REPORT BY THE Comptroller General OF THE UNITED STATES

The Defense Department Continues To Subsidize The Foreign Military Sales Program By Not Charging For Normal Inventory Losses

GAO reported in September 1977 and August 1978 that the Defense Department was losing millions of dollars because normal inventory losses were not being recovered on foreign military sales. The Arms Export Control Act was amended in September 1978 to expressly require the recovery of these losses on certain inventory sales.

Although the military services have since identified almost $600 million in inventory losses, foreign governments have not been charged for their fair share of the losses as required by the act. As a result, the United States has lost millions of dollars. Also, these governments purchase hundreds of millions of dollars of items through sales for which the act does not require charges for inventory losses, thus creating a subsidy to foreign governments.

GAO is recommending that a special effort be taken to charge other governments for inventory losses. GAO is also recommending that the Congress amend the Arms Export Control Act to require that charges be made for inventory losses on all inventory sales to foreign governments. This report was prepared at the request of Senator Charles H. Percy.

UNITED STATES GENERAL ACCOUNTING OFFICE

FGMSD-79-31
MAY 15, 1979

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

B-174901

The Honorable Charles H. Percy
United States Senate

Dear Senator Percy:

In your letter of July 26, 1978, concerning the recovery of normal inventory losses on sales of inventory items to foreign governments, you asked us to determine (1) the nature of inventory losses, (2) if Defense is properly charging foreign governments for inventory losses on sales of non-stock fund items sold under supply support arrangements, and (3) whether the Arms Export Control Act should be further amended to require the recovery of inventory losses on sales of nonstock fund items not covered by supply support arrangements. (Nonstock items are generally reparable and non-expendable items, such as engine motors or generators. Under supply support arrangements, items are provided, in effect, on a prepaid basis since foreign governments are required to invest in Defense's inventories.)

We previously reported (FGMSD-77-43, Sept. 8, 1977, and FGMSD-78-51, Aug. 25, 1978) that Defense was losing millions of dollars on sales to foreign governments because normal inventory losses were not being recovered. Your subsequent amendment to the Arms Export Control Act, enacted in September 1978, expressly required that these losses be recovered on sales from inventories of Defense articles being stored at the expense of the purchaser (supply support arrangements).

This report covers our review of Defense's present actions to recover normal inventory losses on foreign sales. We found that Defense is still not charging foreign governments for inventory losses on nonstock fund items sold under supply support arrangements. Acting on our September 8, 1977, report, Defense directed in May 1978 that the military services identify and recover inventory losses on nonstock fund items sold to foreign governments under supply support arrangements. At the time we completed our review in February 1979, however, the military services were still studying the matter. Although almost $600 million dollars of inventory losses had been identified ($483 million by the Air Force for fiscal 1978 and $109 million by the Navy for the 32 months ended May 1978), foreign governments had not been assessed for their fair share of the losses. Their share amounted to millions of dollars.

It has been almost 10 years since Defense first required that foreign governments be charged for inventory losses on sales of nonstock fund items under supply support arrangements. The Department needs to intensify its efforts to guarantee that its pricing policies are effectively and promptly implemented so the foreign military sales program does not continue to be subsidized. A reasonable attempt should be made to identify and recover undercharges on foreign military sales resulting from the nonrecovery of normal inventory losses.

Also, foreign governments purchase hundreds of millions of dollars of nonstock fund items through other than supply support arrangements. As you know, the Arms Export Control Act does not require recovery of inventory losses on these sales because they are not stored at the purchaser's expense, and Defense had objected to such charges. We believe that failure to recover inventory losses on these sales results in a subsidy to foreign governments and, therefore, the Arms Export Control Act should be further amended to require recovery of inventory losses on all sales from Defense inventories.

Appendix I describes the Defense Department's continuing failure to charge for normal inventory losses and the need to amend the Arms Export Control Act to require such charges on all sales from Defense's inventory. We discussed our findings with Defense Department and military service officials and, where appropriate, their comments have been considered in preparing this report. The categories of inventory losses are discussed in appendix II. A list of our previous reports concerning foreign military sales cost recovery is in appendix III. The scope of our review is in appendix IV, and a copy of your letter requesting the review is included as appendix V.

As arranged with your office, we are sending copies of this report today to interested parties and will make copies available to others upon request.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

FINDINGS AND RECOMMENDATIONS ON THE DEPARTMENT OF DEFENSE'S CONTINUED FAILURE TO CHARGE FOREIGN GOVERNMENTS FOR NORMAL INVENTORY LOSSES

In recent years, increased congressional awareness has focused upon the dramatic increases in the dollar volume of U.S. foreign military sales. Department of Defense sales of articles and services to foreign governments have grown from $953 million in fiscal 1970 to $13.5 billion in fiscal 1978.

BACKGROUND

Sales of articles to foreign governments are authorized by the International Security Assistance and Arms Export Control Act of 1976 (Public Law 94-329, June 30, 1976). The act provides that the Defense Department may sell articles from its stocks (inventories).

In implementing the act, the Department of Defense included the following provisions in the standard sales contract used for Defense articles sold to foreign governments:

--Prices of items shall be at their total cost to the U.S. Government.

--The U.S. Government will attempt to notify the foreign government of price increases that will affect the total estimated contract price by more than 10 percent. However, failure to so advise the government does not alter its obligation to reimburse the U.S. Government for the total cost incurred.

--The foreign government agrees to reimburse the U.S. Government if the final cost exceeds the amount estimated in the sales agreement.

In addition to major articles, such as tanks and aircraft, Defense sells articles that are commonly referred to as secondary items to foreign governments. Secondary items fall into two categories: (1) stock fund items and (2) other Defense inventory items commonly referred to as nonstock fund items. Stock fund items are generally low-cost and expendable items, such as gears, bearings, and gaskets. Nonstock fund or other inventory items are generally reparable and nonexpendable items, such as engine motors, manifolds, and generators.

Secondary items may be purchased by foreign governments through supply support arrangements or other sales agreements. Supply support arrangements set forth the terms and conditions for providing articles, in effect, on a prepaid basis through the Defense supply system. These arrangements require the investment of foreign government money in Defense inventories. The intent is to provide foreign governments with continuous and timely spare parts support by allowing them to invest and participate in Defense's logistics system. Other sales agreements generally do not require foreign government investment.

NATURE OF INVENTORY LOSSES

In maintaining secondary item inventories, Defense incurs normal inventory losses such as damage, deterioration, pilferage, inventory shortages, and disposal of excess items, which includes obsolescence. (A detailed description of these categories is included in app. II.)

The Arms Export Control Act, as amended on September 26, 1978, (Public Law 95-384), expressly requires that normal inventory losses be charged to foreign governments on all sales "from stock of Defense articles that are being stored at the expense of the purchaser of such articles." The legislative history of the act indicates that the Congress intended that direct, as well as indirect, costs be recovered so that the foreign military sales program would not be subsidized by Department of Defense appropriations.

As pointed out in our September 8, 1977, and August 25, 1978, reports, since at least 1969 Defense has required in its Instruction 2140.1 that inventory losses be recovered under supply support arrangements for nonstock fund items. On sales to foreign governments from stock fund inventories, Defense required that inventory losses be assessed on all sales, including sales not covered by supply support arrangements. As we reported, the military services were assessing a surcharge to recover inventory losses on stock fund sales but were not charging for inventory losses on nonstock fund sales even where such sales were covered by supply support arrangements.

Acting on our September 8, 1977, report, the Defense Department, in a May 26, 1978, memorandum to the military services, reemphasized the need to charge foreign governments for inventory losses on nonstock fund items sold under supply support arrangements. It told the services to establish inventory loss rates based on past experience. The procedures for identifying and assessing inventory losses, however, were left to each of the services.

The results of our present review are discussed below.

DEFENSE HAS NOT CHARGED FOR INVENTORY LOSSES ON NONSTOCK FUND SALES UNDER SUPPLY SUPPORT ARRANGEMENTS

Despite the requirement of the Arms Export Control Act, the military services are still not charging foreign governments for inventory losses on sales of nonstock fund items sold under supply support arrangements. Only the Air Force has made appreciable progress in quantifying its inventory losses and in formulating alternatives for recovering these costs. As of February 1979, the Army and Navy have made little effort in implementing Defense's May 26, 1978, memorandum requiring that inventory losses be identified and recovered. As a result, Defense is losing millions of dollars on sales from inventory to foreign governments.

Air Force efforts to identify and recover inventory losses

Although it has not yet begun charging foreign governments for inventory losses on nonstock fund sales under supply support arrangements, the Air Force has identified over $480 million of inventory losses in its nonstock fund inventory for fiscal 1978 and has developed two alternatives for assessing foreign governments for their fair share of these losses.

In June 1978, Air Force headquarters directed the Air Force Logistics Command to determine the annual value of inventory losses incurred for the nonstock fund inventory and develop procedures for recovering these costs from foreign governments. The Command's study, which was completed in November 1978, identified the following annual inventory losses:

Schedule of Air Force's Annual Inventory Losses

Category	Inventory Losses	Inventory Gains	Net inventory loss (gain) (millions)
	---(millions)---		
Damage and deterioration	$330.6	-	$330.6
Disposal of excess items	153.6	$ 3.9	149.7
Inventory shortages	63.1	57.0	6.1
Pilferage	1.3	-	1.3
Inventory recoveries	-	4.4	(4.4)
Total	$548.6	$65.3	$483.3

Using this information, Air Force headquarters is considering two alternatives for recovering a proportionate share of these costs from foreign governments. Under the first alternative, foreign governments are charged for inventory losses based on the estimated on-hand portion of supply support arrangement nonstock fund items. For example, if the value of the estimated on-hand portion of supply support arrangement nonstock fund items represents 1 percent of the total inventory, foreign governments would be charged for 1 percent of the annual inventory losses. Based on the value of inventory on hand at the time of our review, application of this alternative, which is not based on the use of the inventory, would recover an estimated $4.6 million annually.

The second alternative would require that foreign governments be assessed a surcharge for inventory losses only when items are obtained from inventory. The surcharge is computed by allocating total annual inventory losses over total estimated annual nonstock fund sales. As foreign governments obtain nonstock fund items from inventory, the appropriate surcharge would be added to the price of the item. Based on current supply support arrangements, an estimate of the value of annual nonstock fund inventory sales, and the amount of fiscal 1980 losses, Air Force recoveries for inventory losses under this alternative could amount to as much as $17 million annually.

The second alternative is the more equitable method because inventory losses would be assessed on the actual use of the nonstock fund inventory. This is the same principle the stock fund uses to charge for inventory losses and would assure that foreign governments pay only their fair share of these costs.

For example, the San Antonio Air Logistics Center maintained a $125 million inventory of nonstock fund items to support certain reciprocating and jet aircraft engines. The estimated value of the on-hand portion of supply support arrangement items was $6.3 million, or almost 5 percent of the value of the total inventory. Annual sales from this inventory amounted to about $70 million which included $48 million (69 percent) in sales to Defense organizations and $22 million (31 percent) in sales to foreign governments under supply support arrangements. Annual inventory losses totaled over $6.7 million. Using the Air Force's first alternative for recovering inventory losses, foreign governments would be charged about $340,000 annually, or about 5 percent of total losses based on the estimated value of the on-hand portion of supply support arrangement items. Under the second alternative, the foreign governments' share of these losses would amount to $2.1 million or about 31 percent of total losses based on the foreign governments use of the inventory. As discussed above, this is the same principle the stock fund uses to charge for inventory losses and would assure that foreign governments pay their fair share of the losses.

Navy efforts to identify and recover inventory losses

The Navy has not been assessing foreign governments for inventory losses on nonstock fund items sold under supply support arrangements. As of February 1979, very little had been done to quantify inventory losses and to establish procedures for recovering from foreign governments their share of the losses.

Navy officials explained that higher priority work had not allowed them an opportunity to determine the value of the losses and to formulate a policy for recovering these costs. In response to Defense's May 26, 1978, memorandum, Navy headquarters directed in July 1978 that the Naval Material Command and the Marine Corps determine the rate of inventory losses. The information that was received, however, contained wide discrepancies and could not be used by headquarters. For example, the Naval Material Command reported losses ranging from .06 percent to 3.6 percent while the Marine Corps reported losses ranging from 2.7 percent to 19.1 percent.

Navy officials said that they would formulate procedures for recovering inventory losses. At the conclusion of our review, although they still had not formulated the procedures, they had identified $109 million of inventory losses related to the entire Navy inventory system for the 32 months ended May 1978.

In discussing our findings on March 28, 1979, Navy officials said that procedures for charging foreign governments for inventory losses would be formulated and applicable charges would be computed no later than June 30, 1979.

Army's efforts to identify and recover inventory losses

The Army has not identified and recovered the cost of inventory losses on sales of nonstock fund items to foreign governments with supply support arrangements. As of February 1979, they had taken no action on Defense's May 26, 1978, memorandum.

Army officials said that they planned to (1) contact field organizations and request that information on inventory losses be gathered so that a uniform loss rate could be computed and (2) include in their foreign military sales pricing regulation procedures on how to compute and recover the cost of inventory losses. At the conclusion of our review, however, these plans had not been developed and the value of inventory losses had not been identified.

In discussing our findings on March 28, 1979, Army officials said that since the conclusion of our review, they have developed and are evaluating a method for assessing foreign governments for inventory losses and are in the process of establishing milestones for implementation.

Underlying cause for Defense's failure to charge foreign governments

Its continued failure to charge foreign governments for normal inventory losses on sales of nonstock fund items under supply support arrangements is indicative of Defense's continuing problems in implementing foreign military sales pricing policies. During the past decade, we have issued many reports covering a wide range of problems which resulted in the failure to recover hundreds of millions of dollars in costs from foreign countries. (See app. III.)

The major reason Defense has consistently failed to recover all costs is a general lack of effort on its part to insure that pricing policies are properly implemented. In our August 25, 1978, report, we emphasized this problem and recommended that the Secretary of Defense assign specific responsibility for administering pricing policy and monitoring pricing systems to a new organization or some existing organization that can be sufficiently freed from other work to provide careful surveillance over pricing functions. We concluded in our September 27, 1978, report, "Summary of Efforts to Recover U.S. Government Costs in Foreign Military Sales" (ID-77-56), that inadequate implementation by the military services of foreign military sales policy and insufficient followup or monitoring by Defense policymakers of actual cost recovery practices were at the heart of the cost recovery problem. In another report (FGMSD-77-20, Apr. 11, 1978), we stated that Defense has emphasized customer satisfaction more than the implementation of good pricing and accounting practices.

Further, in a March 22, 1979, report, "Improperly Subsidizing the Foreign Military Sales Program--A Continuing Problem" (FGMSD-79-16), we noted that the number of personnel assigned to the Office of the Secretary of Defense to make sure that pricing policy is effectively implemented is insufficient. The Office of the Secretary has only two accountants who are assigned to prepare and update pricing policy. They are also responsible for the billing, collecting, and accounting policies for foreign military sales. We recommended that the Congress require that the Secretary of Defense (1) produce a plan for overcoming the foreign military sales pricing problems that will specify any organizational changes that will be made and (2) identify the number of additional personnel to be assigned to these activities.

CONCLUSIONS

Sufficient management attention still has not been given to recovering normal inventory losses on sales of nonstock fund inventory items under supply support arrangements. Nearly 10 years have elapsed since the Defense Department issued instructions requiring the recovery of these costs and nearly 1 year has passed since it reemphasized this requirement to the military services. Not only have the services been slow in implementing Defense's directive, but each service has implemented the requirement as it saw fit, and the result has been a lack of uniformity.

Unless timely action is taken to begin assessing foreign governments for their share of inventory losses, additional millions of dollars will not be recovered. We believe that application of a surcharge based on the actual use of the nonstock fund inventory is the best means of assuring that prompt and uniform action is taken. Procedures for computing losses should be prescribed by the Defense Department to assure uniformity.

In recovering costs of foreign sales, up to and including final billing, the Defense standard sales contract provides that adjustments may be made to estimated costs which are not commensurate with actual costs. Therefore, any inventory losses that have not been recovered by the military services and that are on sales contracts for which final billing has not been made, could and should be subsequently billed.

As to undercharges which may be found after final billing, Defense Instruction 2140.1 provides that adjustments to final billings are permitted when unauthorized deviations from Department pricing policies exist.

The longer Defense takes to attempt to collect undercharges, the more difficult it will be to recover these amounts from foreign governments. Until action is taken to attempt to collect undercharges, the military services should not make final billings for contracts in which undercharges occurred.

RECOMMENDATIONS

We recommend that the Secretary of Defense direct that uniform procedures for charging foreign governments for normal inventory losses be prescribed by the Defense Department based on the use of inventory and be implemented by the military services without further delay.

We further recommend that the Secretary of Defense direct the military services to make a reasonable attempt to identify and recover undercharges on foreign military sales resulting from costs of normal inventory losses that are not recovered.

NONSTOCK FUND ITEMS PURCHASED OUTSIDE OF SUPPLY SUPPORT ARRANGEMENTS LEAD TO SUBSIDY

Foreign governments are purchasing hundreds of millions of dollars of nonstock fund items from Defense inventories through sales agreements other than supply support arrangements. In the Air Force alone these sales totaled an estimated $245 million in fiscal 1978. However, neither the Arms Export Control Act nor Defense pricing policies require recovery of inventory losses on these sales. As a result, foreign governments receive a subsidy. We believe that the Arms Export Control Act should be amended to require the Defense Department to recover inventory losses on all sales from inventories and end this subsidy.

In our previous reports, we concluded that inventory losses are a normal cost of operating the Defense inventory system and, to the extent foreign governments purchase items from the system, they should share in those losses. We pointed out that foreign governments entering into supply support arrangements also enter into other sales agreements for the purchase of secondary items and, in some cases, they purchase the same items under both types of agreements. We recommended that pricing policies be changed to require that inventory losses be recovered on all sales of inventory items to foreign governments.

The Assistant Secretary of Defense (Comptroller), in a November 17, 1977, letter responding to our report, stated that inventory losses should not be recovered on nonstock fund items sold through other than supply support arrangements. According to the Assistant Secretary, foreign governments without supply support arrangements do not invest or participate in the Defense logistics system and, therefore, do not derive benefits from Defense maintaining the nonstock fund inventory. The Assistant Secretary said that requisitions for items not under supply support arrangements are not to be filled from inventory but are to be placed on "back order" status unless inventory levels are above Defense requirements. Foreign governments must, therefore, wait until adequate inventory levels are achieved or until special procurements are made.

While it is true that foreign governments who purchase nonstock fund items through other than supply support arrangements do not invest in the Defense nonstock fund inventory, we do not agree that they do not participate or receive benefits from the inventory.

In reevaluating the position taken in our September 1977 report, we noted that Defense's pricing policies governing sales from inventory are inconsistent. Foreign governments are charged a fair share of inventory losses on all sales of stock fund items, not just those under supply support arrangements. On the other hand, Defense argues that for nonstock fund items sold under sales agreements other than supply support arrangements, these charges are not equitable.

As discussed in our September 1977 report, we questioned the inconsistency between charges for inventory losses on sales of stock fund and nonstock fund inventory items. According to officials of the Joint Logistics Command Panel on Standardization of Foreign Military Sales Procedures, since the stock fund is a revolving fund and, therefore, intended to be self-sustaining, it must recover normal inventory losses from its customers or its capital will continually shrink. On the other hand, money to buy nonstock fund material comes directly from the Congress through the military service appropriations. Inventory losses are, therefore, recovered through the appropriation process.

For example, between September 1977 and October 1978, the San Antonio Air Logistics Center sold foreign governments about $5.3 million of stock fund items through sales agreements other than supply support arrangements. On these sales, a 12-percent surcharge was included in the price of each item to recover the cost of inventory losses. During the same period, the Center sold foreign governments about $15.1 million of nonstock fund items not covered by supply support arrangements. These sales amounted to almost three times the value of stock fund sales, and nothing will be recovered for inventory losses.

In practice, Defense's policy does not, as the Assistant Secretary indicates, limit foreign government purchases not covered by supply support arrangements. The Air Force and Navy nonstock fund inventories, which together are valued at $12.7 billion, contain $4.4 billion (35 percent) of inventory that is above Defense's forecasted need. These inventory items can be purchased by foreign governments without restriction. For instance, according to the Navy and Air Force, their nonstock fund inventories include about $1.2 billion of items which are being held only in anticipation of foreign requirements; the services have no need for these items.

Also, we noted several instances where foreign governments purchased nonstock fund items from the Air Force through other than supply support arrangements when inventory levels were well below Defense's own forecasted need. For example, a foreign government ordering engine nozzles from the Air Force on a requisition not covered by a supply support arrangement was provided the nozzles even though adequate stock was not on hand to meet Defense needs. Within 4 months Air Force aircraft engines could not be repaired and remained inoperable for up to a year because engine nozzles were not available.

As discussed in our September 1977 report, foreign governments frequently purchase the same items under both supply support arrangements and other sales agreements. During our present review, we identified 748 nonstock fund items which were purchased under both types of sales arrangements from the San Antonio Air Logistics Center.

It is our view that, when a foreign government's requisitions are filled from a Defense inventory, the foreign government is receiving the benefits of the Department's maintaining the inventory. Therefore, as we have noted above, the foreign government should share in the total cost of maintaining the inventory, including the cost of inventory losses. Not assessing foreign governments for those losses results in a subsidy. The Air Force Logistics Command, for example, reported that fiscal 1978 foreign government nonstock fund sales from inventory that were not covered by supply support arrangements exceeded $245 million. Under the second alternative the Air Force has proposed for recovering inventory losses (see pp. 6 and 7), foreign governments' share of inventory losses on these sales alone could amount to about $24 million annually based on the estimated value of annual sales.

As noted in our August 25, 1978, report, operating level military service officials have also expressed concern over the failure to recover normal inventory losses in the sale of nonstock fund items. In a May 1976 memorandum to a higher command, the comptroller of a major Army command said that 75 percent of nonstock fund issues were to foreign governments, and, therefore, a charge for normal inventory losses appeared appropriate. In an April 1977 message to Air Force headquarters, the Air Force Logistics Command said that when purchasing nonstock fund items from inventory, the customer should share in the cost of normal inventory losses.

In discussing our findings, Defense officials reiterated the position taken in the November 17, 1977, letter from the Assistant Secretary of Defense (Comptroller). They still contend that foreign governments should not share in inventory losses for nonstock fund sales not covered by supply support arrangements because they do not own part of the inventory.

As discussed above, we disagree with this position and believe that the Defense Department should assess foreign governments for stock losses on all inventory sales just as a business would recover its costs and just as a surcharge is assessed on stock fund items. Officials could not explain the inconsistency between stock fund and nonstock fund sales other than to say that, historically, all customers have been charged for this cost on stock fund sales.

CONCLUSIONS

Because foreign governments are not charged for normal inventory losses on sales from the nonstock fund inventory not covered by supply support arrangements, the U.S. Government is losing millions of dollars annually. We continue to believe that foreign governments that use the Defense inventory system should share in the total cost of maintaining that inventory whether or not the sale is under a supply support arrangement. The inclusion of these costs would be consistent with the intent of the Arms Export Control Act that Defense appropriations not subsidize the foreign military sales program.

RECOMMENDATIONS

We recommend that the Congress amend the Arms Export Control Act to require that normal inventory losses be recovered on all sales to foreign governments from Defense inventories. We will provide specific legislative language if the Congress so desires.

CATEGORIES OF INVENTORY LOSSES

Following are the general categories of inventory losses which occur in both the stock fund and nonstock fund inventories.

DISPOSAL OF EXCESS ITEMS

Excess items occur when there are more assets on hand than can be used. Excesses are caused by (1) abrupt changes in programs, (2) errors in reporting issues and asset data, (3) technological changes in design, (4) inaccurate usage factors, (5) erroneous computer programs, and (6) misinterpreted policies. Losses occur when excess items are transferred from inventory to disposal activities. Gains occur when an unexpected need is generated for items previously transferred to disposal but not yet sold and the items are returned to the inventory.

DAMAGE AND DETERIORATION

Nonstock fund inventories contain both serviceable and unserviceable items. To maintain satisfactory inventory levels of serviceable stock, unserviceable items are sent to repair facilities and returned as a serviceable unit. When unserviceable items are found to be damaged beyond economical repair, the inventory is adjusted and an inventory loss is recorded. Air Force unserviceable nonstock fund inventory, which is valued in the billions of dollars, includes unserviceable items previously purchased from foreign governments and items only used by foreign governments. The repair of unserviceable items is a normal and integral part of the nonstock fund inventory system and resulting losses are considered normal inventory losses.

INVENTORY SHORTAGES AND OVERAGES

The military services physically inventory their stocks periodically. When discrepancies (gains or losses) are identified, inventory adjustments are made. Discrepancies involving less than $500 normally are not subjected to an investigation. Inventory records are automatically increased or decreased, as appropriate. For discrepancies involving $500 or more, however, a complete investigation is made to resolve the differences and formal reports of the investigation are made before adjusting the inventory balances.

PILFERAGE

Defense has special storage facilities to protect inventories of items that have widespread uses outside of the Government. In the stock fund, pilferable items consist of such items as knives, spark plugs, and common automotive components. The pilferable nonstock fund inventory contains items such as special and general tools, watches, life rafts, and other similar types of items. These inventories are to be physically counted semiannually, and all discrepancies are fully investigated and adjusted in the inventory records.

PREVIOUS GAO REPORTS

CONCERNING FOREIGN MILITARY

SALES COST RECOVERY

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, April 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. Letter report 1/ discussing DOD's estimates of increased reimbursements resulting from revision of pricing policy, FGMSD-77-40, May 6, 1977.

1/Letter reports are untitled.

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.

17. "Improperly Subsidizing the Foreign Military Sales Program --A Continuing Program," FGMSD-79-16, Mar. 22, 1979.

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 Plants and Equipment," B-174901, Oct. 7, 1974.

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

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

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

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

SCOPE OF REVIEW

We reviewed the military services' procedures for recovering the cost of inventory losses on sales under the foreign military sales program. Our review included an examination of legislation, policies, procedures, documents, and transactions dealing with inventory operations. At the time of our review, only the Air Force had fully quantified inventory losses in its nonstock fund inventory and had formulated alternatives for recovering these losses. Our review, therefore, concentrated on the Air Force.

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

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

--The Air Force Logistics Command; Wright-Patterson Air Force Base, Ohio.

--The San Antonio Air Logistics Center; San Antonio, Texas.

--The U.S. Army Materiel Development Readiness Command; Washington, D.C.

United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, D.C. 20510

July 26, 1978

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

Dear Elmer:

In September 1977, your office reported that, with the exception of sales from the stock fund, the Defense Department was not charging foreign governments for ordinary inventory losses.

I have introduced an amendment to the Arms Export Control Act requiring the recovery of ordinary inventory losses on all sales from Defense inventories except for sales of nonstock fund items not covered by supply support arrangements. The Defense Department objected to charging foreign governments for losses on nonstock fund sales not covered by supply support arrangements stating that such charges would not be equitable to foreign governments. Further, Defense officials have advised my staff that they, in general, do not believe that inventory losses are occurring for nonstock fund items.

I would appreciate your staff reviewing this matter further. Specifically, I would like to know (1) if Defense is properly charging foreign governments for inventory losses on sales of nonstock fund items sold under supply support arrangements, (2) what is the nature of inventory losses and (3) whether the Arms Export Control Act should be further amended to require the recovery of inventory losses on sales of nonstock fund items not covered by supply support arrangements.

My staff has discussed this review with members of your Financial and General Management Studies Division, Systems in Operation group. I would appreciate a report on this matter by March 31, 1979.

Sincerely,

Charles H. Percy/wnc
United States Senator

GAO note:
We subsequently arranged with Senator Percy's office to issue the report by May 15, 1979.

(903820)

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