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MILLIONS IN LOSSES CONTINUE ON DEFENSE STOCK FUND SALFS TO FORE--ETC(U)
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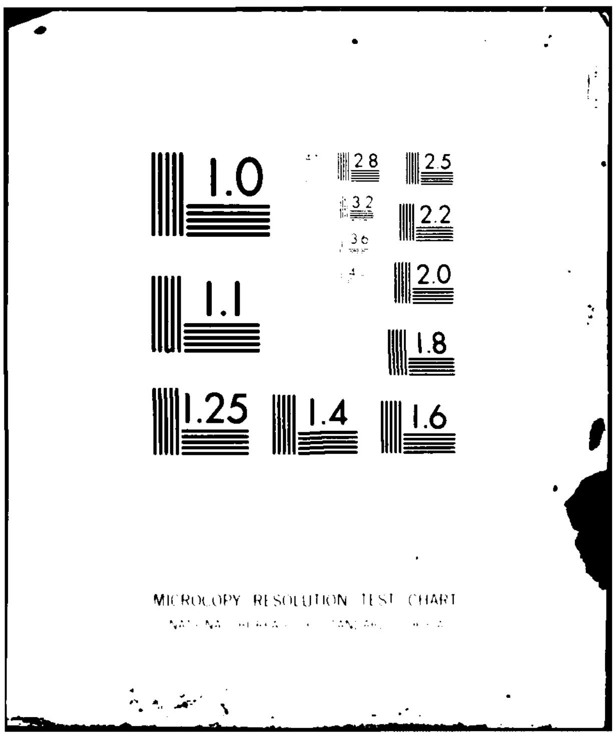
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REPORT BY THE

# Comptroller General

OF THE UNITED STATES

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

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The Department of Defense continues to sell items to foreign customers from its stock fund inventory for less than estimated replacement cost. As a result, Defense appropriations are subsidizing foreign sales by millions of dollars each year--a practice the Congress wants Defense to avoid.

This report, prepared at the request of Senators Percy and Hollings, discusses pricing problems similar to those reported by GAO in 1978. In establishing sales prices, Defense does not:

- (1) adequately consider the impact of inflation in determining replacement costs, and
- (2) update often enough the sales prices charged foreign customers.

GAO is recommending actions necessary to improve Defense's pricing policies and procedures for stock fund items sold from inventory.

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UNITED STATES GENERAL ACCOUNTING OFFICE



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SEPTEMBER 10, 1981

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

B-204458

The Honorable Charles H. Percy
United States Senate

The Honorable Ernest F. Hollings
United States Senate

Your letter of May 27, 1980, expressed concern that prior General Accounting Office recommendations to improve the accounting and financial management of the foreign military sales program had not been implemented by the Department of Defense. You asked that we evaluate recent Defense actions to improve its financial management of the program and to reduce its budget by eliminating subsidies to the foreign military sales program.

This report focuses on the actions taken by Defense to revise and implement the policies, procedures, and accounting systems used to price sales of stock fund items to foreign customers. Specifically, the report discusses whether prices billed foreign customers for stock fund items are adequate to replace the items in Defense inventories and thus avoid Defense subsidization of the foreign military sales program.

At your request, we did not obtain official agency comments on the matters discussed in this report.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request.

Milton J. Socolar

Acting Comptroller General
of the United States

REPORT BY THE
COMPTROLLER GENERAL
OF THE UNITED STATES

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

## DIGEST

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

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

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

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

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

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

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

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

Tear Sheet.

AFMD-81-62
SEPTEMBER 10, 1981

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

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

Table 2

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

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

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

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

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

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

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

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

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

## RECOMMENDATIONS

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

--adopting a more realistic inflation index,

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

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

GAO also recommends that the Secretary of Defense

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

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

## AGENCY COMMENTS

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

## Contents

# CHAPTER 1

## INTRODUCTION

In a May 27, 1980, letter (app. I), Senators Percy and Hollings expressed concern that prior General Accounting Office recommendations to improve the accounting and financial management of the foreign military sales program had not been implemented by the Department of Defense. They requested that we evaluate recent Defense actions to improve its financial management of the foreign military sales program and to reduce its budget by eliminating subsidies to the foreign military sales program.

In accordance with the Senators' request, we have made a followup review of Defense's pricing and billing of stock fund items sold to foreign customers under the foreign military sales program. In 1978, we reported that Defense had failed to properly price and bill the replacement cost of equipment and spare parts sold to foreign customers. 1/ As a result of this failure, the Department of Defense did not charge, as required by law, for millions of dollars of incurred costs for items sold through selected foreign military sales. In effect, Defense appropriations subsidized the program.

This report focuses on the actions taken by Defense to revise and implement the policies, procedures, and accounting systems used to price sales of stock fund items to foreign customers. Specifically, the report discusses whether prices billed foreign customers for stock fund items are adequate to replace the items in Defense inventories and thus avoid Defense subsidization of the foreign military sales program.

### STOCK FUND OPERATIONS

Each military service maintains a stock fund to finance commodities that are generally low cost, expendable, and nonreparable. These stock funds finance the procurement of materiel that is issued to consuming agencies. The consuming agencies and foreign customers reimburse the stock fund for the materiel they receive and these reimbursements, in turn, finance the purchase of replacement or new inventory items. This arrangement allows the stock funds to serve as revolving, self-sustaining funds as long as sales provide sufficient capital to finance new purchases.

Defense consumers use primarily operation and maintenance appropriations to buy stock fund items. The amounts budgeted each year for stock fund purchases by Defense activities are based on

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1/GAO report entitled "The Department Of Defense Continues To Improperly Subsidize Foreign Military Sales" (FGMSD-78-51, Aug. 25, 1978).

program requirements (quantity of goods needed) and estimated stock fund prices. Since Defense operation and maintenance budgets are based on stock fund prices, stock fund managers try to stabilize these prices for the budget year to avoid unexpected expenses in the annual operation and maintenance budgets.

Although sales to foreign customers represent only about 10 percent of total Defense nonfuel stock fund sales, the amounts involved are significant. During fiscal 1976 through 1980, stock fund sales of nonfuel items to foreign customers totaled nearly $2.3 billion. Stock fund sales of these items to foreign customers in fiscal 1980 alone totaled over $500 million.

## REQUIREMENTS TO RECOVER REPLACEMENT COST

The Arms Export Control Act of 1976 gives the Department of Defense authority to sell Defense articles and services to foreign countries at no cost to the U.S. Government. Section 21 of the act authorizes, under certain conditions, the sale of Defense articles from stock to eligible foreign governments and international organizations. The act requires that articles sold from Defense inventories to foreign governments be priced at either

--actual value, when the article is not intended to be replaced in the Defense inventory; or

--replacement cost, when the article is intended to be replaced.

Both the act and its legislative history indicate congressional intention that all costs of goods and services sold to foreign countries be recovered so that the foreign military sales program is not subsidized by Defense appropriations.

The act states that when an item to be replaced in inventory is sold, the estimated replacement cost of the item should be recovered. Defense provides for the recovery of replacement cost through Department of Defense Manual 7290.3-M, which governs the pricing of Defense articles sold to foreign countries. The manual provides that nonexcess stock fund materiel will be sold to foreign customers at its established standard price after adjusting for transportation charges where necessary. The manual states that the standard price is to be established to ensure recoupment of the moneys necessary to procure replacement items. The recovery of this amount is necessary because, by the very nature of these funds, the items sold are intended to be replaced.

This manual is further supplemented by Defense Directive 7420.1, which governs stock fund operations including pricing procedures. The directive requires that each item financed under a stock fund have a standard price for both inventory accounting and sales reimbursement. Each standard price is to include

--the procurement cost of the item (last known purchase price),

--transportation cost incurred by the fund, and

--a surcharge to compensate the fund for normal inventory losses.

Also, in 1974 the Secretary of Defense approved the inclusion of a price stabilization factor to provide for inflation and improve the stock fund's cash and working capital position. Beginning in fiscal 1976, this factor or surcharge was to be added to the standard price of all stock fund items. This computed standard price was to be reviewed continually, but revised price lists were to be published normally not more often than once a year. However, significant price changes essential to protect stock fund capital and to ensure equitable charges to the users were permitted. Defense's intent was to have stable standard prices during the budget year to preclude excessive and/or unanticipated changes to the operation and maintenance budgets of Defense components--the stock fund's principal customers.

## PRIOR AUDIT REPORTS

As indicated, we previously reported on the need for Defense to recover the full cost of goods and services sold under the foreign military sales program. The Defense Audit Service also recently reported on this matter. In August 1978, we reported to the Congress that Defense was continuing to subsidize foreign military sales. The report stated that sales were subsidized by $35 million in the Air Force and at one Army command because the military services did not charge replacement costs for items sold from inventory. We recommended that the Secretary of Defense take action to revise the method used to determine and charge the replacement cost for items sold to foreign governments from Defense inventories. We also recommended that compounded inflation factors be used when items were purchased in years previous to the year of sale to ensure that replacement costs were recovered.

In January 1980, the Defense Audit Service also reported that improvements were needed in determining the amount of the surcharges applied to the procurement cost in order to reimburse the stock fund for transportation expenses, inventory losses, and inflation. The Defense Audit Service recommended that Defense require independent reviews of the annual update of standard prices to ensure that prices were accurately computed and correctly updated.

## OBJECTIVES, SCOPE, AND METHODOLOGY

The overall objective of this review was to determine if Defense's stock fund pricing policy, as implemented by the military services, ensured that amounts billed foreign customers were adequate to recover the cost of replacing the items sold. Our specific objectives were to

--determine the adequacy of procedures used to compute standard prices for stock fund items,

--evaluate the impact of Defense's policies of updating standard prices once a year and not accumulating inflation factors, and

--analyze Defense's efforts to perform quality assurance testing on stock fund pricing.

We were guided by a May 27, 1980, request from Senators Percy and Hollings that we evaluate recent actions by Defense to (1) implement the recommendations in past GAO reports and (2) improve Defense financial management of the foreign military sales program. Our past reports disclosed that Defense was subsidizing the program by not recovering replacement costs of stock fund items, and recommended corrective actions.

This review was made during November 1980 through May 1981, and included reviews of applicable Department of Defense and military service regulations, accounting procedures and reports, computer printouts, and other documents relating to pricing of stock fund items under the foreign military sales program, as well as discussions with responsible program officials. We reviewed the legislative history of the Arms Export Control Act of 1976 and amendments thereto, and reviewed and analyzed related Defense and military service instructions and regulations governing the foreign military sales program. At the five service locations visited, we interviewed management personnel to identify policies and procedures for determining prices charged on foreign sales and gathered data to assist in evaluating the adequacy of pricing policies and procedures.

Our review was conducted at the Department of Defense and Headquarters, Departments of Army, Navy, and Air Force, Washington, D.C.; Air Force Logistics Command, Dayton, Ohio; San Antonio Air Logistics Center, San Antonio, Texas; Robins Air Logistics Center, Warner-Robins, Georgia; U.S. Army Materiel Development and Readiness Command, Washington, D.C.; U.S. Army Tank-Automotive Command, Warren, Michigan; U.S. Army Communications and Electronics Command, Ft. Monmouth, New Jersey; U.S. Navy Ships Parts Control Center, Mechanicsburg, Pennsylvania; and the Security Assistance Accounting Center, Denver, Colorado.

Our evaluation of whether item replacement costs were being recovered involved a detailed examination of sales of stock fund items to foreign customers. We recognized that Defense pricing policy was not expected to recover replacement cost on every item, even though items are usually intended to be replaced. Instead, the policy was designed to recover replacement cost on a total basis. Therefore, our analyses were made on a total basis.

At the two air logistics centers visited, we applied statistical sampling techniques to evaluate the pricing of stock fund sales during fiscal 1980. Both statistical samples were based on a 95-percent confidence level. At the San Antonio Air Logistics Center, we randomly selected 136 stock fund sales for detailed review from a universe of 71,023 transactions resulting in inventory shipments during fiscal 1980. We also updated information on selected items examined during our 1978 pricing review, and performed a computer-assisted analysis of the pricing of all stock fund items sold from inventory during fiscal 1980. At the Robins Air Logistics Center, we randomly selected 136 stock fund sales for detailed review from a universe of 2,688 inventory items that were billed during September 1980.

To determine the replacement costs of items sold, we used actual replacement purchase prices when the items sold from inventory had been replaced from new procurement. If no replacement procurements had occurred, we used a series of price escalation factors developed by Headquarters, Air Force Logistics Command to provide realistic replacement cost estimates. We then compared the amounts recovered from the foreign countries with the cost of the replacement items.

At the Army and Navy locations visited, we tracked selected larger dollar items through the pricing system but did not use statistical sampling procedures to select items for review. Consequently, we did not project our sample results to all stock fund sales at these Army and Navy activities.

At the Army Tank-Automotive Command, we examined selected stock fund items from a sample of fiscal 1980 foreign military sales transactions previously studied by command personnel. These 20 transactions examined were valued at $117,725. In addition, at the Army Communications and Electronics Command and the Navy's Ships Parts Control Center, we selected transactions from fiscal 1980 billing documents. The 18 transactions selected at the Army command were valued at $446,487, while the 15 transactions examined at the Navy command were valued at $548,099.

Because of these limitations in the scope of our coverage, the results of our review cannot be projected to other activities or considered to be an all-inclusive review of the activities visited. We believe, however, that procedural problems similar to those discussed in this report may exist at other Defense activities not included in the review because all activities operate under standard pricing guidelines issued by Defense and use similar accounting and financial management systems.

The financial information in this report is based mainly on Department of Defense accounting records and information provided by Defense officials. Verification of this information could not be made in the short time available for preparing this report because the accounting systems involved are highly complex and the foreign military sales financial data is voluminous, with thousands of individual cases involved.

## CHAPTER 2

## FOREIGN CUSTOMERS CONTINUE TO BE CHARGED LESS THAN REPLACEMENT COST FOR ITEMS SOLD FROM INVENTORY

The Department of Defense is still not charging foreign governments the estimated replacement cost of stock fund items sold from its inventories although required by law to do so. Over the past few years, the cost of replacing items sold from inventory generally has been much higher than the price charged. Consequently, Defense appropriations are subsidizing foreign military sales by many millions of dollars each year. We found that:

--Inflation factors used to estimate replacement costs were too low and were not compounded when the items were purchased more than 1 year prior to sale.

--Sales prices charged foreign customers should be updated more frequently.

Incurring losses on sales of inventory items has been a longstanding problem in Defense. We reported in FGMSD-78-51 that millions of dollars were being lost because replacement cost was not being recovered. As a result of not charging enough, it was necessary for Defense to apply an additional surcharge to stock fund billings to foreign military sales customers during calendar 1980 to help meet stock fund cash requirements to purchase inventory. Although this adjustment, in the short term, decreased the amount of subsidies to the foreign military sales program, Defense will continue to subsidize the program by millions of dollars annually until adequate pricing policies and procedures are adopted. To help ensure that pricing will improve in the future, Defense has begun to establish a special unit which will conduct pricing reviews.

### FOREIGN MILITARY SALES SUBSIDIES CONTINUE

Defense has continued to sell stock fund items from inventory to foreign customers for less than replacement costs. Our random statistical sample of stock fund sales at two Air Force locations shows that Defense continues to significantly underprice items sold to foreign customers. Examinations of selected Army and Navy stock fund sales show similar underpricing. We also reexamined specific items that we found to be underpriced in our 1978 audit. Almost all are still significantly underpriced. This continued underpricing has taken its toll on the stock fund cash position; in order to provide cash to replenish the inventory, Defense officials applied a one-time surcharge to calendar 1980 stock fund sales to foreign customers.

At the two Air Force activities visited, we examined statistical samples of transactions, and at one of the activities, the San Antonio Air Logistics Center, we correlated our statistical projections with the results of a computer-assisted analysis of all fiscal 1980 transactions.

We estimate that fiscal 1980 sales of $42,947,562 at the San Antonio location were underpriced by $16,670,770 or 39 percent. 1/ At the Robins Air Logistics Center, we estimate that September 1980 sales of $1,395,548 were underpriced by $814,097 or 58 percent. 2/ The fiscal 1980 sales at the Robins Air Logistics Center were about $20 million.

At the Army locations, we examined 38 sales transactions valued at $564,212. We estimate that the items sold were underpriced by $154,898 or 27 percent. Similarly, at the Navy location we examined 15 sales transactions valued at $548,099 and we estimate that the items sold were underpriced by $126,324 or 23 percent.

Underpricing of stock fund items is a longstanding problem. A rechecking of specific items examined in our 1978 review showed that the items were still underpriced. At that time we reported that 40 of 52 items sold by the Air Force were underpriced. A reexamination of the same 52 items showed that 43 were sold to foreign countries in fiscal 1980. Analyzing the pricing of these 43 items, we found 39 were underpriced; billings on the 39 items failed to recover replacement cost by an average of about 45 percent.

Poor stock fund pricing practices applied to all of the fund's sales--those to the military services as well as those to foreign governments. As a result, the fund suffered a large cash shortage and in January 1980, Defense requested and received a $797.4 million supplemental appropriation to provide cash to purchase stock for inventories. Since prices for fiscal 1980 were not revised, Defense recognized that sales to foreign customers would continue to result in losses. To avoid subsidizing stock fund losses with the supplemental appropriation, Defense applied a one-time 14.5 percent surcharge to calendar 1980 sales of stock fund items to foreign customers.

Although the one-time surcharge reduced the amount of subsidies to the foreign sales program, the rate of the surcharge does not approach the rate of losses we found for sales in 1980.

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1/Statistical analysis based on 95-percent confidence level with an error range of ± $8.3 million.

2/Statistical analysis based on 95-percent confidence level with an error range of ± $195,439.

Further, this ad hoc attention does not correct the general deficiencies in pricing policies and practices as discussed below. Until these deficiencies are corrected, Defense will continue to lose many millions of dollars annually.

## DEFICIENCIES STILL EXIST IN DEFENSE'S PRICING POLICIES AND PRACTICES

Replacement cost was not recovered on stock fund sales to foreign governments because of weaknesses in Defense's pricing policies and practices. We found that Defense (1) used inflation factors that were unrealistically low, (2) failed to compound inflation factors when the items were purchased more than a year prior to their sale, and (3) failed to update often enough the sales prices charged foreign customers.

These pricing problems continued despite our 1978 report, which alerted Defense management that large losses were occurring. In a delayed response to one of our recommendations, however, Defense has recently begun to establish a special unit that will conduct pricing reviews which should help improve future pricing.

### Unrealistic inflation factors are used to compute replacement prices

The inflation factors used by Defense to estimate replacement costs were unrealistically low. The rates used are those provided by the Office of Management and Budget for preparation of the President's budget. Historically, these rates have been shown to be a conservative forecast of price changes. A Defense official told us the rates have proved to be too conservative in 10 of the last 11 years.

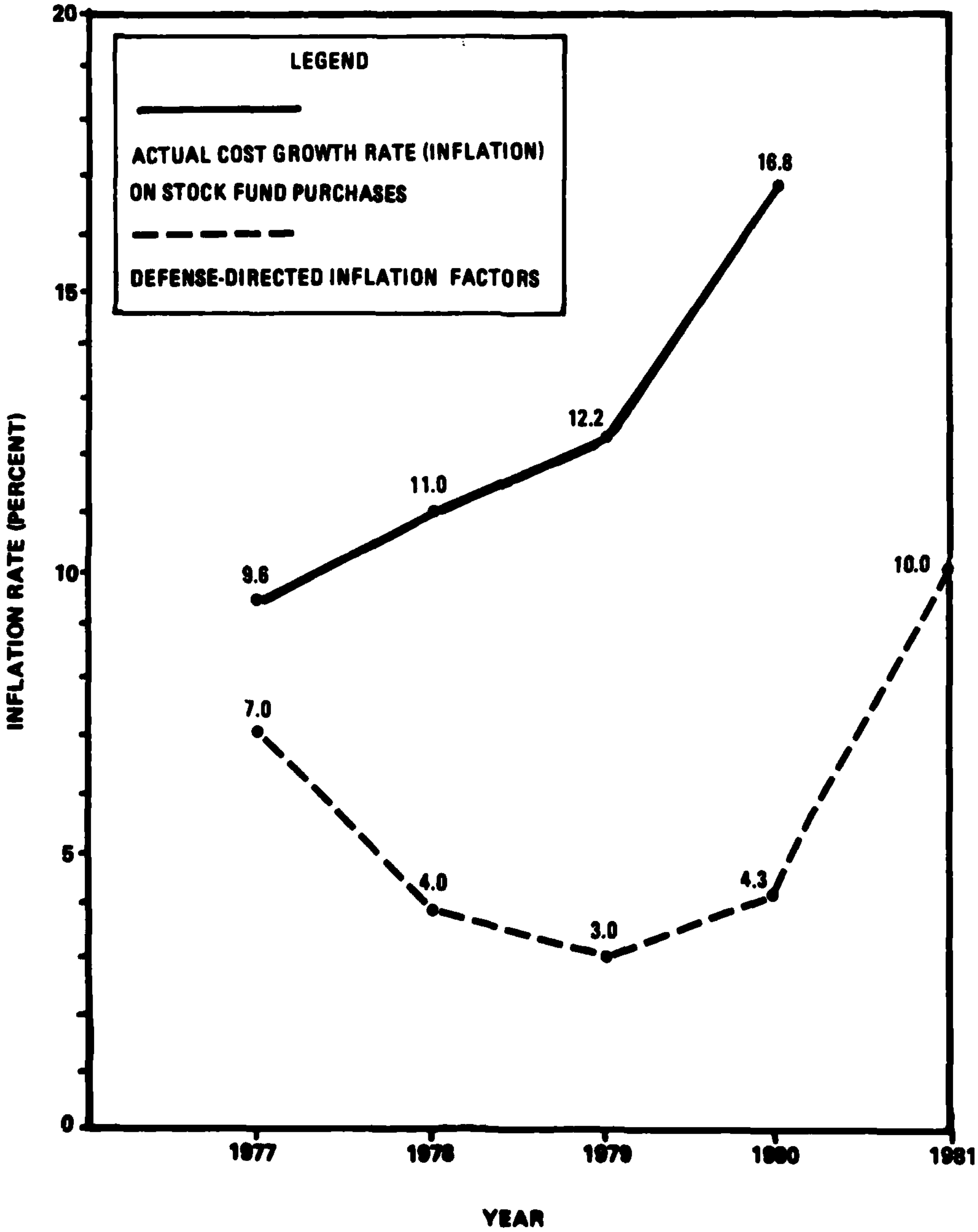
Defense used rates of 7 percent, 4 percent, 3 percent, 4.3 percent, and 10 percent respectively for each year from fiscal 1977 through 1981. The difference between these rates and actual experienced cost growth has continued, resulting in prices charged foreign governments that do not nearly recover replacement costs. The graph on page 9 shows the difference between actual inflation experienced on Air Force stock fund purchases of spare parts and the prescribed inflation factor that was used in computing prices.

While there may be valid reasons for making conservative assumptions in predicting a low rate of inflation for budgetary purposes, we believe it is counterproductive to use conservative inflation rates when pricing goods sold to foreign governments.

### Defense failed to compound inflation rates

Besides being unrealistically low, the inflation factors used by Defense were not compounded in setting sales prices for those items purchased more than a year prior to their sale. Defense requires that only the current year's inflation factor be used. Stock

## COMPARISON OF ACTUAL COST GROWTH RATE AND DEFENSE-DIRECTED INFLATION FACTORS ON AIR FORCE STOCK FUND PURCHASES



fund items that were purchased 1 or more years before the year of sale are priced at the last purchase price plus the inflation factor current at the time of sale. This method has produced an unrealistically low estimate of replacement cost.

In our 1978 report we recommended that inflation factors be compounded for pricing items purchased more than a year before the year of sale. Defense advised us that it believed its pricing policy was adequate to recover replacement cost. Our review has clearly demonstrated that this is not the case and that inventory items are still being significantly underpriced.

Stock fund item managers at various military service locations are aware of the problems inherent in failing to accumulate the effects of inflation from year to year. Comptroller staff, both at the U.S. Army Tank-Automotive Command and at Navy headquarters, have noted this as a weakness in existing pricing procedures. In July 1980, the Air Force Logistics Command recommended to Air Force headquarters that the price stabilization factor be made cumulative from year to year for items not procured during the preceding fiscal year. While headquarters personnel noted that this approach would require system changes, they said that making the changes would be "minor in both cost and time."

The need to consider accumulating the effects of inflation from year to year is further illustrated by a computer-assisted analysis performed at the San Antonio Air Logistics Center. We analyzed the procurement histories of stock fund items sold from inventory to foreign countries during fiscal 1980. This analysis shows that 76 percent of the items were purchased before fiscal 1980. The results of our analysis are shown on the next page in table 1.

It is evident that the method used by Defense would be feasible only if items were procured at least once during the previous year or if the inflation factor used for the year was sufficiently high to consider time lapse between procurements.

Table 2 uses examples found at the Robins Air Logistics Center to show the inadequacy of using a single year's inflation factor to estimate replacement cost. The replacement costs shown are based on actual purchases of identical replacement items during fiscal 1980.

Table 1

| Fiscal year of purchase | No. of items purchased | Percent of total |
|---|---|---|
| 1980 | 6,095 | 24 |
| 1979 | 4,037 | 16 |
| 1978 | 2,207 | 9 |
| 1977 or earlier | 8,403 | 34 |
| No purchase date identified (note a) | 4,163 | 17 |
| Total | 24,905 | 100 |

a/The procurement history file used for this analysis was created in 1972; conversion and consolidation of prior data bases led to loss of data on pre-1972 purchases.

Table 2

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

Unrealistically low estimates of replacement costs obviously lead to substantial losses on sales. For example, the San Antonio Air Logistics Center had not purchased a particular gearshaft for an aircraft engine since fiscal 1974. In arriving at the fiscal 1980 standard price charged foreign customers, the Air Force followed established procedures and adjusted the 1974 purchase price of $269.26 upward by the 1980 inflation rate of 4.3 percent, to $280.84. This underestimated the 16-percent rate actually experienced at the San Antonio Air Logistics Center on stock fund purchases during fiscal 1980 and completely ignored the inflation experienced between fiscal 1974 and 1980. The Air Force is now considering a contract offer to buy this item at a price of

$561.32. Thus the Air Force's standard price was about half of its expected replacement cost. During fiscal 1980, the air logistics center sold foreign customers 403 of these gearshafts. Air Force billings totaled $110,606; the estimated replacement cost would be $226,212 based on current bids.

### Sales prices should be updated more frequently

Standard prices of stock fund items are normally updated once a year by the Navy and the Air Force as required by Defense instructions. Purchases made near the beginning of a fiscal year are not considered in establishing the year's standard price because the cutoff point for considering a new purchase price is usually late June or early July for the fiscal year beginning in October. As a result, Navy and Air Force fiscal 1980 standard prices were usually based on purchase prices prior to July 1979. The Army, however, updates quarterly the sales prices charged foreign customers. Consequently, its foreign sales prices give consideration to the more recent purchase prices.

To determine the impact of the Army's pricing procedure for foreign military sales as compared to the impact of procedures used by the other services, we applied the logic of the Army system to sales made by the Robins Air Logistics Center. The comparison showed that the Army's pricing update feature would have reduced the rate of losses significantly. Recomputing billing prices based on the most recent purchase of the item sold would, we estimate, have resulted in total September 1980 charges of $1,772,448 instead of the $1,395,548 actually charged, an increase of about 33 percent. 1/ While this billing procedure would not recover the full $2,099,833 required to replace inventory items sold during the month, 2/ it would recover substantially more than the annual fixed pricing feature stated in Defense policy.

The Army, in deviating from Defense policy, has recognized that doing business outside the Government requires different systems and concepts. By updating prices more frequently, the Army was able to use more recent purchase prices in billing foreign customers. Annual updates by the Navy and Air Force can cause delays of up to 15 months before increases in purchase prices affect foreign customer billing prices. Such lengthy delays can and do cause significant underestimates of replacement cost. For example, the Air Force did not recover replacement cost on second-stage turbine blades for the J-85 engine because of the pricing

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1/Statistical analysis based on 95-percent confidence level with an error range of ± $103,530.

2/Statistical analysis based on 95-percent confidence level with an error range of ± $195,439.

methods used. The recent stock fund procurement history of the turbine blades was as follows:

| Date of purchase | Quantity purchased | Unit price |
|---|---|---|
| Aug. 2, 1978 | 21,712 | $33.20 |
| Nov. 29, 1979 | 44,701 | 38.50 |
| Oct. 6, 1980 | 25,421 | 44.98 |

The standard price for fiscal 1980 was $37.62, including charges of $2.99 for transportation and inventory losses, and was based on the $33.20 unit price paid in 1978. The November 1979 purchase at $38.50 occurred too late to be considered in establishing the fiscal 1980 price. The Air Force filled orders from foreign customers for 9,998 blades from inventory during fiscal 1980. When the inventory was replenished in October 1980, turbine blades cost $44.98 each, or $10.35 more than had been recovered. As a result, the Defense pricing policy followed by the Air Force failed to recover $103,479 in replacement costs for this item.

Similar problems were noted at the Navy activity we visited. For example, in February 1980 the Ships Parts Control Center sold 18 transmitter modules to a foreign customer. The billing price represented the Navy's estimated replacement price of $1,801. However, prior to the sale, the Navy purchased the module at a cost of $2,290. Again, because of Defense's policy requiring updating of standard prices only once a year, the Navy lost $8,807.

Even when the services have not made procurements of replacement items for long periods of time, current price information may be available for updating prices. For example, in November 1979 the San Antonio Air Logistics Center awarded a catalog contract covering 112 items of J-85 and TF-34 engine spares for which they anticipated demand during the next year. A catalog contract is a prepriced ordering agreement that establishes the purchase price of contract items for the term of the contract without committing the Air Force to order the items. This November 1979 contract, which was in effect for about 12 months, established the replacement cost for all contract items. Since Defense policy recognized only the latest actual procurement in updating prices, the Air Force did not consider the available information and failed to recover about $180,000 in replacement costs from foreign customers. The standard price of one item was established at $626.16, based on a January 1979 purchase. The $797.46 price agreed to in the fiscal 1980 catalog contract was not considered.

During fiscal 1980, Defense shipped a total of 709 of these items to foreign customers from inventory. Although some of the shipments were billed at the fiscal 1980 standard price of $626.16, other shipments were sold at the fiscal 1979 standard price of $307.05. Total Air Force billings on this item amounted to $418,135, compared to an actual replacement cost of $565,399 which was established in the catalog contract. In effect, the Air Force sold the item to foreign customers at a discount of about 32 percent.

Losses on other selected items covered by the catalog contract were also significant, as shown by the following table:

| Item description | Number sold | Amount billed for replacement cost | Replacement cost | Loss on 1980 sales |
|---|---|---|---|---|
| Outer leaf, exhaust nozzle | 604 | $ 86,204 | $284,122 | $197,918 |
| Stator vane, segment 3 | 2,226 | 106,773 | 151,813 | 45,040 |
| Stator vane, segment 4 | 2,271 | 93,736 | 135,397 | 41,661 |
| Stator vane, segment 5 | 3,263 | 157,587 | 217,740 | 60,153 |
| Stator vane, segment 6 | 2,815 | 97,110 | 153,671 | 56,561 |
| Total | | $541,410 | $942,743 | $401,333 |

## Quality assurance pricing program is being established

Defense has initiated action to establish quality assurance controls over its pricing of foreign military sales. The persistence of pricing problems over several years prompted the recommendation in our August 1978 report that a Defense organization be given specific responsibility for ensuring effective and consistent implementation of foreign military sales pricing policies. Although this responsibility was assigned to the Security Assistance Accounting Center in September 1978, the function is still not fully staffed.

We have recommended that, in order to alleviate Defense's longstanding pricing problems,

> "the Secretary of Defense assign specific responsibility for administering pricing policy and monitoring pricing systems to a new organization or some existing organization that can be sufficiently freed from other work to provide careful surveillance over the pricing function."

In January 1978 and September 1979, Defense charged the Security Assistance Accounting Center with the responsibility for ensuring correct pricing data for foreign military sales. However, not until August 1980 did the Center attempt to establish a quality assurance program.

Security Assistance Accounting Center officials, in planning to implement the quality assurance program, estimated that 14 positions would be necessary but only 4 were subsequently approved.

It was not until March 1981 that the Center finally received a total of 12 personnel space authorizations. According to a Defense official, the delay was attributed to a personnel shortage.

The quality assurance program, if implemented properly, can help ensure that the foreign military sales program is not subsidized by Defense appropriations.

## Past undercharges should be recouped

In recovering costs of foreign sales up to and including final billing, the Department of Defense standard sales contract provides that adjustments may be made to estimated costs that are not commensurate with actual costs. Therefore, any costs that have not been recovered by the military services on those sales contracts for which final billing has not been made could and should be billed. As to undercharges that may be found after final billing, Department of Defense Manual 7290.3-M provides that adjustments to final billings are permitted when there are unauthorized deviations from Defense pricing policies.

## CONCLUSIONS

Defense pricing policies and practices for foreign military sales of stock fund items still do not recover estimated replacement costs as required by law. As a result, many millions of dollars continue to be lost and Defense appropriations continue to subsidize the foreign military sales program. To comply with this statutory requirement and the intent of the Congress that these sales not be subsidized, Defense must correct the weaknesses in its pricing policies and practices.

Defense should also make a reasonable attempt to collect from foreign customers the undercharges that resulted from failure to charge a reasonable approximation of replacement cost.

The longer Defense takes to attempt to collect undercharges, the more difficult it will be to recover these amounts from foreign governments. Action should be taken to attempt to collect undercharges as expeditiously as possible before the military services make final billings for contracts on which the undercharges occurred. Also, final billings should be adjusted when unauthorized deviations from Defense pricing policies are discovered.

## RECOMMENDATIONS

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

--adopting a more realistic inflation index,

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

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

We also recommend that the Secretary of Defense

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

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

**United States Senate**

COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, D.C. 20510

May 27, 1980

The Honorable Elmer B. Staats
Comptroller General
of the United States
Washington, D.C. 20548

Dear Elmer:

During the past several years, the General Accounting Office has issued a number of reports on the accounting and financial management of the Foreign Military Sales Program by the Department of Defense. These reports have resulted in budget reductions in the past and indicate that a potential exists for further budget reductions in the future.

As several of the recommendations have not been implemented, the Defense appropriations are apparently being used to subsidize the Foreign Military Sales Program. This has been a continuing problem within Defense and it appears that Defense needs to devote additional attention to this area to bring about budget reductions.

In this regard, we would appreciate your staff reviewing recent actions by Defense to implement the recommendations in your reports and other actions taken by Defense to improve its management of the program. We would appreciate your office developing questions for use by the Committee during hearings on the fiscal 1982 Defense budget. In addition, we would appreciate a detailed report on this matter by June 30, 1981.

Senator Percy's staff has discussed this review with members of your Financial and General Management and Studies Division, Systems in Operation group.

Sincerely,

Charles H. Percy
United States Senator

Ernest F. Hollings
United States Senator

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