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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

SEPTEMBER 6, 1984

RELEASED

B-214394

The Honorable Dante B. Fascell
Chairman, Committee on
Foreign Affairs
House of Representatives

Dear Mr. Chairman:

Subject: Requirement that U.S. Companies Recover U.S. Government Research and Development Costs from Foreign Customers (GAO/NSIAD-84-156)

This letter replies to the late Chairman Zablocki's request dated June 23, 1983, concerning implementation of U.S. law by the Department of Defense (DOD) regarding the recoupment by contractors of certain U.S. government research and development costs from foreign customers. Specifically, he asked if DOD's requirement for recoupment on commercial sales correctly implements U.S. law and asked us to determine

--DOD practice,

--whether DOD is correctly implementing U.S. law, and

--whether the Committee should consider legislation or other action.

The request originated from concern expressed by a U.S. company about the appropriateness of recouping these costs on commercial sales. The contractor argued the law only required the recoupment of nonrecurring costs on government foreign military sales of major defense equipment, i.e., defense equipment which costs more than $50 million to develop and more than $200 million to produce. The contractor also stated that the payment of these charges to the government places the contractor in a losing situation in the highly competitive arms market. In some cases, the contractor believed that the competition was coming from U.S. government sales which did not require a recoupment charge.

As part of our work, we reviewed the Arms Export Control Act (the act) of 1976 and related legislation, the Federal Acquisition Regulation, DOD directives, and other applicable reports and documents.

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The act states that letters of offer for the government-to-government sale of defense articles or services shall include appropriate charges for "a proportionate amount of any nonrecurring costs of research, development, and production of major defense equipment."

The act contains no requirement to recover a pro rata share of nonrecurring costs on commercial sales by defense contractors. To our knowledge, no statute directs DOD to recover nonrecurring costs from defense contractors on commercial sales. At the same time, we are not aware of any statute which prohibits DOD from recovering these costs from contractors on commercial sales.

The DOD supplement to the Federal Acquisition Regulation (part 25.7306) states that it is Department policy to seek reimbursement from both domestic and foreign customers if nonrecurring research, development, and test and evaluation (RDT&E) costs or nonrecurring production costs exceed $5 million.

Recovery of nonrecurring RDT&E and production costs dates back to 1967. DOD Directive 2140.2 required that these costs be recouped for major defense equipment sold through foreign military sales (FMS), i.e., government-to-government sales, or sold directly to a foreign buyer by a U.S. company, i.e., commercial sales. Major defense equipment was defined then as defense equipment or systems having a total cumulative DOD RDT&E investment in excess of $25 million, or for which a total production investment to exceed $100 million was estimated.

In 1974, DOD revised this directive to include cost recoupment of nonrecurring production costs for non-major defense equipment from both commercial and government sales. Non-major defense equipment was defined as defense equipment or a weapon system, other than major defense equipment, with an estimated production cost of $5 million or more but less than $200 million.

Thus, prior to the enactment of the act, directives required the recovery of nonrecurring RDT&E and production costs on both commercial and government sales of major defense equipment, and recovery of nonrecurring production costs on non-major defense equipment. Legislative predecessors of the act did not address specifically recoupment of these nonrecurring costs, but did call for full cost recovery, except for authorized waivers or reductions, on all foreign military sales.

Both DOD Directive 2140.2 and the Defense Acquisition Regulation were amended again--in 1977 and 1979, respectively--to expand the nonrecurring cost recoupment policy. This expansion was based on the August 1974 Council on International Economic

Policy decision memorandum which was approved by the President.[1] It required that costs be recouped if $5 million or more was invested in nonrecurring RDT&E costs on products and technology, or $5 million or more was invested in nonrecurring production costs on products, for both commercial and government sales.

Later in 1979, DOD revised the Defense Acquisition Regulation to require that all RDT&E and production contracts and subcontracts of $1 million or more include a clause that requires the contractor to reimburse the U.S. government the pro rata nonrecurring costs on applicable commercial sales.

The contractor, who made the allegation to which this report responds, claimed that equipment sold under FMS does not have the recoupment charge included. However, while DOD does not separately identify a pro rata charge for nonrecurring costs in the FMS letter of offer and acceptance, it does include in the total item price to the country a pro rata charge for the recovery of such costs. DOD advises countries of the established pro rata charge, if requested. In a commercial sale, the contractor is responsible for paying the applicable pro rata charge to DOD and determines on his own whether or not to separately identify the pro rata charge to the customer.

In both commercial and FMS sales, waivers may be granted to NATO-member countries and Japan, Australia, and New Zealand. These waivers may be considered if they would significantly advance U.S. interest in standardization with the armed forces of those countries, or foreign procurements in the United States under a coproduction arrangement. According to DOD officials, waivers must be requested before sales agreements are concluded, are not automatically granted, and are considered on a case-by-case basis after regarding the total benefits to the United States.

CONCLUSION

Although not legislatively mandated, we believe it is appropriate for DOD to require contractors to pay the U.S. government a pro rata share of U.S. government RDT&E and production investment costs when commercial sales are made by defense contractors. Further, unless the regulations governing recoupment of these costs are amended by proper authority or determined to be invalid by the judiciary, the regulations must be followed by

[1]The Council existed from January 1971 to September 1977. It was created by Presidential Memorandum and authorized by Congress in Public Law 92-412. The Council was created to fulfill the urgent need for better coordination between the agencies formulating and implementing foreign economic policy. The President chaired the Council; other members included key cabinet-level and executive office officials.

defense contractors. Our reports have supported full cost recovery, to the extent required, on foreign sales of military articles and services when it was cost effective. (See enclosure I for a list of GAO reports issued in recent years on FMS cost recovery.)

We are continuing our work on recovery of nonrecurring costs by commercial firms, including items licensed by both the Department of State's Office of Munitions Control and the Department of Commerce's Office of Export Administration. We want to determine whether DOD is recovering all costs that it should on items exported under both agencies' licenses. We will consider whether specific legislation is needed to strengthen the U.S. government's ability to recover a fair share of nonrecurring costs associated with development and procurement of defense articles and services sold under commercial sales arrangements.

In a letter dated August 14, 1984, the Director of the Defense Security Assistance Agency stated that legislation is not needed to enforce the recoupment of nonrecurring RDT&E and production costs. The Department stated that the policy already is firmly established to treat commerical sales and government-to-government sales under the same guidelines. DOD's comments are contained in enclosure II of this report.

As arranged with Committee staff, unless you publicly announce its contents earlier, we plan no further distribution of this letter until 14 days after its issuance to you. At that time, we will send copies to the Chairmen, Senate Committee on Foreign Relations; House and Senate Committees on Appropriations; House Committee on Government Operations; and Senate Committee on Governmental Affairs; the Director, Office of Management and Budget; the Secretaries of State, Defense, and Commerce; and other interested parties.

Sincerely yours,

Frank C. Conahan
Director

Enclosures - 2

GAO REPORTS THAT HAVE INCLUDED RECOMMENDATIONS FOR DOD TO IMPROVE COST RECOVERY ON FOREIGN SALES

The Department of Defense Continues to Improperly Subsidize Foreign Military Sales, FGMSD-78-51, August 25, 1978

Cost Waivers Under the Foreign Military Sales Program: More Attention and Control Needed, FGMSD-78-48, September 26, 1978

Improperly Subsidizing the Foreign Military Sales Program--A Continuing Problem, FGMSD-79-16, March 22, 1979

The Defense Department Continues to Subsidize the Foreign Military Sales Program By Not Charging for Normal Inventory Losses, FGMSD-79-31, May 15, 1979

Efforts to Charge for Using Government-Owned Assets for Foreign Military Sales: Marked Improvement But Additional Action Needed, FGMSD-79-36, June 1, 1979

Millions in Losses Continue on Defense Stock Fund Sales to Foreign Customers, AFMD-81-62, September 10, 1981

Improvements Still Needed in Recouping Administrative Costs of Foreign Military Sales, AFMD-82-10, February 2, 1982

Air Force Does Not Recover All Required Costs of Modification Kits Sold to Foreign Governments, GAO/PLRD-82-11, August 27, 1982

DEFENSE SECURITY ASSISTANCE AGENCY

WASHINGTON, D.C. 20301 - 2800

14 AUG 1984

In reply refer to:
I-11738/84

Mr. Frank C. Conahan
Director
National Security and
International Affairs Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

This is in response to your letter to Secretary Weinberger of June 28, 1984, regarding General Accounting Office (GAO) draft report, "Requirement that U.S. Companies Recover U.S. Government Research and Development Costs from Foreign Countries," dated June 28, 1984, GAO Code No. 463718.

In general, the Department of Defense agrees with the draft letter to Congressman Fascell. We agree with your conclusion that it is appropriate for contractors to pay a pro rata share of DOD nonrecurring RDT&E and production costs, when applicable, when commercial sales are made. In our view the requirement to recover a pro rata share of such DOD costs should be the same for all sales regardless of the channel used for the sale.

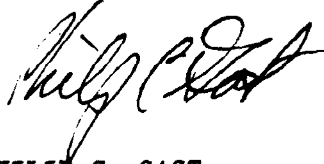
DOD does not recommend legislation as the best route to achieve the needed enforcement of the collection of these charges for direct commercial sales. The policy already is firmly established to treat commercial sales and government-to-government sales under the same guidelines. In our view, GAO's endorsement of that policy in this report, followed by Department of State, Office of Munitions Control and DoD action to strengthen recoupment procedures would be sufficient. Accordingly, we recommend against proposing new legislation and that the DoD position be included in this report.

In addition to the above, recommend the annotated changes included in the attached copy of the draft report. These changes are primarily editorial and are intended to assure the accuracy of the report, especially regarding the current DOD policy and procedures.

ENCLOSURE II

For your information we have also included a copy of Secretary Weinberger's response to Congressman Zablocki's 23 June, 1983 inquiry on this matter.

Sincerely,



PHILIP C. GAST
LIEUTENANT GENERAL, USAF
DIRECTOR

Attachments
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ENCLOSURE II

FINDINGS

FINDING A: Applicable Statutes Do Not Require Or Prohibit DoD Recoupment of Nonrecurring Costs In Commercial Sales. GAO found that the governing statute, the Arms Export Control Act, does not mandate that DoD recover nonconcurring costs from Defense contractors on their commercial sales, but neither does it preclude DoD from doing so. GAO concluded that there is no statute that either directs or precludes a policy of requiring recovery of such costs. (pp.1-2, GAO Draft Report)

DOD Position: Concur

FINDING B: DoD Requires Recoupment of Nonconcurring RDT&E And Production Costs In Commercial And Governmental Sales. GAO found that current DoD policy is to seek reimbursement from both domestic and foreign customers of nonrecurring RDT&E or production costs in excess of $5 million. GAO concluded that, although not required by statute, it is appropriate for DoD to require defense contractors to pay a pro rata share of nonrecurring RDT&E and production costs incurred by the U.S. Governemnt when the contractors make commercial sales. (pp.2-3, GAO Draft Report)

DOD Position: Concur

FINDING C: Defense Acquisition Regulations Require Contract Clause Providing For Sharing of Nonrecurring Costs. GAO found that, in the case of FMS sales, while DoD does not separately identify a pro rata charge for recovery of nonrecurring costs, it does factor such a charge into the FMS sale price. GAO also found that in a commercial sale, the contractor specifically identifies the pro rata charge in the offering price. (p. 3, GAO Draft Report)

DOD Position: Partially concur. Recommend the revisions to page 3 of the report to clarify the following points:

(1) DOD includes the established pro rata nonrecurring cost recoupment charge in the item price offered on the FMS Letter of Offer and Acceptance. If requested, the DOD will advise the country of the established charges.

(2) In a direct commercial sale, the contractor is responsible for paying the applicable pro rata charge to the USG and determines on his own whether or not to separately identify the pro rata charge to the customer.

(3) The waiver of a charge for nonrecurring costs for NATO, NATO member countries, Japan, Australia, or New Zealand may be considered if they would significantly advance U.S. interest in standardization with the Armed Forces of those countries. Waiver or reductions are not automatic and are considered on a case-by-case basis after consideration of the total benefits to the U.S.