FOREIGN MILITARY SALES

DOD’s Stabilized Rate Can Recover Full Cost

September 1997
B-275670

September 18, 1997

The Honorable Charles E. Grassley
United States Senate

Dear Senator Grassley:

This report responds to your request that we review the Department of Defense's (DOD) use of stabilized rates for charging foreign military sales (FMS) customers for goods and services sold through DOD's Defense Business Operations Fund (DBOF).¹ You expressed concern that stabilized rates may not represent the full cost of the goods and services sold to FMS customers as required by the Arms Export Control Act of 1976. You specifically asked that we determine (1) if there is a dollar difference in pricing goods and services at full cost compared to the stabilized rate and, if so, (2) whether DOD's current practice of billing foreign customers at the stabilized rate is consistent with the full cost requirements of the act.

The Arms Export Control Act gives the President authority to sell defense articles and services to eligible foreign countries, generally at no cost to the U.S. government. While the Defense Security Assistance Agency (DSAA) has overall responsibility for administering the FMS program, the Army, Navy, and Air Force normally execute the sales agreements—commonly referred to as sales cases. As of September 30, 1996, there were over 90 foreign countries participating in the FMS program, about 75 percent of which had been in the program for at least 10 years. During fiscal years 1995 and 1996, annual DOD sales to FMS customers totaled about $10 billion, $2 billion of which were made by the Defense Working Capital Funds (WCF).² Of the $2 billion in annual WCF sales, $1.5 billion or 75 percent were related to the sale of inventory items from Army, Navy, Air Force, and Defense Logistics Agency supply activities. Supply activities' inventories consist of over 5 million different items ranging from food and clothing to new or rebuilt spare parts for various military weapon systems. The remaining $500 million of sales were made by the nonsupply WCF activities such as Army, Navy, and Air Force maintenance depots which perform

¹On December 11, 1996, the Under Secretary of Defense (Comptroller) reorganized DBOF and created four working capital funds: Army, Navy, Air Force, and Defense-wide. The four working capital funds will continue to operate under the revolving fund concept and charge customers the full cost of providing goods and services to them. Therefore, our findings and recommendations are applicable under the new working capital fund structure.

²The other $8 billion of annual sales is generally for major weapons systems, such as aircraft and ships. These sales are made by non-WCF activities.
maintenance and repair work on various weapon systems, including ships, tanks, and aircraft.

Results in Brief

DOD’s stabilized rate generally is designed to recover full costs from DOD and FMS customers over the long term. The concept of applying the stabilized rate is a viable method to recover the cost of goods and services from these customers. Our analysis of cost elements in the stabilized rates showed that generally, the stabilized rate included the cost elements necessary to recover full cost. However, we did identify two cost elements—pension and postretirement health benefits—related to retirement benefit costs of civilian personnel working on FMS cases, that were not included in the stabilized rates. We estimate that WCF supply activities undercharged FMS customers at least $40.5 million during fiscal years 1992 through 1996 and will undercharge millions more in fiscal year 1997. We discussed this matter with DOD officials and they agreed that not all civilian retirement benefit labor costs were included in the rates that activities were charging FMS customers. They now plan to revise their policy to require that this cost be included in the prices charged FMS customers.

Background

Foreign military sales are made on a case by case basis. The cases are initiated by a foreign country sending a letter of request to DOD asking for various information, such as precise price data. After the country obtains and reviews this information and decides that it wants to do business with the U.S. government, DOD prepares a Letter of Offer and Acceptance (LOA) stating the terms of the sale for the goods and services being provided. If accepted by the country, the LOA becomes the formal sales agreement by which the U.S. government contracts with the country to sell it defense articles or services.

Once the LOA is accepted, the foreign country is generally required to pay, in advance, amounts necessary to cover costs associated with the sales agreement. DOD then uses these funds, held in trust by the Department of the Treasury, to pay private contractors and to reimburse DOD activities for the cost of executing and administering the FMS agreement. As payments are made, the military services report detailed disbursing and accounting data to a central activity—the Defense Finance and Accounting Service, Denver Center—which maintains the records of each country’s trust fund balance and issues quarterly statements to foreign customers summarizing amounts charged to their cases.
In October 1991, DOD established DBOF, which consolidated into one revolving fund, nine existing industrial and stock funds that had operated within DOD for about 45 years, as well as the Defense Finance and Accounting Service, Defense Industrial Plant Equipment Service, Defense Commissary Agency, Defense Reutilization and Marketing Service, and Defense Technical Information Service. In establishing DBOF, one of DOD’s primary goals was to identify the total cost of operations and to highlight the cost implications of management decisions. DOD’s Financial Management Regulation 7000.14-R, Volumes 11B and 15 prescribe the financial management requirements, systems, and functions that WCF activities are to follow when establishing prices and billing FMS customers. Generally, billings to these customers shall reimburse the WCF for the full cost incurred by the U.S. government for providing the goods or services. According to the regulation, full cost is determined by the application of the stabilized rates or unit prices which are set to achieve a break-even operating result in the budget year—that is, neither to make a profit nor incur a loss.

Since the concept of DBOF was first put forth in February 1991, we have monitored and evaluated its implementation and operation. We have issued numerous reports discussing various problems with fragmented cost accounting systems and inaccurate financial reporting. More specifically, one problem we found was that not all costs were being captured in the price-setting process, thus, resulting in less than full cost recovery. However, in our May 1997 testimony before the Subcommittee on Defense, Senate Committee on Appropriations, we noted that DOD has progressed significantly in identifying the cost of doing business and including those costs in the prices DBOF charged its customers.

Scope and Methodology

To determine regulatory requirements for billing FMS customers using stabilized rates and prices, we obtained and analyzed laws, policies, procedures, regulations, and guidance from DOD, Army, Navy, and Air Force officials. During our visits to DOD locations, we gathered and analyzed budget and accounting reports to identify cost elements in the prices of goods and services sold to FMS customers. We compared these...
cost elements with other cost data in various databases and met with responsible agency officials to discuss and clarify any differences in (1) cost elements used for FMS and DOD customers and (2) the amounts charged.

To determine the amount of civilian pension and postretirement health benefit costs that should have been collected from FMS customers by WCF supply activities, we obtained and analyzed financial reports that showed sales and expense data for Army, Navy, Air Force, and Defense Logistics Agency supply activities for fiscal years 1992 through 1996. Because these activities generally did not maintain data to identify how much time personnel spent providing services to FMS customers, we estimated the amounts of civilian pension and postretirement health benefit costs related to FMS using certain assumptions. To do this, we first calculated the dollar value of FMS sales as a percentage of total dollar sales for each of the activities for each fiscal year. For example, if a supply activity showed that its annual sales were $1 billion of which $100 million were to FMS customers, we calculated sales to FMS customers to be 10 percent ($100 million divided by $1 billion).

To calculate the pension benefit costs, we multiplied the percent of each year’s FMS sales by the total amount of civilian personnel salaries reported as paid during the year to determine a pro rata dollar amount for FMS civilian personnel salaries. Finally, to determine the estimated amount of civilian pension benefit costs to be collected from FMS customers, we multiplied the pro rata dollar amount of FMS personnel salaries times the civilian pension benefit cost factor of 14.7 percent for each activity for fiscal years 1992 through 1996. According to the Office of Management and Budget (OMB) and DOD officials, the 14.7 percent rate represents the “unfunded” portion of the pension benefit cost which is derived by subtracting DOD’s 7 percent contribution to the pension costs of its employees (21.7 percent less 7 percent). The 7 percent DOD contribution is already included in the stabilized rate as a funded fringe benefit cost.

To determine the amount of civilian postretirement health benefit cost, we multiplied the percentage of FMS sales to total sales times the civilian end

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6The Office of Management and Budget provided DOD, based on Office of Personnel Management data, composite percentage factors to use in calculating the government’s cost of civilian retirement benefits. For fiscal years 1992 through 1996, the composite factor for the civil service and federal employee retirement systems for the government’s portion of the pension benefit costs was 21.7 percent.
strength for each supply activity for fiscal years 1992 through 1996.\textsuperscript{7} For example, if the pro rata amount of FMS sales to total sales was 10 percent for fiscal year 1996 and an activity reported civilian end strength at 5,000 employees for the same period, our calculated FMS civilian end strength would be 500 full time employees involved with FMS activities (10 percent times 5,000 employees). Using these numbers, we multiplied the pro rata amount by $2,166 which was the Office of Personnel Management (OPM) calculated amount of average postretirement health benefit cost per employee for fiscal year 1996.\textsuperscript{8} To determine the postretirement health benefit cost per employee for fiscal year 1995 and earlier, we contacted officials in OPM’s Office of Actuaries, including the Deputy Director of the Office of Actuaries. According to the OPM officials, prior to fiscal year 1996, OPM had not published any formal amounts for agencies to use in calculating pension or postretirement health benefit costs. However, OPM officials told us that postretirement health benefit costs have increased by about 7 percent each fiscal year. Therefore, according to OPM officials, we could determine the fiscal year 1995 postretirement health benefit cost by dividing the fiscal year 1996 cost of $2,166 by 107 percent. Fiscal year 1994 could then be determined by dividing the fiscal year 1995 postretirement health benefit cost by 107 percent and so on for each preceding fiscal year. The OPM officials generally agreed with our methodologies for calculating estimated pension and postretirement health benefit costs.

We did not calculate pension benefit cost for nonsupply activities because the nonsupply activities were generally including these costs in their prices for FMS customers. They did not, however, include the postretirement health benefit cost in their prices. Since they were recovering the largest segment of the retirement benefit cost, we did not attempt to estimate undercharges for postretirement health benefit cost for the nonsupply activities. To do so would have required us to analyze numerous detailed accounting and budget reports of over 100 additional WCF activities. Over the years, both we and the DOD Inspector General have reported that the DOD’s financial systems used to collect and report data are not capable of producing accurate and reliable information. Our estimates were based on financial information provided by DOD which we did not independently verify.

\textsuperscript{7}Civilian personnel end strength (actual number of people employed at the end of the fiscal year) was generally lower than full time equivalent personnel (average full time usage of authorized positions during the fiscal year). We used the more conservative civilian end strength numbers for our calculations.

\textsuperscript{8}According to OPM’s Deputy Director of the Office of Actuaries, it was later determined that the $2,166 was overstated by about $55. However, at the time of our audit, OPM had not provided agencies with a revised number for personnel costs. Therefore, we used $2,166 for our calculations.
We performed our work at the headquarters, Departments of the Army, Navy, Air Force; Defense Security Assistance Agency; and Office of the Under Secretary of Defense (Comptroller) in Washington, D.C. We also performed audit work at the Army Materiel Command, Alexandria, Virginia; Air Force Materiel Command, Wright Patterson Air Force Base, Dayton, Ohio; Naval Inventory Control Point, Mechanicsburg, Pennsylvania; Naval Air Warfare Center, Patuxent River, Maryland; Naval Surface Warfare Center, Indian Head, Maryland; Defense Logistics Agency, Fort Belvoir, Virginia; and Letterkenney Army Depot, Chambersburg, Pennsylvania. We conducted our review from November 1996 through July 1997 in accordance with generally accepted government auditing standards.

We requested written comments on a draft of the report from the Secretary of Defense or his designee. The Acting Under Secretary of Defense (Comptroller) provided written comments, which are discussed in the “Agency Comments” section and reprinted in appendix I.

### Stabilized Rates Should Allow Recovery of Costs Over the Long Term

The concept of a stabilized rate is a viable method to use for pricing goods and services sold to FMS customers. If this rate is applied consistently and contains all known cost elements, it should recover the full cost of operations over the long term. In analyzing the cost elements in the stabilized rate, we identified additional elements—pension and postretirement health benefit costs which are part of the civilian labor costs—that should have been included in developing the stabilized rate and charged to FMS customers. Omission of these costs resulted in estimated underbillings of more than $40.5 million since fiscal year 1992.

### Stabilized Price-Setting Process

Present DOD policy requires the WCF activities to establish prices that allow them to recover from their customers the expected costs, including any prior years' losses. WCF activities are to establish prices prior to the start of each fiscal year and apply these predetermined (stabilized or standard) prices to most orders and requisitions received during the year. Because sales prices are based on expected costs and workload, higher-than-expected costs or lower-than-expected customer demand for goods and services can cause the WCF activities to incur losses. Conversely, lower-than-expected costs or higher-than-expected customer demand for goods and services can result in profits.
The process for establishing stabilized prices for WCFs generally begins about 2 years before the prices go into effect, with managers from each WCF developing workload projections for the budget year. After WCF managers estimate their workloads based on customer input, they (1) use productivity projections to estimate how many people they will need to accomplish the work, (2) prepare a budget that identifies the labor, material, and other expected costs, and (3) develop prices that, when applied to the projected workload, should allow them to recover operating costs from their customers. Not all cost elements are applicable to all WCF activities. For example, the cost element of inventory losses/obsolescence generally applies only to WCF supply activities that maintain inventories. Below is a list of major cost elements used to develop stabilized rates:

- direct and indirect labor,
- direct material,
- general and administrative expenses,
- inventory losses/obsolescence,
- inventory maintenance,
- condemnation of inventory items,
- inflation,
- accumulated operating results gains or losses,
- depreciation, and
- joint logistics systems center (JLSC) surcharge.

Major commands responsible for the overall management of the WCFs review the budget estimates and consolidate individual business area activities’ budget estimates. The military services’ and DOD components’ headquarters and the Office of the Secretary of Defense also review the budget estimates before they are submitted to the Congress as part of the annual budget. Any changes made during the DOD budget review process are incorporated into the WCFs’ prices before the beginning of the fiscal year. With the exception of retirement benefit costs for civilian employees, which is discussed below, we found that all of the key cost elements to recover full cost from FMS customers are now included in the stabilized price.

Civilian Pension and Postretirement Health Benefit Costs Were Not Included in Supply Prices

The costs not charged by the WCF supply activities, which were responsible for about $1.5 billion (75 percent) of the WCFs annual sales to FMS customers, consisted of a portion of the government’s share of the full cost for pension and postretirement health benefit costs for civilian personnel who worked on FMS cases. The employee and the employing agency both
contribute annually toward the cost of the future pension benefits. While the contributions made by DOD are now part of the stabilized rate, the employee and agency contributions are less than the full cost of providing the pension benefits. Therefore, the federal government must, in effect, make up the funding shortfall. In addition, neither the agency nor the employee pays the federal government’s portion of postretirement health benefit costs. Both the pension and postretirement health benefit costs will eventually be paid out of the general funds in the Treasury—not by DOD. Since the pension and postretirement health benefits are costs to the government, they should be added to the stabilized rate and recovered from FMS customers. In this regard, we found that the nonsupply activities we visited recognized this and modified the stabilized rate to include the full pension costs in the prices they charged FMS customers. However, they did not include the postretirement health benefit cost. As noted earlier, we did not attempt to estimate the postretirement health benefit cost for nonsupply activities.

Including retirement benefit costs is consistent with the Statement of Federal Financial Accounting Standards Number 4, which states that federal agencies should measure and report direct and indirect costs that contribute to output, regardless of funding sources. It is also consistent with OMB Circular No. A-25, which established the guidelines for federal agencies to assess fees for government services. The guidance notes that user charges will be sufficient to recover the full cost to the federal government of providing the service, resource, or goods. The circular points out that “full cost” is to include all direct and indirect costs to any part of the federal government of providing a good, resource, or service. Under the circular, these costs include, but are not limited to, an appropriate share of direct and indirect personnel costs, such as accrued retirement cost not covered by employee contributions.

Because WCF supply activities did not maintain data to identify the time personnel spent providing services to FMS customers, our estimates for civilian pension and postretirement health benefit costs were calculated based on assumptions discussed in our scope and methodology. Table 1 shows the results of our calculations for each of the WCF supply activities for fiscal years 1992 through 1996.

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9DOD policy requires WCF activities to return collections of these costs to the Department of the Treasury.
Table 1: Estimated Undercharges Related to Civilian Pension and Postretirement Health Benefits for Fiscal Years 1992 Through 1996

<table>
<thead>
<tr>
<th>WCF supply activity</th>
<th>Pension benefit undercharges</th>
<th>Postretirement health benefit undercharges</th>
<th>Total benefit undercharges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense Logistics Agency</td>
<td>$12.4</td>
<td>$5.5</td>
<td>$17.9</td>
</tr>
<tr>
<td>Navy</td>
<td>6.2</td>
<td>2.2</td>
<td>8.4</td>
</tr>
<tr>
<td>Army</td>
<td>5.5</td>
<td>1.7</td>
<td>7.2</td>
</tr>
<tr>
<td>Air Force</td>
<td>5.3</td>
<td>1.7</td>
<td>7.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$29.4</strong></td>
<td><strong>$11.1</strong></td>
<td><strong>$40.5</strong></td>
</tr>
</tbody>
</table>

In discussing this matter with DOD Comptroller officials, they acknowledged that civilian retirement benefits were a cost to the government which should be included in the stabilized rate and charged to FMS customers. They told us they are planning to revise their policy so that this cost will be included in the prices charged FMS customers beginning no later than fiscal year 1998.

With regard to the $40.5 million of undercharges shown in table 1 and any additional undercharges that were made during fiscal year 1997, DOD policy requires that all proper charges be recorded against the applicable FMS case. According to the policy, case closure does not stop the billing process. Further, the standard FMS sales contract provides that the FMS customer is to pay the U. S. government the total cost of the items even if that cost exceeds the amounts estimated in the LOA. Also, we have issued numerous reports over the years that have (1) identified tens of millions of dollars of undercharges related to the costs for goods and services provided to FMS customers and (2) recommended that DOD retroactively collect the underbillings. Generally, DOD agreed with our earlier findings and recommendations and has rebilled and collected undercharges in the past. Therefore, since DOD policy and the contractual terms provide for adjustments to an FMS case, even if it has been closed, and DOD has collected undercharges in the past, DOD should make every reasonable attempt to recover the past undercharges for civilian pension and postretirement health benefit costs. In this regard, DOD should first consider the cost effectiveness of determining how much each FMS customer was undercharged.

Conclusions

DOD’s stabilized rate policy, if applied properly, should allow WCF activities to recover the full cost of their operations over the long term. However, the stabilized rate should be adjusted to include all pension and...
postretirement health benefit costs to the U.S. government for items sold or services provided to FMS customers. DOD recognizes that these additional retirement benefit costs, whose omission has resulted in millions of dollars of undercharges, should be charged to FMS customers, and is in the process of revising its policy to require that these costs be included in future rates.

**Recommendations**

We recommend that the Secretary of Defense direct the Under Secretary of Defense (Comptroller) to

- implement the stabilized rate policies and procedures as soon as possible to require WCF activities to include pension and postretirement health benefit costs in the prices they charge FMS customers, and
- make every reasonable attempt to bill for and collect the undercharges for pension and postretirement health benefit costs identified in this report. Such action should be taken only if cost effective to do so.

**Agency Comments**

DOD concurred with our findings and recommendations. The Acting Under Secretary of Defense (Comptroller) agreed that DOD should have been charging FMS customers for civilian retirement and postretirement health benefits and issued guidance on August 27, 1997, instructing that these charges be added to DOD’s prices effective immediately. The Acting Under Secretary also requested that DSAA and the military services review FMS cases, going back through fiscal year 1992, and bill the FMS customers for the costs of civilian retirement and postretirement health benefits where cost effective.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Armed Services, the Senate Committee on Governmental Affairs, the House Committee on National Security, the House Committee on Government Reform and Oversight, and the House and Senate Committees on Appropriations; the Secretary of Defense; the Director of the Office of Management and Budget; and other interested parties. We will make copies available to others upon request.
Please contact me at (202) 512-6240 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix II.

Sincerely yours,

Jack L. Brock, Jr.
Director, Defense Information and Financial Management Systems
Appendix I

Comments From the Department of Defense

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Dodaro:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report “FOREIGN MILITARY SALES: DoD’s Stabilized Rate Can Recover Full Cost,” dated July 31, 1997 (GAO Code 511613/OSD Code 1425).

The Department reviewed the draft report and concurs with the two recommendations. The Department has already issued new working capital fund (WCF) pricing policy (copy enclosed) that requires the DoD Components to modify WCF stabilized rates for the costs of unfunded civilian retirement and postretirement health benefits for Foreign Military Sales (FMS). This new policy will be included in the next revision to the “DoD Financial Management Regulation.”

Additionally, this office has requested the Defense Security Assistance Agency, in conjunction with the Military Departments, to review FMS cases, going back through FY 1992, and bill the FMS customers for the costs of unfunded civilian retirement and postretirement health benefits where cost effective.

My point of contact on this matter is Mr. Nelson Toye, Deputy Chief Financial Officer. He may be reached by telephone at (703) 697-0503.

Sincerely,

Alice C. Maroni
Acting Under Secretary of Defense
(Comptroller)

Enclosure
MEMORANDUM FOR DIRECTOR FOR ADMINISTRATION AND MANAGEMENT
DIRECTORS OF THE DEFENSE AGENCIES
ASSISTANT SECRETARIES OF THE MILITARY DEPARTMENTS (FINANCIAL MANAGEMENT AND COMPTROLLER)
COMMANDER, JOINT LOGISTICS SYSTEMS CENTER

SUBJECT: Price of Department of Defense (DoD) Working Capital Fund Activity Defense Articles and Services Sold to Foreign Military Sales (FMS) and Other Non-Federal Customers

Current DoD policy requires DoD working capital fund activities to charge all customers (DoD and non-DoD) the same standard (stabilized) price or rate on the sale of defense articles and services. Effective immediately, the standard (stabilized) price or rate charged FMS and non-federal customers of DoD working capital fund activities for defense articles and services shall be adjusted to include an amount for unfunded civilian retirement and postretirement health benefits costs. Amounts collected for unfunded civilian retirement and postretirement health benefits costs shall not be retained by DoD working capital fund activities; rather, such amounts shall be deposited into the Miscellaneous Receipts Account 3210, “General Fund Proprietary Receipts, Defense Military.”

To determine the adjustment to the standard (stabilized) price or rate for unfunded civilian retirement and postretirement health benefits costs, the civilian salary and overtime costs (not including benefits), included in the standard price or rate, shall be multiplied by the unfunded civilian retirement and postretirement health benefits costs rate. The current rate for FY 1997 is 16.7 percent. This office annually updates this rate, in conjunction with the update of various other reimbursable rates. The DoD reimbursable rates can be found on the Internet at www.dtic.mil/comptroller/rates.

This change in policy will be included in the next revisions to Volumes 11B and 15 of the “DoD Financial Management Regulation.”

Mr. Thomas Short and Mr. Stephen Tabone are my points of contact on this matter. Mr. Short may be contacted by e-mail: shortt@oustdc.osd.mil or by telephone at (703) 697-6875, and Mr. Tabone may be reached by e-mail: tabones@oustdc.osd.mil or by telephone at (703) 693-6520.

Alice C. Maroni
Acting Under Secretary of Defense (Comptroller)
Appendix II

Major Contributors to This Report

Accounting and Information Management Division, Washington, D.C.

Larry W. Logsdon, Assistant Director
Harold P. Santarelli, Senior Auditor-in-Charge
Cristina T. Chaplain, Communications Analyst

Office of General Counsel

Frank Maguire, Senior Attorney
Related GAO Products


Letter to the Deputy Secretary of Defense on the results of the DOD-wide review and suggestions for improving the implementation of DBOF (GAO/AIMD-94-7R, October 12, 1993).


Letter to Congressional Committees on DOD’s progress in implementing DBOF and GAO suggestions for improvement (GAO/AFMD-93-52R, March 1, 1993).
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