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RELEASED

SUPPLEMENT TO A REPORT BY THE

Comptroller General

OF THE UNITED STATES

Millions In Losses Continue On Defense Stock Fund Sales To Foreign Customers

This report supplement contains GAO's analysis and response to the comments of the Department of Defense subsequent to the GAO report issued to the Congress on September 10, 1981.

GAO is responding to the comments at the request of the Chairman, House Committee on Government Operations, who was concerned about Defense's negative characterization of the report and its contention that GAO based the report on an erroneous application of the Arms Export Control Act and used unvalidated data to support its conclusions.

Although Defense took strong issue with GAO's findings, it agreed with the report's main recommendation that more realistic inflation factors for pricing stock fund items be adopted.

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GAO/AFMD-81-62 S
MAY 18, 1983

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

B-204458

The Honorable Jack Brooks
Chairman, Committee on
Government Operations
House of Representatives

Dear Mr. Chairman:

Your December 7, 1981, letter expressed concern about Defense's negative characterization of two GAO reports dated September 10 and October 5, 1981, on pricing of foreign military sales inventory items. You asked us to evaluate the reasons for the Department of Defense allegation that the reports were based on an erroneous application of the Arms Export Control Act and that unvalidated data were used to support our conclusions. We have previously addressed the Defense comments to the October 5, 1981, report in a supplemental report, GAO/AFMD-81-105S, which was transmitted to you on August 6, 1982. In that supplement we concluded that Defense had erred and that our report was accurate and our recommendations appropriate.

This report supplement is an integral part of our September 10, 1981, report entitled "Millions in Losses Continue on Defense Stock Fund Sales to Foreign Customers" (AFMD-81-62). It contains the Defense comments on the report and our analysis and response to those comments.

In that report we demonstrated that Defense continues to substantially subsidize the foreign military sales program by underpricing sales of stock fund items to foreign customers--a practice that is clearly not authorized under the Arms Export Control Act. Defense concurred in three of the five recommendations made, including our most important recommendation: that Defense should use more realistic inflation factors in determining the price to charge. Further, subsequent to our report Defense modified its stock fund pricing policy to require the military services to include higher inflation estimates in stock fund item prices.

Even though it concurred in most of the recommendations, Defense disagreed that it subsidized the foreign sales program by millions of dollars and expressed concern that our report conveyed a wrong conclusion about the Department's foreign military sales pricing policies. Defense charged that its review of our report and our underlying workpapers showed that our conclusions were incorrect and not supported by the facts. Defense alleged that

--we misinterpreted the law because we included in our random samples of sales transactions a large number of items not subject to the replacement pricing requirements of the Arms Export Control Act, and

--our methodology for determining the replacement costs of many of the sample transactions was in error.

Defense questions our interpretation of the Arms Export Control Act

The Arms Export Control Act generally authorizes the sale of Defense articles to foreign countries on a cost-reimbursement basis. The two basic types of sales are (1) direct sales by the United States from existing Defense inventory, which are governed by section 21 of the act, and (2) U.S. procurement of articles from Defense contractors for resale to the foreign countries, which is governed by section 22. For sales from inventory, section 21 requires that foreign customers be charged the estimated replacement cost of those Defense articles that are intended to be replaced. Under section 22 sales, Defense is required to charge the full amount of the sales contract with the Defense supply contractor (that is, the procurement cost) which will insure the United States against any loss on the contract.

Defense alleges that our random sampling of stock fund sales at our audit locations was invalid because about 76 percent of the transactions sampled were covered by supply support arrangements and therefore were not subject to the replacement pricing requirements of section 21 of the act which we used as criteria in conducting our audit.[1] Defense believes that since under supply support arrangements the foreign customer has invested in the Defense inventory system, sales of stock fund items should be priced at procurement cost as required under section 22 of the act rather than replacement cost. Defense argues that it is not appropriate to charge a foreign country replacement cost for items that have been procured with its own money.

The Defense argument that supply support arrangements are treated under section 22, rather than section 21, of the act is inconsistent with its own regulations which were in effect during our review. The regulations we used as criteria for our audit, which are the only regulations to specifically address this point, state that section 21 applies to sales made under supply support arrangements. However, Defense does raise an issue which deserves careful consideration. Considering the fact that supply support customers

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[1]Supply support arrangements are agreements between foreign governments and the United States, whereby the foreign governments through cash advances buy equity in the Defense inventory system in return for spare and repair parts support.

provide substantial funds in advance of requisitioning items, some allowance should be made for this "equity" when pricing.

In this regard, we recognize that supply support arrangements represent a hybrid form of transaction which does not fit neatly under either section 21 or section 22. Supply support arrangements resemble a section 22 transaction in the sense that Defense may procure additional stock fund items in order to fulfill the participating foreign customer's needs. In addition to its "equity" contributions to the stock fund, the foreign customer provides a "dependable undertaking" which is treated as contract authority and can be used to procure items for the stock fund. On the other hand, section 22 appears to contemplate the existence of a contract for specific, identifiable defense items. Supply support arrangements usually do not relate to specific items at the time they are entered into; they constitute a general commitment by a foreign customer to purchase stock fund items at some time in the future. Further, Defense does not have a system which identifies items purchased specifically for supply support arrangement customers.

In any event, the underlying objective of the cost recovery requirements for both section 21 and section 22 transactions is the same: that the United States is to be reimbursed for its costs. Consistent with this objective, section 22 requires that foreign customers be charged the full amount of the sales contract with the defense contractor, "which will assure the United States Government against <u>any loss</u> on the contract." (Emphasis added.)[2]

Although Defense disagrees with the way we determined whether the United States was being reimbursed for its costs, Defense decided shortly after our original report was issued that it should charge more under the criteria it was using for pricing, and accordingly revised its pricing policy.

Regardless of which section of the law Defense chooses to rely on, its pricing policies for supply support arrangements should be consistent with the above objective, to ensure that the United States incurs no loss as a result of these arrangements.

<u>Defense questions our estimating methodology</u>

Defense also questioned our methodology for determining the estimated replacement cost for many of the sales items we reviewed.

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[2]As a further measure to ensure that the United States is reimbursed for its costs, in 1976 the Congress enacted legislation requiring the charging for certain indirect costs (such as administrative expenses) of foreign military sales (22 U.S.C. 2761 (e)). The legislative purpose of this requirement is to ensure that all sales include "a fair share of all indirect costs so that there are no longer any elements of subsidy in the sales program."

It said we used inflation factors that were not determined to be valid by our audit and therefore should not have been used in estimating replacement cost. The inflation factors we used to make the estimates had been developed over a period of years by the Air Force. These factors have proven to be adequate as demonstrated by a test we made in following up our audit. We found that, subsequent to our review, 23 of the sales items for which we had estimated a replacement cost were replaced in the Defense inventory. In some cases, replacement cost was higher than our estimate; in other cases the opposite was true. Overall, however, actual replacement costs exceeded our estimates. In our report we estimated that the replacement cost for the 23 transactions would total $34,934. We found that the actual replacement cost totaled $37,381.

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Your request is included as appendix I to this supplement and the Defense response to our basic report is appendix II. A detailed explanation of our position on this response is in chapter 2.

As arranged with your office, we are sending copies of this supplement to Senators Percy and Hollings. Unless you publicly announce its contents earlier, no further distribution of this supplement will be made until 7 days from its date.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

Contents

REPORT BY THE
COMPTROLLER GENERAL
OF THE UNITED STATES

MILLIONS IN LOSSES CONTINUE ON DEFENSE STOCK FUND SALES TO FOREIGN CUSTOMERS

D I G E S T

The Department of Defense continues to largely subsidize the foreign military sales program by not charging foreign governments the estimated replacement cost of equipment and spare parts sold from inventory through Defense stock funds. Sales of stock fund items to foreign governments amounted to over $500 million in fiscal 1980.

Senators Percy and Hollings asked GAO to review Defense actions on previous GAO recommendations for improving the accounting and financial management of the foreign military sales program.

According to the Arms Export Control Act of 1976, estimates of the cost to replace items should be used when making sales to foreign countries if the items sold are to be replaced in the Defense inventory. To implement the act, Defense policy provides for charging standard stock fund prices, which are to include an inflation factor adequate to recover the replacement costs of items sold.

GAO estimated that, because of weaknesses in pricing policies and practices, millions of dollars were not recovered from foreign governments during fiscal 1980. For example, at one of the five Air Force Logistics Centers, GAO found that fiscal 1980 sales of $42,947,562 were underpriced by nearly $17 million. Inherent in Defense pricing policy and practices were three main weaknesses:

1. Inflation factors used to estimate replacement cost were unrealistically low.

2. Inflation factors were not compounded when the items were purchased more than 1 year prior to their sale.

3. The Air Force and the Navy normally updated sales prices only once a year.

For several years, inflation factors used by Defense to estimate replacement costs were unrealistically low. For example, in 1980 when inflation

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SEPTEMBER 10, 1981

was relatively high, Defense used a 4.3 percent inflation factor. This was the factor prescribed by the Office of Management and Budget for use in the President's budget. GAO was informed by a Defense official that the factors prescribed for the budget proved to be too conservative in 10 of the last 11 years. While there may be valid reasons for making conservative assumptions in predicting a low rate of inflation for budgetary purposes, GAO believes it is counterproductive to use conservative inflation rates when pricing goods sold to foreign governments. (See p. 8.)

Besides being unrealistically low, the inflation factors used by Defense were not compounded when Defense estimated replacement costs for items purchased more than a year before their sale. Defense requires that only the current year's inflation rate be used. Several pricing examples from one of the Air Force's air logistics centers show the inadequacy of this requirement in estimating replacement cost.

Table 2

Item	Last purchase of item prior to fiscal 1980: Date	Unit price	Actual replacement cost in 1980	Actual inflation experienced	Defense inflation factor used
				(percent)	
A	June 11, 1976	$237.42	$673.69	184	4.3
B	June 13, 1974	2.84	7.80	175	4.3
C	Apr. 19, 1977	185.62	416.00	124	4.3
D	Jan. 20, 1977	34.50	70.35	104	4.3
E	Oct. 11, 1977	220.40	369.66	68	4.3

The Army updates sales prices charged foreign customers quarterly, which gives consideration to current purchase prices. On the other hand, the Navy and the Air Force, in accordance with Defense instructions, normally update the sales prices only once a year. GAO tested the Army's system at an air logistics center for September 1980 and found that amounts charged foreign customers would have properly increased from $1,395,548 to $1,772,448, or about 33 percent, if the Army system had been used. (See p. 12.)

Although Defense continues to underprice stock fund sales to foreign customers, some action has been taken to reduce losses. In January 1980, to help alleviate a severe stock fund cash shortage resulting from higher than anticipated inflation, Defense directed that a one-time 14.5 percent surcharge be placed on calendar 1980 foreign sales billings. The rate of the surcharge is much less than the rate of losses GAO found in 1980 sales at the locations visited. Further, the one-time action does not correct the pricing deficiencies discussed above.

Incurring losses on sales of inventory items is a longstanding problem in Defense. In 1978, GAO reported (FGMSD-78-51) that millions of dollars were being lost because replacement cost of items was not being recovered and recommended that compound inflation factors be used to estimate replacement cost. Defense rejected GAO's recommendation, and took the position that its present pricing policy was adequate.

GAO also recommended that Defense provide the resources needed for surveillance over the pricing function. The Security Assistance Accounting Center was given the responsibility for ensuring correct pricing data for foreign military sales cases. However, only recently has the Center initiated steps to meet its responsibilities for ensuring correct pricing data.

Although the standard Defense sales contract provides that adjustments may be made to estimated costs that are not commensurate with actual cost, up to and including final billing, such adjustments were rarely made on stock fund items. Therefore, any costs that have not been recovered by the military services on those sales contracts for which final billing has not been made could and should be billed.

As to undercharges that may be found after final billing, Defense Manual 7290.3-M provides that adjustments to final billings are permitted when there are unauthorized deviations from Defense pricing polices.

The longer the Defense Department takes to attempt to collect undercharges, the more difficult it will be to recover these amounts from foreign governments. Action should be taken to attempt to collect undercharges as expeditiously as possible before the military services make final billings for contracts on which the undercharges occurred.

To comply with the Arms Export Control Act of 1976 and with congressional intent that Defense not subsidize foreign military sales, the Defense Department must take action to ensure that a valid estimate of replacement cost is charged on sales of stock fund items to foreign customers.

RECOMMENDATIONS

GAO recommends that the Secretary of Defense require that a more adequate method of estimating replacement cost be used, including

--adopting a more realistic inflation index,

--compounding inflation factors when computing estimated replacement cost for those items purchased more than 1 year prior to their sale, and

--more frequent updating of foreign sales prices (for example, quarterly rather than annually).

GAO also recommends that the Secretary of Defense

--direct the quality control unit recently established at the Security Assistance Accounting Center to make sure that Defense components adequately and uniformly implement the revised estimating procedures, and

--direct the military services to make a reasonable attempt to recover from foreign governments the undercharges in sales from the stock fund resulting from the failure to charge a reasonable estimate of replacement cost as required by law.

AGENCY COMMENTS

As requested by the Offices of the Senators requesting this review, GAO did not obtain official comments from the Department of Defense.

CHAPTER 2

ANALYSIS AND RESPONSE TO COMMENTS

FROM THE DEPARTMENT OF DEFENSE

Defense concurred with our most important recommendation that it use more realistic inflation factors in determining the price to charge. However, with regard to our findings it expressed concern that the report conveyed a wrong conclusion about the Department's foreign military sales pricing policies. Defense took exception to our report primarily because it believes that

--the majority of our random sample transactions were covered by supply support arrangements which, according to Defense, are not subject to replacement pricing under the law; and

--we did not use the correct methodology in estimating replacement cost for many of our sample transactions.

Defense also criticized our use of examples in the report because it contended they were "worst case" examples, not a part of our random sample, and cannot be construed as representative of the typical sales transaction.

We evaluated Defense's allegations and found they were generally in error. The Defense argument that supply support arrangements are treated under section 22, rather than section 21, of the act is inconsistent with its own regulations which were in effect during our review. Defense, however, does raise an issue which deserves consideration in that supply support arrangement customers provide funds in advance of requisitioning items and some allowance should be made for this "equity" when pricing. In any event, shortly after our report was issued, Defense decided it should charge more under the criteria it was using for pricing and accordingly revised its pricing policy for all foreign customers, including those under supply support arrangements.

Also, Defense has erred in its belief that we used incorrect methodology in estimating replacement prices for our random sample of sales transactions. The inflation factors we used to make the estimates had been developed by Headquarters, Air Force Logistics Command and these factors have proven to be adequate.

Finally, many of the specific examples used in our report were, in fact, taken from the random samples and most of the examples show a smaller percentage loss than the overall sample results. Further, it is the overall results of our work, and not any one specific example, that we believe indicates the nature of the typical actual transaction. Our conclusions and recommendations, based on the random samples, together with the examples demonstrate the obvious need for Defense to take corrective action.

EVALUATION OF DEFENSE COMMENTS
ON GAO RECOMMENDATIONS

Our recommendations to the Secretary of Defense were designed to help ensure equitable and effective pricing of stock fund items and avoid subsidies to foreign customers. The Defense comments on each recommendation follow, along with our evaluation.

1. RECOMMENDATION: Adopt a more realistic inflation factor for pricing stock fund items.

Defense reply: Defense indicated that it concurred with our recommendation. It said the Secretary of Defense had raised the issue with the Director, Office of Management and Budget of how to improve methods of estimating and budgeting for inflation in Defense programs. Also, in October 1981, Defense modified its stock fund pricing policy to provide for the use of more realistic inflation factors.

GAO evaluation: We believe that modifying the stock fund pricing policy is a positive step. If the policy is effectively implemented by the military services, stock fund sales prices should be more accurate and underpricing should be reduced.

2. RECOMMENDATION: Use compound inflation factors when computing estimated replacement cost for those items purchased more than 1 year prior to their sale.

Defense reply: Defense disagreed with this recommendation. It said that its own studies and review of our audit data indicate that the Defense policy of including an inflation factor on all sales, whether replacement of the item sold is required or not, results in full recoupment on an overall basis. Also, Defense said that price growth appears to depend more on source of supply and quantity procured than on time. It will make periodic studies to ensure that its pricing policy results in full recoupment and make changes where appropriate.

GAO evaluation: Since Defense appears to be using more realistic estimates of inflation in its stock fund sales prices, there may be no need to use compound inflation factors to realize full cost recoupment. Defense, however, should pursue its intention to perform periodic studies to ensure that its pricing policies result in full cost recoupment.

3. RECOMMENDATION: Update foreign sales prices more frequently.

Defense reply: Even though Defense did not concur with this recommendation, it did agree to make periodic studies to ensure that its pricing policy results in full cost recoupment and to make changes where appropriate.

GAO evaluation: We believe the actions taken by Defense in modifying its stock fund pricing policy and agreeing to make periodic studies to determine if the policy results in full cost recoupment essentially satisfies the intent of our recommendation.

4. RECOMMENDATION: Direct the quality control unit recently established at the Security Assistance Accounting Center to make sure Defense components adequately and uniformly implement the revised estimating procedures.

Defense reply: Defense concurred with our recommendation.

GAO evaluation: As indicated above, Defense did not agree to revise its estimation procedures in order to use compounded inflation factors and to update sales prices more frequently. It did, however, modify its pricing policy to provide for more realistic inflation factors. The control unit should help ensure effective implementation of the revised pricing policy.

5. RECOMMENDATION: Direct the military services to make a reasonable attempt to recover from foreign governments the undercharges in sales from the stock fund resulting from the failure to charge a reasonable estimate of replacement cost as required by law.

Defense reply: Defense concurred in principle with this recommendation. However, it advised us that since no convincing evidence exists of overall underrecoupment, there is no basis for making additional charges on individual sales.

GAO evaluation: The longer Defense delays in attempting to collect undercharges, the more difficult it is to recover these amounts from foreign governments. Since our report was issued more than 1-1/2 years ago, even if Defense now changes its position it may be too late to effect significant collections.

DEFENSE OBJECTIONS TO GAO FINDINGS

Defense took strong exception to our findings. It contends that a large portion of our random samples of sales transactions were covered by supply support arrangements, which it contends are not subject to the replacement pricing requirements of the Arms Export Control Act. Defense also objects to our methodology for determining the replacement cost of many of the transactions we sampled. Further, Defense objects to our use of what it considers to be "worst case" examples as support for our conclusions.

The following is our evaluation of the Defense allegations regarding our findings.

Defense contends the samples were invalid

Defense contends that our random sampling of stock fund sales at our audit locations was invalid because about 76 percent of the sample transactions were not subject to replacement pricing requirements of the Arms Export Control Act. The transactions that Defense questions are sales of stock fund inventory covered by supply support arrangements. Under these arrangements foreign governments provide funds in advance of requisitioning stock fund items. These funds are to be used by Defense components to purchase stock fund items so the items will be available upon demand by the foreign customer. Defense contends that since the items are bought with the foreign customer's own money, the items should be priced under section 22 of the act, rather than section 21. Section 21 of the Arms Export Control Act requires that foreign customers be charged the estimated replacement cost of items intended to be replaced in Defense's inventory. Section 22 requires that foreign customers be charged the procurement cost of the sales item. Because we applied section 21 replacement pricing requirements to our entire random sample of stock fund sales from inventory, including those under supply support arrangements, Defense alleges that our sample was not a valid test of its compliance with the law.

The Defense argument that supply support arrangements are treated under section 22, rather than section 21, of the act is inconsistent with its own regulations which were in effect during our review. The regulations we used as criteria for our audit, which are the only regulations to specifically address this point, state that section 21 applies to sales made under supply support arrangements. However, Defense does raise an issue which deserves careful consideration. Considering the fact that supply support customers provide substantial funds in advance of requisitioning items, some allowance should be made for this "equity" when pricing.

In this regard, we recognize that supply support arrangements represent a hybrid form of transaction which does not fit neatly under either section 21 or section 22. Supply support arrangements resemble a section 22 transaction in the sense that Defense may procure additional stock fund items in order to fulfill the participating foreign customer's needs. In addition to its "equity" contributions to the stock fund, the foreign customer provides a "dependable undertaking" which is treated as contract authority and can be used to procure items for the stock fund. On the other hand, section 22 appears to contemplate the existence of a contract for specific, identifiable defense items. Supply support arrangements usually do not relate to specific items at the time they are entered into; they constitute a general commitment by a foreign customer to purchase stock fund items at some time in the future. Further, Defense does not have a system which identifies items purchased specifically for supply support arrangement customers.

In any event, the underlying objective of the cost recovery requirements for both section 21 and section 22 transactions is the same: that the United States is to be reimbursed for its costs. Consistent with this objective, section 22 requires that foreign customers be charged the full amount of the sales contract with the defense contractor, "which will assure the United States Government against any loss on the contract." (Emphasis added.)[1]

Although Defense disagrees with the way we determined whether the United States was being reimbursed for its costs, Defense decided shortly after our original report was issued that it should charge more under the criteria it was using for pricing, and accordingly revised its pricing policy.

Regardless of which section of the law Defense chooses to rely on, its pricing policies for supply support arrangements should be consistent with the above objective, to ensure that the United States incurs no loss as a result of these arrangements.

Defense disagrees with methodology for estimating replacement cost

Defense also questioned our methodology for determining estimated replacement costs for many of the sales items we reviewed. Defense contended we used inflation factors that were not determined to be valid by our audit and therefore should not have been used in estimating replacement cost.

The inflation factors we used were developed by Headquarters, Air Force Logistics Command. These factors, developed over a period of years, have proven to be adequate as demonstrated by a test we made in following up our audit. We found that, subsequent to our review, contracts had been awarded to replace 23 of 89 sales items for which we had estimated replacement costs. We found that some replacement costs exceeded our estimates and other replacement costs were lower than our estimates. Overall, however, the actual replacement costs exceeded our estimates. In our report we had estimated that replacement costs for the 23 transactions would be $34,934. We found that actual replacement costs included in the contracts totaled $37,381. For example, one of the items replaced subsequent to our review was sold for $22.52. Using the inflation factors mentioned above, we estimated that the replacement cost of the item was $27.20. When the item was actually replaced, however, the cost was $29.13.

Defense alleges unrepresentative examples were used to support conclusions

Defense also alleges that we used "worst case" examples which were not part of our random samples and therefore could not be construed as representative of the typical actual transaction.

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[1]As a further measure to ensure that the United States is reimbursed for its costs, in 1976 the Congress enacted legislation requiring the charging for certain indirect costs (such as administrative expenses) of foreign military sales (22 U.S.C. 2761 (e)). The legislative purpose of this requirement is to ensure that all sales include "a fair share of all indirect costs so that there are no longer any elements of subsidy in the sales program."

Although it is true that some of the examples used were not taken from our statistical sample, they were used for illustrative purposes only and had no bearing on the conclusions reached. It is the overall results of our work, and not any one specific example, that indicates the nature of the typical actual transaction and that we used to arrive at our conclusions and recommendations. Defense has failed to recognize that most of the examples used in our report show a smaller percentage of loss than that shown by our overall random samples. The examples used coupled with the overall results of our review as reflected by the statistical sample demonstrate the need for Defense to take corrective action.

The methodology we used in our audit to arrive at our conclusions and recommendations is discussed in detail on page 3 of the original report.

NINETY-SEVENTH CONGRESS

Congress of the United States

House of Representatives

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-373
WASHINGTON, D.C. 20515

December 7, 1981

The Honorable Charles A. Bowsher
Comptroller General of the United States
U.S. General Accounting Office
Washington, D. C. 20548

Dear General Bowsher:

By letter of November 25, 1981, the Secretary of Defense responded to me about the two recent GAO reports on the foreign military sales program as based on erroneous application of the Arms Export Control Act and the use of unvalidated data to support its conclusions. The two reports are entitled "Millions in Losses Continue on Defense Stock Fund Sales to Foreign Customers," AFMD-81-62, September 10, 1981, and "Defense Continues to Subsidize Sales of Secondary Items to Foreign Governments Because of Poor Pricing Policies," AFMD-81-105, October 5, 1981.

I am interested in these two reports and requested a response from DOD because of the seriousness of the apparent underpricing and the waste of millions of dollars in taxpayers' money. As you know, the Legislation and National Security Subcommittee held hearings on these matters and issued a report that was used by the Appropriations Committee to require notification of the Congress when costs are waived by DOD under the Arms Export Control Act.

I would appreciate it if you could evaluate the reasons for the Secretary's negative characterization of these recent GAO reports. A copy of Secretary Weinberger's letter is enclosed. An early response would be greatly appreciated. (See GAO note below.)

With all good wishes, I am,

Sincerely yours,

Jack Brooks

JACK BROOKS
Chairman

<u>GAO note</u>:

We discussed this request with the Chairman's office and agreed to defer our response until Defense made final comments. (See app. II.)

Enclosure

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

COMPTROLLER

2 JAN 1982

Honorable Charles A. Bowsher
Comptroller General of the United States
Washington, D.C. 20548

Dear Mr. Bowsher:

This is in reply to your letter to the Secretary of Defense regarding your report dated September 10, 1981, entitled "Millions In Losses Continue On Defense Stock Fund Sales To Foreign Customers," (OSD Case #5799) (GAO AFMD-81-62).

We have reviewed the report and its underlying work papers. Based on these reviews, we are of the opinion that the conclusion expressed in the title of the report is incorrect and unsupported by the facts. The basis for this opinion is discussed more fully in Enclosure 1, and summarized below:

1. Over 76 percent of the transactions randomly selected for audit examination were not subject to replacement pricing. Thus, the audit sample was not a valid test of DoD's compliance with the Arms Export Control Act (AECA) inventory pricing requirements.

2. Of the items subject to replacement pricing, actual replacement contracts had been awarded for only 21 of the transactions randomly selected for audit examination. The total selling price of these transactions was 2 percent more than total replacement contract cost.

3. The reported millions in losses on stock fund sales from inventory, in fact, represent the difference between GAO estimates of replacement cost and the DoD estimated replacement cost.

4. The specific examples of underpricing discussed in the audit report were not part of the random sample, but were selected "worst case" examples. They cannot be construed as representative of the typical actual transaction.

Our position on your recommendations is presented below; more detail is contained in Enclosure 1.

1. Recommendation: Adopt a more realistic inflation index.

   Position: Concur. The Secretary of Defense has already raised the issue of how to improve our methods of estimating and budgeting for inflation in Defense programs to the Director of the Office of Management and Budget. Any changes resulting from this effort will be incorporated in our Foreign Military Sales pricing policy.

2. <u>Recommendation</u>: Compound inflation factors when computing estimated replacement cost for those items purchased more than 1 year prior to their sales.

   <u>Position</u>: Nonconcur. DoD studies and our review of the GAO data indicate that the DoD policy of including an inflation factor on all sales, whether replacement is required or not, results in full recoupment on an overall basis. Also, price growth appears to be more dependent on source of supply and quantity procured than on the time element. We will make periodic studies to ensure that our pricing policy results in full recoupment and make changes where found appropriate.

3. <u>Recommendation</u>: More frequent updating of foreign sales prices.

   <u>Position</u>: Nonconcur. The audit report does not support the recommendation. Further, other less costly techniques can achieve the same end.

4. <u>Recommendation</u>: Direct the quality control unit recently established at the Security Assistance Accounting Center to make sure that Defense Components adequately and uniformly implement the revised estimating procedures.

   <u>Position</u>: Concur. The duty of the quality control unit is to assure pricing is in compliance with DoD pricing policy.

5. <u>Recommendation</u>: Direct the Military Services to make a reasonable attempt to recover from foreign governments the undercharges in sales from the stock fund resulting from the failure to charge a reasonable estimate of replacement cost as required by law.

   <u>Position</u>: Concur. It is DoD policy that, where pricing is not in accordance with DoD pricing guidance, adjustments in price must be made in customers' bills. However, in this case, there is no convincing evidence of overall under-recoupment. Since our aim is to strike a balance on overall sales, there is no basis for making additional charges on any individual sales.

We are very concerned that this audit report conveys a wrong conclusion about DoD FMS policies. While we recognize that GAO could not provide DoD an opportunity to comment formally on a draft report, we did advise the GAO staff of shortcomings in their methodology. Apparently, our views were not taken into consideration in the final report. I think this is extremely unfortunate. It runs counter to our mutual efforts to achieve a high degree of professionalism and cooperation in improving management in this Department. While we are always receptive to valid suggestions for management improvements in this or any other area of Defense operations -- as shown by our positive response to certain of the recommendations discussed above -- we cannot agree to the sweeping allegation conveyed by the title of the report.

Sincerely,

Jack Borsting

Jack R. Borsting
Assistant Secretary of Defense

Enclosure

Detailed Analysis of GAO Report

1. Page i, para 3. This paragraph summarizes the results of your random statistical sample of San Antonio Air Logistics Center transactions. You project a loss of $16,670,770 on FMS FY 1980 sales of $42,947,562. The projection is not statistically valid because required data was available on only 15 of the randomly selected 136 transactions. If projections were made on those transactions with complete data, the result would have been a projected gain of $6,871,600 (16%) on sales of $42,947,562. Your loss was based on your estimates of what replacement costs would be and we do not believe the use of such estimates results in a valid projection.

2. Page i, para 4. This paragraph criticizes the use of inflation factors developed by OMB as part of the budget process. When projected inflation rates are required, we believe it is appropriate to use such rates.

3. Page ii, para 2. This paragraph, which is duplicated on page 11 of your report, provides examples where normal inflation indexes did not equal procurement costs. The cited examples are "worst cases." Average inflation indexes will seldom precisely reflect actual procurement cost on every individual item. With a little research you could provide a list of "best cases" to show when the OMB inflation indexes exactly recovered procurement costs. Similarly, you could also provide a listing of instances where the indexes recoup far more than procurement cost.

4. Page ii, para 3. In this paragraph you praise Army for not pricing in accordance with DoD policy. We feel this is inappropriate from a management viewpoint because it is important that all Components implement prescribed policies. Then we can have some degree of assurance that changes in policy will have the desired impact.

5. Page iii, para 1. In this paragraph you report that a one-time surcharge of 14.5% was added to FMS stock fund sales. However, you criticize the use of a one-time surcharge. Your comments ignore the position DoD took on your 1978 audit report on stock fund FMS sales. In part, our position was that "...We will monitor the adequacy of recoupments from FMS sales. If a determination is made that an additional price growth factor is required for FMS sales, DoD Instruction 2140.1 will be modified to provide for the use of an additional factor...." In FY 1980, an additional FMS surcharge of 14.5% was in effect. Your audit test shows that standard price as adjusted by this factor recovered actual replacement contract costs on an average basis. Because your audit sample included only FY 1980 transactions, you have no basis to conclude that losses were experienced in other fiscal years. It should be noted that additional FMS surcharges on stock fund sales are in effect for FY 1982.

6. Page iii, para 4. This paragraph indicates that prices for inventory items can be modified at any time. You have misinterpreted the AECA and the

general terms and conditions applicable to FMS sales. Inventory items must be priced at estimated replacement cost at the time they are dropped from inventory. The adjustment is applicable to new procurement items.

7. Page 2, section entitled "Requirements to Recover Replacement Costs." Your discussions fail to recognize the fact that items can be procured and stored in DoD inventories for FMS customers. Such procurements take place under Cooperative Logistics Supply Support Agreements (CLSSAs). Sales under CLSSAs are not subject to AECA replacement pricing requirements, but rather to AECA Section 22 new procurement pricing requirements. The basic rule for CLSSAs is that the FMS selling price must recoup procurement cost and the cost of holding inventory.

8. Page 3, section entitled "Objectives, Scope and Methodology." This section provides an overview of your audit approach. The actual procedures used in the audit had major flaws which invalidate audit results.

The first flaw discovered was that 208 of the 272 transactions or 76% of the transactions statistically selected for audit examination were shipped under CLSSAs. Such shipments are not subject to replacement cost pricing procedures. Under CLSSAs, customer funds are provided at least 17 months in advance of consumption requisitions. These customer funds are used to procure additional inventory levels and establish an inventory replacement pipeline. Thus, sales under CLSSAs are priced under Section 22 of the AECA, which requires that procurement cost and the cost of holding inventory be recouped. It is not appropriate to charge a foreign country replacement costs for items that have been procured with his own cash.

A second major flaw occurred in your evaluation of the remaining 64 transactions. Actual replacement procurements had been made on only 21 of the transactions. Therefore, your auditors estimated replacement costs on the remaining 43 transactions using estimated inflation indexes which were not validated through audit. Compliance with basic statistical sampling rules requires that the audit sample be expanded until enough transactions with complete data are included in the sample to serve as a basis for projection to the population.

The bottom line is that complete data including actual replacement contract cost were available for only 21 of the 272 FMS transactions statistically selected for audit examination. The FMS billing price and replacement contract cost for these 21 requisitions are scheduled at Enclosure 2. Significantly, DoD pricing policies resulted in charging FMS customers 2 percent more for the 21 items than was incurred in award of contracts to replace the items. In these circumstances, we find it difficult to agree with the conclusion that FMS customers were underbilled millions of dollars

9. Page 6, section entitled "Foreign Customers Continue to be Charged Less Than Replacement Cost for Items Sold from Inventory." This section alleges that DoD is still not charging FMS customers replacement cost for items sold

from its inventories. As previously explained, we believe this conclusion is not supported by your detailed audit examination.

10. Page 6, section entitled "Foreign Military Sales Subsidies Continue." This section again alleges that DoD is not charging FMS customers replacement costs for items sold from its inventories. You also report that underpricing had resulted in a large cash shortage which had resulted in the need for supplemental appropriations and a one-time 14.5 percent charge to FMS customers in FY 1980. These statements are not true. We are recouping replacement cost. Further, there had been no actual cash shortage but rather an anticipated cash shortage. The 14.5 percent charge to FMS customers was made to assure that FMS sales did not result in a loss. Also, the 14.5 percent was one time only in the context that this percentage was applied to FY 1980 FMS sales. A different percentage increase is in effect for FY 1982. FY 1982 percentages follow:

	Army	Navy	MC	Air Force	DLA
CLSSA Customers	6%	7%	3%	16%	5%
Non-CLSSA Customers	17%	8%	9%	26%	10%

11. Page 8, section entitled "Defense Failed to Compound Inflation Factors." In this section you indicate that compounding inflation factors will improve pricing. We totally disagree with this conclusion and it is obviously not based upon any audit analysis. In fact, the schedule you present on pages ii and 11 of your report show that using compound inflation factors will not improve the ability to estimate replacement costs on an item-by-item basis. For example, your Example A shows a 184 percent price increase during a four-year period. Even compound inflation factors will not match this rate of price growth. Review of the 15 transactions that were in your random statistical sample of FY 1980 sales shows replacement prices actually decreased on seven items or about 50 percent of the items on which complete data were available. An objective analysis would have resulted in the conclusion that price growth is more dependent on quantity procured, source of supply, competitive conditions and standard price errors than upon the number of years between procurement actions.

12. Page 12, section entitled "Sales Prices Should Be Updated More Frequently." Comment #4 applies to this section. The section also includes narrative discussions of "worst case" examples that were not part of your random statistical sample. The adequacy of prices must be determined on a total basis. Individual transactions can be selected to illustrate any type condition desired. You selected "worst case" examples, but it would also be possible to select transactions that show the DoD pricing method exactly recouped replacement cost. Similarly, we could also provide a listing of instances when the DoD method recouped far more than procurement cost. This fact is illustrated by the items in your random sample. Sample transaction A2 was priced at $13,319 over actual replacement cost.

Items With Actual Procurement Made After Shipment - Real Replacement Cost -

GAO Sample No.	NSN	Unit FMS Selling Price			Unit Replacement Contract Cost	No. of Items Shipped on Requistion	Gross Gain or (loss)	Gross Selling Price
		Std Price	14.5% FMS Surcharge	Total Unit Selling Price				
Kelly #95	6340-00-628-6482	$152.28	$22.08	$174.36	$113.71	2	$121.30	$348.72
Kelly #98	1560-00-581-0469	225.46	32.69	258.15	132.00	5	630.75	1,290.75
Kelly #119	5306-00-446-6527	54.73	7.94	62.67	53.24	6	56.58	376.02
Kelly #86	1680-00-148-3907	152.38	22.10	174.48	121.87	8	420.88	1,395.84
Kelly #79	2840-00-169-0178	279.61	40.54	320.15	285.21	10	349.40	3,201.50
Kelly #68	4710-00-343-6914	35.32	5.12	40.44	29.66	30	323.40	1,213.20
Kelly #65	2835-00-572-4304	362.98	52.63	415.61	666.52	1	(250.91)	415.61
Kelly #64	4820-00-013-6908	16.59	2.41	19.00	17.00	24	48.00	456.00
Kelly #46	5340-00-897-4877	32.89	4.77	37.66	49.25	1	(11.59)	37.66
Kelly #41	2840-00-957-3747	81.01	11.75	92.76	80.80	10	119.60	927.60
Kelly #40	5360-00-568-0690	.22	.03	.25	.22	20	.60	5.00
Kelly #35	1560-01-053-8976	64.51	9.35	73.86	118.24	1	(44.38)	73.86
Kelly #33	5910-01-025-5082	22.22	3.22	25.44	25.28	10	1.60	254.40
Kelly #23	3120-00-924-3074	3.32	.48	3.80	2.39	22	31.02	83.60
Kelly #17	4730-00-361-2672	106.75	15.48	122.23	111.76	15	157.05	1,833.45
WR #62	1560-01-083-8475	11.00	1.60	12.60	11.00	2	3.20	25.20
WR #42	5826-00-444-5899	52.07	7.55	59.62	47.82	1	11.80	59.62
WR #14	5841-00-099-0012	15.11	2.19	17.30	17.95	6	(3.90)	103.80
A2	1005-01-059-5054	18.94	2.75	21.69	12.19	1,402	13,319.00	30,409.38
A4	5865-00-188-7043	544.94	79.02	623.96	1,184.00	23	(12,880.92)	14,351.08
A5	5865-00-321-7640	220.99	32.04	253.03	280.00	34	(916.98)	8,603.02
Totals							**$1,485.50**	**$65,465.31**

2% gain on sampled items

APPENDIX II

25186

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