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BY THE COMPTROLLER GENERAL

**Report To The Chairman, Subcommittee On
Defense, Committee On Appropriations,
House Of Representatives**

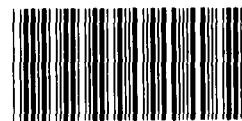
OF THE UNITED STATES

Review Of Pricing Of Silver Sold Under The Foreign Military Sales Program

In just the last 4 fiscal years, the Department of Defense provided contractors with about 11 million troy ounces of reclaimed silver for use in the production of Defense and foreign military sales items.

When the reclaimed silver was used to produce items such as batteries, and the batteries were sold to foreign countries, Defense charged only the cost of reclaiming the silver instead of the market value as required by law. At just three Defense locations, GAO found over \$2.3 million of silver underpricing in batteries that foreign governments had either bought or ordered.

GAO and Defense auditors have issued over 40 reports on Defense's poor pricing practices, but the failure to recover all required costs continues. GAO recommends ways to help recover the market value of silver and improve pricing practices for the sales program.



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

B-206977

The Honorable Joseph P. Addabbo
Chairman, Subcommittee on Defense
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

Your letter of February 3, 1981, expressed concern that the Department of Defense may not be recovering the full costs of Government-furnished precious metals used in items sold in the foreign military sales program. You asked us to evaluate the military services' pricing practices for precious metals included in such items.

This report focuses on Defense's pricing practices for Government-furnished silver used in manufacturing batteries. Specifically, the report discusses Defense's failure to charge enough to cover the full cost of the silver used in the batteries that are sold to foreign customers.

As agreed with your office, we are sending copies of this report today to interested parties and will give copies to others who request them.

Sincerely yours,

A handwritten signature in black ink, reading "Charles A. Bowsher".

Comptroller General
of the United States

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D I G E S T

Since at least 1974, Defense has been selling items containing silver to foreign governments for a fraction of the market value of the silver. As a result, Defense has undercharged over \$2.3 million and has improperly subsidized the foreign military sales program. Over the past decade, GAO and internal auditors have issued over 40 reports on Defense's continued failure to recover all required costs even though the Congress has made it very clear that Defense may not subsidize the sales program. The Congress, in passing the Arms Export Control Act of 1976, required recovery of the actual value or replacement cost of items sold to foreign countries. (See p. 1.)

The Chairman of the Subcommittee on Defense, House Appropriations Committee, asked GAO to review Defense's pricing of items containing precious metals sold to foreign customers. GAO found that the precious metal most found in sales items is silver. The problems in pricing items for sale arise when Defense provides silver to contractors as Government-furnished material. (See p. 2.)

The Defense inventory of silver results from a program in which silver is recovered from scrapped items, such as photographic materials. From fiscal 1978 through 1981, about 11 million troy ounces of silver was provided as Government-furnished material to Defense contractors for the production of Defense and foreign military sales items. About half this silver was used to make batteries. (See p. 2.)

The cost to recover silver from scrapped items is far less than its replacement cost (market value). For example, when the market value was about \$20 a troy ounce, Defense's cost to recover silver was about \$0.82 per troy ounce. In order to reduce the cost of procurement, Defense furnishes recovered silver to contractors for use in producing items it needs. (See p. 2.)

GAO found that Defense used the cost to recover silver in computing a standard price for the silver. In reviewing selected transactions involving sales of batteries at 3 of over 40 military activities engaged in the sales program, GAO found that the Army, Navy, and Air Force had improperly used the standard price for the recovered silver rather than the market value in pricing the silver included in silver-bearing items sold to foreign countries. Thus, for those transactions reviewed, there were undercharges of over \$2.3 million. (See p. 7.)

The Army activity discovered its pricing errors just prior to GAO's audit. A troubleshooting team had been sent to Morocco to investigate a complaint about the performance of batteries sold to that country. This caused a reexamination of the sales cases which revealed that batteries containing 40.5 troy ounces of silver were priced at only \$180 each. Altogether, the 240 batteries involved in the cases were priced at \$43,200. The Army now estimates that an additional \$175,500 should have been charged in order to recover replacement cost of the silver. This prompted a review of other sales cases which revealed several additional instances of under-billing. (See p. 7.)

The Navy and Air Force activities were unaware they were underpricing Government-furnished silver contained in items sold to foreign countries. For example, in sales of other types of batteries, GAO found:

- In July 1980, the Navy sold 18 batteries (with 700 troy ounces of silver in each) to Greece for \$52,038. Based on the market value of silver then (\$15.55 a troy ounce), each battery contained \$10,885 worth of silver. However, the Navy charged only about \$700 for the silver in each battery. The Navy, therefore, undercharged Greece a total of about \$184,000. (See p. 8.)
- In early October 1980, the Air Force shipped 16 batteries containing a total of 960 troy ounces of silver to Thailand. The Air Force charged Thailand the standard price of silver in effect at that time (\$2.91 per troy ounce) instead of the market value of about \$20.75 per troy ounce. As a result, the Air Force underpriced the silver by about \$17,126. (See p. 8.)

Although GAO limited its review to three activities, the deficiencies found may be occurring Defense-wide because the procedures for pricing items are standard within each service and because each service uses similar accounting and financial management systems.

Now that the erroneous pricing method has been disclosed, Defense must act to correct the problems for future sales and make a reasonable effort to recover the past undercharges. Silver is included in items such as batteries, photographic film, and dental supplies. Defense, however, does not have a system which identifies items containing Government-furnished silver sold to foreign countries. Thus, Defense will have to determine those sales cases in which significant amounts of Government-furnished silver were involved. Also, Defense must devise a system which will help ensure that items containing Government-furnished silver are identified so that silver can be priced at market value or replacement cost.

Over the past decade, GAO and military internal auditors have issued over 40 reports on Defense's failure to bill for all required costs of foreign military sales. Defense's corrective action has usually been slow, narrowly confined, and inconsistently implemented. For example, GAO reported in August 1978 that there was a need to assign responsibility to a Defense organization to ensure that pricing policies are effectively implemented by the military services. It was not until March 1981 that the first person was assigned to such an organization. Further, by November 1981 only eight people were assigned to this function. A Defense official advised that given the magnitude of the sales program (\$8.5 billion in sales agreements for fiscal 1981), eight people were not enough to adequately monitor the implementation of pricing policies. (See p. 10.)

Defense officials have advised GAO that the number of personnel assigned to administer the sales program is constrained by annual personnel ceilings. They said that requests for additional authorized personnel spaces for administering foreign military sales must compete under the ceiling constraints with the personnel requirements of other important functions in Defense. The Office of Management and Budget has long advocated personnel ceilings as a method for controlling the Federal Government's labor force

and each year the Congress sets ceilings for military and civilian personnel in the Defense Authorization Act. (See p. 11.)

Since foreign governments are required to reimburse Defense for all administrative costs of the sales program, including pay and salaries, it would make sense to adequately staff the function--particularly those jobs whose incumbents would ensure that Defense does not lose money in sales to foreign countries. The Subcommittee on Defense, House Appropriations Committee, has considered this matter and in reporting out the Department of Defense Appropriation Bill, 1982 (H. Rept. 97-333), the Committee said "Because the additional personnel needed to improve accounting and financial management of the FMS (foreign military sales) program would not cost the U.S. taxpayers any money, personnel ceilings should not be imposed." GAO also believes that Defense personnel assigned to administering the foreign military sales program should be exempt from personnel ceilings. (See p. 11.)

RECOMMENDATIONS

GAO recommends that the Secretary of Defense

- establish policies and procedures to identify items with Government-furnished silver sold to foreign countries,
- require that the market value of silver be used in pricing such items, and
- direct responsible organizations to make a reasonable effort to recover undercharges on foreign sales resulting from nonrecovery of the replacement cost or market value of silver.

GAO also recommends that the Secretary of Defense seek authority from the Congress and the Office of Management and Budget to exempt foreign military sales administrative positions from personnel ceilings. In seeking the exemption, the Secretary should provide data on validated administrative staffing needs, the cost of which would be reimbursed by foreign governments.

AGENCY COMMENTS AND OUR EVALUATION

Defense concurs with GAO's recommendations to (1) establish policies and procedures to identify

items with Government-furnished silver and (2) to require market value pricing of reclaimed silver. Regarding GAO's recommendation to recover undercharges, Defense plans to recover undercharges for silver in cases in which silver-bearing items were directly procured from contractors for foreign governments. While this action might result in recovering substantial underbillings, GAO believes the action would be incomplete because many items containing silver may be sold from Defense inventories. To ensure that all significant undercharges are identified and recouped, Defense should include in its recouping actions items sold from inventory.

Regarding GAO's recommendation that Defense seek authority to exempt foreign military sales administrative positions from personnel ceilings, Defense officials advised GAO that Defense's position on this recommendation is still being coordinated and that it will be included in its written response to congressional committees required by section 236 of the Legislative Reorganization Act of 1970.



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CHAPTER 1

INTRODUCTION

In a February 3, 1981, letter to us, the Chairman of the Subcommittee on Defense, House Appropriations Committee, expressed concern about Defense's practice for pricing precious metals included in items sold to foreign countries and asked us to audit this matter. In a subsequent meeting with the Chairman's office it was agreed that a report should be issued on our findings, conclusions, and recommendations. We learned that the precious metal found most often in sales items is silver. Accordingly, we restricted our review to pricing of that precious metal.

THE FOREIGN MILITARY SALES PROGRAM AND COST RECOVERY PROVISIONS

Foreign military sales are transacted under authority of the Arms Export Control Act of 1976. The legislative history of the act indicates congressional intention that all costs, both direct and indirect, be recovered so that the foreign military sales program is not subsidized by Defense appropriations.

Since 1970, foreign military sales have grown dramatically. Cumulative foreign military sales agreements from fiscal 1950 through 1981 amounted to about \$115.5 billion with over \$100 billion occurring since fiscal 1970. In fiscal 1981 alone, sales agreements amounted to \$8.5 billion.

The Congress is concerned that the sales program be conducted at no cost to the Government and that the program not be subsidized by Defense appropriations. The act of 1976, therefore, sets forth the following cost recovery requirements:

- For articles from Defense stock (inventories) not intended to be replaced--not less than the actual value.
- For articles intended to be replaced--the estimated replacement cost of the article.

As a matter of policy, Defense has long recognized its responsibility under foreign sales legislation to recover from foreign buyers all direct and indirect costs associated with foreign military sales. Defense includes the following provisions in the standard contract used for sales 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 a foreign government of price increases which will affect the total estimated contract price by more than 10 percent; but failure

to so advise does not alter the foreign government's obligation to reimburse the U.S. Government for the total costs incurred.

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

In addition, Defense recognizes in its manual (DOD 7290.3-M) that there may be occasions when closed contracts should be reopened to correct mistakes such as computer errors in establishing prices or unauthorized deviations from Defense instructions.

DEFENSE PROVIDES SILVER AS GOVERNMENT-FURNISHED MATERIAL TO ITS CONTRACTORS

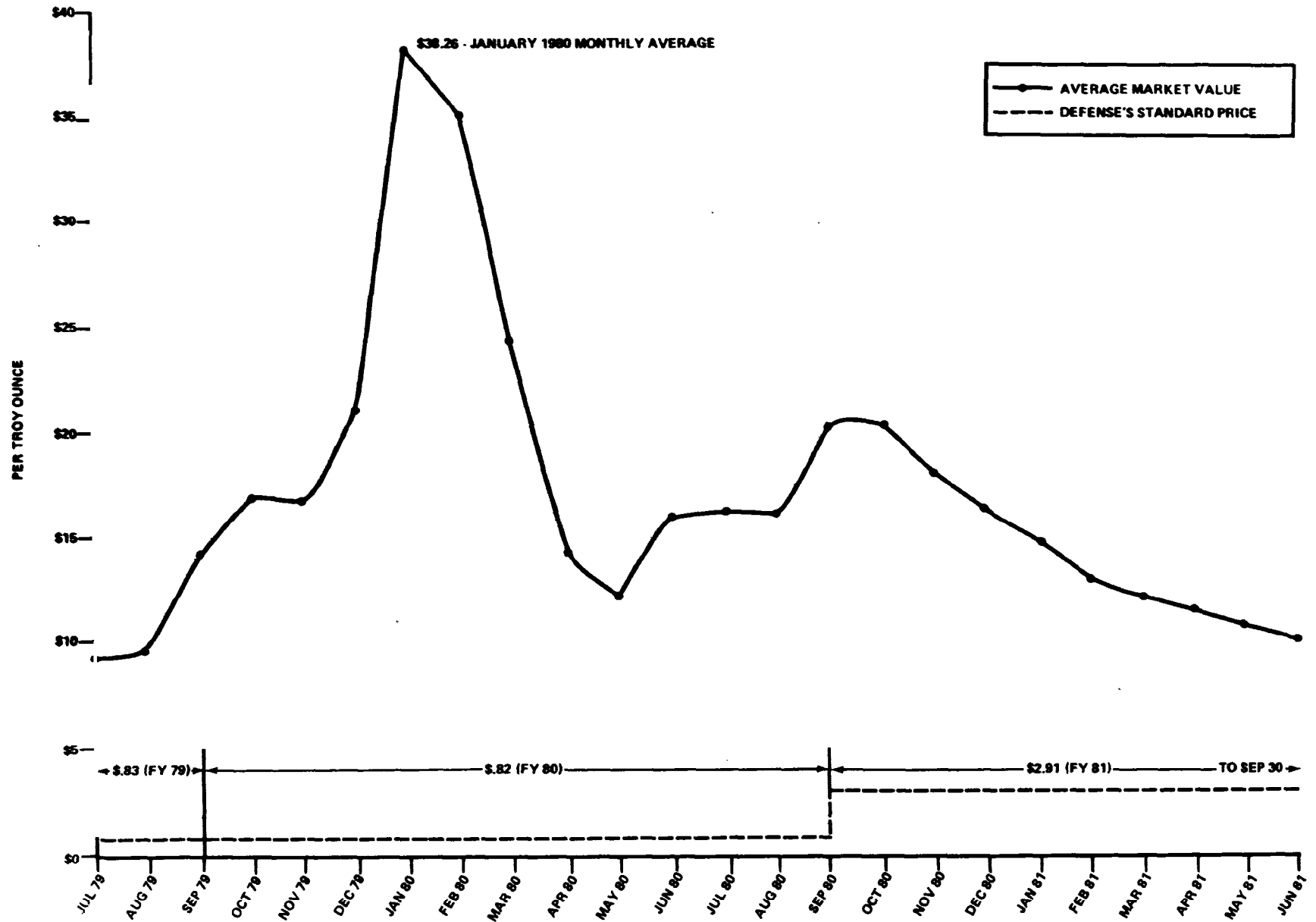
As discussed in this report, the problem in pricing silver occurs when Government-furnished silver is used in an end item. During fiscal 1978 through 1981, about 11 million troy ounces of silver was shipped as Government-furnished material to defense contractors for incorporation in Defense-procured items.

The source of the silver provided to the contractors is the Defense precious metals recovery program. Under this program, Defense reclaims metals from scrapped items such as photographic material. In addition to silver, gold and platinum are also recovered, but in relatively small quantities.

Under the management of the Defense Industrial Supply Center, military contracting officers requisition silver for use as Government-furnished material for items such as electronic parts, rechargeable batteries, dental supplies, and x-ray and photographic film. The items manufactured are placed in inventory for use by Defense activities and/or sales to foreign countries. In certain cases, the items may be shipped directly from the contractor to foreign countries. Defense officials advised us that about one-half of the Government-furnished silver used goes into the production of batteries. Using Government-furnished silver reduces the cost of procurement.

Generally, the Defense silver recovery cost is determined each fiscal year by dividing the total annual cost of recovery by the total number of troy ounces recovered. This figure is referred to as the "standard price." There has been a considerable difference between the cost of recovery (standard price) and the market value of silver in recent years as shown in the following chart.

PRICE OF SILVER MARKET VALUE vs DEFENSE'S STANDARD PRICE



Average monthly prices computed from daily prices.

Source of Averages: Minerals & Materials/A Monthly Survey, Bureau of Mines, U.S. Department of the Interior (July 1981, p. 32).

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this review was to evaluate Defense's policy and procedures for pricing items containing Government-furnished precious metals for sale to foreign governments. After determining that relatively small amounts of gold and platinum were being furnished to contractors, we confined our review to evaluating the policy and procedures for pricing silver. Further, based on information furnished by Defense, about half of the Government-furnished silver was used for making batteries. We, therefore, restricted our review to sales transactions involving certain batteries.

We reviewed applicable Department of Defense and military service regulations, accounting procedures and reports, computer printouts, and other documents on the pricing of items containing Government-furnished precious metals under the foreign military sales program. We also discussed the issue with responsible program officials. We reviewed the legislative history of the Arms Export Control Act of 1976 and its amendments and regulations governing the foreign military sales program. At the service locations visited, we interviewed managers to identify policies and procedures for determining prices charged for foreign sales and gathered data to assist in evaluating the adequacy of pricing policies and procedures.

Because Defense does not have a system to readily identify those items containing Government-furnished silver which are sold to foreign governments, we could not identify the universe of sales transactions involving silver. However, given that about 11 million troy ounces of silver was furnished to contractors over a 4-year period for inclusion in defense items and that foreign military sales of items for the same 4-year period amounted to about \$28.1 billion, there may be substantial amounts of Government-furnished silver contained in items sold to foreign governments.

Over 40 activities are engaged in foreign military sales. However, because procedures for pricing items are standard within each service and because each service uses similar accounting and financial management systems, we limited our review to the Army, Navy, and Air Force activities that managed the particular batteries we identified that contained silver.

For our audit of an Army activity engaged in foreign military sales, we selected the U.S. Army Communications and Electronics Command, Ft. Monmouth, New Jersey. Command officials had become aware of Government-furnished silver pricing errors just before our visit. Therefore, rather than selecting transactions for review, we monitored the Command's actions to identify all of the errors in pricing Government-furnished silver in open and closed sales cases. We also determined the cause of the problem and evaluated the Command's corrective action.

For our audit of a Navy activity engaged in foreign military sales, we selected the U.S. Navy Ships Parts Control Center, Mechanicsburg, Pennsylvania. We queried the requisition history file of the Center for foreign military sales cases involving one type of battery which contained 700 troy ounces of silver. For our audit of an Air Force activity, we obtained information regarding three types of silver-bearing batteries requisitioned from the Sacramento Air Logistics Center, Sacramento, California. As none of the services had a system to identify Government-furnished silver-bearing items sold to foreign governments, the items we reviewed were those that item managers told us they thought might have been sold in the sales program. Air Force officials advised that there may be other silver-bearing items sold to foreign governments, items which they were not aware of.

In addition to the above locations, our review was conducted at the Department of Defense and Headquarters, Departments of the Army, Navy, and Air Force, Washington, D.C.; Air Force Logistics Command, Dayton, Ohio; Air Force Aeronautical Systems Division, Dayton, Ohio; Defense Logistics Agency, Washington, D.C.; Defense Industrial Supply Center, Philadelphia, Pennsylvania; and the U.S. Army Materiel Development and Readiness Command, Washington, D.C.

Our examination was conducted in accordance with our current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions." During the examination, Defense supplied us with the documents we used. Because of the highly complex accounting system involved and the large volume of foreign military sales financial data, we could not totally verify the information. The financial information in this report is based on Department of Defense accounting records and documents and information provided by Defense officials.

CHAPTER 2

FAILURE TO RECOVER MARKET VALUE OF SILVER IN SALES TO FOREIGN GOVERNMENTS

For over 20 years, Defense has had a program that recovers silver from scrapped items and that furnishes the recovered silver to contractors as Government-furnished material. We found that since at least 1974 Defense has been selling Government-furnished silver contained in items to foreign customers for a fraction of its market value. The Army, Navy, and Air Force have improperly used the Defense standard price in pricing sales in lieu of properly using the market value of silver. The Congress has made it very clear that Defense is not to subsidize the sales program.

Defense does not have a system to identify items containing Government-furnished silver which are sold to foreign governments. Thus, Defense must make a special effort to (1) identify how much of the millions of troy ounces of silver furnished to contractors was eventually sold to foreign governments and (2) recover the amounts underbilled. Given the substantial foreign sales that have been made in recent years, the underbillings could be significant. Defense must also devise a system which will identify those items containing Government-furnished silver to be sold to foreign governments so that the market value of silver will be charged in future transactions.

The improper pricing of silver in foreign military sales is another example of Defense's continued failure to recover the proper costs of items sold as required by law. Over the past decade, GAO and internal auditors have issued over 40 reports on Defense's failure to recover all required costs of foreign military sales. However, corrective action has been slow, narrowly confined, and inconsistently implemented. Defense officials have advised us that the number of people assigned to administer the sales program, including those who monitor pricing of sales, is constrained by annual personnel ceilings. Since foreign governments are required to reimburse Defense for administrative costs, personnel assigned to sales administration should be exempt from the ceiling.

CRITERIA FOR PRICING GOVERNMENT-FURNISHED SILVER IN FOREIGN MILITARY SALES

For many years, Defense has had a program to recover silver from scrapped items and to furnish the recovered silver to contractors as Government-furnished material. For Defense's internal financial management and logistics programs it has been Defense's policy for several years to price Government-furnished silver included in Defense items (such as batteries, photographic film, and electronic wires) at the cost to recover the silver. While this policy may be appropriate for items to be manufactured for Defense, it is not appropriate in pricing items for sale to

foreign countries. Defense directives implementing the Arms Export Control Act of 1976 require recovery of actual or replacement cost (market value) of articles sold. There is a significant difference between the cost to recover silver and its replacement cost (market value).

FAILURE TO CHARGE MARKET VALUE FOR
GOVERNMENT-FURNISHED SILVER

We reviewed selected transactions involving sales of batteries containing silver at 3 of over 40 military activities engaged in the sales program and found that the Army, Navy, and Air Force had improperly used the Defense standard price in pricing the sales rather than using the market value of silver. As a result, undercharges for the transactions reviewed amounted to over \$2.3 million. The results of our review at each military activity follow.

Army

The U.S. Army Communications and Electronics Command discovered its pricing errors just before our audit. A troubleshooting team had been sent to Morocco to investigate a complaint about batteries sold to that country. This caused a reexamination of the sales case which revealed that only \$180 was charged for each battery even though each of the batteries contained 40.5 troy ounces of silver. Altogether, the 240 batteries involved in the case were priced at \$43,200. The Army estimates that additional billings of \$175,500 will be needed to recover the market value of the silver in the batteries.

Realizing that this problem may not have been limited to the Morocco sales, command officials reviewed other foreign military sales of batteries with Government-furnished silver to determine if the countries involved had been charged properly. Sales cases from July 1975 through June 1981 were reviewed, and sales of batteries with over 112,000 troy ounces of Government-furnished silver that had already been shipped and incorrectly priced were found. In addition to the shipped items, command officials identified about another 73,000 troy ounces of Government-furnished silver in batteries that had been ordered and incorrectly priced but not yet shipped. Command officials stated that the standard price of recovered silver was used in all foreign sales cases instead of the market value, and estimated that about \$892,000 will have to be rebilled for the open cases for which the batteries have already been shipped. For those batteries on order but not yet shipped, officials estimated that foreign customers' bills will need to be increased by about \$994,000 to recover the market value of the silver.

Also 13 closed sales cases were identified with about \$152,000 worth of silver not charged to foreign customers. The Commander of the U.S. Army Security Assistance Center with the concurrence of the Comptroller, U.S. Army Materiel Development and

Readiness Command, directed that the 13 cases not be reopened for the additional billings. As a result, the Army does not intend to collect \$152,000 for the underpriced silver.

It should be noted that the Command's corrective action was restricted to reviewing pricing of batteries sold to foreign governments. Since Government-furnished silver could have been included in many different items, the Command's corrective action is incomplete.

Navy

For our audit of a Navy activity engaged in foreign military sales, we selected the U.S. Navy Ships Parts Control Center, Mechanicsburg, Pennsylvania. We queried the requisition history file of the Center for foreign military sales cases involving a type of battery containing 700 troy ounces of silver which an item manager thought might have been sold in the sales program.

We found that the Center had sold this type battery to Greece and was about to sell more to that country at a loss to the U.S. Government. Details follow.

--In July 1980, 18 batteries (700 troy ounces of silver in each) were shipped to Greece, which was billed \$52,038 (\$2,891 for each battery). Based on the market value of silver then (\$15.55 a troy ounce), each battery contained \$10,885 worth of silver. We estimate that the most the Navy charged for the silver was \$700 or \$1 per troy ounce. The Navy, therefore, undercharged the foreign customer about \$184,000.

--In August 1981, the Center received orders from Greece for an additional 43 batteries which will require 30,100 troy ounces of silver. After we disclosed the previous pricing errors to Navy officials, they said they would act to ensure that the market value of the silver will be charged.

There are two major divisions at the Center. After our field work was completed one of the divisions initiated an effort to identify all batteries and other items which contained Government-furnished silver that were sold to or were on order for foreign governments. Navy officials plan to correct their pricing and billings as a result of this effort. We were given no reason why the other division did not take similar corrective action.

Air Force

For our audit of an Air Force activity we obtained information regarding three types of silver-bearing batteries requisitioned from the Sacramento Air Logistics Center. We found that between 1973 and 1981 the Air Force sold 1,446 of the batteries in question to several foreign countries. Of the 1,446 batteries,

the records indicate that 358 contained Government-furnished silver and in all cases the standard price was charged rather than the market value, resulting in a loss of \$127,000. For the remaining 1,088 batteries involved in the sales, the Air Force was unable to immediately determine whether any or all of the batteries contained Government-furnished silver. Air Force officials promised that additional work would be done to make such a determination.

Examples in which foreign countries were clearly undercharged:

--In early October 1980, 16 batteries containing a total of 960 troy ounces of silver were shipped to Thailand. The silver standard price was \$2.91 per troy ounce while the market value was about \$20.75 per troy ounce. The Center underpriced the silver in the 16 batteries by about \$17,126.

--During February 1975, 61 batteries containing a total of 3,660 troy ounces of silver were shipped to South Korea. South Korea was charged \$0.59 per troy ounce while the market value was about \$4.25 per troy ounce. The total amount underpriced for the silver alone was about \$13,400.

Air Force officials said that there may be more items than the three types of batteries we reviewed that contain Government-furnished silver and were sold to foreign countries. They also said that the standard price rather than the market value of silver may have been charged when the items were sold. When we completed our field work, the Air Force was planning corrective action.

NO DEFENSE SYSTEM IDENTIFIES ITEMS WITH GOVERNMENT-FURNISHED SILVER

Now that Defense is aware of the erroneous pricing of Government-furnished silver, it must act to (1) correct the problem for future sales, (2) find out how much of the millions of troy ounces of silver furnished to contractors was included in items already sold to foreign countries, and (3) make a reasonable effort to recoup the undercharged amounts. (About 11 million troy ounces of silver were provided as Government-furnished material to defense contractors from fiscal 1978 through 1981.) Although we limited our review to batteries sold by three activities, the deficiencies we found may be occurring Defense-wide because the procedures for pricing items are standard within each service and because each service uses similar accounting and financial management systems. Since many billions of dollars in items have been sold to foreign governments in recent years, underbillings resulting from erroneous charges for Government-furnished silver could be significant.

Defense, however, does not have a system to identify those items that contain Government-furnished silver that are sold to

foreign countries. It will be necessary, therefore, for Defense to make a one-time effort to determine those sales cases where significant amounts of Government-furnished silver were involved. Also, Defense must devise a system which will help ensure that all items containing Government-furnished silver are identified so that the silver can be priced at market value.

CONTINUED FAILURE TO RECOVER
COSTS OF FOREIGN MILITARY SALES

The failure to charge foreign customers the market price of Government-furnished silver is indicative of Defense's continuing problems in recovering costs as required by law. During the past decade, we and Defense internal audit agencies have issued over 40 reports covering a wide range of problems resulting in the failure to bill for all required costs.

Defense's corrective action, however, has usually been slow, narrowly confined, and inconsistently implemented. For example, in 1977 and 1978, we reported 1/ that inadequate methods were used to account for and recover personnel costs of administering the foreign military sales program. In February 1982, we reported 2/ that Defense is still unable to adequately estimate the full costs incurred by the military services in administering the program. Also, in another report 3/ issued in August 1978 we said there was a need to assign responsibility to a Defense organization which would ensure that pricing policies are effectively implemented by the military services. It was not until March 1981 that the first person was assigned to such an organization. Further, by November 1981, only eight people were assigned to this function. A Defense official told us that given the magnitude of the sales program (\$8.5 billion in sales agreements for fiscal 1981), he needed more than eight people to adequately monitor the implementation of pricing policies.

Defense officials have advised GAO that the number of personnel assigned to administer the sales program is constrained by annual personnel ceilings. They said that requests for additional personnel spaces must compete under the ceiling constraints with

1/"Inadequate Methods Used to Account for and Recover Personnel Costs of the Foreign Military Sales Program," FGMSD-77-22, Oct. 21, 1977, and "Inadequate Methods Still Used to Account for and Recover Personnel Costs of the Foreign Military Sales Program," FGMSD-78-47, July 25, 1978.

2/"Improvements Still Needed in Recouping Administrative Costs of Foreign Military Sales," AFMD-82-10, Feb. 2, 1982.

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

the personnel requirements of all other important functions in Defense. The Office of Management and Budget has long advocated personnel ceilings as a method for controlling the Federal Government's labor force, and each year the Congress sets numerical ceilings for military and civilian personnel in the Defense Authorization Act. Since foreign governments are required to reimburse Defense for all administrative costs to run the sales program, including pay and salaries, it would make sense to adequately staff the function--particularly those jobs whose incumbents would ensure that Defense does not lose money in sales to foreign countries. As noted in our February 1982 report, however, Defense must improve its system to ensure that all administrative costs are recouped.

The Subcommittee on Defense, House Appropriations Committee, has considered this matter, and in reporting out the Department of Defense Appropriation Bill, 1982 (H. Rept. 97-333), the Committee said "Because the additional personnel needed to improve accounting and financial management of the FMS (foreign military sales) program would not cost the U.S. taxpayers any money, personnel ceilings should not be imposed." Accordingly, the Committee told Defense that it should "provide relief from personnel ceilings for individuals who spend more than 50 percent of their time performing foreign military sales functions for which Defense is reimbursed by the foreign customers." We also believe that Defense personnel assigned to administering the sales program should be exempt from personnel ceilings.

CONCLUSIONS

In order to comply with the provisions of the Arms Export Control Act of 1976 and implementing Defense directives, the military services must begin to charge the market value for Government-owned silver included in items sold to foreign governments.

Although we limited our review to three activities and to cases involving batteries, the deficiencies we noted may be occurring Defense-wide because the procedures for pricing items containing Government-furnished silver are standard within each service and each service uses similar accounting and financial management systems.

Also, to ensure that the administration of foreign military sales is properly staffed, personnel assigned to this function should be exempt from personnel ceilings. (No additional costs would accrue to the U.S. Government because foreign governments are required to reimburse Defense for all administrative costs of the sales program.)

RECOMMENDATIONS

We recommend that the Secretary of Defense

--establish policies and procedures to identify items with Government-furnished silver sold to foreign countries,

--require that the market value of silver be used in pricing such items, and

--direct responsible organizations to make a reasonable effort to recover undercharges on foreign sales resulting from non-recovery of the replacement cost or market value of silver.

We also recommend that the Secretary of Defense seek authority from the Congress and the Office of Management and Budget to exempt foreign military sales administrative positions from personnel ceilings. In seeking the exemption the Secretary should provide data on validated administrative staffing needs, the cost of which would be reimbursed by foreign governments.

AGENCY COMMENTS AND OUR EVALUATION

Defense officials told us that Defense concurs with our recommendations to establish policies and procedures to identify items with Government-furnished silver sold to foreign countries and to require Defense components to use the market value of silver for pricing. They will ensure that their pricing manual is changed accordingly.

Regarding our recommendation to recover undercharges, Defense officials advised that Defense components will be directed to review those contracts under which silver was provided to a contractor as Government-furnished material. If the contract was awarded to fill foreign military sales requirements, then the foreign country will be billed the replacement cost of silver. Although this action might result in recovering substantial underbillings, we believe the action would be incomplete because many items containing silver may be sold to foreign governments from Defense inventories. The corrective action proposed would cover only those sales items directly procured from contractors. To ensure that all significant undercharges are identified and recouped, Defense should include in its recouping actions items sold from inventory.

Defense officials pointed out that the significance of the total underbillings for recovered silver is in doubt. Prices of silver fluctuated widely since 1974 and all the examples in the report occurred during the period of high silver prices. Also, regarding the 11 million troy ounces of silver provided to Defense contractors, there was no determination of the portion related to foreign military sales.

The significance of the amounts underbilled will not be determined until Defense effectively implements our recommendation to recover amounts that have been undercharged. Our examination of a limited number of transactions disclosed underbillings of \$2.3 million--a large sum by most criteria. Defense is in error in indicating that all our pricing examples occurred during the period of high silver prices. The specific examples in the report contain market prices of silver ranging from \$4.25 per troy ounce to \$20.75 per troy ounce.

Defense is correct in indicating that there was no determination as to how much of the 11 million troy ounces furnished to contractors was related to foreign military sales. Since Defense has no system to account for the value of silver-bearing items sold to foreign governments we could not make the determination. However, given the fact that foreign military sales amount to billions of dollars each year, the losses incurred by not charging the market price for silver may be substantial.

Regarding our recommendation that Defense seek authority to exempt foreign military sales administrative positions from personnel ceilings, Defense officials advised us that their response is still being coordinated within the Department and that Defense's position will be included in its written statement to the appropriate congressional committees as required under section 236 of the Legislative Reorganization Act of 1970.

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