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GOVERNMENT
CONTRACTING

Reimbursement of
Foreign Selling Costs





United States
General Accounting Office
Washington, D.C. 20548

**National Security and
International Affairs Division**

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The Honorable Robert C. Byrd
Chairman, Committee on Appropriations
United States Senate

The Honorable Sam Nunn
Chairman, Committee on Armed Services
United States Senate

The Honorable Jamie L. Whitten
Chairman, Committee on Appropriations
House of Representatives

The Honorable Les Aspin
Chairman, Committee on Armed Services
House of Representatives

This report is provided in accordance with sections 826 of the Department of Defense (DOD) Authorization Act of 1989 and 8105 of DOD's Appropriations Act of 1989, Public Laws 100-456 and 100-463, respectively. These sections require our office and the DOD's Inspector General to make separate assessments of whether the published regulations on the allowability of foreign selling costs provided appropriate (1) incentives to stimulate exports of U.S. defense industry products and provide cost savings and (2) criteria to ensure that allowable costs are reasonably likely to provide future cost savings to the government. The Inspector General completed a separate report in September 1990.

This report analyzes the effect of foreign selling costs allowability on U.S. government contract costs and the intended result of expanded defense industry export sales and related cost savings to the government.

We are sending copies of this report to the Secretary of Defense; the Director, Office of Management and Budget; and other interested parties. Copies will also be made available to others on request.

This report was prepared under the direction of Paul F. Math, Director of Research, Development, Acquisition, and Procurement Issues. He may be reached at (202) 275-8400. Other major contributors are listed in appendix V.

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Executive Summary

Purpose

The Department of Defense (DOD) Authorization and Appropriations Acts of 1989 provide that defense contractor costs in promoting the export of U.S. defense industry products are allowable for government reimbursement for a 3-year trial period. The legislation expires in 1991, unless extended. Reimbursement is limited to 110 percent of the costs incurred in the previous fiscal year.

The acts require GAO and the DOD Inspector General to make separate assessments of whether the implementing regulations stimulate exports of defense industry products and ensure future savings to the government. Specifically, GAO's objectives were to determine (1) what effect reimbursing U.S. firms for foreign selling costs has on their efforts to export and (2) whether the U.S. government would realize incremental cost savings, that is, savings beyond those attributed to foreign sales while foreign selling costs were not allowable for reimbursement on U.S. government contracts.

Background

Cost reimbursement under DOD contracts is governed by the cost principles set forth in the Federal Acquisition Regulation (FAR) and related agency guidance. Under cost principles in effect before March 1979, contractors' costs for marketing products and services were considered allowable for reimbursement on U.S. government contracts if reasonable, allocable, and not otherwise unallowable. After March 1979, the cost principles provided that selling costs incurred in connection with the sale of a military product or service to a foreign customer were not allocable to and therefore, not allowable on, U.S. government contracts for U.S. government requirements. The costs were, however, allocable to and allowable on foreign contracts.

Representatives of the defense and aerospace industries objected to the unallowability of foreign selling costs on government contracts. Industry officials believed that the sale of defense products to foreign customers provided cost savings through lower contract prices on products purchased by DOD. Defense industry representatives contended that because DOD shared in the benefits of foreign sales, DOD should pay a share of the foreign selling costs. The legislation, as enacted in 1988, resulted in a change of DOD policy and regulation that had previously prohibited the reimbursement of foreign selling costs on DOD contracts.

Results in Brief

Making foreign selling costs allowable on U.S. government contracts does not appear to provide the desired effect of stimulating exports of

defense industry products. Foreign marketing decisions are not greatly influenced by contract cost principles on reimbursing foreign selling costs.

GAO found no convincing evidence that reimbursing foreign selling costs on U.S. government contracts was likely to provide incremental cost savings to the U.S. government. No federal cost principle or criteria exists that would ensure such savings and it is doubtful whether one could be devised. When foreign selling costs were unallowable for reimbursement under U.S. government contracts, the U.S. government did not reimburse these costs. However, the foreign customers reimbursed these costs when they were allocated to foreign contracts. GAO believes that the U.S. government reimbursement of such costs should stop.

Principal Findings

Not a Major Stimulant for Defense Exports

GAO's work at 12 defense contractor business entities and 36 responses to a GAO questionnaire did not disclose convincing evidence that reimbursing foreign selling costs on U.S. government contracts would stimulate defense industry exports, result in incremental cost savings for the U.S. government, or assure future cost savings. In addition, contractor officials did not consider the implementing regulations to be an important factor in foreign marketing decisions and those decisions were not significantly influenced by government contract cost reimbursement of foreign selling costs. Instead, decisions were heavily influenced by such factors as customer requirements and financing, probability of obtaining government export licenses, company resources and competition. In addition, these officials did not believe the 110-percent ceiling on reimbursement of foreign selling costs had a significant impact on foreign marketing decisions.

No Incremental Cost Savings to the Government

GAO's review indicated that reimbursement of foreign selling costs on U.S. government contracts would increase U.S. government contract costs. At all 12 contractors' business entities that GAO reviewed, higher costs would have been charged to government contracts because of disproportionately higher ratios of foreign selling costs to the foreign sales compared to the ratios of domestic selling costs to domestic sales. If the 12 entities' foreign selling costs had been allowable on U.S. government

contracts for a 3-year period, GAO estimates the government would have incurred additional contract costs of \$87 million.

In 1985, a Congressional Budget Office (CBO) study concluded that foreign selling cost reimbursement would probably cost the government from \$80 million to \$300 million or more per year. The study further noted that it was unlikely that there would be a sufficient increase in foreign sales to offset these reimbursement costs. CBO reiterated these conclusions in 1988. Although CBO and GAO used different methodologies, they reached the same conclusions.

GAO agrees with the concept that, under appropriate conditions, all customers benefit from increased sales; the U.S. government benefits from foreign sales and foreign customers benefit from industry sales to DOD. However, the benefits and savings to the U.S. government existed when foreign selling costs were allowable on foreign contracts, but were unallowable for reimbursement against U.S. government contracts.

Recommendation to the Congress

GAO recommends that the Congress allow section 2324(f)(5) of title 10, U.S.C., to cease to be effective in 1991 as provided in the legislation.

Recommendation to the Secretary of Defense

If the Congress does not extend the subject legislation, GAO recommends that the Secretary of Defense take appropriate steps to have the FAR amended to make foreign selling costs unallowable on U.S. government contracts. Further, GAO recommends that the regulation make it clear that foreign selling costs are allowable on foreign sales contracts to the extent that they meet the other FAR tests for allowability.

Agency and Contractor Comments and GAO Evaluation

In commenting on a draft of this report, DOD, the Aerospace Industries Association of America, Inc. AIA, and 9 of the 12 contractors' business entities reviewed by GAO generally disagreed with GAO's conclusions and recommendations. From their perspective no valid reason exists to disallow foreign selling costs on U.S. government contracts. DOD agreed with the facts presented in the report but suggested that the legislation be extended for 3 more years to allow for ample time for assessment.

After carefully evaluating these comments, GAO continues to affirm its position that it found no convincing evidence that would support the

contention that reimbursement of foreign selling costs on U.S. government contracts stimulates exports or ensures future cost savings to the government. Without such evidence, GAO continues to believe that the defense industry should recover its foreign selling costs through its foreign contracts and that the U.S. government should not bear or subsidize these costs.

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Abbreviations

AIA	Aerospace Industries Association of America, Inc.
CAS	Cost Accounting Standards
CBO	Congressional Budget Office
DFARS	Defense Federal Acquisition Regulation Supplement
DOD	Department of Defense
FAR	Federal Acquisition Regulation
GAO	General Accounting Office
G&A	general and administrative

Introduction

The Department of Defense (DOD) Authorization Act of 1989, Section 826, and the DOD Appropriations Act of 1989, Section 8105, amended section 2324(f) of title 10 U.S.C. to provide that costs to promote the export of U.S. defense industry products shall be allowable for contract reimbursement provided they are allocable, reasonable, and not otherwise unallowable. The allowability of foreign selling costs is also subject to a determination by the Secretary of Defense that they will likely result in future cost savings to the government. For contractors' business segments that allocate \$2.5 million or more of foreign selling costs to DOD contracts in any fiscal year, the allowable costs cannot exceed 110 percent of such costs incurred in the previous fiscal year. The ceiling was intended to keep any increases in reimbursable costs that may occur within reasonable levels. Unless extended, this allowability provision will expire in 1991, 3 years from the date of the legislation.

Changes in Cost Principles on Reimbursing Selling Costs

The reimbursement of costs under DOD contracts is governed by the cost principles set forth in the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS). Factors considered in determining the allowability of contract costs are (1) reasonableness, (2) allocability, (3) standards issued by the Cost Accounting Standards (CAS) Board, (4) contract terms, and (5) limitations set forth in the FAR subpart on contract principles and procedures.

Selling costs encompass efforts to market contractors' products or services. Direct selling efforts are actions to induce customers to purchase products or services, and are characterized by person-to-person contact to familiarize customers with products or services, conditions of sale, and product capabilities. Direct selling includes negotiation, liaison between customer and contractor personnel, technical and consulting activities, individual demonstrations, and any other activities having as their purpose the application or adaptation of the contractor's products or services to a particular customer's use.

Before March 1979, selling costs were allowable for DOD contract reimbursement to the extent the costs were reasonable and allocable to government business. Effective March 12, 1979, the then Armed Services Procurement Regulation¹ was revised to restrict the reimbursement of foreign selling costs. It provided that selling costs incurred by potential

¹The Armed Services Procurement Regulation was redesignated the Defense Acquisition Regulation on March 8, 1978. The FAR and the DOD FAR Supplement replaced the Defense Acquisition Regulation, effective for new solicitations issued on or after April 1, 1984.

and actual Foreign Military Sales (FMS), as defined by the Arms Export Control Act, or foreign sales of military products, shall not be allocable to U.S. government contracts for U.S. government requirements. The revision was prompted by President Carter's general policy to discourage arms exports as provided in Presidential Directive 13, dated May 13, 1977. The policy intended the foreign customer to pay for all costs. The regulation was therefore worded so that the foreign selling costs could be allocated to and recovered on foreign sales.

Some industry officials believed that cost allocation was restricted to the province of the CAS Board and that DOD's decisions on cost allocation were not valid; that is, DOD's authority was limited to the allowability of costs. Therefore, when the cost principle was revised, effective January 20, 1986, to implement a provision of the 1985 Appropriations Act, the wording was changed from "unallocable" to "unallowable." This provision stated that none of the funds appropriated under the act could be used to reimburse foreign selling costs. The cost principle remained unchanged as the 1986 through 1988 DOD appropriations acts retained the specific prohibition on reimbursing foreign selling costs on U.S. government contracts. The prohibition was dropped from the 1989 legislation and both the 1989 DOD appropriations and authorization acts provided that foreign selling costs would be reimbursable against government contracts for 3 years.

Industry Position on Foreign Selling Cost Reimbursement

Defense contractors and various industry associations have, for many years, expressed concern about the cost principles disallowing the reimbursement of foreign selling costs on government contracts. In January 1985, the Deputy Under Secretary of Defense for Acquisition Management requested several industry associations to provide specific examples of why it was cost effective for DOD to reimburse its share of foreign selling costs. The request was prompted by the Conference Report on the 1985 DOD Appropriations Act, in which the Committee expressed a willingness to reconsider reimbursing foreign selling costs on government contracts if the Secretary of Defense certified that it was cost effective to do so.

Five industry associations and 18 companies responded to the request. The responses were summarized in an issue paper dated June 25, 1985. Industry officials believed that excluding foreign selling cost reimbursement on government contracts (1) was contrary to national policy, (2) failed to recognize benefits of foreign sales, (3) discriminated against

small business, and (4) forced class of customer² pricing. The officials pointed out that with increasing trade deficits, the government should not discourage trade by disallowing reimbursement of foreign selling costs on government contracts.

Industry officials had identified benefits from foreign sales of defense products. Some of the areas mentioned were higher production efficiencies and stable work load, research and development cost recoupment, improved defense mobilization capabilities, contribution to the balance of payments, creation of jobs, and funding of capital expenditures.

Industry officials also had expressed concern that the continued ban on reimbursement of foreign selling costs could lead contractors to establish separate foreign and domestic selling cost pools. These officials stated that since foreign selling costs were less than such costs for U.S. government sales, selling costs allocated to government contracts would increase if separate foreign and domestic indirect cost pools were established.

DOD Recommended Removal of Foreign Selling Cost Prohibition

In 1987, the Deputy Secretary of Defense wrote to the Chairmen of the House and Senate Appropriations Committees recommending removal of the foreign selling cost prohibition. The Deputy Secretary said that the long-term benefits from export of U.S. defense contractors' products could be substantial and provided examples industry cited for use in the 1985 issue paper. DOD officials regard the 1987 correspondence as the Secretary of Defense's determination that foreign selling costs are likely to result in future cost savings to the government.

DOD Regulations Implementing 1989 Legislation

To implement the 1989 legislation, DOD issued an interim rule, published in DFARS, effective December 15, 1988. The rule provides that the costs of broadly targeted and direct selling efforts and market planning (other than long-range planning), incurred to promote export sales of U.S. defense industry products are allowable on DOD contracts. The rule requires these costs to be allocable, reasonable, and not otherwise unallowable, and subject to the 110-percent reimbursement ceiling for contractors that allocate \$2.5 million or more of these costs to defense contracts. This interim rule was adopted, with no change, as the final DFARS regulation, published on December 29, 1989.

²Grouping of selling costs in expense pools by class of customer sales such as DOD, other U.S. government, foreign, commercial, for allocation over their respective bases.

FAR Revision

The FAR was amended on April 15, 1991, effective May 15, 1991, to make foreign selling costs allowable on all U.S. government contracts, not just DOD contracts. The FAR provides uniform policies and procedures for acquisition by all executive agencies.

Objectives, Scope, and Methodology

The DOD Authorization and Appropriations Acts of 1989 require that our office and the DOD Inspector General make separate assessments of whether the implementing regulations on reimbursing foreign selling costs allocable to U.S. government contracts stimulate exports of defense industry products and ensure future cost savings to the government. Specifically, our objectives were to determine (1) what effect reimbursing U.S. firms for foreign selling costs has on their efforts to export and (2) whether the government would realize incremental cost savings, that is, savings beyond those attributed to foreign sales while foreign selling costs were not allowable for reimbursement on U.S. government contracts.

To determine whether reimbursing foreign selling costs on U.S. government contracts stimulates the exports of U.S. defense industry products, we held discussions with contractor officials, and obtained industry input through a questionnaire on (1) major considerations affecting foreign marketing decisions, (2) the extent to which reimbursement of foreign selling costs contributed to increased expenditures, and (3) the impact of the 110-percent reimbursement ceiling on decisions to promote exports of defense industry products.

To determine whether reimbursement of foreign selling costs on government contracts provided savings to the government, we reviewed indirect expense (overhead)³ claims submitted to the government by 12 business entities of 8 major defense contractors for the most recent 3-year period, usually 1986-88, and recomputed the claimed indirect expense rates, assuming the costs were allowable on defense contracts. The 12 business entities are identified in appendix I. We also requested these entities to provide examples or illustrations of cost savings to the government from the reimbursement of foreign selling costs. The responses are summarized in appendix II.

³Contractors are required to submit claims for final indirect cost rates within 90 days of the end of the accounting period to the contracting officer for use in determining the amount of allowable costs for contract reimbursement purposes under the provisions of FAR, part 31, Contract Cost Principles and Procedures.

These 12 business entities also completed a questionnaire that we developed specifically for this report. The 8 major defense contractors were ranked in the top 20 receiving the largest share of DOD prime contract awards in fiscal year 1990. We judgmentally selected the business entities for review from a list, provided by Defense Contract Audit Agency, of defense contractors with large amounts of foreign selling costs.

To ensure that our review included representative industry views, we also provided a similar questionnaire to 55 additional large and small defense contractors selected from a list of the 500 largest defense contractors for fiscal year 1989. Twenty-four contractors responded.

We coordinated our review methodology, scope of audit, and contractor locations with the Office of the DOD Inspector General to avoid duplication of effort. In addition, we reviewed a number of defense industry studies, made at the request of DOD in 1985, on the cost-effectiveness of reimbursing foreign selling costs.

We reviewed applicable FAR and DFARS cost principles; files at the Office of the Deputy Assistant Secretary of Defense for Procurement concerning policy considerations and deliberations on foreign selling cost reimbursement; and cost principle case files of the Defense Acquisition Regulatory Council, which contained industry viewpoints on the proposed cost principle changes. We also reviewed CAS Board files on a project to establish a standard on allocating selling and marketing costs. In addition, we reviewed a 1985 Congressional Budget Office (CBO) study of the budgetary impact of charging foreign selling costs to DOD contracts and subsequent 1988 CBO cost estimate for the 1989 DOD authorization bill. We also interviewed seven experts in the field of cost accounting from academia, public accounting, and government.

Meetings were held with officials of the Aerospace Industries Association of America, Inc. (AIA) to obtain an industrywide perspective on the reimbursement of foreign selling costs. The results of our review were discussed with contractor officials at the business entities and corporate offices, as well as government representatives at the cognizant contract administration and audit offices at the contractors' locations. We also obtained comments on a draft of this report from DOD, AIA, and contractors representing 9 of the 12 business entities we reviewed.

Our review was performed between August 1989 and July 1990 in accordance with generally accepted government auditing standards.

Minimal Effect on Exports

Reimbursement of foreign selling costs on U.S. government contracts does not appear to stimulate exports of defense industry products. Based on information collected from 36 defense business entities and discussions with numerous company marketing officials, the consensus was that foreign marketing decisions were not greatly influenced by contract cost principles on reimbursing foreign selling costs. The CBO, in a 1985 study, also concluded that marketing activities were not constrained by selling cost reimbursement and noted that industry officials had expressed doubt that foreign sales would increase if foreign selling costs were reimbursable on U.S. government contracts.

Considerations in Foreign Marketing Decisions

Only one of the 36 defense business entities identified the reimbursement of foreign selling costs as an important factor in making foreign marketing decisions. Responses from the other 35 indicated that foreign selling cost reimbursement was unlikely to stimulate export of defense industry products. Major considerations in foreign marketing decisions mentioned by these entities included knowledge of customer requirements, the extent of competition, the availability of export licenses, company resources, risk assessment with other business opportunities, previous experience with the customer, likelihood of program success, conformance with the company's strategic business plan, and terms and conditions of the sale. Only 5 of the 36 entities identified allowability of foreign selling costs on government contracts as a consideration in foreign marketing decisions.

Limitation on Reimbursing Foreign Selling Costs

The 36 business entities, in replying to our questionnaire, indicated that they did not believe the 110-percent ceiling on reimbursing foreign selling costs has a significant impact on foreign marketing decisions.

Foreign Marketing Expenditures and Budget Projections

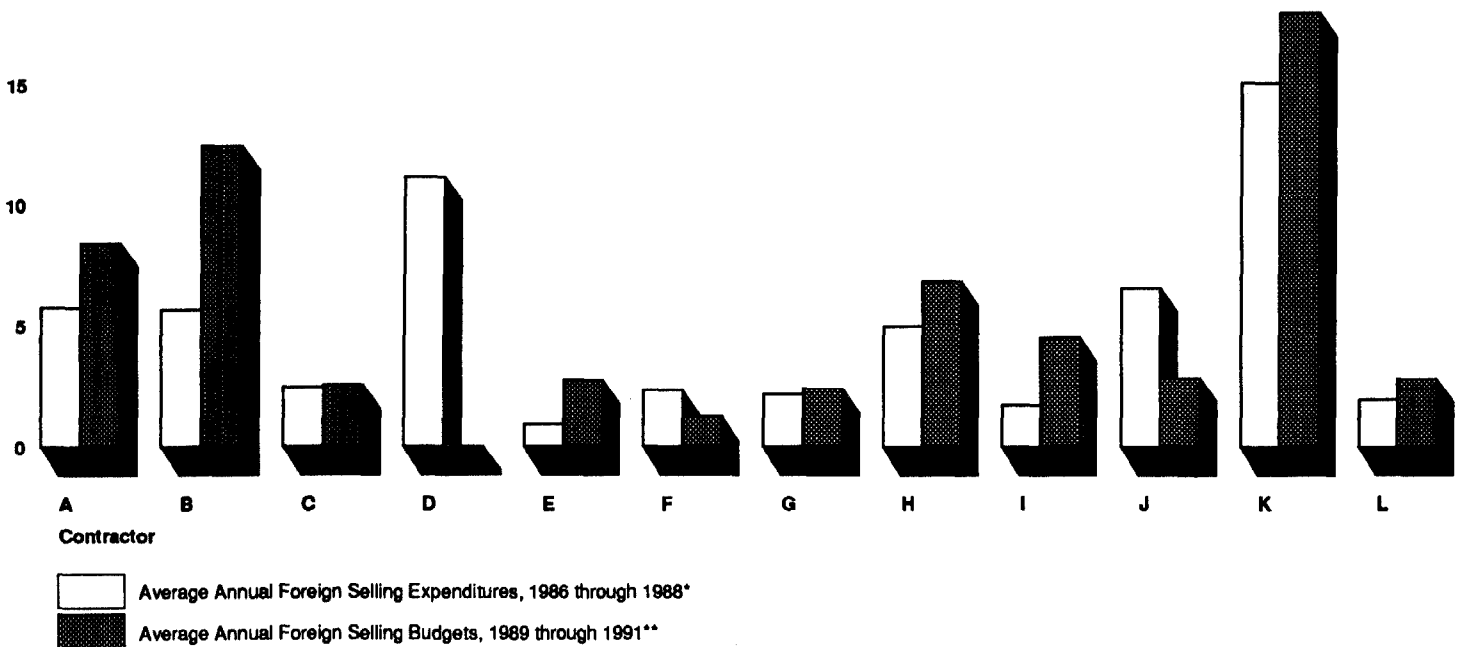
Foreign marketing expenditures at the 12 business entities where we examined overhead claims generally increased during the 3-year period, from 1986 through 1988, when the costs were unallowable for reimbursement on government contracts. Budget projections of these entities for 1989 through 1991 also reflected comparable increases. None of the entities indicated that expenditure levels or budget projections were greatly influenced by cost principles governing the reimbursement of foreign selling costs. Several entities attributed the increases in budget projections to the downturn in DOD spending, and a strategy to cushion the impact through more aggressive foreign marketing activities. Other

entities attributed the larger budgets to increased competition in marketing defense products.

Figure 2.1 shows the 3-year average foreign marketing expenditures and budget projections for the 12 business entities. Expenditure data is for 1986 through 1988, while budget projection data is for 1989 through 1991, except as noted.

Figure 2.1: Foreign Marketing Expenditures and Budget Projections

20 Millions of Dollars



* Contractor C Expenditure Data is for 1988 through 1989

** Contractor C Budget Data is for 1990 through 1991

Contractor D Budget Data Not Provided

Congressional Budget Office Study

In 1985, the Chairman, Subcommittee on Defense, Senate Committee on Appropriations, requested CBO to examine the budgetary impact of allocating marketing costs on foreign military sales to DOD contracts. The results, reported in a July 17, 1985, letter to the Chairman, concluded that removing the restriction on reimbursing foreign selling expenses

would cost the U.S. government from \$80 million to \$300 million or more a year. The letter further concluded that it was unlikely that foreign sales would increase sufficiently to offset the additional costs. In addition, the CBO stated that industry representatives had expressed doubt that foreign sales would increase if marketing costs were allocated to DOD contracts, as foreign sales are such an integral part of the business that marketing is unconstrained by cost allocability.

In 1988, the CBO cost estimate for the 1989 DOD Authorization Act stated that the legislation's foreign selling cost reimbursement provision would probably cost the government from \$80 million to \$300 million or more per year, based on two DOD foreign selling cost estimates and the assumption that foreign sales would not increase sufficiently to offset that additional cost.

Incremental Cost Savings Are Doubtful

Reimbursing foreign selling costs allocated to U.S. government contracts does not appear to provide incremental cost savings to the government. At the 12 business entities where we reviewed overhead claims, it was considerably more expensive to market defense industry products to foreign customers than to DOD and other U.S. government agencies. In the 3 years for which we reviewed the overhead claims, permitting contractors to have foreign selling costs reimbursed on U.S. government contracts would have resulted in disproportionately higher general and administrative (G&A) expenses charged to DOD and other U.S. government contracts.

There is no FAR or DFARS cost principle or criteria that would ensure future cost savings. Moreover, DOD officials told us that they were uncertain how to devise criteria that would, in effect, guarantee future cost savings. We have doubts about whether such criteria could be devised.

Disproportionately Higher Foreign Selling Costs

Our analysis showed that for the 12 business entities where we reviewed overhead claims, the ratio of foreign selling costs to the foreign sales was generally significantly higher than the ratio of domestic selling costs to domestic sales. Table 3.1 shows the difference between the foreign and domestic selling expense rates for 9 of the 12 entities. Rates for the other three business entities were not available.

Table 3.1: Comparison of Domestic and Foreign Selling Expense Rates

Figures in percent

Company	Year	Domestic	Foreign	Difference
A	1986	0.836	3.438	2.602
	1987	0.689	3.481	2.792
	1988	0.757	5.036	4.279
B	1987	1.311	1.503	0.192
	1988	1.628	1.554	(0.074)
C	1986	1.815	5.251	3.436
	1987	1.989	12.513	10.524
	1988	1.796	10.996	9.200
D	1985	0.205	2.323	2.118
	1986	0.207	1.505	1.298
	1987	0.266	1.369	1.103
E	1986	1.155	1.735	0.580
	1987	1.467	1.601	0.134
	1988	1.613	1.536	(0.077)
F	1986	3.183	15.195	12.012
	1987	3.137	9.817	6.680
	1988	4.366	12.951	8.585
G	1986	0.823	7.744	6.921
	1987	1.477	7.517	6.040
	1988	1.870	11.121	9.251
H	1986	1.348	4.076	2.728
	1987	1.748	4.711	2.963
	1988	2.377	5.477	3.100
I	1987	1.365	1.569	0.204
	1988	1.598	2.085	0.487

Impact of Foreign Selling Cost Reimbursement

Table 3.2 shows that reimbursing foreign selling costs on U.S. government contracts would have increased costs allocated to the government in the aggregate by about \$87.2 million over a 3-year period, or an average of about \$2.4 million a year at each of the 12 business entities. This estimate assumes that the legislation and implementing regulation had been in effect during the 3-year period for which the indirect expense claims had been submitted.

Chapter 3
Incremental Cost Savings Are Doubtful

Table 3.2: Estimated Cost Impact From Foreign Selling Cost Reimbursement

Dollars in millions		
Company	Year	Cost impact
A	1986	\$4.443
	1987	5.179
	1988	5.854
B	1987	0.691
	1988	(0.234)
C	1986	0.981
	1987	2.067
	1988	2.314
D	1985	6.520
	1986	5.317
	1987	5.462
E	1986	0.454
	1987	0.094
	1988	(0.062)
F	1986	2.113
	1987	1.169
	1988	1.508
G	1986	2.156
	1987	2.132
	1988	2.148
H	1986	4.477
	1987	4.278
	1988	4.114
I	1987	0.153
	1988	0.385
J	1986	2.525
	1987	2.674
	1988	2.356
K	1986	2.242
	1987	0.672
	1988	0.740
L	1986	3.775
	1987	4.153
	1988	4.341
Total		\$87.191

Accounting Practices on Allocating Selling Costs

All seven of the cost accounting experts we interviewed agreed that cost accounting principles and practices do not prohibit contractors from setting up separate pools for selling costs when circumstances warrant. Our review showed that 10 of the 12 business entities changed their accounting practices for selling costs when foreign selling costs were made unallowable on government contracts. Foreign and domestic selling costs were accumulated in separate pools and allocated over their respective bases. As a result, foreign selling costs that were unallowable on government contracts were allowable on foreign contracts.

Contractors Benefit From Improved Competitive Position

Most of the business entities we reviewed stated that government reimbursement of foreign selling costs would improve their competitive position in foreign markets. In essence, the higher ratio of foreign selling costs would be allocated over a larger G&A cost input base and would permit lower price offers to potential foreign customers. Under this arrangement, the U.S. government would, in effect, be subsidizing contractors with foreign sales in the international competitive environment.

This acknowledgment refutes an industry position that establishing separate foreign and domestic selling expense pools would increase costs allocated to government contracts because of the belief that foreign selling costs were lower than selling costs incurred for U.S. government contracts. On the contrary, our review showed that foreign selling costs were disproportionately higher than domestic selling costs.

Contractor Estimates of Government Benefits

We asked the 12 business entities where we reviewed overhead claims for recent examples of cost savings and benefits to the government from export of defense industry products and the reimbursement of foreign selling costs. Only four entities provided recent examples. However, in these examples the benefits were due largely to estimates of cost savings associated with increased sales and production efficiencies similar to those cited in the 1985 DOD issue paper. (These four business entities' responses are summarized in app. II.) Five other business entities provided us with their responses for the 1985 DOD issue paper, and stated that they were still valid.

We agree with the concept that, under appropriate conditions, all customers benefit from increased sales; the U.S. government benefits from foreign sales and foreign customers benefit from industry sales to DOD. However, the benefits and savings existed when foreign selling costs were unallowable on government contracts. The information provided

by the contractors did not contain evidence to convince us that reimbursement of foreign selling costs on government contracts would provide incremental cost savings to the U.S. government.

Conclusions and Recommendations

Conclusions

Making foreign selling costs allowable on government contracts does not appear to provide the desired incentive to stimulate exports of defense industry products. Foreign marketing decisions are not greatly influenced by contract cost principles on reimbursing foreign selling costs.

Further, reimbursing foreign selling costs on government contracts is not likely to ensure future cost savings to the government. Making foreign selling costs allowable on U.S. government contracts will increase overhead costs allocated to those contracts. While the government receives economic benefits from foreign sales, benefits are likewise received by foreign customers on the larger sales of products to DOD. Economic benefits from foreign sales existed while the foreign selling costs were unallowable for reimbursement on government contracts. Our review did not disclose evidence to convince us that reimbursement of foreign selling costs on government contracts would provide incremental cost savings to the U.S. government.

When foreign selling costs were unallowable for reimbursement under U.S. government contracts, the U.S. government did not reimburse these costs. However, the foreign customers reimbursed these costs when they were allocated to the foreign contracts. Because foreign selling expense rates are usually higher than domestic rates, selling costs allocated over the G&A cost input base results in higher costs charged to government contracts.

Recommendations

Recommendation to the Congress

We recommend that the Congress allow section 2324(f)(5) of title 10, U.S.C., to cease to be effective in 1991 as provided in the legislation.

Recommendation to the Secretary of Defense

If the Congress does not extend the subject legislation, we recommend that the Secretary of Defense take appropriate steps to have the FAR amended to make foreign selling costs unallowable on U.S. government contracts. Further, GAO recommends that the regulation make it clear that foreign selling costs are allowable on foreign sales contracts to the extent that they meet the other FAR tests for allowability.

Agency and Industry Comments and Our Evaluation

In commenting on a draft of this report, DOD, AIA, and contractors representing 9 of the 12 business entities that we reviewed generally disagreed with our conclusions and recommendations. From their perspective, no valid reason exists to disallow foreign selling costs on U.S. government contracts. DOD agreed with the facts presented in the report, but suggested that the legislation be extended for 3 more years to allow ample time for assessment.

After carefully evaluating these comments, we continue to affirm our position that we found no convincing evidence which would support the contention that reimbursing the defense industry for its foreign selling costs stimulates exports or ensures future government savings. Without such evidence, we continue to believe the defense industry should recover foreign selling costs on its foreign contracts and the U.S. government should not bear or subsidize these costs.

We have reprinted DOD's comments in their entirety in appendix III and included a summary of industry comments in appendix IV. Each of these appendixes also contains our evaluation of the specific comments.

Defense Contractor Locations

DOD contractors	Rank of parent corporation among DOD contractors
Bell Helicopter Textron, Inc. Fort Worth, TX	19
General Dynamics Corporation Fort Worth Division Fort Worth, TX	2
Hughes Aircraft Company Electro-Optical and Data Systems Group El Segundo, CA	4
Hughes Aircraft Company Ground Systems Group Fullerton, CA	4
Hughes Aircraft Company Space and Communications Group El Segundo, CA	4
Lockheed Corporation Aeronautical Systems Company Burbank, CA	6
Lockheed Corporation Aeronautical Systems Company Marietta, GA	6
Martin Marietta Corporation Electronics and Missiles Group Orlando, FL	7
McDonnell Douglas Corporation McDonnell Aircraft Company St. Louis, MO	1
Raytheon Company Equipment Division Marlborough, MA	5
Raytheon Company Missile Systems Division Bedford, MA	5
Rockwell International Corporation Autonetics Electronics Systems Anaheim, CA	13

Contractor Estimates of Government Benefits

During our review at 12 business entities, we asked the entities for recent examples of cost savings from foreign selling cost reimbursement and export of defense industry products. Only four entities provided recent examples. However, in these examples the benefits were due largely to estimates of cost savings associated with increased sales and production efficiencies similar to those cited in the 1985 DOD issue paper. In addition, these benefits and savings existed even when foreign selling costs were unallowable on U.S. government contracts. The information provided does not contain convincing evidence that reimbursement of foreign selling costs would provide incremental cost savings to the U.S. government. The four responses provided are summarized below.

Rockwell, Autonetics Electronics Systems

Rockwell officials provided us an estimate of savings to the government of \$29 million for a 5-year period, 1988 through 1992, as a result of lower net indirect expense rates due to increased business volume from foreign sales. The estimate consists of \$20.6 million in overhead costs allocated to existing foreign contracts that otherwise would have been allocated to government contracts, \$17.5 million in overhead costs allocated to foreign contracts for potential sales in 1990-92 of the Shipboard Inertial Navigation Systems for the North Atlantic Treaty Organization and the F-111 aircraft Avionics Update Program for the Royal Australian Air Force, and a \$9-million offset in higher foreign selling costs allocated to government contracts.

Hughes, Electro- Optical and Data Systems Group

Hughes officials advised us that potential foreign sales of a night vision upgrade to the M65 Airborne TOW system over a 5-year period could result in estimated savings of \$9 million to the government in recoupment of research and development costs. Although unable to quantify the savings, the officials also cited additional potential benefits from (1) rental of government-owned test equipment, tooling, and facilities, (2) elimination of production line start up costs, (3) lower unit production costs from sales to the Army, and (4) lower costs to maintain technical data packages.

**Martin Marietta,
Electronics and
Missiles Group**

Martin Marietta officials advised us that existing and projected foreign sales of LANTIRN and PATHFINDER navigation and targeting systems could afford the government economies of scale not otherwise available because of reduced U.S. Air Force purchases of LANTIRN systems. Additional foreign sales of TADS/PNVS targeting and night sensor systems were cited as contributors to lower production costs for future U.S. Army requirements.

**General Dynamics, Ft.
Worth Division**

The General Dynamics officials' estimate of government benefits from foreign sales was based on an April 1987 study of scheduled and potential sales of F-16 aircraft from 1978 through 1993. Estimated savings to the government from firm aircraft deliveries was \$1.187 billion generated from (1) lower overhead costs of \$203 million, (2) learning curve and labor improvements of \$128.2 million, (3) contractor and government-furnished equipment of \$272.4 million, (4) recoupment of aircraft development, production tooling, and support systems costs of \$569.1 million, and (5) rental charges of \$14.7 million.

Comments From the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



PRODUCTION AND LOGISTICS

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301-8000

January 4, 1991

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "GOVERNMENT CONTRACTING: Reimbursement of Foreign Selling Costs," dated October 30, 1990 (GAO Code 396132), OSD Case 8523. While the Department agrees with the factual data contained in the report, the DoD disagrees with the primary conclusion reached by the GAO.

It is the DoD position that the GAO review was performed too early in the 3-year trial period to make valid conclusions about the impact of implementing regulations upon U.S. defense exports. The GAO review was initiated only 10 months after foreign selling costs became reimbursable under the FY 1989 DoD Appropriations Act. That time interval was insufficient to generate the prerequisite empirical data for valid conclusions about the effects of the legislation. Consequently, the derivative GAO estimate of the impact, based upon data for the preceding 3 years during which foreign selling costs were unallowable, is arguably no more reliable than the savings estimates the GAO elicited from industry.

To assess adequately the effect of reimbursing foreign selling costs on defense contracts, analyses must focus upon the current and anticipated sales mix of defense products and services which generate the potential savings. Studies which focus elsewhere are likely to reach erroneous conclusions that are inherently inequitable and detrimental to the viability of the U.S. industrial base. The current legislation should, therefore, be retained until sufficient time has elapsed to permit an adequate analysis of its effect.

It also should be noted that selling costs are a normal cost of doing business and are generally allowable. There is no valid reason to disallow foreign selling costs on U.S. Government contracts.

See comment 1.

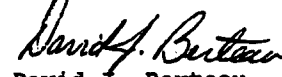
See comment 2.

See comment 3.

Appendix III
Comments From the Department of Defense

The Department appreciates the opportunity to comment on the draft report. Detailed comments on the report findings and the matter for Congressional consideration are enclosed.

Sincerely,



David J. Berteau
Principal Deputy

Enclosure

GAO DRAFT REPORT - DATED OCTOBER 30, 1990
(GAO CODE 396132) OSD CASE 8523

"GOVERNMENT CONTRACTING: REIMBURSEMENT OF
FOREIGN SELLING COSTS"

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

FINDINGS

- o FINDING A: Department of Defense (DoD) Authorization and Appropriation Acts of 1989. The GAO explained that under the cost principles in effect before March 1979, contractors' costs for marketing products and services were considered allowable for reimbursement on U.S. Government contracts, if reasonable, allocable, and not otherwise unallowable. The GAO, however, pointed out that after March 1979, the cost principles provided that selling costs incurred in connection with the sale of a military product or service to a foreign customer were not reimbursable on U.S. Government contracts for U.S. Government requirements. The GAO reported that defense and aerospace representatives objected to the unallowability of foreign selling costs on Government contracts because industry officials believed that the sale of defense products to foreign customers provided cost savings through lower contract prices on products purchased by the DoD. The GAO explained that defense industry representatives contended that, since the DoD shared in the benefits of foreign sales, the DoD should pay a share of the foreign selling costs. As a result, the GAO found that legislation was enacted in 1988 to allow the reimbursement of foreign selling costs under DoD contracts. (pp. 3-4, p. 9/GAO Draft Report)

DOD POSITION: Concur. The DoD Authorization and Appropriations Acts of 1989 provide that costs to promote the export of U.S. defense industry products shall be allowable for contract reimbursement provided they are allocable, reasonable, and not otherwise unallowable. The allowability provision is subject to a ceiling of 110 percent of such costs incurred in the previous fiscal year.

- o FINDING B: Changes in Cost Principles on Reimbursing Selling Costs. The GAO found that the reimbursement of costs under DoD contracts is governed by the principles set forth in the Federal Acquisition Regulations and Defense Federal Acquisition Regulations. The GAO stated

Enclosure

that selling costs encompass efforts to market contractors' products or services. The GAO noted that before March 1979, selling costs were allowable for DoD contract reimbursement to the extent that the costs were reasonable and allocable to Government business. The GAO pointed out, however, that effective March 12, 1979, the then Armed Services Procurement Regulation revision was so worded that the foreign selling costs associated with the foreign sales of military products could only be allocated to, and recovered on, foreign sales.

The GAO observed that, based on the objection of some industry officials, the cost principle was again revised, effective January 20, 1986, to change the regulation wording from "unallocable" to "unallowable". The GAO explained that the revised provision stated that none of the funds appropriated under the 1985 Appropriations Act could be used to reimburse foreign selling costs. The GAO reported that the prohibition on reimbursing foreign selling costs was dropped from the 1989 legislation and both the DoD Appropriation and Authorization Acts provided that foreign selling costs would be reimbursable for three years. (pp. 9-11/GAO Draft Report)

DoD Position: Concur. The 1979 regulatory change was necessitated by Presidential Decree No. 13, which was directed at discouraging defense sales abroad. The regulatory prohibition on reimbursement of foreign selling costs subsequently was retained, in keeping with provisions of the 1985 through 1988 DoD Appropriations Acts. The regulatory prohibition was rescinded when the 1989 DoD Authorization and Appropriations Acts were passed, permitting reimbursement of foreign selling costs for a trial period of three years.

- o FINDING C: Industry Position on Foreign Selling Cost Reimbursement. The GAO observed that defense contractors and various industry associations have expressed concern with the cost principles disallowing the reimbursement of foreign selling costs on Government contracts. The GAO found that the Conference Report on the 1985 DoD Appropriations Act prompted the Deputy Under Secretary of Defense for Acquisition Management to request several industry associations to provide specific examples of why it was cost effective for DoD to reimburse its share of foreign selling costs.

The GAO noted that five industry associations and 18 companies responded to the request. The GAO noted that the industry officials believed that excluding foreign selling costs reimbursement on Government contracts (1) was contrary to national policy; (2) failed to recognize benefits of foreign sales; (3) discriminated against small business; and (4) forced class of customer pricing. The GAO pointed out that industry officials identified cost benefits from foreign sales of defense products resulting from higher production efficiencies and stable workload, research and development cost recoupment, improved defense mobilization

capabilities, contribution to the balance of payments, creation of jobs, and funding of capital expenditures. The GAO also reported that the contractors indicated that selling costs allocated to Government contracts would increase, if separate foreign and domestic indirect cost pools were established. (pp. 11-12/GAO Draft Report)

DoD Position: Concur. The Conference Report on the 1985 DoD Appropriations Act stated that the Committee would reconsider the allowability issue if the Secretary of Defense certified that it was cost effective to reimburse contractors' foreign selling costs. It was for that reason the Deputy Under Secretary of Defense for Acquisition Management elicited opinions on the subject. Cost savings data received from industry appeared consistent with earlier findings of the Congressional Budget Office published in its staff working paper of May 24, 1976, entitled "Budgetary Cost Savings to the Department of Defense Resulting from Foreign Military Sales." The study reported that the foreign sales mix of weapons, services, and construction determines the degree of budgetary cost savings generated and that these savings can be significant.

- o FINDING D: DoD Recommends Removal of Foreign Selling Cost Prohibition. The GAO observed that, in 1987, the Deputy Secretary of Defense wrote to the Chairmen of the House and Senate Appropriations Committees recommending the removal of the foreign selling cost prohibition. The GAO learned that DoD officials regard the letter as a determination that foreign selling costs are likely to result in future cost savings to the Government. To implement the 1989 legislation, the GAO stated that the DoD issued an interim rule, published in the Defense Federal Acquisition Regulation Supplement, effective December 15, 1988. The GAO stated that the rule provides that the costs of broadly targeted and direct selling efforts and market planning incurred to promote export sales of U.S. defense industry products are allowable on DoD contracts. The GAO pointed out that the interim rule, adopted on December 29, 1989, requires these foreign selling costs be allocable, reasonable, and not otherwise unallowable, and subject to the 110 percent ceiling for contractors that allocate \$2.5 million or more of these costs to defense contracts.

The GAO reported that, as of October 1990, the Civilian Agency Acquisition and Defense Acquisition Regulatory Councils have not published the proposed revision to the Federal Acquisition Regulation. The GAO explained that the revision will supercede the Defense Federal Acquisition Regulation and make foreign selling costs allowable on all U.S. Government contracts. (pp. 12-13/GAO Draft Report)

DOD POSITION: Concur. The Department has long supported removal of the statutory prohibition against reimbursing foreign selling costs as an allowable cost on defense contracts. As indicated in the comments on Finding C above, Congressional Budget Office studies have indicated that significant budgetary savings can accrue from foreign sales of defense products through factors such as economies

of scale and recoument of research and development costs. To fully implement the 1989 legislative provision regarding allowability of foreign selling costs, the Civilian Agency Acquisition and Defense Acquisition Regulatory Councils have been working closely together to develop appropriate language for the Federal Acquisition Regulation revision. That task is now complete and the revised cost principle will be included in Federal Acquisition Circular 90-4, currently scheduled for publication early in 1991.

- o FINDING E: Considerations in Foreign Marketing Decisions. The GAO stated that based on information collected from 36 defense contractor entities and discussions with company marketing officials, the consensus was that foreign marketing decisions were not greatly influenced by contract cost principles on reimbursing foreign selling costs. The GAO concluded that the reimbursement of foreign selling costs on U.S. Government contracts does not appear to stimulate exports of defense industry products. (pp. 18-20/GAO Draft Report)

DOD POSITION: Partially concur. The DoD Inspector General "Report on the Audit of Foreign Direct Selling Costs," dated September 18, 1990, indicated that interviews of industry representatives yielded responses similar to those reported by the GAO. Nonetheless, lacking any empirical data to evaluate, the Inspector General report also stated that it was too early in the 3-year trial period to draw a conclusion regarding the impact of the new legislation upon U.S. Defense industry exports. The Department agrees with the Inspector General's assessment. Although the GAO made an earnest attempt to determine the effect of the statutory change upon U.S. defense industry exports, it had only prior years' data available for evaluation. That necessitated a methodology entailing assumptions, recomputations, and conclusions that appear speculative, since there is no practical way to test their validity. The only reliable means to ascertain if the desired incentives and cost savings have been achieved is to evaluate empirical data generated after implementing regulations were issued.

- o FINDING F: Congressional Budget Office Study. The GAO observed that the 1985 Congressional Budget Office study reported (1) marketing activities were not constrained by cost reimbursement and (2) industry officials had expressed doubt that foreign sales would increase, if foreign selling costs were reimbursable on U.S. Government contracts. The GAO found that the Congressional Budget Office cost estimate for the 1989 DoD Authorization Act stated the legislation's foreign selling cost reimbursement provision probably would cost the Government from \$80 to \$300 million more per year, while the increase in foreign selling would not be sufficient to offset this additional cost. (pp. 20-21/GAO Draft Report)

DOD POSITION: Partially concur. The DoD does not question the results of the Congressional Budget Office survey of industry representatives. The Department does, however, have serious doubts as to the reliability of the estimated

See comment 1.

See comment 2.

annual cost impact to the U.S. Government that purportedly results when foreign selling costs are charged to defense contracts. The Congressional Budget Office acknowledged that it lacked sufficient data to make a decisive estimate of the impact. It also acknowledged that the range of impact would largely depend upon the mix of defense products being sold in foreign markets, because some products generate significant cost savings while others do not. Moreover, the sales data used by the Congressional Budget Office is now five to eight years old and may bear no relationship to current programs. Even if that were not the case, the \$300 million estimate is meaningless, since it was extrapolated from a judgmental sample of only four contractors. Consequently, there is no valid basis to conclude reimbursement of foreign selling expenses would cost the Government from \$80 million to \$300 million annually. It is inappropriate to assert or imply otherwise.

- o **FINDING G: Incremental Cost Savings are Doubtful.** The GAO found that for the years 1986 to 1988, the overhead claims permitting contractors to have foreign costs reimbursed on U.S. Government contracts would have resulted in disproportionately higher general and administrative expenses charged to the DoD and other U.S. Government contracts. Assuming the legislation and implementing regulation had been in effect during the period 1986 to 1988, the GAO estimated that reimbursing foreign selling costs on U.S. Government contracts would have increased costs allocated to the Government by \$87.2 million over the three year period. The GAO stated that Government reimbursement of foreign selling costs would improve the competitive position of the contractors in foreign markets. Therefore, the GAO concluded that the U.S. Government would, in effect, be subsidizing the contractors for foreign sales contracts in the international competitive environment. The GAO further concluded that this showed that foreign selling costs were disproportionately higher than domestic selling costs. The GAO stated that the information provided by the contractors did not contain evidence to prove that reimbursement of foreign selling costs would provide incremental costs savings to the U. S. Government. (pp. 22-26/GAO Draft Report)

See comment 1.

DOD POSITION: Nonconcur. The DoD disagrees with the GAO rationale for several reasons. First, the GAO made an earnest attempt to determine the effect of the statutory change upon U.S. defense industry exports, but had only prior years' data available for evaluation. That necessitated a methodology entailing assumptions, recomputations, and conclusions which appear speculative, since there is no practical way to test their validity. The only reliable means to ascertain the impact of the legislative change and its implementing regulations is to analyze data generated after they were promulgated.

Second, the GAO acknowledges that, under appropriate conditions, all customers benefit from increased foreign and domestic sales. The GAO argues, however, that existing

See comment 2.

benefits and savings would be diminished if the U.S. Government reimburses contractors for its allocable share of foreign selling costs, unless subsequent annual foreign sales and related savings are sufficient to offset the allowed costs (i.e., the Government must break even). Finding no evidence that a significant sales increase was likely to occur, the GAO concluded that reimbursement of foreign selling costs would not provide incremental cost savings to the U.S. Government. The DoD considers this assessment incomplete; and, therefore, misleading. It did not consider product sales mix which, according to Congressional Budget Office studies, is the primary savings determinant. Consequently, analyses which assume that sales volume is the sole or primary savings determinant likely will reach misleading conclusions.

See comment 4.

Third, it is not accurate or relevant to assert that the U.S. Government is effectively subsidizing its defense contractors by reimbursing them for legitimate, necessary export business expenses. To the extent that foreign export sales benefit U.S. defense contracts, the prerequisite beneficial relationship for allocability exists. Accordingly, any coincidental improvement in a contractor's competitive position derived from reimbursements for these or any other allocable costs is not a relevant or legitimate basis to advocate disallowance of the costs.

See comment 5.

Fourth, when foreign selling costs are disallowed as a matter of policy, small contractors who lack a foreign sales base, and large contractors who find it impractical to allocate selling costs over separate foreign and domestic sales allocation bases, must use the general and administrative expense base to allocate selling costs. This results in a basic inequity; Government contracts do not receive allocable foreign selling costs, although foreign customer contracts receive allocations of domestic selling costs. The Department considers that inequity worthy of emphasis.

In summary, the DoD disagrees with the GAO conclusion that incremental cost savings are doubtful. A valid impact analysis of the current legislation and implementing regulations requires availability of empirical data and recognition of the relevant savings determinants. That information was not yet available when the GAO performed its review. Moreover, the Department considers it inappropriate to regard enhanced contractor competitiveness as a relevant factor in the analysis. It seems equally inappropriate to overlook the basic inequity of disallowing foreign selling costs which are allocable to U.S. Government contracts while simultaneously permitting foreign sales contracts to absorb allocable domestic selling costs. Selling costs are a normal cost of doing business and are generally allowable. As a necessary cost of doing business, they will be incurred whether or not allowable.

* * * * *

MATTER FOR CONGRESSIONAL CONSIDERATION

- o CONSIDERATION 1: The GAO suggested that Congress may wish to consider allowing the legislation to expire in 1992, since the evidence does not support the contention that reimbursement of foreign selling costs stimulates exports and ensures future cost savings to the Government.
(p. 28/GAO Draft Report)

DOD POSITION: Nonconcur. The DoD disagrees because the GAO analysis was performed too early in the 3-year trial period to make an accurate assessment of the new legislation's impact on defense industry exports and the amount of savings realized. Accordingly, it is the Department's position that a valid basis has not been established to suggest that Congress should consider allowing the legislation to expire in 1992. Instead, the DoD suggests that an additional 3 years will be needed if the Congress desires to provide ample time for an accurate assessment of the legislation's impact.

See comment 6.

GAO Comments

The following are GAO's comments on the Department of Defense's letter dated January 4, 1991.

1. The industry responses to our questionnaire clearly indicated that the new cost principle was not a strong incentive to increase foreign sales activities. Without some evidence that in the future foreign and domestic selling expense relationships will change significantly as a result of the new cost principle, we do not believe it is too early to draw conclusions on this matter.

To acquire the empirical data that would resolve DOD's concerns would require contractors to establish duplicate accounting systems. This would be expensive, and we think that policymakers should be able to reasonably address the prospective impact of policy changes without causing the industry to expend such resources. Our prospective analysis was based to some extent on assumptions that were validated or corroborated by industry responses to our questionnaire.

2. Although the data base used in the 1985 CBO study is now out of date, DOD has not recognized that CBO reiterated its position in 1988 based on further study for its cost estimate. While our methodology for cost estimates was different from the one used by CBO (for example, CBO considered the effect of product mix in its report, while our methodology did not), we both came to the same conclusion that reimbursing foreign selling costs would not result in cost savings to the government.

3. Foreign selling costs are legitimate, necessary export business expenses and should be recovered; however, we believe they should be recovered against the export business. We have revised the report to further emphasize that while foreign selling costs should be unallowable on U.S. government contracts, the regulations should make it clear that foreign selling costs are allowable and thus recoverable on foreign sales contracts.

4. DOD's comment does not consider the reimbursement of contractors' foreign selling costs to be a subsidy, even when foreign selling costs are disproportionately higher than domestic selling costs. DOD's comment emphasizes the benefit to U.S. defense contracts from foreign export sales but ignores the far larger benefit foreign customers receive from U.S. defense sales. If foreign and domestic selling costs relationship were reversed, that is, domestic selling costs were disproportionately higher than foreign selling costs, we believe it is unlikely that DOD would expect

foreign customers to subsidize DOD contracts because domestic sales benefited the larger foreign sales base.

5. We found no evidence to support the contention that large contractors find it impractical to establish separate pools for foreign and domestic selling costs for allocation over separate foreign and domestic sales bases. In fact, 10 of the 12 business entities (large contractors) we reviewed had made such an accounting change to accommodate the reimbursement policy. Regarding small contractors with no foreign sales, we agree that until they achieve some foreign sales, the policy we have recommended would cause minor problems. These problems, however, are inherent to any company when it enters a new business arena. At the urging of AIA, we sent questionnaires to 55 additional companies, some of which could be classified as small contractors. Not one indicated that having foreign selling costs allowable on government contracts would prompt them to make greater attempts to sell to foreign customers.

In addition, information published with the final DFARS cost principle in the Federal Register indicates that the rule would not have significant economic impact on a substantial number of small businesses because most contracts awarded to small businesses are competitive fixed-price and the cost principles do not apply to these contracts.

6. DOD provides no evidence to suggest that the disproportionate relationship of foreign and domestic selling cost will change in the near future as a result of this legislation. In the absence of such evidence we continue to believe that the legislation should not be extended or made permanent.

Summary of Industry Comments and GAO Evaluation

We obtained comments on a draft of this report from the Aerospace Industries Association of America, Inc. (AIA) and contractors representing 9 of the 12 business entities whose overhead claims we analyzed during our review. This appendix summarizes the respondents' comments and outlines our position on the points raised.

General Benefits Theory

Respondents stated that benefits to the government from foreign sales justified government reimbursement of foreign selling costs.

Respondents, however, did not acknowledge that foreign customers benefit from sales of defense products to DOD. Further, the benefits and savings resulting from foreign sales existed during the period when foreign selling costs were unallowable for reimbursement on government contracts. We found no evidence that the legislation would provide incremental benefits over and above those benefits that existed when foreign selling costs were unallowable for government reimbursement. In fact, all of the respondents to our questionnaire indicated that making the costs allowable against government contracts would not be a significant incentive to increase foreign selling activity. Accordingly, the general benefits theory embraced is not persuasive as a basis for reimbursing foreign selling costs on U.S. government contracts.

Inequitable for Government Not to Reimburse Foreign Selling Costs

Respondents said that it was unfair and inequitable for the government to accept the benefits of the foreign business but refuse reimbursement of foreign selling costs, which were a necessary cost of doing business and should be allowable.

We agree that selling costs are a necessary cost of doing business. We believe that foreign selling costs should be unallowable on U.S. government contracts, but that they should be allowable against foreign sales. To emphasize this point, we have revised our report to include a recommendation to DOD that if the law expires, the implementing regulation should make it clear that foreign selling costs are allowable against foreign business.

Cost Allocation Principles

Two respondents expressed concern that our recommendation, if followed by Congress, could lead to severe fragmenting of overhead pools that would eventually be a detriment to the U.S. government. They believe that separate pooling of costs could shift additional cost to the government, which currently benefits from a broad cost allocation base.

All seven of the cost accounting experts we interviewed agreed that cost accounting principles and practices do not prohibit contractors from setting up separate pools for selling costs when circumstances warrant. We found that 10 of the 12 business entities in our review did set up separate pools, when foreign selling costs were made unallowable on U.S. government contracts, so that the foreign selling costs could be recovered on foreign sales contracts. Our review showed that for the 12 entities where we reviewed overhead claims, the ratio of foreign selling costs to foreign sales was generally significantly higher than the ratio of domestic selling costs to domestic sales, and that reimbursing those foreign selling costs on U.S. government contracts would have increased costs allocated to the government.

GAO Study Undertaken Prematurely

Several respondents expressed concern that our study was premature and that our conclusions were invalid because they were based on an extrapolation of overhead claims from 1986-88.

The 1986-88 data were the most recent available at the time of our fieldwork. We have no reason to believe that future overhead claims will differ from claims submitted before the new legislation. Our questionnaire results indicated that making foreign selling costs reimbursable on U.S. contracts would not influence foreign marketing decisions and that the new cost principle was not a strong incentive to increase foreign selling activities. Accordingly, we have no reason to believe that in the future foreign and domestic selling expense relationships will change as a result of the new cost principle. Therefore, we believe that the data were valid in the overhead submissions that we reviewed.

Policy Change Would Hurt Small Contractors

AIA made the comment that “the allowability of its foreign military selling costs may be one of the most relevant decision factors for the smaller company with no existing foreign military business base against which to recover its foreign military selling costs.”

None of the questionnaire responses that we received from small contractors indicated that the allowability of foreign selling costs was particularly important in foreign marketing decisions. In addition, information published with the cost principle in the Federal Register indicates that the cost principle would not have a significant economic impact on a significant number of small businesses because most contracts awarded small businesses are competitive fixed-price and the cost principles do not apply to these contracts.

Recent Government Policy Hurts Contractors Cash Flow

One respondent stated that “over the past several years, the U.S. government has denied contractors the opportunity to recover more and more of their normal and reasonable costs of doing business.”

Although we did not address this issue in our study, we did publish a report in May 1989 entitled Effect of Changes in Procurement and Tax Policy on the Defense Industry, (GAO/NSIAD-89-121) on this issue. However, the respondent implied that our recommendation would make the foreign selling costs unallowable. To the contrary, the costs of doing business abroad would be recovered against the foreign sales, under our recommended course of action. Making foreign selling cost unallowable for U.S. government reimbursement will not effect cash flow because such costs would be recoverable on foreign customer contracts.

Recent Government Policy Hurts U.S. Companies’ Competitive Edge

One respondent expressed concern that if foreign selling costs are not allowable for U.S. government reimbursement, recovery on foreign customer contracts will adversely effect the company’s ability to compete in foreign markets.

We believe that making the costs allowable against U.S. government contracts was, in effect, a subsidy to contractors with foreign sales. We believe that if the government wants to subsidize contractors for making foreign sales, there are more direct and effective ways to do so.

Reimbursement Ceiling Is Not an Incentive

One respondent said that the 110-percent ceiling on foreign selling cost reimbursement acted as a disincentive to promote defense industry exports.

Our questionnaire results indicated the 110-percent ceiling specified in the law would not have a significant impact on foreign marketing decisions.

Macro Benefits to U.S. Government From Foreign Sales Should Be Considered

Two respondents believed that our report focuses too much on the narrow issue of reimbursing foreign selling expenses. A concern was expressed that U.S. defense industrial base policy should recognize the importance of foreign sales by focusing more on their contribution to preserving future costs savings on U.S. weapons programs rather than on the ability to expand future cost savings. One raised the issue of “whether the U.S. government will have the foresight to develop an

overall defense industrial base policy that sets an integrated, quantitative framework for evaluating and controlling the effects that various U.S. government financing and investment policy decisions have on the composition and financial health of the defense industry.” This respondent said that such a plan is eminently crucial.

The Congress, for the last 3 years, has been seeking such a plan from DOD, so far with little success. The National Defense Authorization Act, Fiscal Year 1989, required the Secretary of Defense to prepare an integrated contract financing, return on investment, and risk-sharing plan. This plan was to ensure that DOD policies are structured to meet the long-term defense industrial base needs for industrial resources and technology innovation.

As we have indicated in prior reports,¹ we believe the DOD plan should include a requirement for a reporting system that would provide a more real-time barometer of the financial health of the defense industry.

¹A Proposal for a Program to Study the Profitability of Government Contractors (GAO/NSIAD-87-175, Sept. 1987), The Effect of Changes in Procurement and Tax Policy on the Defense Industry (GAO/NSIAD-89-121, May 1989), and Financial Measures for Evaluating Contractors Profitability, (GAO/NSIAD-90-200BR, Sept. 1990).

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