.339
73	3.828	4.981	-1.981
74	1.828	4.829	-3.829
75	4.828	5.153	-1.153
76	3.828	5.158	-2.158
77	2.828	5.279	-3.279
78	2.828	5.341	-3.341
79	-8.828	5.153	2.853
80	2.828	4.858	-2.858
81	2.828	4.832	-2.832
82	7.828	5.293	1.787
83	6.828	6.876	-.876
84	1.828	5.132	-4.132
85	2.828	4.826	-2.826



COMPTROLLER
(Management Systems)

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

May 1, 1979

MEMORANDUM FOR MR. BORDLEY, DLA

SUBJECT: QA Costs Incurred in Support of Foreign Country Direct
Commercial Contracts

Attached is the sample of QA costs recorded by the New York Control Point on a sample of closed contracts. Information on the techniques used to select the sample and population size may be obtained from Mr. Jensen, Autovon 994-9191.

I would appreciate your having a statistician review the sample per our discussion of last week. We need the right buzz words, i.e., confidence level, mode, etc. Also, the sample results should be portrayed on a curve. My current plan is to use the study results in responding to the GAO report on QA.


Michael Melburn

Attachment

	AMOUNT	BILLED	PAID	REQUESTED	PERCENT
AT-0044-77	\$ 145.	2	37.00	Q	26.2%
AT-0055-76	188,345.	120	2340.00	Q	1.2%
AT-0058-76	17,680.	8	156.00	Q	.9%
AT-0058-77	1,367.	6	117.00	Q	8.6%
BE-0005-75	13,500.	4	78.00	Q	.6%
BE-0005-77	19,900.	2	39.00	Q	.2%
BE-0009-75	2,324.	3	56.00	Q	2.5%
BE-0009-76	1,800.	3	54.00	Q	3.0%
BE-0016-76	3,450.	2	39.00	Q	1.1%
BE-0034-74	340.	3	58.50	Q	17.2%
FR-0004-73	309,032.	60	1170.00	Q	.4%
FR-0006-75	85,370.	16	312.00	Q	.4%
FR-0009-77	61,322.	15	292.50	Q	.5%
FR-0012-75	6,600.	5	97.50	Q	1.5%
GY-0003-77	25,650.	7	136.50	Q	.5%
GY-0075-76	58,590.	10	145.00	Q	.3%
GY-0085-78	27,787.	6	117.00	Q	.4%
GY-0272-77	33,087.	5	97.50	Q	.3%
GY-0275-77	33,016.	5	97.50	Q	.3%
GY-0307-77	1,034.	4	78.00	Q	7.5%
GY-0307-78	4,265.	4	78.00	Q	1.8%
GY-0309-77	1,482.	2	39.00	Q	2.6%
GY-0314-76	748.	3	58.50	Q	7.8%
GY-0323-77	125,025.	4	78.00	Q	.03%
GY-0362-76	1,060.	2	78.00	Q	3.7%
GY-0372-76	11,486.	5	97.50	Q	.8%
GY-0397-76	957.	7	136.50	Q	14.3%
GY-0399-78	27,011.	3	58.50	Q	.2%
GY-0434-76	156,249.	31	604.50	Q	.4%
GY-0527-74	38,885.	45	877.50	Q	2.2%
GY-0556-77	28,200.	4	78.00	Q	.2%
GY-0590-75	900.	2	39.00	Q	4.5%
GY-0590-76	11,348.	19	370.50	Q	3.3%
GY-0626-76	1,768.	1	19.50	Q	1.1%
GY-0647-76	16,972.	12	234.00	Q	1.4%
GY-0657-73	5,284.	8	156.00	Q	3.0%
GY-0657-77	252.	3	58.50	Q	23.2%
GY-0664-76	2,105.	8	156.00	Q	7.4%
GY-0687-77	12,229.	3	58.50	Q	.5%
GY-0697-76	555.	1	19.50	Q	3.5%
GY-0707-77	41,144.	4	78.00	Q	.2%
GY-0732-76	2,175.	3	58.50	Q	2.7%
Sub total	1,380,439		8,970		.7%

FCAS NUMBER	DOLLAR VALUE OF CONTRACT	TOTAL HOURS BILLED	FUNCTION REQUESTED	
			@ 19.50	Cost %
IS-0033-77	\$ 28,850.	24	468.00	Q 1.6%
IS-0039-78	666.	5	97.50	Q 14.6%
IS-0044-78	3,069.	4	78.00	Q 2.5%
IS-0045-74	11,595.	6	117.00	Q 1.0%
IS-0045-78	3,600.	4	78.00	Q 2.2%
IS-0048-75	2,085.	3	58.50	Q 2.8%
IT-0022-78	9,000.	2	39.00	Q .4%
IT-0022-74	159,796.	46	897.00	Q .6%
IT-0026-74	114,823.	22	429.00	Q .4%
MO-0002-76	36,163,622.	7232	141,024.00	Q .7%
MO-0002-77	45,789,118.	7360	143,520.00	Q .3%
NE-0006-73	15,523,858.	8844	172,458.00	Q 1.1%
NE-0014-76	6,251.	5	97.50	Q 1.6%
NE-0015-76	15,341.	15	292.50	Q 1.9%
NO-0007-76	23,887.	16	312.00	Q 1.3%
NO-0009-73	1,572,325.	384	7488.00	Q .5%
NO-0012-73	50,246.	137	2671.50	Q 5.3%
UK-0002-77	40,898.	5	97.50	Q .2%
UK-0005-78	10,583.	7	136.50	Q 1.3%
UK-0012-78	55,000.	14	273.00	Q .5%
UK-0013-77	122,500.	31	604.50	Q 1.2%
UK-0015-77	3,470.	3	58.50	Q 1.7%
UK-0068-75	4,776.	9	175.50	Q 3.7%
UK-0070-73	3,685.	10	195.00	Q 5.3%
UK-0073-76	6,320.	2	39.00	Q .6%
UK-0074-73	99,856.	64	1,248.00	Q 1.3%
UK-0074-76	4,550.	9	175.50	Q 3.9%
UK-0075-73	18,320.	16	312.00	Q 1.7%
UK-0080-74	6,000.	6	117.00	Q 2.0%
UK-0081-75	1,750.	4	78.00	Q 4.5%
UK-0082-75	4,200.	9	175.50	Q 4.2%
UK-0083-75	748.	7	136.50	Q 18.2%
UK-0084-75	420.	8	156.00	Q 37.1%
UK-0086-73	13,800.	16	312.00	Q 2.3%
UK-0091-75	458.	4	78.00	Q 17.0%
N4-0044-75	1,216.	2	39.00	Q 3.2%
N4-0046-78	1,160.	5	97.50	Q 8.4%
N4-0048-78	372.	2	39.00	Q 10.5%
N4-0075-77	14,535.	4	78.00	Q .5%
N4-0078-78	1,369.	4	78.00	Q 5.7%
N4-0087-78	9,196.	5	97.50	Q 1.1%
N4-0106-78	1,177.	4	78.00	Q 1.2%
N4-0122-77	5,850.	4	78.00	Q 1.3%
Subtotal	99,684,153.00		475,462.50	.48%

FCAS NUMBER	DOLLAR VALUE OF CONTRACT	TOTAL HOURS BILLED	FUNCTION REQUESTED	0.00 of 100
N4-0140-75	\$ 26,711.	27	Q	9.2
N4-0155-74	① 11,400.	21	Q	3.6
N4-0159-76	1,430.	3	Q	4.1
N4-0169-77	483.	1	Q	4.0
N4-0175-77	4,692.	4	Q	1.7
N4-0175-78	4,798.	3	Q	1.2
N4-0184-78	6,386.	2	Q	1.6
N4-0234-76	7,190.	2	Q	1.5
N4-0251-77	4,689.	8	Q	3.3
N4-0273-78	865.	2	Q	4.5
N4-0201-78	531.	2	Q	7.3
N4-0216-75	6,560.	7	Q	2.1
N4-0216-76	16,822.	6	Q	1.7
N4-0221-78	4,458.	1	Q	1.4
N4-0225-78	445.	2	Q	8.5
Subtotal	\$ 87,460.00	17774.50		2.0%
minus found 101	1,380,437.00	8,970.00		
102	99,284,153.50	475,468.50		
Grand total	\$ 101,352,052.00	\$ 486,213.00		.46%

population = 10,000

sample size = 100 contracts

randomly selected