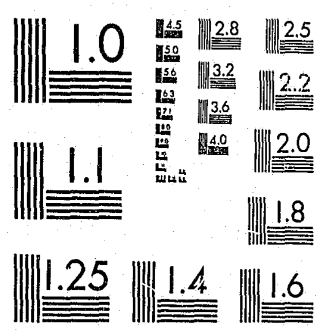

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Department of Defense Recoupment of Normal Inventory Losses on FMS--Report

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

DIVISION OF FINANCIAL AND GENERAL MANAGEMENT STUDIES

B-174901

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

As you may know, we are reviewing whether the Department of Defense obtains full reimbursement for the sale of defense articles to foreign governments. To date we have found that because normal inventory losses are not being recovered, the Department is losing millions of dollars on sales of articles to foreign governments. In the Air Force, for example, we estimate that such losses approximate $30 million each year. Although our work is continuing, we are reporting our findings to you now so you can take prompt, corrective action.

We analyzed Defense regulations, interviewed responsible officials, and tested transactions to evaluate whether pricing systems would recover the full cost of articles sold. Our review was done at the Departments of Defense, the Army, the Navy, and the Air Force, Washington, D.C.; the Air Force Logistics Command, Wright-Patterson Air Force Base, Ohio; San Antonio Air Logistics Center, Kelly Air Force Base, Texas; the Army Missile Materiel Readiness Command, Huntsville, Alabama; the Army Tank-Automotive Materiel Readiness Command, Warren, Michigan; the Navy Aviation Supply Office, Philadelphia, Pennsylvania; and the Navy Ships Parts Control Center, Mechanicsburg, Pennsylvania.

BACKGROUND

Sales of articles to foreign governments are authorized by the International Security Assistance and Arms Export Control Act of 1976 (Public Law 94-329, June 30, 1976). The act provides that the Defense Department may sell articles from its stocks (inventories). For articles which Defense does not intend to replace, the act requires that the foreign government pay "not less than the actual value thereof."

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The act further provides that for articles which Defense intends to replace, the foreign government must agree to pay the estimated replacement cost of the article. Also, the act requires the recovery of certain other costs, such as the cost of administering the foreign military sales program. The legislative history of the act indicates that the Congress intended that indirect as well as direct costs be recovered so that the foreign military sales program would not be subsidized by Department of Defense appropriations.

In implementing the act, the Department of Defense included the following provisions in the standard contract used for sale of Defense articles to foreign governments:

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

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

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

In addition to major articles, such as tanks and aircraft, Defense sells to foreign governments articles that are commonly referred to as secondary items. Secondary items fall into two categories: (1) stock fund items and (2) other Defense inventory items commonly referred to as nonstock fund items. Stock fund items are generally low-cost, expendable and nonexpendable items, such as gears, bearings, and gaskets. Nonstock fund or other inventory items are generally reparable and nonexpendable items, such as engine motors, manifolds, and generators.

Secondary items may be purchased by foreign governments through supply support arrangements or other sales agreements. Supply support arrangements set forth the terms and conditions for providing articles, in effect, on a prepaid basis through the Defense supply system. These arrangements require the investment of foreign government money in Defense inventories. Other sales agreements generally do not require foreign government investment.

In maintaining secondary item inventories, Defense incurs normal inventory losses, such as damage, deterioration, obsolescense, and pilferage. Since these losses are normal costs of maintaining Defense inventories, the pricing of items sold to foreign governments should include a factor for recovering the losses. Including these losses in determining total cost is consistent with congressional intent that Department of Defense appropriations should not subsidize the foreign military sales program.

The problems Defense is experiencing in recovering normal inventory losses on sales to foreign governments are discussed below.

NORMAL INVENTORY LOSSES
NOT FULLY RECOVERED

The military services are not recovering from foreign governments millions of dollars of costs incurred in the sale of secondary items from Defense inventories. This has occurred because the Department's pricing policies and the pricing systems used by military services to recover normal inventory losses were inadequate.

Sale of nonstock fund items

For nonstock fund secondary items, Department of Defense Instruction 2140.1 requires that normal inventory losses will be recovered under supply support arrangements. For at least 8 years the instruction has required that the military services recover for normal inventory losses by assessing foreign governments amounts proportionate to the ratio that the value of supply support arrangements bear to the total value of stock in storage. The military services, however, have not implemented this requirement. As a result, normal inventory losses on sales of nonstock fund items sold under supply support arrangements are not being recovered. In continuing our review of Defense sales to foreign governments, we will try to determine why the military services have not implemented the above requirement.

For nonstock fund secondary items sold through other sales agreements (that is, sales agreements other than supply support arrangements), the instruction does not require, nor do the military services attempt, recouping for normal inventory losses.

We questioned Department officials on the apparent inconsistent policy of requiring charges for normal inventory losses on supply support arrangement sales (although not implemented by the military services) but not requiring such charges on other sales agreements. Defense officials said that under supply support arrangements, foreign countries are investing in Defense inventories and, in effect, own a portion of the inventory. Therefore, they believe it is logical for the foreign countries to share in normal inventory losses. On sales made under other sales agreements, Defense officials said that foreign governments should not be required to pay for normal inventory losses because:

--Foreign governments do not invest in Defense inventories and thus do not own a portion of the inventory as they do under supply support arrangements.

--The Arms Export Control Act prohibits the Defense Department from purchasing inventory in anticipation of these sales. 1/

We agree that the act prohibits Defense from purchasing inventory in anticipation of foreign military sales requirements unless the foreign country invests in the inventory, as in supply support arrangements. We disagree, however, that the act, in prohibiting the purchase of inventory in anticipation of foreign sales, prevents the Defense Department from charging for normal inventory losses on sales agreements other than supply support arrangements. Inventory losses are a normal cost of operating the Defense inventory system. To the extent foreign governments purchase articles from this system, they should share in these losses. This is consistent with the congressional intent of the Arms Export Control Act that Defense appropriations not subsidize the foreign military sales program.

Foreign governments entering into supply support arrangements in many cases also enter into other sales agreements for the purchase of secondary items. In some cases the foreign countries purchase the same items under both types of agreements. For example, during the 14-month period ended

1/This is distinguishable from sales of inventory through supply support arrangements in which foreign governments must invest in inventories.

November 30, 1976, a foreign government ordered 20 J-85 engine fuel controls from the Air Force. The foreign government cited supply support arrangements on orders for 13 items and cited other sales contracts on orders for the remaining 7 items. Using Defense's rationale, the foreign government would be charged for normal inventory losses for those items purchased under supply support arrangements, but would not be assessed this charge for items purchased under other sales agreements. However, normal inventory losses were not recovered on any of the 20 items sold. For, as discussed on page 3, the military services have not implemented Defense requirements to recover normal inventory losses on sales under supply support arrangements.

Sale of stock fund items

Defense's rationale that only sales under supply support arrangements should include a charge for normal inventory losses is inconsistent with the stock fund pricing policy. Defense Department Directive 7420.1, governing stock fund sales, requires the inclusion of a surcharge for normal inventory losses on all sales from the stock fund. For instance, the prices of articles sold to customers, including foreign governments, through the Air Force stock fund includes a 12-percent surcharge to cover normal inventory losses. In fiscal year 1976, the San Antonio Air Logistics Center, which was one of five air logistics centers participating in the foreign military sales program under supply support arrangements and other sales agreements, sold foreign governments about $22 million of secondary items managed through the stock fund system. Included in the $22 million amount was about $2.4 million to cover normal inventory losses. The Army and Navy similarly recover normal inventory losses on their stock fund sales through the application of surcharges to the standard price of the article being sold.

We questioned the inconsistency between charges for normal inventory losses on sales of stock fund and nonstock fund inventory items. Officials of the Joint Logistics Command Panel on the Standardization of Foreign Military Sales Procedures said that since the stock fund is a revolving fund and therefore intended to be self-sustaining, it must recover normal inventory losses from its customers or its capital will continually shrink. On the other hand, money to buy nonstock fund material comes directly from the Congress through the military service appropriations. Normal

inventory losses are therefore recovered through the appropriation process.

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The following table summarizes those cases in which normal inventory losses are and are not being recouped by the military services and the Defense policies governing recoupment.

Policies and Practices for the Recovery of Normal Inventory Losses

Category	Type of sale: Supply support arrangement	Type of sale: Other sales agreements
Nonstock fund		
Pricing policy	Recoupment required by Defense Instruction 2140.1.	Recoupment not provided for.
Practice	No recoupment made. Provisions of Instruction 2140.1 have not been implemented.	No recoupment made.
Stock fund		
Pricing policy	Recoupment required by Defense Instruction 2140.1 and Defense Directive 7420.1.	Recoupment required by Defense Directive 7420.1 but not provided for in Defense Instruction 2140.1.
Practice	Recoupment made by assessing a percentage surcharge as required by Defense Directive 7420.1.	Recoupment made by assessing a percentage surcharge as required by Defense Directive 7420.1.

Failure of the military services to recoup normal inventory losses on sales of nonstock fund secondary items is costing the U.S. Government a lot of money. A partial listing of nonstock fund sales, for instance, showed that during fiscal year 1976 the San Antonio Air Logistics Center sold at least $30 million of nonstock fund secondary items. Applying the 12-percent charge for normal inventory losses used for stock fund sales, 1/ the Air Force would have charged foreign governments about an additional $3.6 million on those sales at the Center alone. Statistics on nonstock fund inventory items the Air Force sold to foreign governments were not readily available. A responsible Air Force Logistics Command official estimated the value of nonstock fund inventory items the Air Force sold to foreign governments to be about $250 million annually. Applying the 12-percent charge to this amount, the Air Force alone would lose about $30 million annually by not recovering normal inventory losses on these sales.

Although we have not developed estimates of the amount of undercharges in the Army and Navy, we believe that substantial undercharges exist in these services.

CONCLUSIONS

Sufficient management attention has not been given to the recovery of normal inventory losses on the sale of nonstock fund inventory items. It has been over 8 years since the Defense Department issued instructions requiring the recovery of these losses from foreign governments on sales under supply support arrangements. Furthermore, Defense's policies on sales from inventory not covered by supply support arrangements are costing the U.S. Government millions of dollars. The inclusion of these costs would be consistent with the intent of the Arms Export Control Act that Defense appropriations not subsidize the foreign military sales program.

Unless timely action is taken by Defense to change its policy guidance and by the military services to implement the guidance provided, additional millions of dollars of normal inventory losses related to the sale of secondary items to foreign governments will not be recovered.

In recovering the costs up to and including final billing, the Department of Defense standard sales contract provides that adjustments may be made to estimated costs when they are not commensurate with actual costs incurred. Therefore, any costs that were not recovered by the military

1/According to officials of the Air Force Logistics Command, normal inventory losses for nonstock fund items should amount to about the same as the surcharge rate currently applied on sales of stock fund items.

services on those sales contracts for which a final billing has not been made could and should be subsequently billed.

As to undercharges that may be found subsequent to final billing, Instruction 2140.1, requiring the recovery of the cost of normal inventory losses on sales under supply support arrangements, provides that adjustments to final billings are permitted when there are unauthorized deviations from Department pricing policies.

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

RECOMMENDATIONS

We recommend that you direct:

--The Department to change its pricing policy for foreign military sales, requiring the inclusion of normal inventory losses in charges to foreign governments for all nonstock fund items sold from Defense inventories.

--The military services to implement Defense policies on the recovery of these losses.

--The military services to attempt to recover previously unbilled costs for normal inventory losses on sales of nonstock fund inventory items for (1) all sales agreements for which a final billing has not been made and (2) supply support arrangements for which a final billing has been made.

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We have informally discussed our findings with Defense officials, and their comments have been included in the report.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate

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Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

We would appreciate being informed of actions taken or planned on our recommendations and of amounts of recoveries of previously unbilled costs. We will be glad to discuss these matters with you or your representatives.

We are sending copies of this report to the House Committee on Government Operations and the Senate Committee on Governmental Affairs; the House and Senate Committees on Appropriations and Armed Services; the Director, Office of Management and Budget; and the Secretaries of the Army, Navy, and Air Force.

Sincerely,

D. L. Scantlebury
Director

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