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REPORT BY THE

Comptroller General

OF THE UNITED STATES

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The Defense Department's Systems Of Accounting For The Value Of Foreign Military Sales Need Improvement

GAO identified $1.1 billion of inconsistencies and errors in accounting for fiscal 1977 arms sales. Had the correct sales figure been known, the President's fiscal 1978 arms sales ceiling, based on fiscal 1977 sales, might have been set $420 million lower.

GAO also identified $540 million in differences in sales information on the two systems Defense uses to account for the value of foreign military sales. Further, Defense identified an additional $800 million in differences in sales information on one of these systems.

Defense recognizes that its systems of accounting for the value of arms sales are not adequate and an extensive effort is underway to improve them. A special effort should be made by Defense to assure that the systems are made fully effective and that adequate automated controls are included.

This review was made at the request of the Chairman, Subcommittee on Europe and the Middle East, House Committee on Foreign Affairs.

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FGMSD-79-21
MARCH 16, 1979

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

AGC 5
AGC 15
CNG 1358
DLG 946

B-174901

The Honorable Lee H. Hamilton
Chairman, Subcommittee on Europe
and the Middle East
Committee on Foreign Affairs
House of Representatives

HSE 0111

Dear Mr. Hamilton:

Pursuant to your November 16, 1977 request, we reported to you that our review of Defense's $1.4 billion adjustment to fiscal 1977 foreign military sales figures had disclosed substantial inconsistencies and errors which may have resulted in a substantial overstatement of the fiscal 1978 arms sales ceiling (FGMSD-78-30, Apr. 12, 1978).

This report, our final response to your November request, discusses the procedures by which the Department of Defense computes the value of foreign military sales agreements and the yearly foreign military sales ceiling. The report identifies weaknesses in Defense's systems for accounting for the value of foreign military sales and the need for systems improvements to assure that sales information is accurate and reliable.

At the request of your office, we did not obtain written agency comments; however, the matters covered in the report were discussed with Defense officials. Their comments are included in the report where appropriate.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 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.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE SUBCOMMITTEE ON EUROPE AND THE MIDDLE EAST, HOUSE FOREIGN AFFAIRS COMMITTEE

THE DEFENSE DEPARTMENT'S SYSTEMS OF ACCOUNTING FOR THE VALUE OF FOREIGN MILITARY SALES NEED IMPROVEMENT

D I G E S T

The Defense Security Assistance Agency (45) inconsistently accounted for price changes and made other errors in its accounting for fiscal 1977 foreign military sales. Efforts to correct the accounting records at fiscal year end largely failed and, as a result, the President based the fiscal 1978 arms sales ceiling on incorrect information.

GAO identified $1.1 billion in accounting inconsistencies and errors related to fiscal 1977 sales. The result was a $427 million overstatement of sales of articles and services subject to the President's arms sales ceiling. Had the correct sales figure been known, the ceiling for fiscal 1978 might have been set $420 million lower.

Because of concern over the growth and magnitude of arms sales, President Carter said that the dollar value of new commitments in fiscal 1978 for weapons and weapons-related items would be reduced.

The dollar value of fiscal 1977 arms sales was used as the basis for establishing $8.6 billion as the fiscal 1978 ceiling. The ceiling was to represent a $695 million, or 7.5 percent, reduction in arms sales from fiscal 1977.

Exempted from the ceiling were sales to countries with which the United States has major Defense treaties, such as North Atlantic Treaty Organization countries; sales of articles and services not considered to be weapons or weapons related; and commercial sales. CNG 1358

In November 1977, Defense disclosed that its previously reported estimate of $9.9 billion for fiscal 1977 foreign military sales was

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understated by $1.4 billion because the Department had followed superseded accounting practices.

As GAO reported to the Chairman on April 12, 1978 (FGMSD-78-30), although Defense stated that the entire $1.4 billion adjustment represented the value of sales scope increases, about $464 million of this amount actually pertained to price changes made to agreements signed prior to fiscal 1977. According to Defense accounting procedures, price changes should be accounted for in the year the original sales agreement was signed. In total, GAO identified $698 million in accounting inconsistencies and errors related to the $1.4 billion adjustment, resulting in a net overstatement of $594 million for those articles and services subject to the arms sales ceiling. (See pp. 7 and 8.)

Concerning Defense's accounting for the remaining $9.9 billion in fiscal 1977 foreign sales:

--About $231 million in sales pertaining to items and services subject to the arms sales ceiling was misclassified as sales outside the ceiling. (See p. 9.)

--Fiscal 1977 sales valued at about $78 million were not recorded in Defense's accounting system at the close of fiscal 1977. As much as $17 million of this amount related to articles and services subject to the arms sales ceiling. (See p. 9.)

--About $64 million in sales scope increases and decreases were improperly recorded which caused an overstatement of about $55 million for sales related to articles and services subject to the ceiling. (See p. 9.)

--Fiscal 1978 sales of about $39.6 million were incorrectly accounted for as fiscal 1977 sales, and fiscal 1977 sales of $14.4 million were erroneously shown as fiscal 1976 sales. These errors caused an overstatement of as much as $26 million for those articles and services subject to the arms sales ceiling. (See pp. 9 and 10.)

Concerning Defense's accounting for fiscal 1978 foreign military sales, the Defense Audit Service reported that ceiling-related sales were understated by $140 million. (See p. 11.)

Defense needs to develop a single automated system to improve its current accounting for the value of foreign military sales. Two automated systems were maintained and neither was reliable. Although the Agency's and the Security Assistance Accounting Center's systems were to contain comparable information on the value and status of a sales agreement, GAO identified over $540 million in differences. For instance, for one sales agreement the Agency's system showed a value of $7 million while the Center's system showed $17 million. These differences are in addition to the accounting inconsistencies and errors discussed above. (See pp. 12 and 13.)

Also, the Agency identified an additional $800 million in differences in sales information on its system. Because it could not rely on its automated systems, Defense had to maintain a separate manual system, requiring additional personnel, to account for sales subject to the arms sales ceiling. (See p. 13.)

The automated systems relied heavily on manual procedures and controls to assure accurate processing of data throughout the systems. Better use of automated controls would improve system efficiency and accuracy. Further, the systems did not include enough edit checks to detect invalid data. Well-designed edit checks written into computer programs greatly reduce the possibility of erroneous data being entered into a system. (See pp. 14 and 15.)

Before the arms sales ceiling was established, management emphasis was not placed on accounting for sales values. Defense's systems of accounting for the value of foreign military sales were not designed to accommodate the phenomenal growth of the program and are indicative of the overall problem Defense has experienced in financial management of foreign military sales. In the past few years, GAO has issued numerous reports covering pricing, billing, and collectting problems for the program involving hundreds of millions of dollars. (See pp. 15 and 16.)

Defense has recognized the importance of improving its automated systems of accounting for foreign military sales. An extensive effort has been undertaken to redesign the Center's system and the Agency is assessing alternatives for changes to its system. Further, certain changes to the existing systems have been implemented. (See pp. 17 and 18.)

RECOMMENDATIONS

GAO recommends that the Secretary of Defense require that the Agency and the Center closely coordinate actions to improve their automated systems of accounting for the value of foreign military sales. GAO is recommending that a single system, to include adequate automated computer controls, be developed to eliminate the maintenance of duplicate systems.

GAO also recommends that Defense:

--Make its accounting practices for price changes consistent.

--Correct its accounting records, taking into account the errors GAO identified.

--Have its internal auditors review from time to time the accounting for foreign sales values to assure the effectiveness of the Agency's and Center's efforts to improve their systems.

AGENCY COMMENTS

At the request of the Office of the Chairman, GAO did not ask the Defense Department for formal written comments on this report. GAO did informally discuss the report with Defense officials and, where appropriate, their comments are included.

In commenting on GAO's April 12, 1978, report concerning the $1.4 billion accounting adjustment, Defense did not agree that inconsistent accounting practices were applied when scope and price changes were combined on a contract amendment. Defense said that it intended to treat the entire value of combined amendments as a scope change and contended that as long as an accounting policy is consistently applied, there should be no net effect on the total amount of sales from year to year. (See p. 8.) Defense asserted in this regard that, based on fiscal 1977 experience, following GAO's recommended procedure would reduce reported fiscal 1978 sales by over $400 million. (See pp. 29-30.)

Defense's policy for combined amendments is inconsistent with its overall policy of accounting for price changes and with the Department's disclosure that the entire $1.4 billion adjustment represented the value of scope increases. After considering Defense's comments, GAO still believes the accounting practices are inconsistent. Defense appears to ignore the underlying rationale for distinguishing--as it otherwise does--between price changes and scope changes. Scope changes represent new business, whereas price changes are the result of inflation, production delays, and/or poor price estimating for old business. Further, if future fiscal years' accounting is not to be affected by this practice, as Defense contends, the same magnitude of combined price and scope changes would have to occur. GAO believes this would be unlikely. (See p. 8.)

Defense officials also indicated that although agreeing that improvements were needed in their systems of accounting for the value of foreign military sales, they did not believe a single system was the answer. Instead, they preferred to improve their existing systems.

GAO still believes a single system, to include accounting for the arms sales ceiling, is the best solution to Defense's problems in accounting for the value of sales. If properly designed and implemented, a single system would greatly improve the accuracy and timeliness of sales information. Since the present systems contain common information on the value of sales agreements, GAO sees no reason why a single system could not be developed. (See p. 12 and 13.)

C o n t e n t s

CHAPTER 1

INTRODUCTION

On November 16, 1977, Congressman Lee H. Hamilton, Chairman of the Subcommittee on Europe and the Middle East, House Committee on Foreign Affairs, asked us to (1) review the procedures by which the Department of Defense accounts for the value of foreign military sales agreements and the procedures by which the yearly foreign military sales ceiling is established and (2) analyze the distinction between those items identified as weapons and weapons related and those items that are not and how this distinction affects the arms sales ceiling. (See app. I.) The review was requested after the Defense Security Assistance Agency disclosed in November 1977 that its previously reported estimate of $9.9 billion for fiscal 1977 foreign military sales was understated by $1.4 billion. This matter received widespread attention since the fiscal 1978 arms sales ceiling was to be based on fiscal 1977 sales.

Defense Security Assistance Agency officials said that the $1.4 billion accounting adjustment was made because the Agency had erroneously followed superseded accounting practices. The officials said they were unaware of the magnitude of the error until the end of fiscal 1977. As agreed with the Chairman's office, our initial efforts were directed at reviewing the accuracy of the $1.4 billion adjustment. We reported on April 12, 1978, (FGMSD-78-30) that our review disclosed substantial accounting inconsistencies and errors in the adjustment. (See pp. 7 and 8.)

This report, our final response to the Chairman's request, discusses the procedures by which the Department of Defense accounts for the value of foreign military sales and by which the yearly foreign military sales ceiling is established. It includes an evaluation of Defense's efforts to improve its systems of accounting for the value of foreign military sales and the impact of accounting errors and inconsistencies on the computation of the arms sales ceiling. As requested by the Chairman's office, we informally discussed the contents of this report with Defense officials, and, where appropriate, their comments have been considered in preparing the report.

ESTABLISHMENT OF THE ARMS SALES CEILING

Department of Defense sales of articles and services to foreign governments grew from $953 million in fiscal 1970 to $11.3 billion for fiscal 1977. Because of concern over the growth and magnitude of foreign military sales, President Carter said in a May 19, 1977, policy statement that the dollar value of new commitments under the Foreign Military Sales and Military Assistance Programs for weapons and weapons-related items in fiscal 1978 would be reduced from fiscal 1977 sales totals. The President said that arms sales should be made only when it can be clearly demonstrated that the sale contributes to the security of the United States.

On February 1, 1978, the President announced an arms sales ceiling of $8.6 billion for fiscal 1978. The ceiling was $695 million, or 7.5 percent, less than fiscal 1977 sales, as shown in constant fiscal 1978 dollars. In imposing the ceiling, the President, consistent with his May 19, 1977, policy statement, directed that the following sales be excluded:

--Sales to countries with which the United States has major Defense treaties (North Atlantic Treaty Organization countries, Japan, Australia, and New Zealand).

--Sales of articles and services not considered to be weapons or weapons related, such as the military construction program.

--Commercial sales for which the United States must issue export licenses.

As shown on the next page, the fiscal 1978 ceiling on sales was derived by (1) inflating the value of fiscal 1977 sales (less the exclusions enumerated above) to constant fiscal 1978 dollars and (2) reducing that figure by $695 million, or 7.5 percent, as directed by the President.

Distinction between weapons and weapons-related items

Congressman Hamilton was interested in the distinction between those items that were considered weapons and weapons related and those that were not and how that distinction affects the arms sales ceiling. The distinction was made by the Arms Export Control Board, which decided that all items on the U.S. Munitions List are weapons and weapons related. Included on the Munitions List are combat equipment; military aircraft and missile systems, and the associated spare parts and support equipment for these items; military explosives; firearms and ammunition; and warships and special Naval equipment. (Appendix II lists the items and services designated by the Board as weapons and weapons related.)

Calculation of Value of Fiscal 1978 Arms Sales Ceiling

		Amount (millions)
Total fiscal 1977 sales reported by the 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 weapons or weapons related	($1,479)	(2,700)
Adjusted fiscal 1977 sales		8,769
Add 6-percent inflation factor to equate to fiscal 1978 constant dollars		526
Fiscal 1977 sales in constant fiscal 1978 dollars		9,295
Less reduction in sales set by the President (approximately 7.5 percent)		(695)
Fiscal 1978 arms sales ceiling		$ 8,600

The major items not considered by the Board to be weapons or weapons related amounted to almost $1.5 billion of fiscal 1977 sales. These items included the military construction program; administrative and transportation charges; personnel costs for functions such as building maintenance; and support costs such as office furniture and equipment. For instance, administrative charges amounted to about $280 million, and the construction program, primarily for Saudi Arabia, amounted to about $470 million, and includes the design and construction of naval port facilities, military airbases, infantry and artillery centers, family housing, and medical facilities. The United States does not do any actual construction, but rather provides management services which are roughly 10 percent of the program cost. (Appendix III lists the items and services not considered to be weapons or weapons related.)

Commercial sales

In establishing the ceiling, the President excluded commercial sales. Commercial sales are direct sales by a U.S. contractor to a foreign government. Foreign governments can directly purchase any item included on the Munitions List with certain constraints. For instance, major defense equipment valued at more than $25 million may not be sold commercially except to North Atlantic Treaty Organization countries and an export license must be obtained from the Department of State for all other sales.

Weapons and weapons-related items on the Munitions List are subject to the arms sales ceiling when sold under the foreign military sales program. Purchase of these items directly by the foreign government through a commercial sale does not count against the ceiling. Commercial exports totaled about $1.2 billion in fiscal 1977.

Sales to countries with major defense treaties

The President also excluded from the ceiling all sales to countries with major defense treaties (North Atlantic Treaty Organization countries, Japan, Australia, and New Zealand). Those sales, which totaled over $1.2 billion in fiscal 1977, included articles and services considered to be weapons and weapons related as well as those that were not.

Fiscal 1978 foreign military sales and the arms sales ceiling for fiscal 1979

Defense reported that fiscal 1978 sales of weapons and weapons-related articles and services totaled about $8.5 billion, and were thereby within the President's $8.6 billion arms sales ceiling. However, total foreign military sales grew to about $13.5 billion--sales of items not considered to be weapons or weapons related rose to about $2.8 billion, and sales to countries with major defense treaties increased to about $2.2 billion. Further, commercial exports, which are not included in the ceiling, increased to about $1.7 billion.

For fiscal 1979, the President established an arms sales ceiling of $8.43 billion. However, the recent decision by Iran to cancel billions of dollars of prior and future years' arms purchases could have a great impact on the value of future arms sales since the Iranian sales totaled about $2.6 billion in fiscal 1978. The effect on present and future ceilings of Iran cancelling arms sales has not yet been determined.

CHAPTER 2

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

The Defense Security Assistance Agency used inconsistent accounting practices and made substantial errors in accounting for the value of fiscal 1977 arms sales. The inconsistencies and errors totaled over $1.1 billion and caused an overstatement of $427 million for those fiscal 1977 sales relating to articles and services subject to the arms sales ceiling.

As a result, the President used erroneous sales information as a basis for establishing the arms sales ceiling for fiscal 1978; had corrected sales figures been used, the ceiling may have been $420 million lower.

DEFENSE'S SYSTEMS OF ACCOUNTING FOR THE VALUE OF FOREIGN MILITARY SALES

The Defense Security Assistance Agency maintained an automated accounting system which, when supplemented by manual records, provided detailed information on the value of foreign military sales. The Agency is responsible for assuring that the value of foreign military sales of weapons and weapons-related items does not exceed the President's ceiling. To do so, the Agency established a ceiling management division in January 1978. The division entered in the Agency's accounting system the amount of each sale applicable to the ceiling but also maintained a separate manual system of accounting to keep track of the value of sales subject to the ceiling since the systems for accounting for the value of foreign sales were not reliable.

Also, the Security Assistance Accounting Center, which is responsible for the billing and collecting aspects of the foreign sales program, transmitted detailed data to the Agency's automated system on each line item included in a sales agreement. The Center maintained its own automated system for billing and collecting purposes which includes information on the dollar value and status of sales agreements.

In addition to new sales agreements, amendments to prior year sales--scope and price changes--can affect the dollar value of sales reported. The accounting treatment prescribed by the Agency for these types of changes follows.

Scope increases

Scope increases cover additional quantities of items ordered, modifications to the configuration or design of items, and changes in composition of services and training programs. Defense policies require that scope increases in excess of $50,000 be accounted for as sales for the fiscal year in which the amendment was signed. For instance, an amendment signed in fiscal 1977 increasing scope of a fiscal 1975 sales agreement should be accounted for as a fiscal 1977 sale.

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 1977 which decreased the scope of a fiscal 1975 sales agreement, should be accounted for as a decrease in the value of fiscal 1975 sales.

Price changes

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

ACCOUNTING INCONSISTENCIES AND ERRORS RELATED TO THE $1.4 BILLION ADJUSTMENT

As discussed in our April 12, 1978, report, the Defense Security Assistance Agency used inconsistent accounting practices and made substantial accounting errors in increasing by $1.4 billion the reported value of foreign military sales for fiscal 1977. The inconsistencies and errors, which totaled $698 million, resulted in an overstatement of $594 million for those 1977 sales which related to articles and services subject to the arms sales ceiling.

For instance, we pointed out that although the 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 before 1977. According to the Agency's accounting procedures, price changes should be accounted for in the year the original sales agreement was signed. Many of the contract amendments that 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 1977 sale.

In another instance, we pointed out that about $133 million of the 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 non-ceiling sale.

In a letter dated April 24, 1978, the Acting Director of the Defense Security Assistance Agency, said that he did not agree that inconsistent accounting practices were applied in recording the $1.4 billion adjustment where scope and price changes were combined on a contract amendment. (See app. IV.) Agency officials had said that although the Agency did not have a written policy covering cases where scope and price changes were combined on a contract amendment, it intended to treat the entire value of a combined amendment as a scope change. The Acting Director contended that as long as an accounting policy is consistently applied, the total amount of sales from year to year should not be affected since price changes on combined amendments from one year to the next will offset each other. The Acting Director did agree that the $133 million relating to construction work in Saudi Arabia should have been accounted for as a non-ceiling sale.

The Agency's policy for combined amendments is inconsistent with (1) its overall policy of accounting for price changes and (2) its disclosure that the entire $1.4 billion adjustment represented the value of scope increases. Accounting for a price change in the year the original sales agreement was signed in one case and in the current year in another case is inconsistent.

The Agency's contention that their dual policy of recording price changes will not have any effect on the recording of sales in subsequent fiscal years cannot be substantiated. The Agency first attempted to separately account for scope and price changes in fiscal 1977. As a result, the Agency's conclusion was not based on any historical data. The Agency would have to be assured that the same magnitude of combined scope and price changes will occur in future fiscal years to avoid affecting future sales accounting. We believe this assurance is unlikely.

ACCOUNTING ERRORS RELATED TO THE REMAINING $9.9 BILLION IN FISCAL 1977 SALES

We identified accounting errors totaling $427 million relating to the remaining $9.9 billion of reported fiscal 1977 sales. Detailed below are the errors which resulted in a net understatement of about $167 million for those 1977 sales which related to goods and services subject to the arms sales ceiling.

--About $231 million in sales pertaining to items and services subject to the arms sales ceiling was misclassified as non-ceiling sales. The $231 million was related to technical assistance services and equipment and spare parts which were weapons and weapons related and should have been classified as ceiling sales.

--Ninety-seven fiscal 1977 sales agreements valued at about $78 million were not recorded in the Agency's system at the close of fiscal 1977. As much as $17 million of the $78 million related to articles and services subject to the ceiling. For instance, a $10-million sales agreement relating to articles and services subject to the ceiling was not recorded at fiscal year end even though the agreement was accepted by the foreign government on September 30, 1977--2 months before fiscal 1977 sales totals were finalized on November 29, 1977. Another sales agreement, valued at about $51 million was accepted by the foreign government in December 1976 but was not recorded at fiscal year end. This sale was not subject to the ceiling.

--A total of about $64 million in sales scope increases and decreases was improperly recorded causing an overstatement of as much as $55 million for sales related to articles and services subject to the arms sales ceiling. For example, instead of recording sales scope increases of $10 million and $4.9 million, the Agency erroneously recorded the original sales agreement values of $13.5 million and $14 million, respectively, causing sales to be overstated by about $12.6 million. In another case, about $36 million, representing a sales scope decrease pertaining to a fiscal 1977 sales agreement, was not deducted from fiscal 1977 sales as required.

--About $39.6 million in fiscal 1978 sales was incorrectly classified as fiscal 1977 sales. Further, fiscal 1977 sales of about $14.4 million were incorrectly shown in fiscal 1976. As a result, fiscal 1977 sales were overstated by $25.2 million and sales of articles and services subject to the ceiling were overstated by as much as $26 million.

Responsible officials agreed that the above transactions had been improperly recorded.

IMPACT OF ACCOUNTING INCONSISTENCIES AND ERRORS ON ARMS SALES CEILING

The net result of the accounting inconsistencies and errors we identified above was an overstatement of $427 million for the sales of articles and services subject to the arms sales ceiling (the $594 million overstatement on p. 7 less the $167 million understatement on p. 9). Therefore, as shown in the following table, the Defense Security Assistance Agency's calculation of the fiscal 1978 arms sales ceiling may have been overstated by about $420 million.

	Defense Security Assistance Agency	Adjusted for accounting inconsistencies and errors found by GAO	Differences
		(millions)	
Value of fiscal 1977 sales pertaining to items and services covered by the ceiling	$8,769	$8,342	$427
Sales adjusted for inflation from fiscal 1977 to fiscal 1978	$9,295	$8,843	$452
Fiscal 1978 arms sales ceiling	a/ $8,600	$8,180	$420

a/ This figure was set by the President and represents an approximate 7.5-percent reduction from fiscal 1977 ceiling sales adjusted for inflation to fiscal 1978.

The table shows that the ceiling set by the President would reduce sales in fiscal 1978 by $243 million ($8,843 million less $8,600 million), not by $695 million ($9,295 million less $8,600 million), as originally announced.

The table also shows that had a 7.5-percent reduction been applied to the corrected sales figures, the arms sales ceiling would have been $8,180 million, or about $420 million less than the fiscal 1978 ceiling set by the President. This is not to say, however, that the President would have decided on the 7.5-percent reduction had he known the correct value of fiscal 1977 sales.

REVIEW BY THE DEFENSE AUDIT SERVICE OF FISCAL 1978 CEILING

The Defense Security Assistance Agency asked the Defense Audit Service to review the ceiling management division's accounting for sales applicable to the fiscal 1978 arms sales ceiling. The Audit Service found that ceiling-related sales for fiscal 1978 were understated by $140 million. Agency officials agreed with the auditors' findings and said that they had corrected their records.

The Agency's ceiling management division operated under difficult conditions. Becoming operational in January 1978--3 months into the fiscal year--the division had to retroactively determine the value of sales committed against the ceiling for the first quarter. Further, the division had to rely on a separate manual system to account for ceiling sales, since, as shown above and discussed in chapters 3 and 4, systems for accounting for the value of foreign sales were not reliable.

CHAPTER 3

SYSTEMS OF ACCOUNTING INADEQUATE TO

ASSURE THE ACCURACY OF SALES INFORMATION

In addition to the $1.1 billion in accounting inconsistencies and errors relating to fiscal 1977 sales, we found other problems in accounting by comparing sales information on the Defense Security Assistance Agency's system with similar data on the billing and collecting system maintained by the Security Assistance Accounting Center. Differences in the value and status of sales agreements between the two systems totaled over $540 million. Also, the Agency identified over $800 million in differences in sales information on its own system.

Management, therefore, was not provided reliable information on the value of foreign military sales and the Agency's ceiling management division had to rely solely on a separate manual system to account for sales subject to the arms sales ceiling.

The Agency's and the Center's systems did not effficiently use the computer's capabilities, but relied heavily on manual procedures and controls to assure that data was properly processed. Errors would be more effectively and efficiently detected if automated controls were used more extensively, and accounting would be more reliable if a single system of accounting for the value of sales were developed.

NEED FOR DEVELOPMENT OF A SINGLE SYSTEM OF ACCOUNTING FOR SALES VALUES

The two systems were to contain comparable information on the value and status of sales agreements. However, in comparing information from the two systems, we identified over $540 million in differences which relate to fiscal 1978 and prior years sales.

--Values of 119 sales agreements on the two systems differed by over $320 million. For instance, for one sales agreement the Agency's system showed a value of $7 million while the Center's system showed $17 million.

--The status of 134 sales agreements valued at over $220 million, did not agree on the two systems. For example, a sales agreement valued at over $8 million was in an extended status on the Agency's system (the foreign government was still considering whether to accept the sales offer). That same agreement was shown as implemented on the Center's system (it had been accepted and efforts had begun to fulfill the terms of the agreement). The status of a sales agreement is important because the value of the agreement is not included in sales totals until it is recorded in the Agency's system as accepted.

In addition to the differences we identified, in September 1978 the Agency identified over $800 million in differences--$600 million of which related to fiscal 1978 sales agreements. The Agency arrived at the differences by comparing detailed sales information with summary sales information on its own system.

As discussed on page 6, the Center transmits, for entry to the Agency's system, detailed information on the value of individual articles and services included in the sales agreement. The Agency, in turn, enters in its system summary case value information. The summary information should agree with the sum of the detailed information. When it does not, management cannot rely on either category of information.

As a result, the ceiling management division maintained a separate manual system requiring additional personnel and duplicating certain information on the two systems since the Agency's automated system was unreliable.

When systems dealing with the same information maintain separate, or duplicate, data bases, as is the case with the Agency's and Center's systems, time differences in receipt and processing of sales data, processing errors, and the lack of compatibility and uniformity between the systems

--increase the possibility that information between the systems will differ, affecting accuracy and timeliness;

--require accounting functions, such as data entry, to be duplicated; and

--necessitate frequent comparison and reconciliation of the systems' information.

Because the Agency's and the Center's systems are closely related and because the systems contain the same basic information on the value of sales agreements, development of a single automated system, to include ceiling management, should help solve the problems experienced in accounting for the value of foreign military sales.

MORE EFFECTIVE USE OF COMPUTER CAPABILITIES NEEDED

In accounting for the value of sales, the Agency's and the Center's system did not efficiently use the computer's capabilities but relied heavily on manual procedures and controls to assure that data is properly processed. Detection of errors would be more effectively and efficiently accomplished if automated controls were used more extensively.

Controls over rejected data need improvement

An effective method for controlling rejected data in an automated system is through the use of an automated suspense file. Such a file contains all invalid or incomplete information rejected by the system, and rejected items remain listed in the suspense file until corrected.

In both the Center's and the Agency's systems, rejected items appear on an error listing and although accounting technicians are responsible for correcting the erroneous data, no system exists to assure that all corrections are made.

The error rate for five updates of the Agency's system during April 1978 was 3.6 percent. Because of the large volume of sales transactions and the magnitude of accounting errors and differences identified in our review, an automated suspense file is necessary to help assure the full and timely correction of errors.

Better control over source data needed

Two techniques often used in automated systems to help assure complete and accurate processing of data are (1) record counts and (2) predetermined control totals. The Agency's and the Center's automated systems did not use either effectively.

Record counts, which represent the number of documents in a batch being processed, assure that all documents are processed. These counts should be determined when documents are prepared and should accompany the documents through the processing cycle. For example, when data is transmitted to the Agency by the Center, the number of records to be transmitted should be manually counted and entered into the system along with the data being processed. The system will then automatically count the records transmitted and compare the counts. If differences exist, the entire batch would be rejected and would not process until corrected. We reviewed 58 transmissions received by the Agency from the Center during April and

May 1978 and found that 43 transmissions (74 percent) did not use record counts.

Another technique often used to assure complete and accurate processing of information is to determine the total for a selected data field in a group of source documents and compare it with totals generated by the computer. These predetermined control totals should be determined when documents are prepared and should accompany the documents throughout the processing cycle. An example of a predetermined control total would be the total dollar value of all transactions in a batch.

Need for an additional edit check

To help assure that data entering the accounting system is accurate and reliable, computer programs should contain enough edit checks to detect missing or invalid data. An additional edit check is needed to test transaction dates for consistency with one another.

We identified 525 sales agreements on the Agency's automated system that were valued at over $2 billion and for which the transaction dates were not recorded in the proper chronological order. The system shows the dates that a sales agreement was offered to and accepted by the foreign country and implemented by the applicable military service. The proper sequence of dates for any sales agreement is offer, acceptance, and implementation. If the dates are not in the proper sequence, the transaction should be rejected by the system and not processed until corrected.

Acceptance dates are especially important because the system identifies each sale by fiscal year based on the acceptance date. As discussed on pages 9 and 10, we identified sales agreements totaling about $54 million which were accounted for in the wrong fiscal year because the acceptance date in the system was incorrect. For instance, for a sales agreement valued at $10 million, the system showed an offer date of October 13, 1976, and an acceptance date of September 24, 1976. Based on the acceptance, the sale was accounted for in fiscal 1976. The correct acceptance date, however, was November 24, 1976, making it a fiscal 1977 sale. Had the edit checks been sufficient, the incorrect sequence would have been noted and the transaction rejected.

UNDERLYING CAUSE FOR DEFENSE'S PROBLEM IN ACCOUNTING FOR THE VALUE OF ARMS SALES

Defense's systems of accounting for the value of foreign military sales were not designed to accommodate the phenomenal growth of the program and are indicative of the overall problem Defense has experienced in financial management of foreign military sales. In the past few years, we have issued numerous reports on the program's pricing, billing, and collecting problems involving hundreds of millions of dollars. (See app. V.)

Before the arms sales ceiling was established, management emphasis was not placed on accounting for sales values. Defense was not required to differentiate between the sales of those articles and services considered to be weapons and weapons related and those that were not, and the systems were not designed to accumulate this information. Further, Defense officials said that congressionally imposed personnel ceilings have not permitted them to hire adequate staff to fulfill the accounting function. As discussed in chapter 4, Defense has recognized that its systems of accounting are inadequate and is taking action to redesign the systems.

CHAPTER 4

DEFENSE EFFORTS TO IMPROVE ITS SYSTEMS FOR ACCOUNTING FOR FOREIGN MILITARY SALES

Defense has recognized the importance of improving its systems of accounting for foreign military sales. In November 1977, an extensive effort was undertaken to redesign the Center's system by August 1979 to provide new accounting and financial controls. During our review, the Agency contracted for a study of its system and was making plans to assess alternatives for a new system. Further, improvements were made to the Agency's and Center's existing systems.

DEVELOPMENT OF THE DEFENSE INTEGRATED FINANCIAL SYSTEM

Recognizing the problems in financial management of the foreign military sales program, the Assistant Secretary of Defense (Comptroller) in a memorandum dated June 17, 1977, directed that new accounting and financial controls be established. One of the major objectives was to provide an integrated accounting and financial management system that would account for each foreign sales agreement from start to finish.

The Security Assistance Accounting Center realized that its system was inadequate. Transactions processed had increased by 1,400 percent since November 1976. The system, which had been augmented by manual and semi-automated processes, was not capable of providing the total financial accounting and control necessary for the foreign military sales program.

The Center, therefore, began developing the Defense Integrated Financial System in November 1977. Officials said that it will be directed toward solving the accounting problems identified during our review. The system, which will include automated controls, will cover various facets of financial management of the foreign sales program, including billing and collecting, and will ultimately be able to fully assume the accounting responsibility for sales values, thereby eliminating the need for the Agency's system. However, Agency officials said they will not consider eliminating their system until the Defense Integrated Financial System is fully operational and can demonstrate the ability to provide accurate and timely data.

The Defense Integrated Financial System is to be implemented in two phases. Phase 1, which is scheduled for completion on August 1, 1979, includes the design, development, and implementation of the system at the Center. Phase 2, which is scheduled for implementation on October 1, 1979, will provide for direct access to the system by the Agency and the military departments.

OUTSIDE STUDY OF DEFENSE SECURITY ASSISTANCE AGENCY'S SYSTEM

The Defense Security Assistance Agency, recognizing that weaknesses existed in its system of accounting for foreign military sales, contracted in June 1978 for a study of its management information needs. The study team was asked to evaluate the current system and determine if a new system was needed.

The study team identified many problems with the current system. It concluded that significant changes were needed and recommended that Defense undertake the development of an improved system. The team offered various alternatives for a new system and proposed that a requirements study be made to access the alternatives and to quantitatively measure the advantages and disadvantages of each alternative so that a clear and concise course of action could be established. In February 1979, Agency officials said that efforts were underway to contract for that requirements study.

OTHER EFFORTS TO IMPROVE THE SYSTEMS

In addition, the Agency and the Center have already made improvements to their existing accounting systems. For example:

--The Center created a quality control office responsible for reconciliation of the Agency's and Center's data bases. As a result, millions of dollars of corrections were made to the accounting records.

--Certain changes were made to computer programs to improve uniformity and compatibility between the Agency's and Center's systems and to improve the entry and processing of sales information.

--Procedures were developed for entering scope changes by fiscal year to the Agency's system.

CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

The Defense Security Assistance Agency inconsistently accounted for price changes and made other accounting errors which resulted in serious inaccuracies in accounting for fiscal 1977 foreign military sales. The Agency's efforts to correct the accounting records at fiscal year end largely failed and resulted in the President basing the fiscal 1978 arms sales ceiling on incorrect information.

The Agency's and the Security Assistance Accounting Center's automated systems for accounting did not provide management with reliable information on the value of foreign military sales. Improvements are needed to assure that the systems provide accurate and timely information and that they effectively use the computer's capabilities.

Prior to the establishment of the arms sales ceiling, management emphasis was not placed on accounting for sales values. Systems were not designed to accommodate the phenomenal growth of the foreign military sales program and are indicative of the overall problem Defense experienced in financial management of the foreign military sales program.

Defense is aware of its problems in accounting for the value of foreign military sales. Actions already taken and those underway should improve the accuracy of sales accounting. The Center's development of the Defense Integrated Financial System and the Agency's plans to improve its system, however, will not solve the problems inherent in maintaining two systems--assuring the accuracy of financial information for the same sales agreement carried in both systems and duplicating such accounting functions as data entry. Every effort should be made to design a single accounting system to be used by both the Center and the Agency so that the maintenance of duplicate data bases can be eliminated.

Also, where it has not already done so, the Defense Security Assistance Agency should correct those inconsistencies and eliminate those errors we identified in its accounting records and make its accounting practices for price changes consistent.

RECOMMENDATIONS

We recommend that the Secretary of Defense require that the Agency and the Center closely coordinate actions to improve their automated systems of accounting for the value of foreign military sales. A single system of accounting, including adequate automated controls, should be designed to provide both organizations with the sales information they need.

We further recommend that the Secretary of Defense direct the Defense Security Assistance Agency to:

--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, taking into account the inconsistencies and errors found in our review.

--Request the Defense Audit Service to review from time to time the accounting for foreign sales values to assure that the Agency's and Center's efforts to improve their systems are effective.

--Review its accounting for scope and price changes in fiscal 1978 and 1979 to assure that inconsistencies and errors similar to the ones we found were not made and to correct the accounting records where necessary.

AGENCY ACTIONS AND UNRESOLVED ISSUES

In informal discussions of this report, Agency and Center officials agreed with the need for an improved system of accounting for the value of sales, including adequate automated controls. The Agency, however, does not believe that a single system of accounting is the answer, but feels that improvements to the existing systems should be made.

Agency officials said that, effective in fiscal 1979, ceiling accounting has been automated and they are proceeding with plans to upgrade their system. However, they did not provide us with any reasons why a single system could not be used.

We still believe that a single system is the solution to Defense's problems in accounting for the value of sales. Since the systems contain common information on the value of sales agreements and duplicate certain accounting functions, we see no reason why a single system could not be developed.

Also, the Agency's automation of ceiling accounting adds a third system of accounting for sales values. A single system could be designed and implemented to include accounting for the arms sales ceiling and thereby eliminate the need for the third system.

Officials did not object to our recommendation that the Defense Audit Service be requested from time to time to review the efforts to improve the systems of accounting for the value of sales. Officials disagreed with our recommendations relating to accounting for price changes, and reiterated the position taken in their April 24, 1978, letter on our interim report (FGMSD-78-30). (See app. IV.)

CHAPTER 6

SCOPE OF REVIEW

We reviewed 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.

Our review included an (1) examination of policies, procedures, documents, transactions, and reports dealing with the value of commitments from the Foreign Military Sales and Military Assistance Program and the arms sales ceiling, and (2) assessment of two Defense systems of accounting for the value of foreign military sales. We interviewed responsible officials to discuss policies, procedures, and other matters.

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.

Congress of the United States
Committee on International Relations
House of Representatives
Washington, D.C. 20515

The Honorable Elmer B. Staats
Comptroller General of the
United States
General Accounting Office
441 G Street
Washington, D.C. 20548

Dear Mr. Staats:

I would like to request that the General Accounting Office examine the procedures by which the Department of Defense's Defense Security Assistance Agency (DSAA) computes the value of Foreign Military Sales (FMS) agreements and yearly aggregate FMS ceilings.

In your study, I would appreciate your conducting a complete audit of DSAA's accounting system, including an examination of both the automated and manual recording procedures, of how "scope changes" occur and have been and are being recorded, and of any other procedures which may affect the computation of the value of FMS agreements and of FMS yearly arms sales totals.

In addition, it is my understanding the DSAA will be making a distinction between "military-related" and "weapons-related" items in its calculation of yearly arms aggregates. I would, therefore, like you to analyze this apparent new distinction and how it affects the computation of such aggregates for past, present and future fiscal years, and what effect it would have on attempts to adhere to an arms sales ceiling.

I would appreciate your providing me with at least a preliminary report in early 1978, prior to FY 1979 aid hearings, when we will be considering possible amendments to the Arms Export Control Act.

With best wishes.

Sincerely yours,

Lee H. Hamilton, Chairman
Subcommittee on Europe
and the Middle East

LHH:mj

DEPARTMENT OF DEFENSE ITEMS AND SERVICES

DESIGNATED AS WEAPONS AND WEAPONS RELATED

All aircraft
Aircraft modifications
Aircraft spare parts
All ships
Ship cost sharing
Ship spare parts
All missiles
Missile system components
Missile modifications
Missile spare parts
Armored cars
Carrier, cargo, armored
Carrier, personnel, armored, full track
Carrier, personnel, armored, half track
Carrier weapons
Tanks
Tank recovery vehicles
Miscellaneous combat vehicles
Artillery, self-propelled, anti-aircraft
Artillery, self-propelled, anti-tank
Artillery, self-propelled, 105 mm howitzer
Artillery, self-propelled, 155 mm howitzer
Artillery, self-propelled, 4.2 mortar
Artillery, self-propelled, 8-inch howitzer
Artillery, self-propelled, 175 mm howitzer
Artillery, self-propelled, other
Semi-trailers, all types
Trailers all types
Trucks, ¼ ton, all types
Trucks, 3/4 ton, all types
Trucks, 1 ton, all types
Trucks, 2½ ton, all types
Trucks, 5 ton, all types
Fire trucks
Other trucks
Carbines
Pistols
Rifles
Submachine guns
Machine guns
Gun, anti-aircraft
Gun, riot control
Gun, 75 mm
Gun, 90 mm
Gun, 105 mm
Gun, 155 mm
Gun, 175 mm

WEAPONS AND WEAPONS-RELATED ITEMS AND SERVICES (cont.)

Howitzers, 75 mm
Howitzers, 105 mm
Howitzers, 155 mm
Howitzers, 8-inch
Mortars, 60 mm
Mortars, 81 mm
Mortars, 107 mm - 4.2-inch
Mortars, 120 mm
Rifles, recoilless, 75 mm
Rifles, recoilless, 90 mm
Rifles, recoilless, 105 mm
Rifles, recoilless, 106 mm
Rifles, recoilless, 120 mm
Rifles, recoilless, 155 mm
Subcaliber weapons
Other weapons up to 75 mm
Other weapons 75 mm and over
Mounts, 20 mm
Mounts, 40 mm
Mounts, 3 inch/50
Mounts, 5 inch/25
Mounts, 5 inch/38
Mounts, 5 inch/54
Launchers, depth charge
Launchers, rocket
Launchers, torpedo
Loading machines
Fire control directors
Fire control computers
ASW file control systems
Gunfire control systems
Torpedo fire control systems
Submarine fire control systems
Vehicles, miscellaneous types
Other weapons and equipment spares
Artillery charges (thousand)
Artillery projectiles 5 inch and over (thousand)
Bombs (thousand)
Cartridges up through 20 mm (thousand)
Cartridges, 37 mm to 75 mm (thousand)
Cartridges, 75 mm to 90 mm (thousand)
Cartridges, 105 mm - 155 mm (thousand)
Grenades (thousand)
Mines (thousands)
Mortar rounds, 60 mm (thousand)
Mortar rounds, 81 mm - 4.2 inch (thousand)
Naval mines and depth charges

WEAPONS AND WEAPONS-RELATED ITEMS AND SERVICES (cont.)

Riot control gun ammunition (thousand)
Rockets (thousand)
Torpedoes
Other ammunition and components
Air defense systems and equipment
Electronic countermeasures equipment
Radar air search equipment
Radar ground control equipment
Radar mortar tracking equipment
Radar surveillance equipment
Radio ground-air communications equipment
Radio mobile and transportable equipment
Radios, non-tactical
Radio - radar equipment, airborne
Radio receiving equipment
Radio relay equipment
Radios, tactical
Radio transmitting equipment
Other communications equipment
Communications equipment spares
Military bridges
Tractors, crawlered and wheeled
Fork lift trucks
Tool kits and sets
Petroleum oil lubricants, gases and fuels
Repair and rehabilitation
Research and development
Ship overhauls
Training aids and publication-Foreign Military Sales
Training-Foreign Military Sales
Technical Assistance
Technical Assistance Field Team
Weapons production project

DEPARTMENT OF DEFENSE ITEMS AND SERVICES

NOT CONSIDERED TO WEAPONS AND WEAPONS RELATED

Cranes
Major construction equipment items
Generators, 30 kw and larger
Compressors, 100 cem and larger
Prefabricated buildings
Station wagons
Sedans
Buses
Motorcycles/motor scooters
Commercial ambulances
Commercial trucks
Other commercial vehicles
Public address equipment
Recorder, reproducer equipment
Telephone sets
Tel and tel terminal and transportation equipment
Miscellaneous, other support equipment
Other supplies
Miscellaneous material
Construction
Supply operations
Packing, crating, handling and transportation
Operation and maintenance of Military Assistance Program installations
Storage and maintenance of stockpiles
Logistics management expenses
Training aids and publications International Military Education and Training
Training International Military Education and Training
Infrastructure
Other services
International military headquarters
IG state and other expenses
Administrative expenses
Foreign Military Sales Orders I - financing portion

DEFENSE SECURITY ASSISTANCE AGENCY
WASHINGTON, D.C. 20301

24 APR 1978

In reply refer to:
I-3605/78

Honorable Lee H. Hamilton
Chairman
Subcommittee on Europe and Middle East
House International Relations Commitee
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for providing the Defense Security Assistance Agency the opportunity to comment on the GAO report which examines the detailed accounting procedures used to calculate FY 1977 FMS sales, which formed the basis for the President's decision on the $8.6 billion ceiling on arms sales.

The General Accounting Office, in its review, employed different accounting methods to derive sales figures. Since we do not agree with the recording methodology employed, we cannot accept either the conclusions or recommendations contained in the report. The principal point of disagreement is the computation of combined scope and price changes. Scope changes represent alterations in the level or quality of goods or services to be provided. Price changes involve adjustments due to inflation, pricing refinements and changes in total quantity of an item produced, e.g., cuts for US and other customers thus increasing unit costs of remaining production. Scope changes plus combined scope and price changes are charged to the fiscal year in which they occur. Price changes are charged to the fiscal year in which the original contract was signed.

Fiscal year 1977 sales involved over 4,100 separate Letters of Offer and Acceptance—government-to-government contracts--between the U.S. military departments and foreign government procurement activities. These contracts included many more thousands of line items of defense articles and defense services. Included within these 4,100 contracts were approximately 100 modifications to prior year contracts which were executed during FY 1977 and charged to FY 1977 sales because our accountants had classified the transactions as a change in scope to the original contract. The FY 1978 ceiling of $8.6 billion—which is a policy approach established by the President to insure orderly decision-making, not a requirement of law—was established by applying a reduction of about $695 million to the total sales agreements executed during FY 1977.

In examining approximately 100 modifications to sales contracts, which we had classified as scope changes, the GAO contends that FY 1977 sales—which provided the basis for the FY 1978 ceiling—were overstated by $584 million. The GAO arrived at this conclusion by classifying a number of scope changes as price increases and stating that the changes should be shown against prior year activity, even though the modifications were negotiated and executed during FY 1977. Neither the Department of State nor the Department of Defense agree with the GAO conclusion. As long as a consistent recording policy is applied, there should be no net effect on the total amount of sales from year to year.

According to the GAO, the inclusion of approximately $464 million of price increases resulted in overstatement of FY 1977 recorded sales. Over $400 million of this amount resulted from DSAA's consistent practice (labeled as an inconsistency by the GAO) of recording single transactions involving both scope and price increases against current year rather than prior year sales. When occurring separately during FY 1977, scope changes above $100,000 were treated as sales in the year of the change; price changes were not. We are following the same practice in FY 1978 except the threshold has been lowered to $50,000 (i.e., additional scope increases would apply against the FY 1978 ceiling). When an amendment involves changes in both scope and price (e.g., during contract definitization), military departments process the change as a single amendment (Form DD 1513-1) for presentation within the Executive Branch, to the Congress when applicable, and to the purchasing country for acceptance, and DSAA records a single combined amount for the case value. This effect is offset in all subsequent years by the amount of price changes reported in the same cases with scope changes. As long as the treatment is consistent, there should be no net effect on the amount of new arms sales and scope changes in future years under the DSAA procedure, and there will be a significant saving in effort and simplification of the review process. The GAO approach would require separation of all scope and price changes even though they occur concurrently as part of a single transaction against the same case. This would involve difficult judgments as to the parts of the change attributable to scope and to price, but would have no substantial net effect on new sales and scope changes allowed within the ceiling in FY 1978 or in future years. Based on our FY 1977 experience, we believe that if we were to accept the GAO approach, over $400 million in sales would not have to be recorded against the FY 1978 ceiling.

The procedure outlined above has been followed consistently since initial development of procedures to document price increases separately. Prior to May 1976, no distinction was made in documenting scope and price changes; all such changes were accounted for by issuing DD Form 1513-1. The first instruction which called for separate documentation of scope changes vs. price changes is enclosed for your review. This letter instruction was in effect on the date (August 1976) that a DD 1513-1 was issued to Saudi Arabia for the sales amendment mentioned in the first paragraph of page 5 of the GAO report.

On 6 October 1977, the Executive Branch made its final decision as to which item categories would be defined as ceiling related and non-ceiling related sales. After that decision, DSAA produced computer records identifying such sales based on the manner that they were coded in the computer system during FY 1977. In its selective audit, GAO has identified a $133 million sale which, while correctly recorded in FY 1977, should have been accounted for as a non-ceiling sale. This particular transaction was coded into the DSAA recording system shortly after Saudi Arabia accepted the sales amendment on 9 November 1976. GAO is correct that the transaction was not coded correctly. The error was caused by recording the purpose of the sale as technical assistance rather than administrative support. Since virtually all FY 1977 transactions were recorded before firm decisions were reached as to which sales would be considered ceiling related versus non-ceiling related, there was no added effort placed on the coding of individual line items on the Letters of Offer.

The two sets of transactions indicated above led to the GAO conclusion that the information on which the President based the FY 1978 ceiling was substantially incorrect. The primary reason for this conclusion is, in our view, an erroneous interpretation by the GAO of DSAA procedures. The recording procedures which GAO labels inconsistent are those which DSAA applied consistently throughout FY 1977 and has continued to apply consistently in FY 1978. There is room for honest disagreement as to the amount of resources which should be expended to document separately those scope and price changes which occur within a single transaction. There would be disagreement as to how much of such changes were scope versus price; the distinction often cannot be made with certainty when the change occurs as the result of a single transaction.

Most transactions examined by GAO occurred during the first quarter of FY 1977--long before the decision was made to establish a FY 1978 ceiling. It is correct that DOD did not make major revisions to its recording system so as to "fine tune" the system for considerations involving the FY 1978 ceiling. Rather, the position was taken that the system generally was satisfactory as long as recording procedures were apply consistently from year to year.

We do not concur with the recommendations in the draft GAO report because we do not agree with the GAO conclusion relating to combining scope and price increases. We recognize that GAO has found some erroneous data during its selective audit, but if corrected these errors would only result in a less than 1% change in the FY 1977 sales totals.

As you know, the FY 1977 sales reported to Congress at year end simply represent a "snap shot" of the year's activity taken at a point in time shortly after the end of the fiscal year. Price changes, scope decreases, small scope increases, and sometimes program cancellations can affect the original estimated value of sales agreements over their complete life. Thus, DSAA issues annually a revised total of the value of sales agreements for each fiscal year, based on changes which take place in the current year. The true recording discrepancies identified by GAO represent an amount which is inconsequential in relationship to the value that FY 1977 sales totals ultimately will be revised for the reasons indicated above.

In summary, we believe that the GAO does not hold a valid basis for stating that FY 1977 sales were overstated.

Sincerely yours,

Erich von Marbod

ERICH F. VON MARBOD
ACTING DIRECTOR
DEFENSE SECURITY ASSISTANCE AGENCY

GAO note: The Agency's first instruction calling for separate documentation of price and scope changes was attached to this letter but is not included in this report.

PREVIOUS GAO REPORTS ON THE FOREIGN MILITARY SALES PROGRAM

Reports to the Congress

1. "Omission of Significant Costs From Charges to the Federal Republic of Germany for Pilot Training," B-167363, Nov. 19, 1969.

2. "Opportunity to Recover Certain Foreign Military Sales--Administrative Expenses," B-165731, Feb. 26, 1973.

3. "Reimbursements From Foreign Governments for Military Personnel Services Provided Under the Foreign Military Sales Act," ID-75-6, Aug. 16, 1974.

4. "Issues Related to U.S. Military Sales Assistance to Iran," B-133258, Oct. 21, 1974.

5. "Pilot and Navigator Training Rates," FPCD-75-151, Apr. 11, 1975.

6. "Airlift Operations of the Military Airlift Command During the 1973 Middle East War," LCD-75-204, Apr. 16, 1975.

7. "The U.S. Should Recover Full Costs of Reimbursable Satellite Launches," LCD-74-107, May 6, 1975.

8. "The Department of Defense Can Improve Its Free-Asset Management," LCD-76-414, Mar. 3, 1976.

9. "Millions of Dollars of Costs Incurred in Training Foreign Military Students Have Not Been Recovered," FGMSD-76-91, Dec. 14, 1976.

10. "Defense Action to Reduce Charges for Foreign Military Training Will Result in the Loss of Millions of Dollars," FGMSD-77-17, Feb. 23, 1977.

11. A report on DOD's estimates of increased reimbursements resulting from revision of pricing policy, FGMSD-77-40, May 6, 1977.

12. "Inadequate Methods Used To Account for and Recover Personnel Costs of the Foreign Military Sales Program," FGMSD-77-22, Oct. 21, 1977.

13. "The Department of Defense's Continued Failure To Charge for Using Government-Owned Plant and Equipment for Foreign Military Sales Costs Millions," FGMSD-77-20, Apr. 11, 1978.

14. "The Department of Defense Continues To Improperly Subsidize Foreign Military Sales," FGMSD-78-51, Aug. 25, 1978.

15. "Cost Waivers Under the Foreign Military Sales Program: More Attention and Control Needed," FGMSD-78-48, Sept. 26, 1978.

16. "Summary of Efforts To Recover U.S. Government Costs in Foreign Military Sales," ID-77-56, Sept. 27, 1978.

Reports to the Secretary of Defense

1. "Action Needed to Recover Full Costs to the Government of Producing Weapons for Sale to Foreign Governments," B-174901, Sept. 7, 1972.

2. "Recovery of Costs to the Government for Producing Weapons for Sale to Foreign Governments," B-174901, Apr. 9, 1973.

3. "Recovery of Costs on Government-Owned Plant and Equipment," B-174901, Oct. 7, 1974.

4. "Reimbursement for Foreign Military Student Training," FGMSD-76-21, Dec. 1, 1975.

5. A report on weaknesses in DOD's research and development recoupment program, PSAD-76-131, Dec. 18, 1975.

6. "Recovery of Costs Incurred by the Defense Department in Providing Technical Assistance and Training in Iran," FGMSD-76-64, July 13, 1976.

7. "Improvements are Needed To Fully Recover Transportation and Other Delivery Costs Under the Foreign Military Sales Program," LCD-77-210, Aug. 19, 1977.

8. A report on DOD recoupment of normal inventory losses on foreign military sales, FGMSD-77-43, Sept. 8,1977.

9. A report on underpricing of M2 machinegun sales to foreign customers, LCD-77-449, Oct. 7, 1977.

10. A report on unserviceable equipment returned by foreign governments for credit, FGMSD-78-60, Sept. 29, 1978.

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