BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

The Department Of Defense's Continued Failure To Charge For Using Government-Owned Plant And Equipment For Foreign Military Sales Costs Millions

Although Government-owned plant and equipment are used to produce items sold to other countries, these countries generally have not been charged for their use. As a result, foreign governments have been subsidized by as much as $107 million for those sales reviewed by GAO.

Although several reports have been issued by GAO and the military service audit agencies regarding this matter, effective action has not been taken.

A special effort should be made by Defense to improve its systems for charging foreign countries for the use of Government-owned plant and equipment for foreign military sales.

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

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To the President of the Senate and the
Speaker of the House of Representatives

This report describes the Department of Defense's continued failure to charge for using Government-owned plant and equipment for foreign military sales. As a result, foreign governments have been subsidized by millions of dollars, which is contrary to the intent of the Congress.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretaries of the Army, Navy, and Air Force.

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

THE DEPARTMENT OF DEFENSE'S CONTINUED FAILURE TO CHARGE FOR USING GOVERNMENT-OWNED PLANT AND EQUIPMENT FOR FOREIGN MILITARY SALES COSTS MILLIONS

D I G E S T

Despite numerous reports by GAO and military service audit agencies, the Department of Defense generally has not charged foreign governments for the use of U.S. plant and equipment for foreign military sales. As a result, the United States has lost as much as $107 million on just those foreign military sales GAO reviewed. GAO has brought this problem to the Secretary of Defense's attention on four occasions since 1970. While some progress has been made, notably by the Army, special efforts are needed to correct the problem.

To comply with requirements of the Arms Export Control Act, Defense must take positive action to find out if its policies are understood and effectively carried out. The act, formerly called the Foreign Military Sales Act, provides that the U.S. Government be reimbursed for use of its plant and equipment to produce items sold to other governments.

Before passage of the Arms Export Control Act, the Foreign Military Sales Act provided that sales of items to other governments be at "not less than the actual value thereof." To accomplish this, sales prices should have included all indirect costs, such as the cost of using Government-owned assets (commonly referred to as depreciation), as well as all direct costs.

GAO found that:

--Although Defense has required that other governments be charged for the use of

Government-owned equipment (i.e. machine tools) in Government-owned, contractor-operated plants since November 1973, and specified in its guidance the application of an asset-use charge since June 1975, it has not made sure that these requirements are being implemented. This lack of Defense management attention over execution of its pricing policies has contributed to the problem. (See pp. 14 to 16.)

--The Air Force and the Navy ignored Defense policies on these matters and did not try to resolve uncertainties about how the asset-use charge should be applied. Naval Air Systems Command officials did not attempt to have Defense policy clarified although they were unsure how to implement it. About $36 million in charges for using Government-owned assets have not been recovered by this command on sales of four weapons systems alone. (See pp. 7 to 12.)

--The Air Force and the Navy took no action on reports by their service audit agencies dealing with failure to charge for using Government-owned assets for foreign military sales. Even though the Naval Audit Service reported in June 1976 that about $2.6 million had not been included in charges on four sales cases, no attempt was made to recover this amount nor were there plans to do so.

--While the Army took the necessary action to charge other governments for the use of Government-owned assets, one of its commands had not recovered about $1 million on three sales cases. (See p. 13.)

--Defense did not formulate a policy until June 1975 for recovering the cost of using Government-owned assets in contractor facilities. Because of this inaction the services did not recover over $30 million in three instances involving Government-owned assets located in contractors' facilities. (See pp. 18 and 19.)

The failure to charge other governments for the use of Government-owned plant and equipment is an example of the overall problem Defense has experienced in determining whether its pricing policies were effectively carried out. Appendix II summarizes the many reports issued by GAO in the past few years on defective pricing and cost recovery problems.

The Secretary of Defense should:

--Form a task force, consisting of representatives from Defense and the military services, to evaluate whether responsible commands are computing foreign military sales asset-use charges completely and accurately. Where necessary, the task force should assist the commands in applying and collecting asset-use charges. Further, the team should report to the Secretary whether corrective action is taken on the recommendations in this report.

--Require that in the future, Defense officials make sure that new or revised foreign military sales pricing policies are understood by the services and are properly implemented.

--Make every reasonable effort to recover from other governments undercharges which resulted from omitting charges for the use of Government assets since November 1973 including amounts (1) identified by GAO and the military services' audit agencies and (2) related to the use of assets in contractor-owned, contractor-operated facilities and Government-owned, contractor-operated facilities.

AGENCY COMMENTS

The Department of Defense agreed that substantial effort is needed to keep Defense personnel well informed on pricing policies. A Defense official said that a series of

training seminars is now being planned. (See app. III.)

In general, Defense does not plan to bill foreign governments amounts that should have been charged for the use of Government-owned assets.

Contents

CHAPTER 1

INTRODUCTION

During fiscal year 1977, foreign military sales totaled $11.2 billion; these are sales of military articles and services by the U.S. Government to friendly foreign governments and international organizations. As of September 30, 1977, unfilled orders were valued at about $39 billion.

Sales to foreign countries are authorized by the Arms Export Control Act, formerly called the Foreign Military Sales Act. Items sold through the foreign military sales program range from ammunition and spare parts to weapons systems, such as aircraft, missiles, and tanks.

In making, modifying, or repairing items sold to foreign governments, the military services and private contractors use Government assets (that is, plant and production equipment) in facilities throughout the country. Although the cost of wear and tear of assets--depreciation--does not require current expenditures of funds, it is a real cost of the foreign sales program. Facilities having Government assets are classified as follows.

--Government-owned, contractor-operated: These facilities are owned by the U.S. Government but operated by a contractor who uses Government-owned plant and production equipment.

--Government-owned, Government-operated: These facilities, including the plant and production equipment, are owned and operated solely by the U.S Government.

--Contractor-owned, contractor-operated: These facilities are both owned and operated by a contractor who uses Government-owned production equipment.

The cost of Government plant and equipment is approximately $12 billion. Appendix I lists the Government-owned facilities discussed in this report. The scope of our review is discussed in chapter 7.

CHAPTER 2

DEFENSE'S EFFORTS TO CHARGE FOR USING GOVERNMENT-OWNED ASSETS ON FOREIGN MILITARY SALES HAVE LARGELY FAILED

The Defense Department and the military services have not given sufficient attention to recovering the cost of items sold under the foreign military sales program. As a result foreign governments, in general, were not being charged for the use of Government-owned assets to produce items for sale to them under the foreign military sales program. Failure to charge foreign governments has cost the United States as much as $107 million for just those foreign military sales cases we reviewed.

OUR CONCERN FOR RECOVERING THE COST OF USING GOVERNMENT-OWNED ASSETS IN FOREIGN MILITARY SALES

Since 1970, we have been advising the Secretary of Defense that foreign military sales prices have not always included a charge for using Government-owned assets. Defense's actions on our findings have been gradual, as shown below.

Our effort	Defense action
Early 1970--We advised Defense that the military services were not recovering costs of using Government assets to produce items sold to foreign governments.	June 1970--Defense reminded the military services that its instructions required recovering depreciation costs for Government-owned assets at Government-owned and operated facilities. April 1971--Defense agreed to look into the legal and accounting aspects of charging foreign countries for the use of Government-owned assets in Government-owned, contractor-operated facilities and in contractor-owned, contractor-operated facilities.

Our effort	Defense action
September 1972--We issued a report citing the military services' continued failure to recover charges for using Government-owned assets at Government-owned and operated facilities. The report also noted that foreign sales prices did not include the cost of Government assets used in either Government-owned, contractor-operated or contractor-owned, contractor-operated facilities.	July 1973--Defense Instruction 2140.1, "Pricing of Sales of Defense Articles and Defense Services to Foreign Governments and International Organizations," was revised, effective November 17, 1973, to require that sales prices include the cost of using Government-owned, contractor-operated facilities.
April 1973--We issued a followup report on the failure of the subordinate commands of the Army Materiel Command (now named the Development and Readiness Command) to charge foreign governments for the use of Government-owned assets at Government-owned and operated facilities.	March 1974--Defense auditors performed a followup review to evaluate actions taken to improve operations. The review confirmed our findings regarding the Army Materiel Command and identified similar problems within the Navy and the Air Force. Defense auditors also concluded that $3.6 million had not been recovered in fiscal years 1973 and 1974.
October 1974--We reported that the Government continued to sustain losses because the military services failed to recover the costs of using assets at Government-owned facilities to produce items sold foreign governments. The report also noted that Defense had not charged foreign governments for a fair share of the cost of Government-owned assets used in contractor-owned and operated facilities.	June 1975--Defense Instruction 2140.1 was further revised to require the application of an asset-use charge (computed at 4 percent of direct costs billed) to recover the costs of using assets at Government-owned facilities. The instruction also required that the cost of using Government assets in contractor-owned and operated plants be recovered.

RESULTS OF OUR CURRENT REVIEW

Of the $107 million in undercharges identified during our current review, as much as $77 million related to using Government-owned assets in Government-owned, contractor-operated facilities. The main reasons for these undercharges follow.

--Air Force and Navy commands ignored headquarters' instructions to implement Defense policies on charging for using Government assets at Government-owned, contractor-operated facilities and/or did not resolve uncertainties as to how foreign governments should be charged.

--The Air Force and the Navy did not act on reports by their service audit agencies regarding the failure to charge foreign governments for the use of Government-owned assets.

--Defense did not insure that its policies regarding charges for using Government-owned assets were being properly implemented.

In contrast to the Navy and the Air Force, the Army took effective action to comply with Defense pricing policies, the intent of the Congress, and recommendations in our previous three reports.

The remaining $30 million of the $107 million in undercharges was not recovered because Defense did not develop a policy on charging for using Government-owned assets in contractor plants until June 1975.

At the locations we visited, the military services had complied with Defense policies on charging for using Government assets at Government facilities.

These matters are discussed in detail in chapters 3 through 5. Chapter 3 discusses charges for using Government-owned assets at Government-owned, contractor-operated facilities. Chapter 4 addresses such charges at contractor-owned and operated plants. Chapter 5 discusses such charges at Government-owned and operated facilities.

AGENCY COMMENTS

In a January 25, 1978, letter commenting on our report (see app. III) the Acting Assistant Secretary of Defense

(Comptroller) said that to a large extent the report restated findings included in one or more of our previous reports. We have been advising Defense about the problem of recovering for using Government assets on foreign military sales since 1970. (See pp. 2 and 3.) This fourth report highlights the continued seriousness of the problem and the need for more effective action by Defense. Although Defense said in April 1971 it would look into legal and accounting aspects of such charges, its efforts to recover these costs have largely failed. In short, there would have been no need for us to issue four reports if Defense had effectively recovered the charges.

Also, in his letter, the Acting Assistant Secretary alleges that the sales cases we selected for review were too old for Defense to take effective corrective action. Of the 54 sales agreements we included in our review, 42 were signed after November 17, 1973, when the military services should have implemented Defense's July 1973 policy to charge for the cost of using Government assets. All of the agreements we reviewed were open cases and, in many cases, the items being sold had not been delivered. When we noted deficiencies in the pricing of the items during our review in 1976 and 1977, responsible Defense and military service officials were immediately notified and requested to take corrective action. Further, only those sales agreements signed after November 17, 1973, are discussed in this report.

CHAPTER 3

FAILURE TO CHARGE FOR USING GOVERNMENT-OWNED ASSETS AT GOVERNMENT-OWNED, CONTRACTOR-OPERATED FACILITIES

For those cases we reviewed, the Air Force and the Navy had not recovered as much as $76 million in costs for using Government-owned assets at Government-owned, contractor-operated facilities for foreign military sales. In contrast, although we identified $1 million in unrecovered costs at one Army command, the Army has generally done a good job of charging Government assets on foreign sales.

COST RECOVERY REQUIREMENTS

The International Security Assistance and Arms Export Control Act of 1976 (Public Law 94-329, June 30, 1976) requires that foreign governments be charged for the cost of using Government-owned plant and equipment to produce items sold under the foreign military sales program. The legislative history of the act indicates that the Congress intended that direct as well as indirect costs be recovered so that the foreign military sales program would not be subsidized by Defense appropriations.

Before passage of the Arms Export Control Act, the Foreign Military Sales Act of 1968 (22 U.S.C. 2761) provided that the sale of Defense items to foreign countries be at "not less than the actual value thereof." To accomplish this, Defense should have included all direct and indirect costs in sales prices, such as the cost of using Government-owned plant and equipment to produce items for sale.

In July 1973, Defense Instruction 2140.1, which covers pricing policy for foreign military sales, was amended, effective November 17, 1973, to require that foreign governments be charged for the use of Government-owned assets at Government-owned, contractor-operated facilities producing goods or rendering services for foreign military sales.

In June 1975 the instruction was further modified to facilitate recovering these costs through application of a 4-percent asset-use charge. The charge was to be applied as a percentage of direct costs incurred on foreign sales agreements requiring the use of Government-owned assets in other than contractor facilities. The instruction provided

that rental rates were to be charged for using Government-owned assets in contractor plants, as set forth in the Armed Services Procurement Regulation.

In implementing the Arms Export Control and the Foreign Military Sales acts, Defense included the following provisions in the standard sales contract:

--Prices of items shall be at their total cost to the U.S. Government.

--The Government will attempt to notify the foreign government of price increases affecting the total estimated contract price by more than 10 percent; but failure to do so will not alter the foreign government's obligation to reimburse the Government for the total cost incurred.

--The foreign government agrees to reimburse the Government if the final cost exceeds the amount estimated in the sales agreement.

THE NAVY HAS NOT CHARGED FOR USING GOVERNMENT-OWNED ASSETS ON FOREIGN MILITARY SALES

The Navy did not charge foreign governments at least $37 million for those sales cases we reviewed because its (1) commands responsible for pricing foreign sales ignored Defense policies on charging for using Government assets at Government-owned, contractor-operated facilities and were uncertain as to how these charges should have been assessed and (2) headquarters did not insure that commands were including appropriate charges in sales prices.

The Naval Air Systems Command failed to implement Defense pricing policies

The Naval Air Systems Command generally did not charge foreign governments for using Government-owned assets to produce items for sale to foreign governments. This failure resulted in not recovering $36 million for those cases we reviewed.

The Air Systems Command, which is subordinate to Naval Material Command, is responsible for pricing sales of Navy aircraft, missiles, engines, and related aeronautical material. The Air Systems Command issued instructions to those responsible for pricing requiring the inclusion of an asset-use charge on sales to foreign governments, but the instructions did not provide specific guidance as to how

this charge should be computed. We were told that specific guidance was not issued because the Air Systems Command did not understand the Defense Instruction 2140.1 requirement that asset-use charges be applied based on direct costs. The Air Systems Command, however, did not try to resolve its questions concerning the requirement. Instead, it generally ignored Defense policies on charging for using Government assets on foreign sales.

Seven months after Defense Instruction 2140.1 was revised to require including the 4-percent asset-use charge, in January 1976 the Material Command asked its subordinate commands, including the Air Systems Command, to confirm their inclusion of asset-use charges in foreign military sales prices as required by the instruction. The Air Systems Command answered that it was including guidance on applying the asset-use charge in instructions soon to be issued. The Air Systems Command did not ask the Material Command for guidance on computing the asset-use charge nor indicate in any way that it was unsure how to compute the charge. Twelve months later the Material Command had still not issued guidance on the application of the asset-use charge; instead it was drafting a paper outlining several alternatives for computing the charge. Also, the Material Command had not insured that the Air Systems Command was charging for using Government assets.

Charges for using Government-owned assets were not included in prices for four of five Navy weapons systems sales cases we reviewed. For the one system for which a charge was included, foreign governments were charged about $2 million. For the following four systems, for which charges were omitted, the Government did not recover $36 million.

Weapons system	Charge for using Government assets omitted
	(000 omitted)
PHOENIX missile	$ 4,770
HARPOON missile	7,564
F-14 aircraft	18,363
A-7 aircraft	5,280
Total	$35,977

The Naval Sea Systems Command failed to implement Defense pricing policies

The Naval Sea Systems Command also did not charge foreign governments for using Government-owned assets to produce items for sale to foreign governments. Because it did not charge the governments, over $1 million was not recovered for those cases we reviewed.

The Sea Systems Command is responsible for pricing sales of Navy ships and related equipment and, like the Air Systems Command, is subordinate to the Material Command. In responding to the Material Command's January 1976 inquiry on including the asset-use charge in foreign military sales prices, the Sea Systems Command replied on May 11, 1976, that an asset-use charge was being included in sales prices where required. After being told this, the Material Command made no further followup.

The Sea Systems Command, however, was not including the charge in its pricing of items for foreign sales. Sea Systems Command officials told us that they were not required to recover this cost at the time of the sales. They said that Defense Instruction 2140.1, which requires charging for using Government-owned assets in Government-owned, contractor-operated facilities, conflicted with Paragraph 13-406 of the Armed Services Procurement Regulation effective March 19, 1971. The officials said that Paragraph 13-406 was the controlling regulation and precluded the Navy from charging foreign governments for the use of Government-owned assets at Government-owned, contractor-operated facilities.

By its terms Paragraph 13-406 (see app. IV) applied only to those cases where a foreign government was purchasing items directly from a private contractor under commercial sales agreements and not to those sales contracts entered into between a foreign government and Defense. Consequently, those sales in which the contract was between the foreign government and Defense (such as the contracts we reviewed at Sea Systems Command) fell under the provisions of Defense Instruction 2140.1 which required that foreign governments be charged for the use of Government-owned assets at Government-owned, contractor-operated facilities. Although Sea Systems Command officials said that Paragraph 13-406 precluded them from charging for using these assets, we found that the Sea Systems Command knew that the provisions of the paragraph did not apply to contracts between foreign governments and Defense.

In the Sea System Command's May 11, 1976, letter to the Material Command it states:

> "In recovery of 'asset use charge' it is noted that ASPR 13-406 permits rent free use of GOCO (Government-owned contractor-operated) facilities for direct to country sales. However, DODI 2140.1 demands 'asset use charge' for FMS government to government * * *." (Underscoring supplied.)

To determine the effect of the Sea Systems Command's failure to charge for using Government-owned assets, we reviewed the pricing of sales of the STANDARD and DEFENSE missile systems and missile frigates. Over $1 million in charges for using Government-owned assets were omitted from foreign sales prices as follows.

Weapons system	Charge for using Government assets omitted
	(000 omitted)
STANDARD missile	$ 277
DEFENSE missile	123
Missile frigates	641
Total	$1,041

THE AIR FORCE HAS NOT CHARGED FOR USING GOVERNMENT-OWNED ASSETS ON FOREIGN MILITARY SALES

The Air Force failed to charge at least $2.8 million for using Government-owned assets because the Air Force Systems Command and the Air Force Logistics Command did not implement pricing policies as required by Defense and Air Force headquarters.

The Air Force Systems Command failed to implement Defense pricing policies

On July 14, 1975, Air Force headquarters directed its commands to comply with the provisions of Defense Instruction 2140.1. As noted above, the instruction requires the application of a 4-percent asset-use charge to direct costs on foreign sales requiring the use of Government-owned assets. On July 17, 1975, the Air Force Systems Command told its subordinate organizations (including the Aeronautical Systems

Division) to implement the instruction as directed by Air Force headquarters.

On September 22, 1975, the Aeronautical Systems Division told the Air Force Systems Command that it was not sure how to compute direct costs on which to apply the 4-percent asset-use charge. We were told that there were difficulties in determining direct costs because oftentimes component parts used by Government-owned, contractor-operated facilities to produce items for sale to foreign governments are furnished from outside activities which may not have use of Government-owned assets. Further, the Division pointed out to the Air Force Systems Command what it thought was an inconsistency between Defense Instruction 2140.1 and Section XIII, Part 4, Paragraph 13-406 of the Armed Services Procurement Regulation on charging for using Government-owned assets on foreign sales. As noted on page 9, Paragraph 13-406 applied only to those cases where the foreign government was purchasing items directly from a private contractor under a commercial sales agreement.

The Air Force Systems Command relayed the Division's concerns to Air Force headquarters officials who responded that the 4-percent asset-use charge should be applied to the total cost incurred at a Government-owned facility. The Air Force Systems Command, however, later told the Division not to include the asset-use charge in foreign sales prices until Air Force headquarters sent further guidance.

On December 15, 1975, Air Force headquarters again told the Air Force Systems Command to include the asset-use charge in foreign sales prices and reiterated the specific provisions of Defense Instruction 2140.1 requiring the recovery of the cost of using Government-owned assets. Air Force headquarters also said that there were plans to delete Paragraph 13-406 regarding rent-free use of Government property on foreign government contracts placed directly with U.S. contractors. The Air Force Systems Command, however, did not rescind its order to delay inclusion of the asset-use charge in foreign sales prices.

We visited two weapon systems offices under the Division to determine the impact of the Air Force Systems Command decision to hold up the charging of asset-use costs. Based on data provided by the MAVERICK and F-5 weapon systems offices, we estimated that sales prices for the two weapons systems did not include $5.4 million in asset-use charges.

At another office which was responsible for F-15 weapons systems, data was not available to estimate the amount of the asset-use charge costs which will not be recovered. The potential losses, however, are considerable because the value of open orders totaled about $390 million.

After we had discussed the matter with Air Force headquarters officials, the Air Force Systems Command finally rescinded its order to delay including the asset-use charge in foreign sales prices in December 1976. Further, Air Force officials said that after our review, the Division amended prices for sales of the MAVERICK and F-5 weapons systems to include $3 million of the above $5.4 million in asset-use charges leaving an unrecovered balance of $2.4 million.

Air Force Logistics Command failed to implement Defense pricing policies

The Air Force Logistics Command is responsible for managing foreign military sales cases involving spare parts, maintenance, and modification work. The Logistics Command accounts for about 70 percent of the number of Air Force sales and 30 percent of the total dollar value of sales. Total sales by the Logistics Command were approximately $1.5 billion in fiscal year 1976. At the time of our review, the Logistics Command said it could not comply with Air Force instructions to include an asset-use charge in the price of items sold. It could not primarily because the accounting system did not identify those items which were produced at Government-owned, contractor-operated facilities.

Because of the accounting system deficiency, we could not readily identify those foreign sales by the Logistics Command for which Government-owned plant and equipment were used. We did contact the Air Force representative at the Government-owned plant producing parts for the C130H aircraft. Foreign sales contracts for parts for the aircraft exceeded $10 million. Applying the 4-percent asset-use charge to the $10 million being billed by the contractor for these parts, we estimated that about $400,000 in asset-use charges should have been recovered for sales of C130H aircraft parts.

ARMY COMMANDS HAVE GENERALLY CHARGED FOR USING GOVERNMENT-OWNED ASSETS

The Army commands included in our review were generally successful in charging foreign governments as required for the use of Government-owned assets.

The Army effectively implemented Defense policy to charge foreign governments for the use of assets at Government-owned, contractor-operated plants. Army regulations provided detailed procedures and examples for pricing foreign sales. Seminars were held to train Army personnel on how to price items for sales to foreign governments. As a result, the Army commands were generally recovering asset-use costs.

We found one exception; for three foreign sales, the Army Missile Materiel Readiness Command did not charge an estimated $1 million for using Government-owned assets. Missile Command officials stated that the three cases, which involved the LANCE and TOW missile systems, were priced before the Missile Command implemented the Army's instruction requiring charges for the use of Government assets. They said that the Army's instruction was revised in February 1974. The three sales cases in question were implemented on February 26, 1974, May 2, 1974, and November 27, 1974, respectively. Further, as discussed previously, Defense Instruction 2140.1, July 17, 1973, was to be implemented by November 17, 1973.

NO ACTION TAKEN ON SERVICE AUDIT AGENCY REPORTS ON THE FAILURE TO RECOVER ASSET-USE CHARGES

Navy and Air Force internal auditors reported that foreign governments were not being charged for the use of Government-owned assets. Although Navy and Air Force officials agreed with the findings, no action had been taken to correct the problems noted, and the costs identified by the auditors had not been recovered.

In June 1976 the Naval Audit Service reported that the Naval Air Systems Command failed to include about $2.6 million in asset-use charges in billings to foreign governments on four sales of the T-2 and OV-10 aircraft. These aircraft were being assembled at a Government-owned facility. The Naval Audit Service recommended that all open foreign military sales cases be reviewed to insure that applicable charges

were included and the Air Systems Command concurred with the recommendation. At the time of our review, however, the Command had reviewed only 6 of the 409 open foreign sales cases and had no plans to review the remainder. For these six cases, it identified an additional $2 million in omitted asset-use charges. Although the six cases were still open, there was no attempt to charge the $2 million nor to recover the $2.6 million identified by the Naval Audit Service.

In July 1976 the Air Force Audit Agency reported that asset-use charges and nonrecurring production costs (for example, research and development costs) were not being recovered by either the Air Force Logistics Command or the Air Force Systems Command. The auditors estimated that the value of unrecovered asset-use charges and nonrecurring production costs were $31.3 million for sales of the F-4 and F-5 aircraft and the Maverick missile system. Their report did not specify what portion of this amount represented charges for using Government-owned assets and we could not readily determine the amount.

Although the Air Force concurred with the auditors' findings, it did not attempt to recover the $31.3 million nor to identify and recover unbilled charges for foreign military sales not reviewed by the auditors.

NEED FOR DEFENSE TO ASSURE THAT PRICING POLICIES ARE EFFECTIVELY IMPLEMENTED

The failure to recover charges from foreign governments for the use of Government facilities is an example of the overall problem Defense has had in pricing during the past few years.

Large-scale pricing and selling items and services to outsiders is relatively new to Defense. Whereas Defense has developed sophisticated techniques over many years for purchasing items and services, it has had only a short time to develop pricing techniques for foreign military sales. Defense has, in large measure, failed to insure that pricing of items and services results in recovering all costs required by law and intended by the Congress. It has failed because of the

--rapid growth of the foreign military sales program,

--complexities involved in pricing items and services,

--general lack of effort on the part of Defense to assure that its policies are properly implemented, and

--priority given to customer satisfaction.

Defense financial management systems were not designed to accommodate the phenomenal growth of the foreign military sales program. Sales for the program grew from less than $1 billion in fiscal year 1970 to an average of over $9 billion a year for fiscal years 1974 through 1977. Because of time pressures, instead of designing and implementing separate systems to identify elements of costs to be included in pricing of items and services, Defense had to add foreign military sales costing requirements onto existing financial systems. In several cases, because of a lack of pertinent cost data, Defense had to adopt a surcharge or rate methodology for recouping various costs. Because of the lack of a cohesive system for pricing, there was a need for an extraordinary effort to insure that Defense-pricing policies were effectively implemented.

Defense did not take action to detemine whether its pricing policies were put into effect. Instead, it erroneously assumed that its pricing policies would be fully understood by the military services and effectively implemented. The lack of followup action by Defense had contributed toward (1) inconsistent pricing practices by the military services and (2) susbstantial losses to the Government because of underpricing. Examples follow.

1. As demonstrated in this report, the Army was following Defense policy by charging for using Government-owned assets while the Air Force and the Navy were not. As a result millions of dollars have not been recovered from foreign governments.

2. Defense had issued standard pricing policy for computing tuition rates for training courses attended by foreign students, as shown in our December 14, 1976, report to the Congress, "Millions of Dollars of Costs Incurred in Training Foreign Military Students Have Not Been Recovered" (FGMSD-76-91). But considerably different methods in computing tuition rates were used by the military services. The Navy's system was designed to recover the full cost of training foreign students. The Army's system provided that foreign tuition rates would include only the estimated additional direct and indirect costs incurred

to train foreign students. The Air Force's system excluded fixed costs for training students and required that only the variable cost of training be charged to foreign students. The Marine Corps provided free training. The report also showed that substantial undercharges resulted from the inadequate pricing systems used by the services.

3. In a September 8, 1977, letter report (FGMSD-77-43), to the Secretary of Defense, we reported that (1) normal inventory losses were not being recovered on sales to foreign governments and (2) in the Air Force alone the amounts not recovered each year were about $30 million. We noted in the report that although Defense issued instructions to the services over 8 years ago to recover normal inventory losses under certain conditions, the military services never implemented the instructions.

Customer satisfaction seems to have been given priority over implementing effective pricing policies. Appendix II summarizes the many reports we have issued on the failure to recover various costs of foreign military sales. While it is important that customers be satisfied with the items and services provided, the Congress has indicated that the program should not be subsidized by Defense appropriations. We believe that implementing effective pricing policies should, therefore, be given top priority management attention by Defense officials. Defense has taken certain steps to strengthen control over the foreign military sales program such as (1) revising its pricing policies in Instruction 2140.1 on March 9, 1977, (2) centralizing accounting, billing, and collecting for foreign military sales, and (3) revising its pricing policies for foreign training. However, much more attention is needed.

AGENCY COMMENTS

In his letter commenting on our report, the Acting Assistant Secretary implies that the Congress' intent regarding many pricing matters was not clearly stated until June 30, 1976, when the Arms Export Control Act became law, and, therefore, Defense was not to blame for delays in improving pricing guidance. As far back as 1968, the Foreign Military Sales Act required that foreign military sales be at "not less than the actual value thereof." On this basis, it was Defense's responsibility to effectively implement the act through issuing and adhering to clear and complete pricing guidance. As discussed in our three previous reports, foreign governments should have been charged for

the use of Government-owned assets to produce items for them. (See pp. 37 and 38.) Further, the House and Senate Appropriations Committees informed Defense that foreign military sales should not be subsidized by Defense appropriations.

CHAPTER 4

FAILURE TO CHARGE FOR USING GOVERNMENT-OWNED ASSETS AT CONTRACTOR PLANTS

At least $30 million was not charged to foreign governments because Defense did not formulate a policy until June 1975 for recovering the cost of using Government assets in contractor-owned plants.

LONG DELAY IN ISSUING A CLEAR POLICY ON CHARGING FOR GOVERNMENT-OWNED ASSETS USED IN CONTRACTOR PLANTS

We pointed out to Defense in 1970 that the cost of the wear and tear of Government-owned assets by contractors in their plants should be recovered. We expressed the opinion at the time that failing to recover costs was contrary to the intent of the Foreign Military Sales Act which required foreign governments to be charged "not less than the actual value thereof" of the item sold.

In 1970 Defense agreed with us that, in principle, a fair share of the cost of Government assets used by contractors to produce items for foreign governments should be recovered. Defense also agreed that the feasibility of recovering costs should be studied. However, it took about 5 years before Defense formulated a policy. This policy, included in Defense Instruction 2140.1, June 17, 1975, provided that foreign governments be charged rental rates for the use of Government-owned assets in contractor plants as set forth in Part 4, Section XIII of the Armed Services Procurement Regulation. Paragraph 13-406 provided that under certain conditions where the foreign government was purchasing items directly from the contractor, Government assets may be used by the contractor without charge. (See p. 9.) Even though the paragraph only covered direct commercial sales, the services followed these provisions for those sales in which the foreign country contracted with Defense.

On July 16, 1976, following passage of the Arms Export Control Act, Paragraph 13-406 was revised to require that a fair share of the cost of Government plant and equipment used on foreign sales should be recovered whether on Government to Government sales or on direct commercial sales. Defense Instruction 2140.1 was also amended to take the above change into account.

IMPACT OF DEFENSE'S DELAY IN ISSUING A CLEAR POLICY

Because Defense took such a long time to issue a clear policy, foreign governments were not charged millions of dollars for the use of Government-owned assets in contractor plants. Examples follow.

--Air Force officials computed rental charges for using Government assets in contractor facilities to produce F-4 aircraft, which cost over $43,000 each. If this charge had been included in the price of 589 F-4 aircraft sold under 12 sales agreements, about $25.3 million would have been recovered.

--Over 4 years approximately $2.9 million was not charged to foreign governments because the Army allowed a contractor free use of Government-owned assets to produce armored personnel carriers for foreign sales.

--A November 1975 report by the Army Audit Agency cited the omission from foreign sales prices of at least $2.3 million in charges for an aircraft manufacturer's using Army assets for free.

CHAPTER 5

CHARGES FOR USING GOVERNMENT ASSETS IN GOVERNMENT-OWNED AND OPERATED FACILITIES ARE BEING RECOVERED

We visited five Government-owned and operated facilities and found that foreign governments were being charged for the use of Government assets. For example, the Naval Air Rework Facility in Jacksonville, Florida, collected over $191,000 in asset-use charges since July 1975 and will collect additional asset-use charges of more than $100,000 when billings are made for ongoing work.

The success the services have had in charging for using Government-owned assets at Government-owned and operated facilities shows that with sufficient management attention, Defense policy regarding recovering the charges at other facilities could be effectively implemented.

CHAPTER 6

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

For many years, despite numerous audit reports and Defense instructions, the military services have been subsidizing the foreign military sales program by failing to charge millions of dollars for the use of Government-owned plant and equipment. As much as $107 million in unrecovered costs was identified during this review. Most notably the Air Force and Navy had done little to implement Defense policies requiring recovery of these costs. However, the Army had done a creditable job, which demonstrates that Defense policies could have been implemented.

To comply with the law and the intent of the Congress, and because of the previous problems by the Navy and Air Force in implementing Defense instructions, a special management effort is needed to make sure that foreign governments are charged, where appropriate, for the use of Government-owned assets. Defense cannot assume that its policies on pricing are being effectively implemented by the military services. Defense must take positive action to find out if its policies are understood and effectively implemented.

For recovering costs up to and including final billing, the Defense standard sales contract provides that estimated costs may be adjusted when they are not commensurate with actual costs incurred. Therefore, any costs which were not recovered by the services on those sales contracts for which final billing had not been made could and should be subsequently billed.

As to undercharges which may be found after final billing, Instruction 2140.1 provides that adjustments to final billings are permitted when there are unauthorized deviations from Defense pricing policies.

The longer Defense takes to attempt to collect undercharges, the more difficult it will be to recover these amounts from foreign governments. Until action is taken to attempt to collect undercharges, the military services should not make final billings for contracts in which undercharges occurred.

RECOMMENDATIONS

We recommend that the Secretary of Defense:

--Form a task force, consisting of representatives from Defense and the military services, to evaluate whether responsible commands are computing foreign military sales asset-use charges completely and accurately. Where necessary, the task force should assist the commands in applying and collecting asset-use charges. Further, the team should report to the Secretary whether corrective action is taken on the recommendations in this report.

--Require the military services to take action on internal audit findings discussed in this report and attempt to recover those asset-use and rental charges which should have been billed foreign governments.

--Require that in the future, responsible Defense officials make sure that new or revised foreign military sales pricing policies are understood by the services and are properly implemented.

Also, we recommend that the Secretary of Defense require that every reasonable effort be made to collect from foreign governments:

--Charges for use of Government assets omitted by the Navy and the Air Force since November 1973 (that is, when Defense first required the recovery of these costs) for each item of major equipment produced for foreign governments at Government-owned, contractor-operated facilities.

--The $1 million for use of Government-owned assets in the three Army missile sales cases identified during our review.

--Charges for using Government-owned assets in contractor-owned and operated facilities to produce items for sales to foreign governments. At a minimum, all cases that were signed after June 17, 1975, when Defense first required these charges, should be repriced and rebilled to foreign governments.

In those instances where a final billing has been made and the foreign government gives sufficient reason for contesting the rebilling, the services should decide whether further actions are warranted.

AGENCY ACTIONS AND UNRESOLVED ISSUES

In his January 25, 1978, letter, the Acting Assistant Secretary agreed that substantial effort is needed to keep Defense personnel informed about sales pricing policies. Although the Acting Assistant Secretary does not agree that a task force needs to be formed, a Defense official said that a series of training seminars for Defense personnel are now being planned. Further, the Acting Assistant Secretary said that the Defense Audit Service is continuing its reviews of the sales program. The effectiveness of the seminars and Defense audits will determine whether the intent of our recommendation is satisfied.

With the possible exception of unrecovered amounts identified by Defense internal audit agencies, the Acting Assistant Secretary does not intend to bill foreign countries for charges omitted by the military services. He said that such an attempt would produce few dollars and a considerable amount of ill will with our allies. Further, the Acting Assistant Secretary said Defense intended that the free use of Government assets be authorized for cases where a foreign government was purchasing items directly from a private contractor and for sales contracts entered into between a foreign government and Defense. He said these allowances were permitted by Paragraph 13-406 of the Armed Services Procurement Regulation in effect before July 16, 1976. (See p. 9 and app. IV for details regarding Paragraph 13-406.)

Defense gave us no evidence to support the Acting Assistant Secretary's contention regarding the intent of Paragraph 13-406. Clearly the paragraph's language applied only to direct sales. Both the Air Force and the Navy recognized that free-use provisions of the section were applicable to direct sales. (See pp. 10 and 11.) Further, in 1970 Defense agreed with us, in principle, that a fair share of the cost of Government-owned assets used by contractors to produce items for foreign governments should be recovered. (See p. 18.)

We agree that creating conflicts with foreign allies is not desirable. Yet we believe that in deciding whether or not to make an effort to collect for omitted charges, Defense should also consider (1) the substantial sums that should have been billed, (2) the congressional intent that foreign military sales not be subsidized by Defense appropriations, and (3) the interest of the U.S. taxpayer.

CHAPTER 7

SCOPE OF REVIEW

We reviewed the military services' systems for pricing, accounting, billing, collecting, and depositing receipts for using Government-owned plant and equipment on foreign military sales.

Our review included an examination of legislation, policies, procedures, documents, transactions, and internal audit reports dealing with recovering the cost of using Government-owned assets on foreign sales. We interviewed responsible officials to discuss policies, procedures, and other matters.

We performed our review at the following military departments and organizations.

--Departments of Defense, the Army, the Navy, and the Air Force
Washington, D.C.

--Defense Security Assistance Agency
Washington, D.C.

--U.S. Army Materiel Development and Readiness Command
Alexandria, Va.

--U.S. Army Tank-Automotive Materiel Readiness Command
Warren, Mich.

--U.S. Army Armament Materiel Readiness Command
Rock Island, Ill.

--U.S. Army Missile Materiel Readiness Command
Redstone Arsenal, Ala.

--Corpus Christi Army Depot
Corpus Christi, Tex.

--Lone Star Army Ammunition Plant
Texarkana, Tex.

--Red River Army Depot
Texarkana, Tex.

--Naval Material Command
Washington, D.C.

--Naval Air Systems Command
Washington, D.C.

--Naval Sea Systems Command
Washington, D.C.

--Navy International Logistics Control Office
Bayonne, N.J.

--Naval Air Rework Facility
Jacksonville, Fla.

--Air Force Logistics Command
Wright-Patterson Air Force Base, Ohio

--Air Force Systems Command
Andrews Air Force Base, Md.

--Aeronautical Systems Division,
Air Force Systems Command
Wright-Patterson Air Force Base, Ohio

PRINCIPAL GOVERNMENT-OWNED, CONTRACTOR-OPERATED FACILITIES USED TO PRODUCE WEAPONS OR COMPONENTS DISCUSSED IN THIS REPORT

Weapons system	Facilities	Acquisition value of facility (less land) (millions)
PHOENIX missile	Hughes Aircraft Tuscon, Ariz.	$ 38.6
	Rockwell International McGregor, Tex.	22.3
HARPOON missile	McDonnell Douglas St. Louis, Mo.	49.0
	Teledyne CAE Toledo, Ohio	21.0
F-14 aircraft	Grumman Aerospace Bethpage, N.Y.	77.5
A-7 aircraft	Vought Systems Division Dallas, Tex.	84.0
STANDARD missile	General Dynamics Pomona, Calif.	46.8
	Aerojet Solid Propulsion Sacramento, Calif.	36.2
DEFENSE missile	Sperry UNIVAC St. Paul, Minn.	5.3
Missile frigate	FMC Corporation Mineapolis, Minn.	36.7
	Sperry UNIVAC St. Paul, Minn.	a/5.3

a/Also used to produce the DEFENSE missile.

Weapons system	Facilities	Acquisition value of facility (less land) (millions)
F-15 aircraft	McDonnell Douglas/Rockwell International Tulsa, Okla.	$ 51.2
MAVERICK missile	Hughes Aircraft Tulsa, Okla.	a/38.6
F-5 aircraft	Northrup Corporation Palmdale, Calif.	6.8
	General Electric Lynn, Mass.	19.2
C-130H aircraft (components)	Lockheed Georgia Company Marietta, Ga.	113.4

a/Also used to produce the PHOENIX missile.

SUMMARY OF OUR REPORTS CONCERNING

FOREIGN MILITARY SALES COST RECOVERY

"Sales of Inventory Items to Foreign Governments Do Not Recover Normal Inventory Losses."
Report to the Secretary of Defense.
Sept. 8, 1977, FGMSD-77-43.

We reported that the Department of Defense was losing millions of dollars on sales of articles to foreign governments because normal inventory losses were not being recovered as intended by the Congress. For the Air Force alone, we estimated that the losses not recovered were approximately $30 million each year.

We made recommendations to Defense to recover the normal inventory losses on sales of inventory items to foreign governments.

"Inadequate Methods Used to Account For and Recover Personnel Costs of the Foreign Military Sales Program."
Report to the Senate Committee on Armed Services.
Oct. 21, 1977, FGMSD-77-22.

We reported that reliable estimates of personnel requirements for foreign military sales activities were needed to

--give the Congress a basis to authorize personnel ceilings,

--develop a budget for the resources required to administer the program,

--establish a basis for keeping administrative surcharges up to date to be sure that all administrative costs are recovered, and

--provide a basis for reimbursing the appropriation that originally financed the administrative costs from the receipts generated by the program.

Defense agreed that it lacked an adequate system to determine the number of personnel working on the foreign military sales program and had begun corrective action which should improve its management of the program.

"Improvements are Needed to Fully
Recover Transportation and Other
Delivery Costs Under the Foreign
Military Sales Program."
Report to the Secretary of Defense.
Aug. 19, 1977, LCD-77-210.

While Defense intended that charges to foreign governments cover accessorial--packing, crating, handling, and transportation--costs, we found that Defense had problems identifying and billing customers for such services. As a result, many millions of dollars in accessorial costs had not been recovered from foreign governments.

For example:

--Foreign customers had been undercharged about $17 million for air shipment of their items.

--Defense was applying unrealistic percentage factors under the surcharge billing method. We estimated that Defense was recovering only about half of the cost it incurred in packing and handling charges on foreign military sales shipments and that undercharges for this service alone may have exceeded $71 million a year.

--Over $7 million in ocean transportation costs had not been billed to customers on foreign military sales items withdrawn and shipped from depots in Germany, and the future costs of shipping replacement items overseas had not been considered.

We recommended that Defense should:

--Modify its procedures and bill customers for actual transportation and handling charges.

--Establish realistic surcharge rates for packing, crating, and handling.

--Strengthen controls over shipments originating at overseas depots.

--Attempt to recover significant underbilled costs on both past shipments of materials from overseas depots and air shipments from the United States.

--Establish proof of delivery procedures.

"Millions of Dollars of Costs Incurred
In Training Foreign Military Students
Have Not Been Recovered."
Report to the Congress.
Dec. 14, 1976, FGMSD-76-91.

Many millions of dollars of costs incurred in training foreign students had not been recovered by the United States due to faulty pricing, billing, and collecting systems. In the Army alone, such unrecovered costs totaled about $18.7 million during fiscal year 1975.

Defense took action to improve pricing, but subsequently made major reductions to tuition prices, effective October 1, 1976, despite objections by the House and Senate Committees on Appropriations.

The recovery from foreign governments of the full cost of training is required by law. We therefore recommended that Defense rescind the order to reduce tuition prices and attempt to recover from foreign governments amounts that should have been billed but were not.

"Defense Action to Reduce Charges For Foreign Military
Sales Training Will Result in the Loss of Millions
of Dollars."
Report to Congressman Clarence D. Long.
Feb. 23, 1977, FGMSD-77-17.

Responding to Congressman Long's request of October 19, 1976, we estimated that Defense's action to reduce tuition rates discussed above (FGMSD-76-91) would cost the United States over $40 million in fiscal year 1977. We reiterated our previous recommendation that Defense rescind the order to reduce tuition prices and attempt to recover from foreign governments amounts that should have been billed but were not.

"Defense's Reexamination of its Fiscal Year 1978
Budget Relates to Reimbursements for Foreign
Military Sales."
Report to the Chairman, House Appropriations
Committee.
May 6, 1977, FGMSD-77-40.

On March 2, 1977, Chairman Mahon asked Defense to reexamine its fiscal year 1978 budget as it related to reimbursements for foreign military sales and requested that we review the reexamination.

As part of the reexamination, Defense revised its pricing policies for foreign training, as we had previously recommended. We found that the estimate was reasonable and concluded that the pricing revisions were a major step in providing for the recovery of the full cost of training foreign students and estimated that this would increase fiscal year 1978 training reimbursements by $40 million.

"Reimbursement to the Marine Corps for Costs Incurred in the Training of Foreign Military Students."
Report to Lt. Gen. H. M. Fish,
Director, Defense Security Assistance Agency
and Deputy Assistant Secretary (ISA), Security Assistance.
July 15, 1976, B-165731.

Prior to January 1, 1976, the Marine Corps did not bill foreign governments for all training provided under foreign military sales contracts and did not assign dollar values to training provided as grant aid under the Military Assistance Program.

As a result of its pricing practices, the Marine Corps did not recover approximately $252,000 for the training of foreign students under the Foreign Military Sales Act for the 6-month period ended December 1975. In addition, for fiscal year 1975, about $464,000 was not reimbursed to the Marine Corps for training provided as grant aid.

We recommended that the Marine Corps:

--Attempt to recover from foreign governments all costs incurred for training provided without charge during the last 3 fiscal years.

--Insure that in the future the Foreign Assistance Act appropriations will be charged for training services provided by the act.

"Reimbursement For Technical Assistance and Training Services Provided to Foreign Governments by the Department of Defense."
Report to the Secretary of Defense.
July 13, 1976, FGMSD-76-64.

In its "Report on Review of Security Assistance Program in Iran," the Office of the Deputy Assistance Secretary of

Defense (Audit) reported that roughly $28.5 million in costs incurred by the U.S. Government in fiscal year 1975 would not be recovered. The Defense auditors concluded that much of the $28.5 million should be charged to Iran and recommended that (1) a study be made to insure that all costs of providing services are identified and (2) reimbursement for such costs be obtained.

We found that Defense had not initiated the study recommended by Defense auditors and recommended that the Director, Defense Security Assistance Agency, be directed to:

--Initiate and complete the recommended study before the fiscal year 1976 contracts expire to identify the costs which should be reimbursed the U.S. Government.

--Attempt to recover from Iran all reimbursable costs not billed.

--Include in future foreign military sales contracts all costs identified as being associated with providing technical assistance and training services to Iran.

"Reimbursement For Foreign Military Student Training."
Report to the Secretary of Defense.
Dec. 1, 1975, FGMSD-76-21.

During fiscal year 1975, the Air Force did not recover from foreign governments at least $5.7 million in costs incurred in training foreign students primarily because the Air Force:

--Did not charge foreign governments at current tuition rates.

--Used erroneous tuition rates in billing foreign governments.

--Did not include aircraft depreciation costs in tuition rates billed to foreign governments.

Substantial costs would not be recovered for fiscal year 1976 courses unless prompt action was taken to insure that current tuition rates were used in billing foreign governments. We recommended that the Secretary of the Air Force identify and recover amounts undercharged foreign governments.

Acting on our suggestions, the Air Force took action to assure that in the future foreign governments would be billed current course costs. As a result of these actions, we estimated that an additional $17.3 million was recovered from foreign governments during fiscal year 1976.

"Pilot and Navigator Training Rates"
Report to the House Committee on
Appropriations.
Apr. 11, 1975, FPCD-75-151.

The military services were not recovering all costs associated with pilot training under the Foreign Military Sales Act. Also, the military services used different methods in developing reimbursement rates, resulting in a wide variance in the reimbursements for training foreign pilots. Navy prices were based on full average costs incurred, while Air Force prices included only variable costs. As a result, the Navy charged $282,000 for undergraduate jet pilot training, while the Air Force charged only $81,000.

Flight training is the most costly training the services provide. We recommended that in reviewing the Defense Appropriation request for fiscal year 1976, the Committee may wish to consider whether the services should use the same methodology in computing charges for training foreign pilots.

"Reimbursements From Foreign Governments for
Military Personnel Services Provided Under
the Foreign Military Sales Act."
Report to Representative Les Aspin.
Aug. 16, 1974, ID-75-6.

Reimbursements to the Air Force for personnel services in connection with military sales programs during fiscal years 1973 and 1974 totaled $28.8 million and involved an estimated 2,865 staff years. Twenty-six countries were involved, with Iran and Germany making up more than half the total dollars. Most services performed were for pilot training.

In contrast to procedures followed by the Air Force in crediting moneys received to its Military Personnel appropriation account, the Army deposits reimbursements for similar services into the Miscellaneous Receipts of the U.S. Treasury. At the time of our review, efforts were underway to resolve this inconsistency by requiring each military service to follow Air Force procedures.

"Recovery of Costs to the Government
for Producing Weapons for Sale to
Foreign Governments."
Report to the Secretary of Defense.
Apr. 9, 1973. B-174901.

We reported that the Army Materiel Command's subordinate commands were not charging for depreciation of Government-owned plant and equipment used in the production of weapons for sale to foreign governments as required by Defense regulations.

This matter was previously reported to the Secretary of Defense in September 1972.

We recommended that the Secretary of Defense take necessary action to insure that the Army Materiel Command follows Defense regulations.

"Recovery of Costs on Government-
Owned Plant and Equipment."
Report to the Secretary of Defense.
Oct. 7, 1974, FGMSD-75-5.

GAO repeated its previous recommendations to Defense to recover the cost of Government-owned plant and equipment used in foreign military sales.

Subsequently Defense instructions were implemented which provided that an "asset-use charge" of 4 percent to cover the costs of depreciation, attrition, and imputed interest on investment be applied to all foreign military sales cases which required the use of Defense assets located in other than contractor-operated facilities.

"Airlift Operations of the Military Airlift
Command During the 1973 Middle East War."
Report to the Congress.
Apr. 16, 1975, LCD-75-204.

We found that Israel was not billed for about $45.1 million in costs incurred in airlift services provided by the Air Force during the 1973 Middle East War. We recommended that the Secretary of the Air Force should bill the Government of Israel for all costs--funded and unfunded--of the airlift services provided, including depreciation, on a basis consistent with the methods established by the Airlift Service's Industrial Fund and industry practices.

"Action Needed to Recover Full Costs
to the Government of Producing Weapons
for Sale to Foreign Governments."
Report to the Secretary of Defense.
Sept. 7, 1972, B-174901.

Defense regulations required industrial activities to charge nonfederal government customers, including foreign governments, for the use of plant and equipment in producing weapon systems.

We found that two industrial activities were not complying with Defense regulations. As a result, approximately $396,000 was not charged to foreign governments during fiscal years 1969 and 1970.

We recommended that:

--Defense internal review organizations should review prices charged nonfederal government customers for work performed at industrial activities to insure Defense regulations are implemented.

--Defense should take action to recover for the Government a fair share of the cost of Government-owned plant and equipment used by contractors in the production of equipment for sale to foreign governments and should submit appropriate detailed reports to the Congress when fair share is not recovered.

APPENDIX III

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

COMPTROLLER

25 JAN 1978

Mr. D. L. Scantlebury
Director, Division of Financial
and General Management Studies
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Scantlebury:

This is in reply to your letter to the Secretary of Defense regarding your report dated November 16, 1977, on "Continued Failure to Charge for the Use of Government-Owned Plant and Equipment for Foreign Military Sales" (OSD Case #4760).

The report, to a large extent, is a restatement of findings reported on one or more occasions in previous GAO reports. The area covered in the report, in most cases, involves FMS transactions during FY 1970-1975.

Although the report alleges that DoD was slow in improving policy guidance on the FMS program, it must be recognized that the intent of the Congress in many of these matters was not clearly stated until the passage of the Arms Export Control Act (Public Law 94-329) of June 30, 1976.

(See GAO note, p. 38.)

With reference to the recommendation on retroactive billing on items discussed in the various audit reports, your statement that DoDI 2140.1 permits the reopening of cases subsequent to final billings when there are unauthorized deviations from the Department's pricing policies is correct. In situations where policy was not followed, the Services have been directed to bill in accordance with the policy in being when the case was executed. In these cases, the audit staffs of the Services are being requested to follow up on corrective actions.

APPENDIX III

With reference to the findings relating to the alleged failure to charge for the use of Government-owned plant equipment, it is important to relate each specific case to the policy in being when the Letter of Offer was issued. Prior to Public Law 94-329 of June 1976, the FMS Act required, under Section 22 procurements, that the foreign country should "pay the full amount of such contract." Public Law 94-329, however, included the requirement that "after September 30, 1976, letters of offer for the sale of defense articles . . . shall include appropriate charges for . . . any use of plant and production equipment in connection with such defense articles . . . ."

While DoDI 2140.1, prior to June 17, 1975, required charges for depreciation for use of assets at Government-Owned Contractor-Operated (GOCO) facilities and the June 17, 1975, reissue of DODI 2140.1 required the use of a 4% asset use charge for use of these facilities, in lieu of depreciation, the Armed Services Procurement Regulations Section 13-406, until July 16, 1976, permitted the rent-free use of these facilities under certain conditions. Although DoDI 2140.1 incorporated the requirement, it must be recognized that where its provisions were in conflict with the contractual provisions, the contract must govern. The language in Section 13-406, at that time, did not clearly make it applicable to both direct commercial sales and Foreign Military Sales although it was intended to cover both. DPC 76-6 which revised Section 13-406 in July 1976 specifically states that "In no event shall the revised policy be applied to existing contracts under which rent-free use was authorized in writing." In addition, the policy statement was clarified to cover specifically FMS and direct sales.

(See GAO note, p. 38.)

All of the Navy cases and fifteen Air Force cases were issued prior to July 16, 1976, and are on contracts where "rent-free use" was authorized under ASPR Section 13-406.

One of the major recommendations in the draft report is that a task force be formed to visit and assist the various commands responsible for FMS sales in implementing DoD policy. We agree that substantial effort is needed to keep DoD personnel well informed on FMS policies. The entire area has been given considerable emphasis and visibility over the past two years through conferences, seminars, coverage in Service schools (such as the Defense Institute Security Assistance Management), and field visits by Headquarters personnel. These efforts continue to be emphasized. Also, the Defense Audit Service is continually reviewing the entire FMS program. I believe that the above

actions meet the intent of the GAO recommendation and the establishment of a special task force would duplicate actions already underway.

As an overall observation on the draft report, I believe that GAO assistance, as well as DoD effort, can be more beneficial and productive in working with the current FMS programs. While it is important to correct prior errors in application of policy, an attempt to change agreements, which were entered into in good faith as much as seven years ago, will produce few dollars and a considerable amount of ill will in our relationship with our foreign allies.

We appreciate the opportunity to comment on this report.

Sincerely,

John R. Quetsch

John R. Quetsch
Acting Assistant Secretary of Defense
(Comptroller)

GAO note: The deleted comments relate to matters which have been revised in this report.

ARMED SERVICES PROCUREMENT REGULATION,

PARAGRAPH 13-406 (note a)

13-406 Rent-Free Use of Government Production and Research Property on Work for Foreign Governments.

(a) It is the policy of the Department of Defense to encourage the maximum feasible sales of supplies manufactured or services performed in the United States to friendly foreign governments or organizations thereof. Rent-free use of Government production and research property to promote this policy should be authorized when the requirements of (b) are satisfied. Requests made for such use shall be processed as expeditiously as possible.

(b) Upon the request of a foreign government, or a contractor certifying that he is acting on behalf of a foreign government, the Secretary or his designee cognizant of Government production and research property located in the United States, its possessions, or Puerto Rico, may give written approval for its use without charge on contracts of foreign governments or subcontracts thereunder if:

(i) the foreign government would be authorized to place the contract with the Department concerned under the Foreign Military Sales Act of 1968, as amended, or such use is authorized by an agreement with the foreign government;

(ii) the foreign government's placement of the contract directly with the contractor is consistent with the best interest of the United States;

(iii) it appears that the foreign government will place the contract with the contractor whether or not such use is authorized, or that no competitive pricing advantage will accrue to the contractor by virtue of such use;

(iv) the contractor agrees that no charge for the use of such property will be included in the price charged the foreign government under the contract; and

a/As discussed on page 18, Paragraph 13-406 was revised on July 16, 1976, to require that foreign governments be charged for use of Government assets.

(v) such use will not interfere with foreseeable requirements of the United States.

PRINCIPAL OFFICIALS RESPONSIBLE FOR ADMINISTERING ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office From	To
DEPARTMENT OF DEFENSE		
SECRETARY OF DEFENSE:		
Dr. Harold Brown	Jan. 1977	Present
Donald H. Rumsfeld	Nov. 1975	Jan. 1977
Dr. James R. Schlesinger	July 1973	Nov. 1975
William P. Clements (acting)	May 1973	July 1973
Elliot L. Richardson	Jan. 1973	May 1973
Melvin R. Laird	Jan. 1969	Jan. 1973
ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER):		
Fred P. Wacker	Sept. 1976	Present
Terence E. McClary	June 1973	Aug. 1976
Don R. Brazier (acting)	Feb. 1973	June 1973
Robert C. Moot	Jan. 1969	Jan. 1973
DEPARTMENT OF THE ARMY		
SECRETARY OF THE ARMY:		
Clifford Alexander, Jr.	Feb. 1977	Present
Martin R. Hoffman	Aug. 1975	Feb. 1977
Howard H. Callaway	May 1973	July 1975
Robert F. Froehlke	July 1971	May 1973
ASSISTANT SECRETARY OF THE ARMY (INSTALLATIONS, LOGISTICS AND FINANCIAL MANAGEMENT) (note a):		
Alan J. Gibbs	Apr. 1977	Present
Jack E. Hobbs (acting)	Apr. 1977	Apr. 1977
Hadlai A. Hull	Mar. 1973	Apr. 1977
Richard L. Saint Sing (acting)	Sept. 1972	Mar. 1973
COMPTROLLER OF THE ARMY:		
Lt. Gen. Richard L. West	Oct. 1977	Present
James Leonard (acting)	June 1977	Oct. 1977
Lt. Gen. John A. Kjellstrom	July 1974	June 1977

a/Title changed in June 1977 from Financial Management to Installations, Logistics and Financial Management.

	Tenure of office	
	From	To
DEPARTMENT OF THE ARMY (cont.)		
COMPTROLLER OF THE ARMY: (cont.)		
Lt. Gen. E. M. Flanagan, Jr.	Jan. 1973	July 1974
Lt. Gen. John H. Wright, Jr.	Aug. 1970	Jan. 1973
DEPARTMENT OF THE NAVY		
SECRETARY OF THE NAVY:		
W. Graham Claytor, Jr.	Feb. 1977	Present
J. William Middendorf II	June 1974	Feb. 1977
John W. Warner	May 1972	Apr. 1974
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT):		
George A. Peapples	Nov. 1977	Present
Vacant	May 1977	Nov. 1977
Gary D. Penisten	Oct. 1974	May 1977
Vacant	May 1974	Oct. 1974
Robert D. Nesen	May 1972	Apr. 1974
DEPARTMENT OF THE AIR FORCE		
SECRETARY OF THE AIR FORCE:		
John C. Stetson	Apr. 1977	Present
Thomas C. Reed	Jan. 1976	Apr. 1977
James W. Plummer (acting)	Nov. 1975	Jan. 1976
Dr. John L. McLucas	July 1973	Nov. 1975
Dr. Robert C. Seamans, Jr.	July 1969	July 1973
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT):		
Arnold G. Bueter	Aug. 1977	Present
Everett Keech	Sept. 1976	Aug. 1977
Frances Hughes	Mar. 1976	Sept. 1976
Arnold G. Bueter (acting)	Aug. 1975	Mar. 1976
William W. Woodruff	Apr. 1973	July 1975
Spencer J. Schedler	June 1969	Apr. 1973
COMPTROLLER OF THE AIR FORCE:		
Lt. Gen. Charles G. Buckingham	Sept. 1975	Present
Lt. Gen. J. R. DeLuca	Oct. 1973	Sept. 1975
Lt. Gen. D. L. Crow	Apr. 1969	Oct. 1973

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