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BEFORE THE
SUBCOMMITTEE ON DEFENSE
OF THE HOUSE APPROPRIATIONS COMMITTEE

ON



115302

BETTER ACCOUNTING AND FINANCIAL
MANAGEMENT NEEDED TO ELIMINATE
CONTINUED FOREIGN MILITARY SALES SUBSIDIES

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss with you our past and ongoing work on the longstanding accounting and financial management problems that the Department of Defense has had in administering its foreign military sales program. Your continuing concern about the need for recovering the full costs incurred by the U.S. Government, as required by law, in selling goods and services to foreign customers is warranted by the size of the program and the continuing nature of these financial management problems. As you are aware, foreign military sales is big business within the Department of Defense--the value of unfilled customer orders was over \$53 billion at September 30, 1981.

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Over the past decade, GAO and Defense internal audit staffs have issued numerous reports on the Department of Defense's continued failure to recover hundreds of millions of dollars in costs incurred for foreign military sales and Defense's inability to give foreign governments a proper accounting of how their money was spent. With your permission, a list of the 48 GAO reports issued will be provided for the record. Our current work for this Committee and for Senators Percy and Hollings as well as recent Defense internal audit reports indicate that the accounting and financial management problems plaguing the foreign military sales program remain largely unresolved. The military departments and Defense agencies have not adequately implemented Defense pricing policies and Defense policymakers have not performed sufficient followup or monitoring of actual cost recovery. Further, Defense has not developed an adequate centralized accounting and financial management system for foreign military sales.

Because of these continuing problems, the Congress has found it necessary to clarify and strengthen the law governing cost recovery requirements for foreign military sales. The International Security Assistance and Arms Export Control Act of 1976 gives Defense authority to sell goods and services to foreign countries at no cost to the U.S. Government. Your committee has made it clear that Defense appropriations should not be used to subsidize the foreign military sales program. Also, your committee has directed Defense to develop a plan for centralizing accounting and financial management.

Corrective action has been taken by Defense on some of the problems noted in the GAO and Defense internal audit reports. This action, however, has usually been slow in coming, narrowly confined, and implemented in an inconsistent manner. Moreover, Defense's attention to the overall problem of inadequate foreign military sales cost recoupment has been limited to little beyond the policy formulation stage. In April 1981, the Deputy Secretary of Defense alerted the military departments and Defense agencies to the need for particular emphasis on certain financial management areas. A copy of his memorandum will be provided for the record.

Although some improvements have been made and management awareness has increased, more must be done. Our previous reports, the Defense internal audit reports, and our ongoing work show that Defense still has serious financial management problems and that many millions of dollars are not being recovered from foreign customers as required by law. Further, a centralized accounting system has not been developed.

Many of the more important recommendations made by GAO to improve accounting and financial management in the Department of Defense have not been implemented. We will now discuss in more detail, selected reports and recommendations and the tentative results of current assignments regarding the need to

- develop an adequate centralized accounting system,
- establish and implement pricing policies that result in full cost recovery, and

--provide the Congress with adequate information for effective oversight and control.

NEED FOR CENTRALIZED ACCOUNTING SYSTEM

Defense has continued to experience accounting and financial management problems during the past decade because it lacks an adequate centralized accounting system. The existing accounting systems were not designed to accommodate the phenomenal growth of the foreign military sales program and a standard Defense-wide system was not developed. Defense has been criticized by the Congress and GAO for its inability to properly manage the finances of the foreign sales program. We believe this situation will continue until a comprehensive centralized accounting and financial management system is developed solely for foreign military sales.

We reported in 1979 that there are certain advantages to developing a comprehensive centralized accounting and financial management system. These advantages include:

- Uniform accounting and reporting, thus eliminating the reporting by the services of nonstandard accounting data and providing greater accounting control.
- Timely and complete adoption of Defense's accounting policies.
- Direct control over foreign military sales disbursements.
- Improved accounting for the program, thus better enabling the Department to meet its fiduciary responsibility to its foreign customers.

--Better programwide planning because accounting and financial management will not be fragmented.

Since our report, Defense has allowed each military department and the Security Assistance Accounting Center to continue to operate their own financial management and accounting systems. Because of this need for a centralized accounting system, Defense has continued to experience problems in identifying costs incurred to operate the foreign military sales program and has not been able to provide foreign countries with an accurate accounting for funds deposited in their trust fund accounts.

Efforts to correct foreign military sales accounting and financial management problems have been piecemeal. Policy has been established by the Assistant Secretary of Defense (Comptroller) but implemented inadequately and inconsistently by the military departments. Although Defense was directed to develop a plan for testing centralized accounting, it has not made satisfactory progress in doing so. As a result, some of the more important aspects of the accounting and financial management problems have not been addressed and accounting remains decentralized.

Because Defense had not developed an adequate accounting system, its problems in identifying costs incurred to operate the foreign military sales program and in providing foreign countries with an accurate accounting for their funds have continued. To remedy this serious problem, in May 1979 we recommended that the Congress require Defense to produce a plan for centralizing accounting and financial management of its foreign military sales program. This plan was to include obligation and expenditure

accounting and disbursing of funds, and was to ensure that all costs properly chargeable to the program were fully recovered.

This committee, in its fiscal 1980 report, recommended that Defense produce a plan for centralizing accounting and financial management. The plan was to be developed by March 1980.

However, Defense did not develop a plan addressing the committee's recommendation. Instead, in March 1980, the Department provided a detailed schedule for completing a centralized disbursement test and providing the findings, conclusions, and recommendations by January 31, 1981. Defense stated that it recognized the need to improve the financial management of the program, but had reservations about centralizing the accounting and disbursing.

By June 1980, it became evident that the centralized disbursement test would not result in valid conclusions, primarily because the number of contracts and cases were considered by Defense to be inadequate to constitute a valid test. Also, because significant delays were encountered, the remaining time available for the test was insufficient. The Defense Audit Service, in September 1980 recommended, and Defense agreed, to expand the test and change the established milestone dates given to the committee.

A revised test plan was developed in October 1980. The revised plan increased the test size and called for completion by September 30, 1981, with a final report to the Congress by December 31, 1981. However, significant interim milestone dates have been missed. For example, the transfer of the additional contracts for the test was not accomplished by the date planned.

We do not believe the test as outlined will comply with the original requirements established by the committee to provide a plan to centralize accounting and financial management. The test addresses centralizing disbursement of funds for selected contracts, and expenditure accounting for contracts. However, the test does not address problems in obligation accounting, expenditure authority, or case level accounting, and does not ensure that all costs properly chargeable to the foreign customers are fully recovered. Although Defense has taken other actions to address its problems, it has not developed a comprehensive plan for an integrated foreign military sales accounting system.

Defense efforts to centralize financial management have, in the past, been primarily limited to billing and collecting. In establishing the Security Assistance Accounting Center in November 1976, Defense sought to centralize billing and collecting. Although the Center has provided standardized billing, collecting, and other financial management controls, it still depends on the military departments' accounting systems for its financial information. For the most part, the Center acts as a clearinghouse operation that reports to foreign customers only what it is told.

Although one of the Center's primary fiduciary responsibilities is to advise foreign customers how their money was spent, the Center has had little, if any, input into the design of the military department systems for reporting financial information. As a result, these systems, which were developed independent of each other, have not provided accurate or timely financial data. For example:

--In June 1977, the Assistant Secretary of Defense (Comptroller) directed that a new foreign military sales financial reporting system be adopted. The system, when fully implemented, was intended to give the Department a better view of and control over the use of foreign military sales budget authority and to improve management of the trust fund. Now, nearly 4 years after its implementation was mandated by the Assistant Secretary, the system has not been fully implemented and actions by the military services to implement it have varied.

--Currently, each service is developing a separate customer order control system and data base that will not be integrated or standardized. The Navy is designing its system, while the Army and the Air Force have partially implemented their systems. These systems, if completely implemented, would give each military department a system to control obligations and expenditures. However, these developments are a step toward three separate accounting systems--not one integrated Defense system at the Security Assistance Accounting Center.

Recent GAO reviews show that, as a result of this need for a centralized accounting system, past problems are continuing. To illustrate this point, I will discuss a recent GAO report which shows that the correct trust fund balances of foreign customers are unknown. A standard centralized accounting system would materially assist in eliminating this problem.

Correct Trust Fund Balances
Still Unknown

In November 1978, we reported on the Navy's failure to reconcile \$554 million in differences between the accounting records used to prepare reports to foreign governments and the balances in the governments' trust fund accounts. Last June, we reported that as of September 1979, detailed accounting records for foreign military sales customers differed by \$1.5 billion from trust fund records showing cash on hand. After considering manual processing delays, system deficiencies, and identifiable accounting errors, unexplained differences were still about \$390 million.

Because the correct balance of Defense's foreign military sales trust fund was unknown, Defense did not have adequate control over foreign military sales accounting. As a result, it could not provide foreign customers with an accurate accounting for funds deposited in trust accounts. Also, Defense could not determine the amount of money available to foreign customers for purchasing military goods and services.

Until a centralized accounting system is developed, problems such as inadequate accounting for trust funds can be expected to continue. Also, Defense cannot hope to identify and collect all costs incurred in selling goods and services to foreign customers without an adequate accounting and financial management system.

DEFENSE PRICING PROCEDURES DO NOT
RESULT IN FULL COST RECOVERY

During the past decade, GAO has issued many reports on Defense's continued failure to recover all costs of foreign military sales. This failure has resulted in large subsidies to the sales

program--a practice which your committee has gone on record as wanting Defense to avoid. Because of continuing weaknesses in pricing procedures and practices, hundreds of millions of dollars in costs have not been recouped from foreign governments. These subsidies are expected to continue until certain procedures and practices are revised. Three years ago, we recommended that Defense establish a quality assurance organization which would ensure effective and consistent implementation of foreign military sales pricing policies. To date, Defense has not fully implemented our recommendation.

Failure to charge the right amount for equipment and spare parts is the most significant overall problem Defense has experienced in pricing foreign sales. However, GAO has also identified a wide range of other problems regarding the failure to recover full costs such as those for

- administrative support of the program,
- use of U.S. Government-owned plant and equipment, and
- normal inventory losses.

I will now discuss some of the more serious deficiencies shown by our past and ongoing work.

Pricing of Equipment and Spare Parts

In 1978, GAO reported that Defense was not charging foreign governments the replacement cost of items sold from its inventories as required by law. Defense's failure to charge the replacement cost resulted from

- pricing policies that were ambiguous, conflicting, and difficult to apply; and

--an unworkable system of identifying item replacement cost.

Preliminary results of our current review of pricing for stock fund and secondary items, performed at the request of Senators Percy and Hollings, show that Defense is still not recovering replacement costs because item prices are established by the military services

--without considering the most recent purchase price,
--without accumulating inflation factors, and
--without consistently and accurately applying Defense policies and procedures.

Preliminary information indicates that for stock fund and secondary item sales, Defense is still losing millions of dollars each year because of underpricing of sales to foreign customers.

Recovery of Administrative Support Costs

GAO reports issued in 1977 and 1978 showed that inadequate methods of accounting for and recovering personnel costs incurred in administering the foreign military sales program resulted in millions of dollars of costs not being properly billed to foreign governments. GAO is currently conducting a followup review at the request of Senators Percy and Hollings. Preliminary indications are that millions of dollars are still not being recovered for administrative costs associated with the foreign purchases of military equipment and services. Our review of the fiscal 1980 and 1981 administrative budgets disclosed that problems still exist. We reviewed the selected budget submissions by Defense

activities for fiscal 1981 and found serious deficiencies. We also identified over \$5 million of fiscal 1980 costs that should have been charged to foreign customers but were not.

In addition to these budgets being understated because an inaccurate system was used to budget for and recover personnel costs, the Defense Security Assistance Agency has adopted the position that only those costs that can be proven to vary with fluctuations in the military sales program will be recovered. In our opinion, this is a restriction upon the military services that will not allow them to budget for identifiable expenses. Examples of identifiable expenses that will not be allowed are:

- Salaries and related expenses for personnel working less than 10 percent of their time on supporting the foreign military sales program.

- Pro rata rent or utilities at locations that are not considered to be 100 percent dedicated to supporting foreign military sales.

- Other miscellaneous expenses, such as base support personnel, that could be prorated based on applicable direct man-years of effort.

An idea of the effect of this restriction can best be conveyed by quoting a high level Air Force official regarding the Air Force's fiscal 1981 administrative budget. Commenting on the restriction, the official said, "This budget estimate was computed by using Defense Security Assistance Agency's interpretation of 'full costing.' However, if we had used the GAO interpretation, the estimates would be some 750 man-years or \$21 million higher."

Production Costs Still Not Fully Recovered

Since early 1970, GAO has reported that the costs of using Government-owned assets to produce items sold to foreign governments were not being recovered. In all, six GAO reports have been issued disclosing millions of dollars in unrecovered costs. Our final report in this area, issued in June 1979, recognized that Defense had made a marked improvement in its efforts to recover these costs; however, we pointed out that additional weaknesses in accounting and billing systems still existed. During fiscal 1979 and early 1980, Defense, acting on GAO's recommendations, collected over \$52 million in asset-use and rental charges from foreign governments.

Apparently, Defense has not solved all of its problems in this area. In September 1980, the Defense Audit Service disclosed that Defense had not billed foreign customers for nearly \$1 million in asset-use charges on selected foreign military sales cases. These undercharges resulted because the military services did not ensure that customers were charged for contractors' use of Government-owned facilities and plant equipment and because of cost reporting problems.

Normal Inventory Losses Still Not Recovered

In September 1977, August 1978, and May 1979, GAO reported that Defense appropriations were being used to subsidize the foreign military sales program because customers were not assessed a portion of the cost of normal inventory losses. GAO reported that the Department of Defense was losing millions of dollars on sales to foreign governments each year.

Inventory losses are a normal cost of operating the Defense inventory system and include such elements as disposal of excess or obsolete equipment caused by technological improvements and errors in estimating needed quantities, damage and deterioration due to normal wear, shortages and overages discovered in physical inventories, and pilferage.

The Arms Export Control Act was amended in September 1978 to expressly require the recovery of these costs on Defense items sold under cooperative logistics supply support arrangements. However, our ongoing work shows the military services still have not implemented this requirement.

In our most recent report, we recognized that the Arms Export Control Act does not expressly require that normal inventory losses be charged on sales under other than cooperative logistics supply support arrangements. GAO has long contended that inventory loss costs should be included on all sales of secondary items. Information developed as part of the followup work requested by Senators Percy and Hollings indicates that Defense will lose several million dollars on secondary item sales each year if a factor for normal inventory losses is not included in sales prices of these items.

There is little doubt that noncooperative logistics supply support arrangement customers benefit from Defense's maintenance of an inventory system. Allocating indirect costs such as inventory losses to all customers benefiting from the system which generated those costs is a standard accounting practice. While the act does not expressly require that inventory loss costs be

recovered on noncooperative logistics supply support arrangement sales, it does not prohibit such charges, and their inclusion would be consistent with the intent of the act that Defense appropriations not subsidize the foreign military sales program. We also pointed out in our last report that the selling price of stock fund items does include a surcharge for normal inventory loss costs whether or not the sales are under cooperative logistics supply support arrangements.

Need to Monitor Implementation of Pricing Policy

The persistence of pricing problems over several years resulted in our recommendation in an August 1978 report that a new or existing organization be given specific responsibility for ensuring effective and consistent implementation of foreign military sales pricing policies. Defense initially disagreed with our recommendation because it felt that existing organizations were adequate to ensure that pricing policies were effectively implemented. However, the Security Assistance Accounting Center was told, in September 1978, to periodically perform quality assurance pricing tests. By March 1981, this function had not been fully staffed.

The continuing nature of the many pricing problems I have just described serves to illustrate the need for one activity to have specific responsibility for administering pricing policy and monitoring pricing systems. Until this activity effectively provides the needed surveillance over the pricing function, problems can be expected to continue.

ADEQUATE INFORMATION NOT PROVIDED
FOR OVERSIGHT AND CONTROL

Congressional oversight and control over the foreign military sales program is necessary to ensure compliance with congressional intent that foreign governments not be subsidized through the program. To carry out this oversight and control, the Congress must have adequate information. However, the information provided to the Congress is not always adequate.

One of the most significant problems of this nature reported by GAO is that Defense has not kept the Congress informed of waivers for nonrecurring research, development, and production costs. Since 1976, Defense has authorized cost waivers of over \$800 million without being required to report to the Congress on how the United States benefits from the waivers. Because of the amount of money involved, congressional oversight and control is needed over cost waivers to ensure compliance with congressional intent.

In 1976, an internal audit staff report stated that the Air Force had not included over \$31 million in recoverable nonrecurring production costs on selected sales to foreign countries. Similar practices continued and in 1978, GAO reported on the need for more attention to and control of cost waivers under the foreign military sales program. The report addressed actions taken by Defense to authorize, account for, and report significant costs waived for foreign military sales and the pricing of these sales. The report showed that the Congress had not been informed of the amounts being waived and the specific reasons for granting waivers although this information would have improved its oversight of the program.

GAO, the Defense Audit Service, and the Army Audit Agency all have recently issued audit reports on cost waivers and the failure to recoup the appropriate nonrecurring costs. These reports emphasize the need for compliance with nonrecurring cost recovery requirements and recommend improvements to protect the interests of the United States. Although these deficiencies have been continually reported for the last several years, costs still are either not computed, not computed correctly, or computed but not billed.

Defense did not concur with the recommendations in our report and has waived several hundred million dollars in costs since our report was issued without reporting to the Congress on the amounts of and justifications for these waivers of costs. As a result, the Congress is not being provided a complete picture of the costs excluded from proposed foreign military sales prices. These waived costs are often significant in relation to the total sales price and should be disclosed so that the Congress can carry out its oversight and control responsibility.

The Congress has not taken action to amend the Arms Export Control Act in response to our recommendation that Defense be required to report the amount approved and the reasons for the waivers. Consequently, Defense has not and does not report to the Congress the full costs of a sale including the amount of costs waived or any other material concessions related to the sale. Unless the law is changed, we expect Defense to continue to negotiate waivers without providing this information with the normal congressional notifications of proposed foreign military sales.

RECOMMENDED ACTIONS

In view of the improper subsidies of the foreign military sales program and the continued failure to properly account for funds of foreign customers, we believe actions are warranted on open GAO recommendations.

First, we believe that Defense should comply with the wishes of your committee by developing a plan for a centralized accounting system. Although other alternatives exist, we believe establishment of a centralized accounting organization is the best and most expeditious way for Defense to finally resolve its foreign military sales accounting and financial management problems. This would separate, to the maximum extent practical, accounting for foreign military sales from accounting for Defense's own operations. Until the problems now plaguing the foreign military sales program are solved, the American taxpayer will continue to subsidize foreign customers.

Second, Defense must ensure that its pricing policies are effectively and consistently implemented in systems used by the military departments to price and bill foreign military sales. This goal can be achieved only if the Security Assistance Accounting Center performs its assigned functions. Until the Center expands its efforts to ensure that Defense pricing policies are effectively implemented, the full recovery of costs cannot be assured, and the foreign military sales program will continue to be subsidized.

Third, we believe that continued congressional oversight and control are needed. Defense should be required to keep the

Congress fully informed as to the amount of costs waived as well as any other material price concessions made on foreign military sales.

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Mr. Chairman, this concludes my prepared statement. We shall be happy to answer any questions that you or other members of the Committee may have.