United States General Accounting Office

GAO

Report to the Chairman, Committee on International Relations, House of Representatives

November 1999

FOREIGN MILITARY SALES

Efforts to Improve Administration Hampered by Insufficient Information

G A O

Accountability * Integrity * Reliability

GAO/NSIAD-00-37

Contents

Letter

Letter 3

Appendixes

Appendix I: Breakdown of Foreign Military Sales Administrative Funding and Organizations 28

Appendix II: Comments From the Department of Defense 31

Tables

Table 1: Fiscal Year 1998 Program Management Spending and FMS Administrative Budget Spending by Military Service 10

Table 2: Projections of Foreign Military Sales Versus Actual Sales Realized 13

Table 3: Fiscal Year 1998 FMS Administrative Budget Allocation and Roles of Primary FMS Organizations 29

Figures

Figure 1: Trend in the Value of Foreign Military Sales, Fiscal Years 1989-1998 7

Figure 2: Military Services' FMS Administrative Budgets, 1990-2002 9

Figure 3: FMS Administrative Account Balance, Fiscal Years 1983-1998 14

Figure 4: Projected Administrative Account Balance With 2.5-Percent Administrative Charge at $7.5 Billion Sales and $10 Billion Sales, 1999-2007 19

Figure 5: DOD Organizations That Receive FMS Funding 30

Abbreviations

DOD	Department of Defense
DSCA	Defense Security Cooperation Agency
FMS	Foreign Military Sales

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-283614

November 22, 1999

The Honorable Benjamin A. Gilman
Chairman, Committee on International Relations
House of Representatives

Dear Mr. Chairman:

Foreign military sales are an important component of the U.S. security assistance program and also represent a key Department of Defense acquisition strategy to help lower the unit costs of weapon systems.[1] The Arms Export Control Act provides a number of ways to price defense articles and services transferred under the Foreign Military Sales program, including actual value, replacement value, and full cost, and requires that the Department of Defense recover, with specified exceptions, the full estimated cost of administrating such sales.[2] As a result of budget pressure from declining sales and customer complaints about program inefficiencies, the Defense Security Cooperation Agency, which manages the program, and the military services have begun a number of reinvention efforts to improve the management and implementation of the Foreign Military Sales program.

In response to your concerns, we assessed the Foreign Military Sales program to determine the changes needed to improve the viability of the program. Specifically, we evaluated (1) whether the Foreign Military Sales program has achieved full recovery of its administrative costs, (2) the Defense Security Cooperation Agency's basis for making administrative account adjustments, and (3) the effectiveness of various Foreign Military Sales reinvention efforts in terms of cost recovery.

Results in Brief

The Department of Defense does not have sufficient information to determine the administrative costs associated with the Foreign Military Sales program. As a result, the Department is unable to use actual cost as a

[1]See *Defense Trade: DOD Savings From Export Sales Are Difficult to Capture* (GAO/NSIAD-99-191, Sept. 17, 1999).

[2]See sections 21 and 22 of the Arms Export Control Act (22 U.S.C. 2761 and 2762).

basis to determine what charges should be applied to foreign military sales, and does not know if the percentage charged to the customer on the dollar value of individual sales is appropriately recovering Foreign Military Sales program costs. The allocation of administrative funds to activities responsible for implementing the Foreign Military Sales program is based on past administrative budget outlays and perceived needs. In addition, the military services directly charge customers for some administrative tasks on individual sales. These are referred to as program management charges. Under existing guidelines, the services have discretion concerning which administrative activities associated with the Foreign Military Sales program should be funded through the administrative budget and which should be directly funded through program management charges.

The Defense Security Cooperation Agency uses estimated sales projections and the balance of the administrative account to determine whether program adjustments must be made. Sales projections are judgmental estimates on the part of the agency's country desk officers and are adjusted by the Defense Security Cooperation Agency's management. When the administrative account balance fell below zero, the Defense Security Cooperation Agency increased fees, sought and obtained legislative relief that allowed program costs to be moved to Department of Defense appropriations accounts, and reduced administrative budgets provided to the military services. Conversely, a recent decision to reduce the administrative fee charged was justified, in part, by the large balance currently held in the account. Having a positive balance in the administrative account is important, since a certain level of funding is needed to carry out work that has already been paid for by customers; however, too large an account balance may represent a mismatch between fees and administrative account allocations to those activities implementing the Foreign Military Sales program.

Reinvention efforts by the Defense Security Cooperation Agency and military services include some initiatives that could enable Foreign Military Sales program managers to better identify costs. However, these initiatives lack a common approach and are managed as independent efforts. As a result, these initiatives as currently structured are unlikely to provide the Defense Security Cooperation Agency with complete and consistent information about the costs of administering foreign military sales, thus making it difficult for that agency to ensure that the program is fully recovering required administrative costs, allocating administrative budgets appropriately, or accurately assessing the impact of other reform initiatives.

We make recommendations in this report for the Department to improve program management for foreign military sales by directing that efforts to identify costs use a comprehensive and consistent definition of administrative tasks, by developing and communicating guidance that requires consistent application of program management charges, and by identifying alternative program uses for any excess administrative account balance.

Background

Under the Foreign Military Sales (FMS) program, the Department of Defense (DOD) provides defense items, services, and military training through cash and credit sales, grant, lease, or loan from DOD inventories or through new procurements under DOD-managed contracts. Individual sales transactions between the U.S. government and a foreign government range from sales of major items (such as F-18 aircraft with associated parts, maintenance, and training) to military clothing or commercial vehicles. The value of individual sales—otherwise known as cases—ranges from billions of dollars to less than $100.

The Arms Export Control Act states that FMS sales should include appropriate charges for administrative services to recover the full estimated costs of administering sales—with some costs, for example, fixed base operation costs, specifically excluded—and that such charges should be calculated on an average percentage basis.[3] However, the law does not define the basis for determining if full cost recovery is achieved. Currently, the Defense Security Cooperation Agency (DSCA) applies a 2.5-percent administrative charge on all foreign military sales and a 3.1-percent logistics support charge on certain spare parts, supply, and maintenance items.[4] These charges are collected and held in an administrative cost clearing account within the FMS Trust Fund. Using this account, DSCA manages the FMS program by developing an annual administrative budget that allocates funding to the defense agencies for the execution of the program.

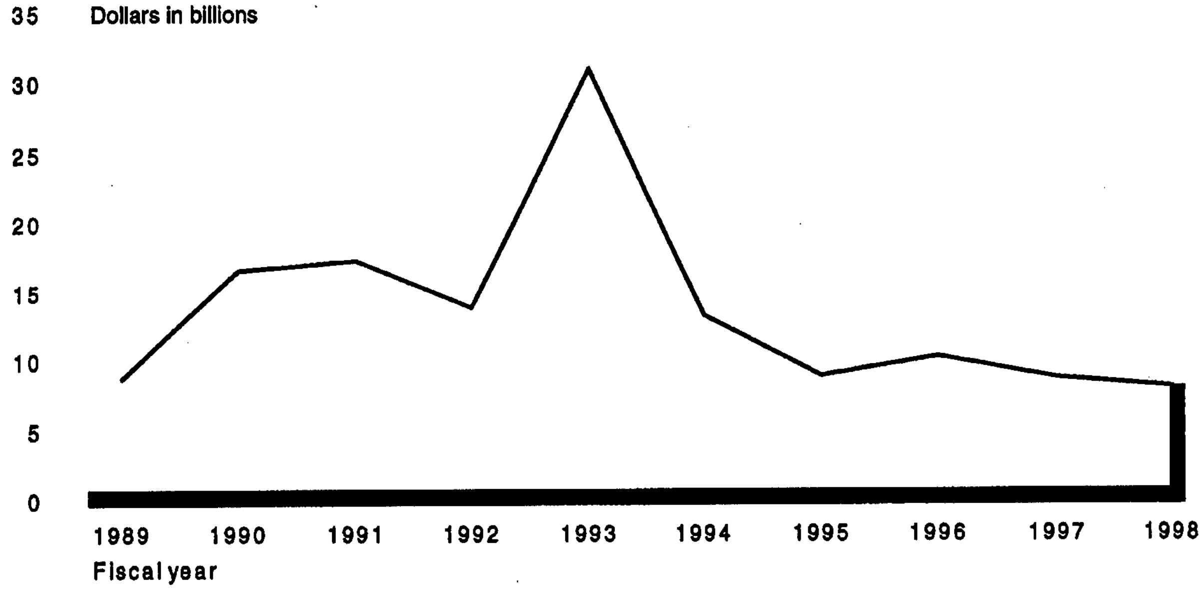
[3]The Arms Export Control Act sets the requirement for recovery of FMS costs. Full accounting for the cost of federal programs is required by federal financial accounting standards.

[4]In June 1999, DOD reduced the administrative charge from 3 to 2.5 percent. Also, instead of the 2.5-percent administrative charge, the FMS program applies a 5-percent administrative charge to sales of nonstandard articles and services.

The FMS Trust Fund, which has an annual balance of approximately $5.9 billion, is a vehicle for processing foreign country funds required for FMS payments to U.S. contractors for new procurements and to DOD components for sales from DOD stock. This trust fund was established to facilitate purchases of U.S. defense articles and services by foreign countries. DSCA uses the administrative cost clearing account, with a current balance of approximately $500 million, to fund its annual FMS administrative budget, which supports the FMS infrastructure and the execution of foreign military sales. In fiscal year 1998, the administrative budget was $350 million. DSCA and the military services distribute this budget to over 60 DOD organizations to assist in the execution of the FMS program. Organizations, such as the military services, that conduct sales receive 64 percent of FMS administrative funding while 36 percent goes toward centralized administrative activities, such as DSCA and the Defense Finance and Accounting Service. (See app. I for details on FMS budget allocations and the organizations that receive FMS administrative funding.) Besides the administrative charges, the military services charge individual sales for administrative expenses that are not ordinarily supported by the administrative budget, such as salaries and expenses associated with program management efforts on weapon system sales.

In early 1998, press accounts drew attention to problems with the FMS program by highlighting declining FMS sales and growing customer dissatisfaction. In recent years, the level of foreign military sales has generally declined, as shown in figure 1. Competition from other countries' exports as well as from direct commercial sales from U.S. suppliers to foreign governments is pressuring the program to perform more efficiently. Although generally supportive of the FMS program, both foreign customers and U.S. industry are complaining about the costs and inefficiencies of the program. The use of cost-based rather than fixed-price contracts and a lack of transparency in the costs are major irritants. Lack of transparency is illustrated by the uncertainty regarding what services are paid for through the administrative charge as compared to direct charges on individual sales. In May 1998, the Deputy Secretary of Defense called for an effort to examine ways to streamline the FMS process, stating that there are major opportunities for re-engineering FMS business practices. DSCA's Director explained that savings could be achieved through consolidating activities that administer sales.

Figure 1: Trend in the Value of Foreign Military Sales, Fiscal Years 1989-1998



Note: In the early 1990s sales increased as a result of the Persian Gulf War.

Source: DSCA.

Information on Cost of Administering FMS Is Not Sufficient to Determine Cost Recovery

In 1997, the DOD Office of the Inspector General reported that DSCA did not have reliable information on either the full cost of the FMS program or the cost of integral tasks that must be performed regardless of the size of the sale or service being purchased.[5] The Inspector General further reported that DSCA and the military services did not have sufficient information to determine administrative budget needs to plan for unexpected requirements or to evaluate the efficiencies and effectiveness of the FMS program. According to DSCA budgeting officials, the administrative budget that is used to pay for the administrative costs of foreign military sales is developed and allocated based on past administrative budget outlays, the perceived needs of the military services, and overall sales projections rather than on the actual costs.

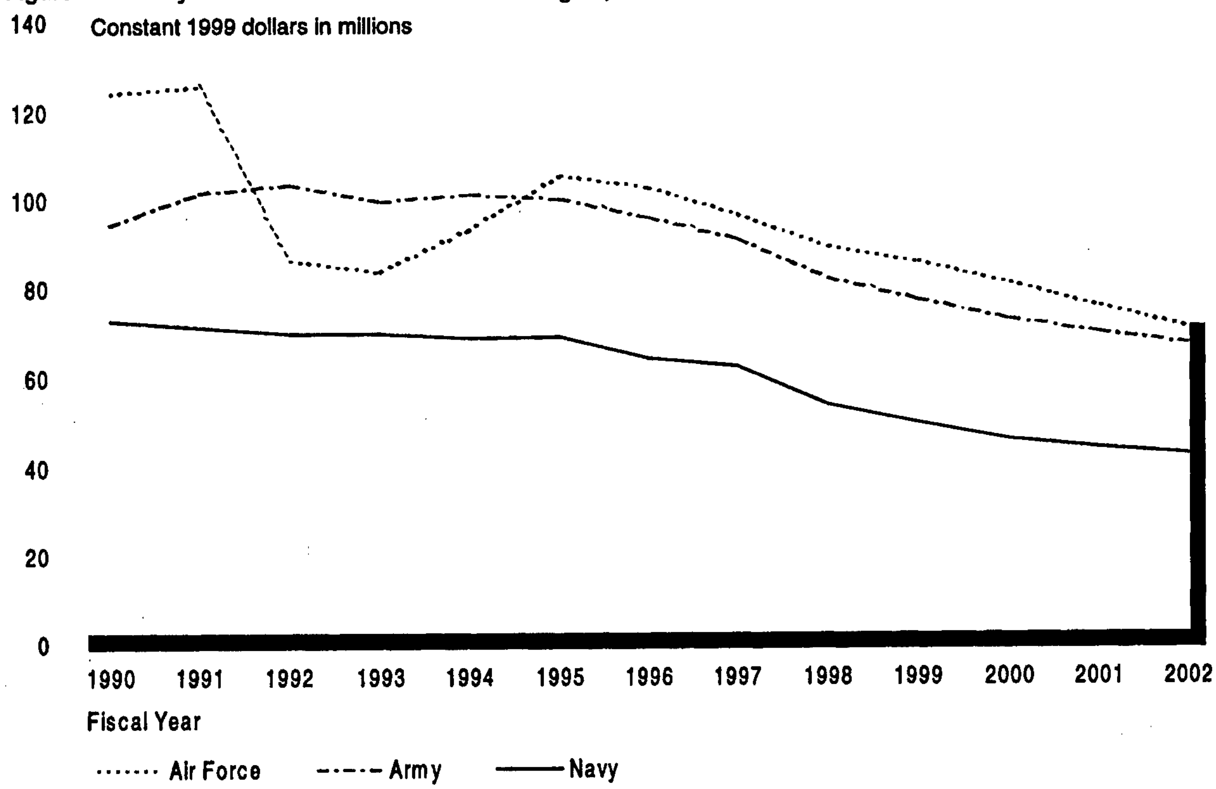
[5] *Foreign Military Sales Administrative Surcharge Fund*, DOD Office of Inspector General, Report No. 97-227, Sept. 30, 1997. In response to the report, DOD activities commented that such information was not necessary.

Our analysis of sales from 1989 through 1998 found that sales valued over $100 million (equaling less than 1 percent of all foreign military sales) generated 61 percent of the program's total dollar value of sales, and sales valued over $14 million (4 percent of FMS sales) generated 82 percent of the dollar value of all sales, but the remaining 96 percent of foreign military sales generated only 18 percent of the dollar value of all sales. Because the administrative charges are applied on a percentage basis to individual sales, administrative revenue collected is a function of the dollar value of individual sales, with larger sales accounting for more of the administrative charges collected than smaller sales. While these smaller sales generate less total revenue, they constitute a sizable portion of the FMS workload. In 1987, DOD created a 3.1-percent logistic support charge on certain spare parts, supply, and maintenance items. This charge was intended to increase administrative revenue from logistics support sales and offset the program's reliance on the largest sales. However, in fiscal year 1998 the logistics support charge equaled only 11 percent of total administrative revenue.

Effect of Budget Reductions on Military Services

Over the last 5 years, DSCA has reduced budget allocations to the military services for funding administrative costs associated with foreign military sales in an effort to reflect declining sales and anticipated reductions in administrative revenues. DSCA also reduced budgets to encourage organizations conducting foreign military sales to become more efficient. The agency reduced the military services' administrative budgets for fiscal year 1995 to reflect defense planning guidance that required a 4 percent reduction in civilian manpower as well as presidential guidance that mandated a 6-percent reduction in overhead costs. Figure 2 shows the individual military services' actual FMS administrative budgets for fiscal years 1990 through 1999 as well as budget levels set by the DSCA through fiscal year 2002. After adjusting for inflation, Air Force, Army, and Navy administrative budgets have decreased by 18 percent, 23 percent, and 28 percent, respectively, since fiscal year 1995; current budget plans call for total reductions of 33 percent, 32 percent, and 38 percent, respectively by 2002.

Figure 2: Military Services' FMS Administrative Budgets, 1990-2002



Source: DSCA.

While reducing FMS administrative budgets, DSCA directed the military services to "restructure organizations, processes and work year levels, as necessary, so that the essential security assistance mission is conducted within the prescribed funding levels." Consequently, each military service is undergoing streamlining efforts to accommodate DSCA budget reductions. However, even with streamlining initiatives, the military services have indicated they will not be able to absorb further budget reductions. For example, the Air Force's fiscal year 1999 budget plan submitted to DSCA stated that although the administrative budget estimates were developed based on projected sales, the number of new sales anticipated indicates that their workload is not decreasing commensurate with budget reductions. In the transmittal letter accompanying the plan, the Air Force cautioned that it would not be able to execute its FMS administrative program if administrative funding continues to decline. Air Force officials stated that, under current budgets, they "cannot afford to make a new sale" unless additional funding is provided. Moreover, Navy officials explained that decreases in efficiencies are a result of inadequate funding. According to the Navy, the decreases in administrative budgets are resulting in an increase in the time it takes to process new sales and a decline in the number of sales the Navy is able to close. Slow case closures have been the subject of FMS customer complaints.

Using Program Management Charges

DOD guidance allows the military services to recover certain costs of administering FMS sales by applying program management charges directly to individual sales. These charges are intended for nonroutine levels of management effort needed to administer a sale. Table 1 shows for fiscal year 1998 the extent to which these program management charges were used by each of the services to administer foreign military sales. When program management charges and administrative budgets are combined, 37 percent of the military services' funding for FMS administrative costs comes from program management charges versus 63 percent from the administrative budget.

Table 1: Fiscal Year 1998 Program Management Spending and FMS Administrative Budget Spending by Military Service

Dollars in millions

	Program management charges		FMS administrative budget		Total	
	Dollars	Percentage	Dollars	Percentage	Dollars	Percentage
Air Force	$63.4	42	$87.4	58	$150.8	100
Army	20.9	21	80.5	79	101.4	100
Navy	47.8	48	52.7	52	100.5	100
Total	**$132.1**	**37**	**$220.6**	**63**	**$352.7**	**100**

Source: DSCA and the Departments of the Air Force, Army, and Navy.

Program Management Guidance Permits Discretion

The Security Assistance Management Manual permits discretion concerning when program management charges may be used and which administrative tasks should be charged to them.[6] According to DSCA and military service officials, the manual does not clearly indicate which tasks should be funded through program management charges and which tasks should be funded through the administrative budget. DSCA does not closely monitor the military services' use of program management charges and has not addressed the need to consistently apply program management charges on all FMS sales. For example, in a Navy sale of Commando helicopter depot-level maintenance valued at $32.8 million, the administrative charge was $897,000 and the sale had a program management charge of $2.1 million. According to this sale's letter of offer and acceptance, additional program management efforts were required to successfully deliver the material and services ordered. These efforts include program planning, direction, monitoring, control and coordination, and related travel. However, in an Army Tank Automotive and Armaments Command sale of 300 refurbished M60 tanks valued at $204 million, the administrative charge was $5.9 million. This sale had no program management charges. The Army's case manager explained that the effort to implement this sale was extraordinary, required intensive management, and in hindsight probably should have had a program management charge. Tank Automotive and Armaments Command officials explained that they used their discretion and funded this effort through the administrative budget.

The military services differ in their reliance on program management charges. While program management charges represent 48 percent of the Navy's total administratively related funding, they represent only 21 percent of such funding for the Army. At key commands that implement FMS sales, the difference is even more significant. In fiscal year 1998, the Naval Air Systems Command's program management charges represented 71 percent of the command's total administrative funding as opposed to 36 percent at the Army Tank Automotive and Armaments Command. Both of these organizations conduct sales of major weapon systems.

These differences may be related, in part, to the differing abilities of commands to determine the actual cost of individual sales. The Naval Air

[6] The Security Assistance Management Manual is maintained by DSCA and establishes policies and procedures required to manage the FMS program and other security assistance programs.

Systems Command has a time and attendance system that is able to capture personnel costs for work on individual foreign military sales. As a result, it is easier for the Command to document program management costs on sales and transfer these costs to the customer. Other commands, such as the Tank Automotive and Armaments Command, do not have the systems in place to capture these costs, and officials there told us that they have only six ongoing sales with program management charges.

Basis for Adjusting the Administrative Budget

Since DSCA is not able to manage based on the cost of conducting foreign military sales, the agency estimates future sales and uses the administrative account balance to plan future budgets and adjust administrative charges. DSCA uses the FMS administrative account to fund administrative budgets in order to support the FMS infrastructure, including work required to execute sales and generate new sales. The administrative account balance is maintained through the 2.5-percent administrative charge on all sales and the 3.1-percent logistics support charge on certain items. A positive balance in the administrative account is desired since funding is needed to support work that has already been paid for by the customers.

To determine future administrative account balances, DSCA makes sales projections to anticipate future administrative revenues. DSCA's process for estimating sales projections is based on subjective analysis and discretionary adjustments. Sales projections tend to reflect incremental changes from year to year, even though prior to 1995 wide variations in actual sales occurred. For example, sales from 1989 through 1990 jumped from $8.8 billion to $16.6 billion, from 1992 through 1993 jumped from $13.9 billion to $31.1 billion, and then from 1994 through 1995 declined from $13.3 billion to $9.0 billion. Table 2 contains DSCA's sales projections and actual sales from 1991 through 1999.

Table 2: Projections of Foreign Military Sales Versus Actual Sales Realized

Dollars in billions

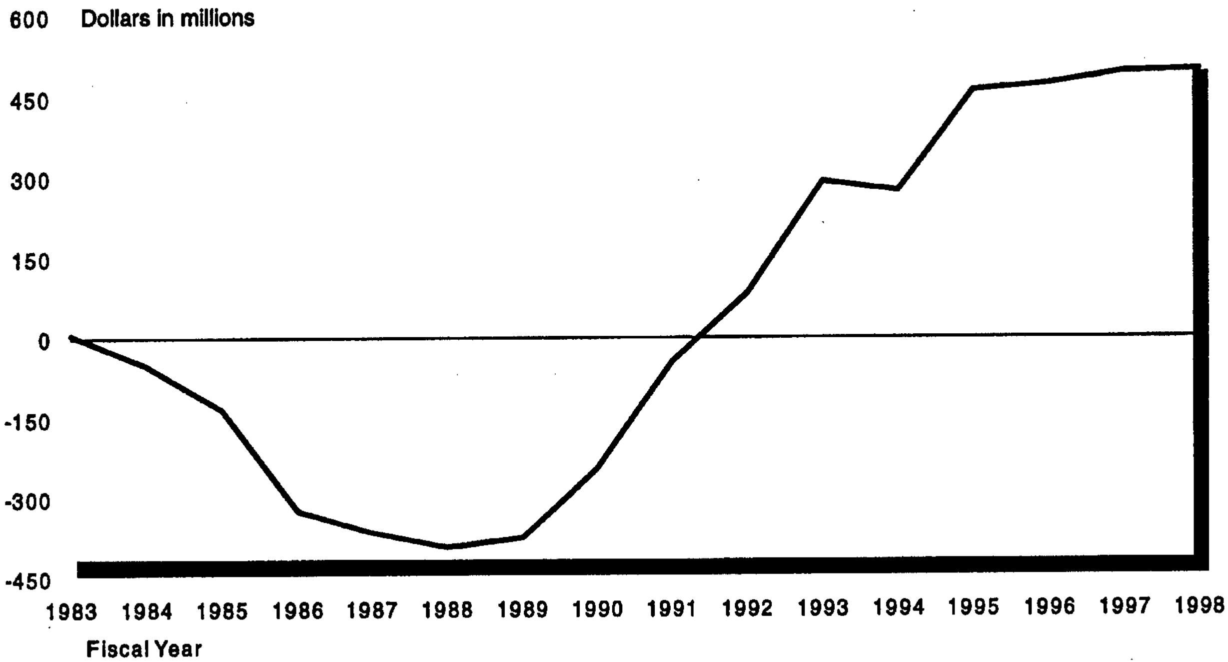
	Sales projection by fiscal year												
Date of projection	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Sept. 1991	$12.0	$11.0											
Sept. 1992		17.0	$12.0	$12.0	$11.0	$11.0	$10.0						
Oct. 1993			11.5	10.0	10.0	10.0	9.0	$9.0					
Oct. 1994				9.0	9.5	10.5	9.0	8.5	$12.0				
Oct. 1995					9.8	9.5	9.0	8.5	12.0	$10.0			
Oct. 1996						10.6	10.5	12.4	12.7	11.3	$11.8		
Jan. 1998							8.9	9.3	8.2	8.3	7.3	$7.5	
Jan. 1999								10.8	9.0	8.3	7.3	7.5	$7.5
May 1999								10.8	9.0	10.0	10.0	10.0	10.0
Actual sales	$13.9	$31.1	$13.3	$9.0	$10.3	$8.8	$8.2						

Source: DSCA.

DSCA projects foreign military sales for the current and the next 5 fiscal years. DSCA country managers or desk officers draft country estimates of projected sales based on their knowledge and experience as well as through consultation with other knowledgeable sources. DSCA offers little guidance or criteria and no systematic tools to its staff concerning how to develop these estimates. DSCA's Director and Deputy Director are provided summaries of country estimates and have wide latitude in adjusting the estimates. For example, in May 1999, sales projections were revised after DSCA had requested a decrease in the administrative charge from 3 to 2.5 percent. In January 1999, DSCA had projected sales of $8.3 billion in fiscal year 2001 to $7.5 billion for fiscal year 2004. Two weeks after DSCA proposed lowering the administrative charge, the DSCA Comptroller submitted $10 billion sales projections for the same fiscal years. The change was based on October 1995 projections, and according to DSCA managers, the projections did not include any new analysis. The basis for the upward adjustment, according to DSCA officials, was essentially judgment. Using the higher sales projections, DSCA estimated higher future balances for the FMS administrative account, which provided additional support for the administrative charge reduction.

From 1984 to 1991, when the administrative account consistently had a negative balance (ranging between $49 million and $389 million as shown in fig. 3), DSCA initiated various actions to improve the balance. These included reducing administrative budget allocations, increasing administrative charges and moving FMS administrative costs to other DOD appropriated accounts. More recently, in June 1999, DOD decreased the administrative charge from 3 to 2.5 percent in part because the balance in the administrative account had grown to $500 million.

Figure 3: FMS Administrative Account Balance, Fiscal Years 1983-1998



Source: DSCA.

The following shows the actions taken to adjust the FMS account balance:

- In 1985, the Arms Export Control Act was amended so that the FMS pro rata share of fixed base operation costs were eliminated as an expense to the FMS administrative account.[7] Until then, the program was required to pay a pro rata share of fixed base operation costs.
- In 1985, timing of payments was revised to collect 50 percent of the administrative charge when a foreign military sale commences and the remaining 50 percent when equipment or services are delivered. Prior to this time, the entire administrative charge was collected as equipment and services were delivered.
- In 1987, military staff years associated with administering the program were reduced by 20 percent. This reduction equated to $60 million in reduced program costs for the first year implemented.
- In 1987, DOD created the 3.1-percent logistic support charge on certain spare parts, supply, and maintenance items. This charge was intended to increase administrative revenue from smaller sales and offset the program's reliance on the largest sales. In fiscal year 1998, the logistics support charge was about $37 million, or 11 percent of total administrative revenue.
- In 1989, the Arms Export Control Act was amended to allow the FMS program to avoid paying for certain costs associated with military personnel who worked on the FMS program as well as unfunded civilian retirement.[8] This action was taken in lieu of a proposal to increase the FMS administrative charge from 3 to 5 percent. During fiscal year 1990, the cost avoidance for the program was about $80 million. Currently, DSCA data shows that this cost avoidance for 1999 would also be about $80 million.
- In 1999, the FMS administrative charge was reduced from 3 to 2.5 percent in part because the account balance was perceived as too high, and DOD wanted to send a message to its foreign customers that it was committed to making the FMS program more effective and efficient.

In addition, although DSCA uses the administrative account balance as a basis for decisions relating to administrative charges and budgets, agency officials acknowledge that there is no guidance on what constitutes a prudent balance for the administrative account. DSCA officials explained

[7] P.L. 99-83, Aug. 8, 1985.

[8] P.L. 101-165, Nov. 21, 1989.

that a positive account balance is needed to support future work that has already been paid for by customers. Estimating an appropriate account balance is difficult since DSCA does not manage based on cost and is not able to estimate the cost of the work it has committed to. Typically, DSCA has sought to maintain a level of about 1-1/2 times the yearly administrative budget, which is roughly equal to the current account balance of about $500 million.

Reinvention Efforts Lack a Common Approach to Administrative Costs

DSCA and the military services are conducting various separate reinvention initiatives to improve the management and implementation of the FMS program. Generally, these initiatives include activities to reduce budgets, streamline organizations, improve business processes, reduce cycle times, improve the FMS program for the customers, and team with U.S. industry to develop hybrid sales with direct commercial and foreign military program components. As knowledge of program costs is necessary to many of these initiatives, the military services and DSCA each have efforts specifically related to identifying costs. However, the separate efforts take different approaches to address cost issues, have different coverage, and have not been coordinated.

DSCA has identified cost recovery as a key issue in its reinvention efforts. In May 1998, DSCA initiated a study to measure the cost of those key tasks funded by the administrative budget at certain military service buying commands, such as the cost of pre-sale, customer support, sale execution, and sale or case closure efforts. The DSCA effort will not capture the total cost of administering the FMS program since it is attempting to capture costs charged to the administrative budget and not administrative costs associated with program management charges.

The Air Force has begun an initiative to outsource a large portion of its workload, which it hopes will improve efficiency. It will also add program charges for certain activities that had previously been funded through the administrative budget. The goal of the initiative is to increase responsiveness to foreign customers, decrease the time required to execute and close sales, provide timely sale reconciliation, reduce costs to the customer, and align fees with services. Under the Air Force initiative, all activities required to execute a sale will be considered for outsourcing except inherently governmental functions—such as exercising program decision authority, contracting officer authority, and financial authority requiring funds certification. The intent of the Air Force initiative is to consolidate all personnel and travel costs required for managing the execution of sales and charge these costs directly on program management lines, whether those costs are incurred by government personnel or contractor personnel. As a result, the Air Force would charge personnel and travel costs previously funded through the administrative budget directly to sales. In an August 1998 memorandum to DSCA, the Air Force outlined its initiative and requested a waiver of the current guidance on program management charges in order to implement the proposal. DSCA did not respond to the Air Force's request. In March 1999, the Air Force decided to proceed with implementing its initiative despite DSCA's lack of response. The Air Force acknowledged in a June 1999 memorandum that the overall costs to customers may increase as they identify specific functions and associated costs that could be directly charged to foreign military sales.

Navy reinvention efforts call for centralized control of Navy administrative funding and program management funding. The Navy plans to document their costs of administering foreign military sales to ensure it is properly reimbursed for these costs. Although the Navy is not yet able to account for its actual costs in administering foreign military sales, it already pays for nearly half of its total administrative costs using program management charges. The Navy strives to charge all costs that can be associated with a sale directly to that sale. For example, the Naval Air Systems Command has implemented a time and attendance system that allows the Command to account for all personnel costs directly associated with particular sales.

The U.S. Army Security Assistance Command has developed a system that breaks down the costs of tasks related to administering sales. The Army plans to allocate its FMS administrative budget according to these tasks. Army officials believe that this will help them justify their administrative budget when DSCA is making budget decisions.

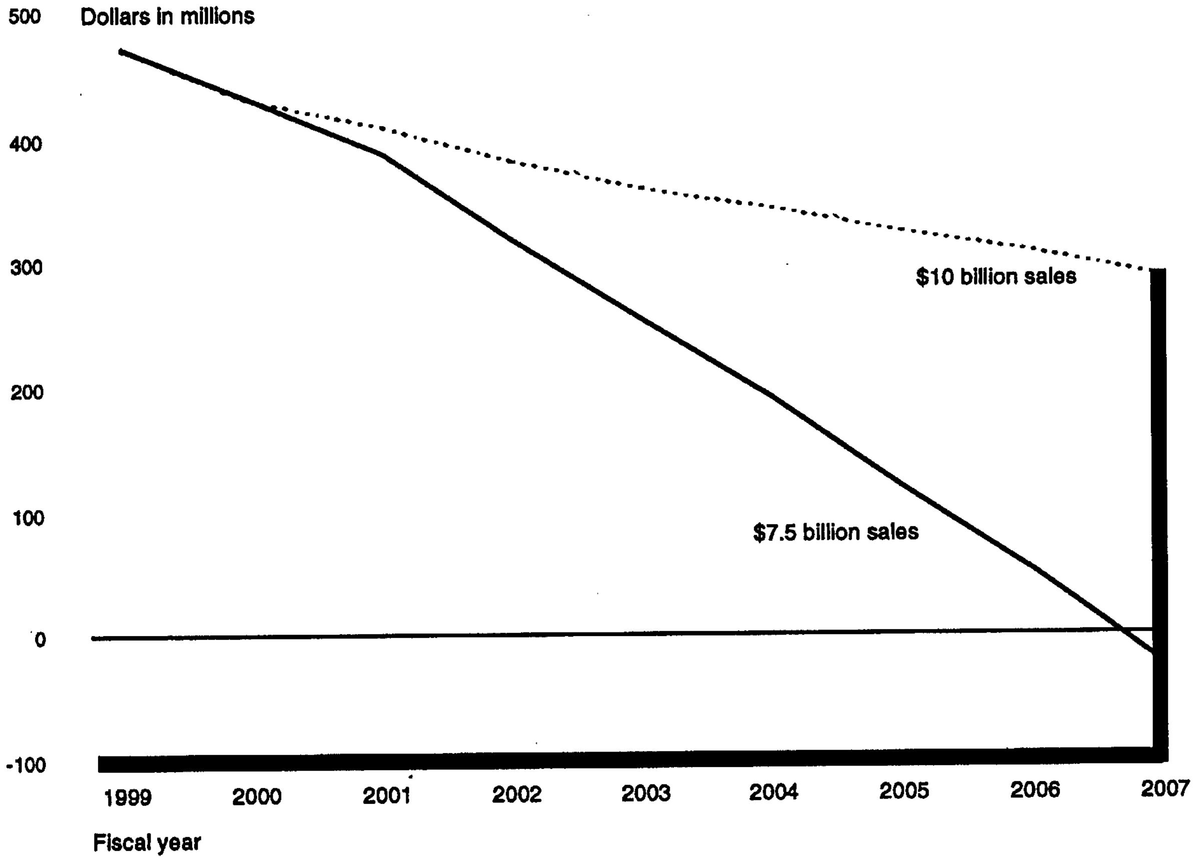
Administrative Charge Reduced Without Cost Information

The most significant action taken under DOD's current reengineering efforts was the June 1999 decision to reduce the administrative charge from 3 to 2.5 percent. DSCA stated that this decision was based on planned streamlining initiatives, anticipated increases in sales as a result of the Balkan conflict, and a high balance in the FMS administrative account. According to DOD, the reduction was intended to show the customer that they were serious about making the process more efficient.

Until mid-May 1999, DSCA's estimates showed that with a 2.5-percent administrative charge the administrative account would reach a deficit by 2007 (see fig. 4).[9] As noted previously, 2 weeks after DSCA's proposal to cut the administrative charge, foreign military sales projections were adjusted, putting the future account balance on a more positive footing. However, DSCA estimates continued to show a downward slope in the account balance. DSCA's estimate of the administrative account balance using higher sales estimates did not consider increases in resources needed to cover the additional administrative costs that would likely be incurred with additional sales. Increased resources and budgets could result in a steeper reduction in the administrative account than shown in figure 4.

[9] *Defense Trade: Decision to Lower FMS Administrative Fee is Premature* (GAO/NSIAD-99-161R, May 13, 1999).

Figure 4: Projected Administrative Account Balance With 2.5-Percent Administrative Charge at $7.5 Billion Sales and $10 Billion Sales, 1999-2007



Source: DSCA.

Conclusions

The Foreign Military Sales program is generally required to recover the full estimated costs of administering sales. Although expected to operate on a cost recovery basis, DOD does not have the systems in place to identify the actual cost of administering foreign military sales. Limited visibility over costs hampers management of costs and affects DSCA's ability to set fee structures and allocate budgets appropriately. It has also resulted in excessively wide ranges in the administrative account balance. In addition, FMS program management is hampered by the lack of a consistently applied definition of those administrative tasks associated with implementing sales that should be charged to the overall administrative account and those that should be charged to program management. As a result, DSCA's attempts to force program efficiencies by reducing the funding it provides to the military services may not be successful. In fact, the services have efforts in place that may be working at odds with DSCA's efforts. Although each of the services is attempting to better identify its costs in implementing the FMS program through various reform initiatives, the Navy is striving to charge cases directly for all known administrative costs, the Air Force is planning to charge cases for costs once covered by the administrative budget, and the Army is collecting cost data to more strongly justify its existing administrative budget allocation.

Lacking an adequate information base on the administrative costs of executing FMS sales, clear and consistently applied guidance on when to use program management funding, and a coordinated approach to reform efforts, the impact of future program management decisions—such as the need to change the fee level or structure, attempts to develop hybrid commercial/government sales, and other DOD initiatives for the program—will not be understood.

Recommendations

To make certain that future program decisions are made on the basis of adequate information, we recommend that the Secretary of Defense direct that current efforts to identify and collect cost information use a comprehensive and consistent definition of administrative tasks.

To enhance the value of the administrative budget as a management tool, we recommend that the Secretary of Defense develop and communicate to the military services guidance that requires consistent application of program management charges.

To assure that the current FMS administrative account balance is appropriate, we further recommend that the Under Secretary of Defense (Comptroller) assess the amount of funds needed to complete existing sales commitments. If the current administrative account balance exceeds the needed funds, we recommend that the Secretary of Defense identify alternative program uses for these funds.

Agency Comments

In commenting on a draft of this report, DOD concurred with three of our four recommendations. DOD also stated that ongoing reinvention efforts will address the majority of our recommendations. However, DOD's comments do not describe how reinvention efforts will address these recommendations. In certain cases, it is not clear how DOD's proposed implementation of our recommendations would resolve the problems described in this report. In addition, DOD stated that our report misrepresents important facts included in several areas. DOD also provided technical comments that we have incorporated as appropriate. DOD's comments are included as appendix II.

In terms of cost information, DOD stated that our report overstates the position that DOD lacks adequate cost information to manage the FMS program and assure full cost recovery. However, DOD's comments and technical remarks focus on cost recovery from a legal perspective. As we note in the report, the Arms Export Control Act excludes some cost associated with executing the FMS program from the act's requirement to recover administrative costs. However, these excluded costs are associated with the program and should be recognized and considered in decisions made about managing the program and in any reengineering or reform efforts. Federal financial accounting standards state that cost information is essential to managing federal programs in the areas of budgeting and control, performance measurement, determination of reimbursements and setting of fees and prices, program evaluations and economic choice decisions.[10] Further, the standards require agencies to accumulate the full cost of outputs regardless of funding sources using appropriate costing methodologies and cost finding techniques. Having sufficient information on the total costs of executing the FMS program might have alleviated DOD's need to seek legislative relief from certain costs, such as military pay and unfunded civilian retirement benefits, that resulted in shifting the pay burden from the FMS program and the foreign customer to DOD's appropriations accounts and ultimately the taxpayer.

Furthermore, DOD's comments stated that our report infers a connection between the lack of cost information, the annual FMS administrative budgets provided to the military services, and the use of program management charges. While DOD concurred with our recommendations related to the lack of cost information and program management guidance, the Department disagrees with our treatment of these issues. We believe there is a connection between the lack of cost information, annual FMS

[10] *Statement of Federal Financial Accounting Standard, "Managerial Cost Accounting Concepts and Standards for the Federal Government."* (SFFAS No. 4, July 31, 1995).

administrative budgets, and the use of program management charges. DOD uses both FMS administrative charges and program management charges to pay for the cost of executing the FMS program. DOD's criteria, as stated in its guidance, identify the level of effort expended in performing management functions as the primary determiner of whether a function or activity should be funded by the administrative budget or through program management charges. DOD allows the military services discretion in determining what level of effort warrants program management charges. As a result, either program management charges or the administrative budget can be used as the source of funding for the same activities by different military services on different foreign military sales. In an environment in which the services have that level of discretion along with insufficient cost information, DOD cannot effectively manage the program by using the FMS administrative budget.

DOD's comment noted that our draft report incorrectly describes the nature of DSCA activities associated with preparing annual sales estimates. However, DOD did not explain what was incorrect. DOD explained that we call their process judgmental, stated that country desk officers lack guidance or criteria in formulating sales estimates, and said that estimates were adjusted at the discretion of DSCA management. However, DSCA's Deputy Director described this process as judgmental in discussions with us and noted that he substantially changed country desk officers' sales estimates. DSCA's June 1998 sales estimate guidance offers a format for reporting sales estimates and includes inflation indexes for adjusting current year dollars, and suggests that factors such as foreign military financing credit levels and political and economic considerations should be considered. This guidance does not offer country desk officers a methodology to be consistently applied for developing sales estimates. Estimating sales is not an exact science, but DSCA does not have a system in place for assessing the probability of future sales, as do large commercial firms that depend on estimates for key business decisions. Credible estimates are important for DSCA to plan future budget allocations and to ensure, as DOD points out, that adjustments related to management decisions do not appear arbitrary.

DOD commented that our report unfairly suggests that DSCA's only tool for managing the FMS program is the administrative fund balance. We disagree with this description of our report and agree that the administrative fund balance is not the only tool DSCA uses to manage the program. As our report explains, DSCA uses the administrative budget to allocate resources to the program and uses the administrative balance as a measure to determine if change is needed. When DSCA perceives that the balance is not appropriate, it has taken action to raise or decrease charges, and shift expenses from the FMS budget to other DOD accounts. An appropriate administrative balance is an outcome of appropriately aligning costs and fees. Lacking adequate information on the costs of administering sales, past efforts to stabilize the administrative account balance have proven unsuccessful. Moreover, DOD concurred with our recommendation to assess the funds needed to assure that the administrative account balance is appropriate.

The Department concurred with our recommendation to make certain that future program decisions are made on the basis of adequate information by directing current efforts to identify and collect cost information to use a comprehensive and consistent definition of administrative tasks. To implement this recommendation, DOD commented that an ongoing Institute for Defense Analyses study and detailed Army functional breakouts would provide information for alternative models. However, the Institute's study and the Army's work are looking only at tasks currently funded by the FMS administrative budget, and they are not collecting information on administrative tasks funded by program management and other administrative charges to the customer. As we point out in this report, the military services are performing administrative tasks that are charged to the administrative budget and to the program management elements of FMS sales. Our recommendation would require the Department to collect and analyze information on all FMS administrative tasks, regardless of the funding source. Without this information, the Department cannot develop a comprehensive understanding of administrative tasks and related costs or use this information to provide the basis for management decisions, including decisions on appropriate budgets and fees that are clearly based on the cost of executing sales.

The Department concurred with our recommendation to enhance the value of the administrative budget as a management tool by developing and communicating guidance to the military services on charges for program management services. The Department indicated it intends to include guidance in the next revision to DOD regulations.

The Department concurred with our recommendation to assess the amount of funds needed to complete existing sales commitments to assure an appropriate level of the administrative account balance by stating that the Department will determine an appropriate "safety level." It is not the intent of our recommendation to set a "safety level" with the sole purpose of avoiding risk. An appropriate balance in the account should result from setting fees at a level to cover costs associated with implementing existing sales. The account balance should clearly be related to the cost of implementing sales and not some predetermined level.

DOD did not agree with our recommendation to identify alternative program uses for excess administrative account funds. DOD points out that administrative account balances are not appropriated funds and are only available for the purposes for which they were collected under the Arms Export Control Act. DOD also points out that Congress imposes annual limits on the amount of these funds that DOD may expend. DOD contends that it cannot legally implement this recommendation under the current law. We disagree. The law does not preclude the Secretary of Defense from identifying alternative program uses for excess administrative account funds. The Arms Export Control Act permits spending this administrative funding for FMS administrative functions. Although annual appropriations laws set a ceiling for FMS administrative spending, the Secretary of Defense can request a higher ceiling or notify Congress that the ceiling will be exceeded, as has been done in the past. In identifying alternative uses, we would expect the Secretary to assess, for example, the value of spending administrative funds on systems that would ensure proper cost accounting. In addition, the military services have stated that they have unfunded needs in their administration of the FMS program. For example, Navy officials told us that they do not have adequate resources to ensure that foreign military sales are closed in an expeditious manner, and that delayed case closure is a significant irritant to its customers. If the Secretary of Defense chooses to identify program uses outside the parameters of the Arms Export Control Act, he can request necessary legislative changes to Congress. For example, the Secretary could request congressional authority to use FMS administrative funds to reimburse military pay associated with security assistance.

Scope and Methodology

To evaluate whether the Foreign Military Sales program has achieved full recovery of its administrative costs, we interviewed and collected documents from DSCA; the departments of the Army, Navy, and Air Force; and U.S. industry representatives. However, we did not validate the accuracy of DSCA's and the services' cost information. To understand outside factors that could affect the condition of the FMS program, we also reviewed documents that describe foreign customer dissatisfaction with the program and interviewed foreign government representatives. We used budget data from the DSCA Comptroller's Office to analyze total administrative budget trends and budget allocations for fiscal year 1998. We also analyzed trends in military services' actual and planned administrative budgets. We studied data about budgets, workload, and performance metrics for at least one buying command in each military service that was allocated a substantial portion of the FMS administrative budget to evaluate the impact of reductions in military services' administrative budgets. We analyzed the differences between the military services' total administrative and program management spending. At the military service commands visited, we also judgmentally selected about 50 foreign military sales of various types and dollar values to discuss the workload related to these sales relative to the administrative and program management funding of sales. We reviewed guidance on identifying administrative and program management charges as well as DOD Inspector General reports related to the FMS program.

To determine the basis for key decisions related to the FMS fee structure and budget management, we analyzed the rationale for and impact of past program decisions on the FMS administrative account. We also reviewed DSCA's process for making sales projections, which is a key component of estimating future administrative account balances, as well as the model that DSCA uses to project future administrative account balances. We met with representatives from two U.S. defense companies to identify how others develop their foreign military sales projections. We sought to identify the criteria DSCA uses for determining the appropriate level of the administrative account balance, but found that no written guidance exists. We collected documents from and held discussions with officials from DSCA and the Office of the DOD Comptroller relating to the FMS administrative account balance, fee structure decisions, budget management decisions, and sales projections.

To evaluate how various FMS reinvention efforts address cost recovery issues, we reviewed DSCA's and each individual military service's reinvention initiatives to determine scope, status, and level of coordination of FMS reinvention efforts. We collected documents from and held discussions with officials at the DSCA, Under Secretary of Defense (Comptroller), the Deputy Under Secretary of the Army for International Affairs, the U.S. Army Security Assistance Command, the U.S. Army Tank Automotive and Armaments Command, the Navy International Programs Office, the Naval Air Systems Command, the Deputy Under Secretary of the Air Force for International Affairs, the Air Force Aeronautic Systems Center, the Air Force's F-16 Systems Program Office, the Air Force Security Assistance Center, the Warner Robbins Air Logistics Center, and the

Security Assistance Directorate of the Defense Finance and Accounting Service Center.

We conducted our work between October 1998 and August 1999 in accordance with generally accepted government auditing standards.

We are sending copies of this report to Representative Sam Gejdenson in his capacity as Ranking Minority Member of the House International Relations Committee and to Senator Jesse Helms and Senator Joseph Biden in their capacities as Chairman and Ranking Minority Member, respectively, of the Senate Foreign Relations Committee. We are also sending copies to the Honorable William S. Cohen, Secretary of Defense, and the Honorable Jacob J. Lew, Director, Office of Management and Budget. We will also make copies available to others on request.

Please contact me on (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report were Blake Ainsworth, Raymond H. Denmark, Jr., and Lillian I. Slodkowski.

Sincerely yours,

Katherine V. Schinasi
Associate Director
Defense Acquisitions Issues

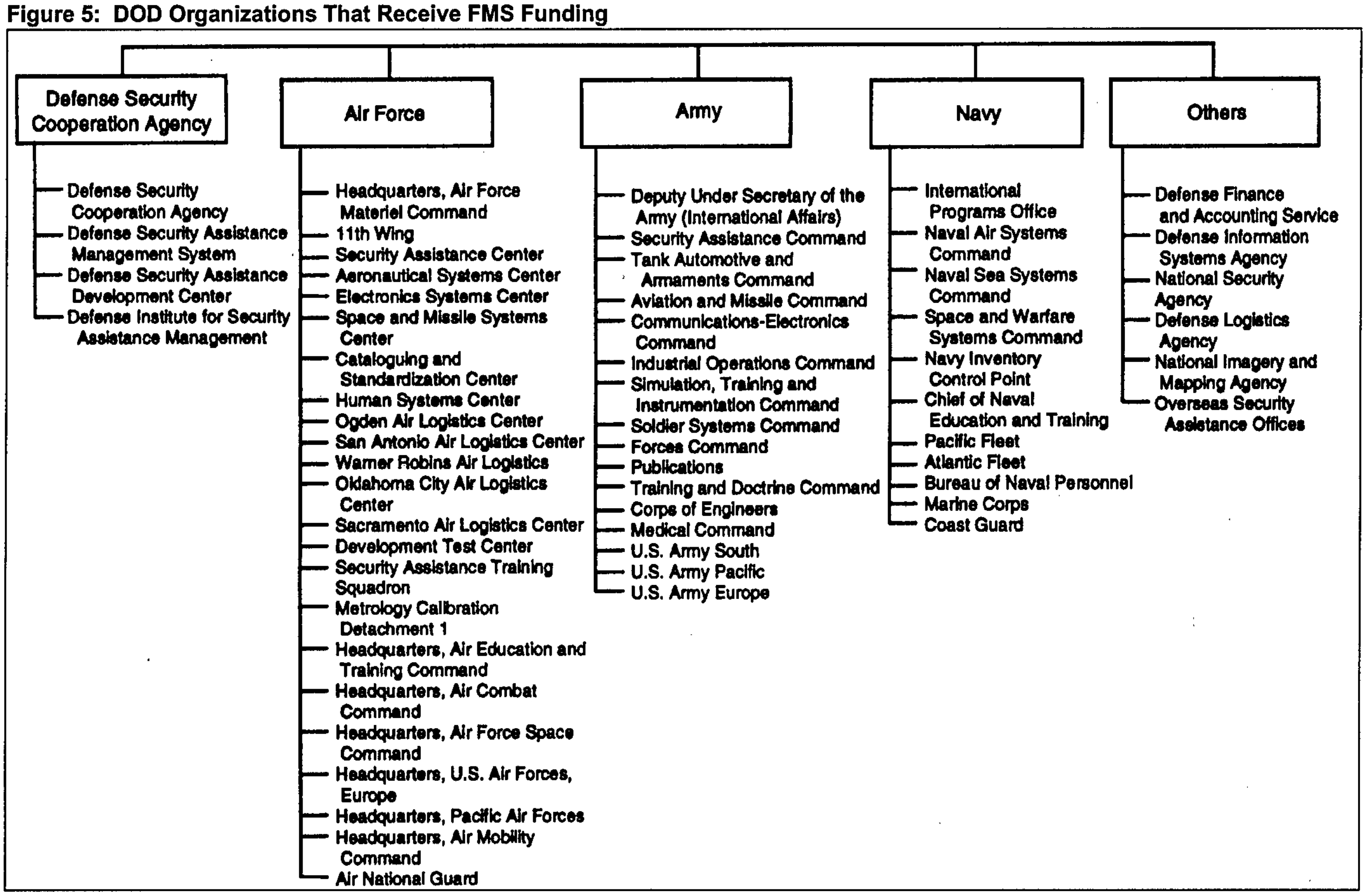
Breakdown of Foreign Military Sales Administrative Funding and Organizations

Table 3 shows the fiscal year 1998 budget allocations that the Defense Security Cooperation Agency (DSCA) distributed among Department of Defense (DOD) organizations. Organizations with the primary responsibility of implementing foreign military sales (FMS) received 64 percent of this allocation, while 36 percent went to centrally managed and implemented activities. As shown in figure 5, over 60 organizations received FMS funding. While the military services receive FMS funding from DSCA, they are responsible for managing this funding and distributing it among their subordinate commands.

Table 3: Fiscal Year 1998 FMS Administrative Budget Allocation and Roles of Primary FMS Organizations

	FY 1998 Administrative Budget $350 million		
Organization	**Dollars (in millions)**	**Percent of budget**	**Description**
Centrally managed and implemented activities			
Defense Finance and Accounting Service	$38.39	11.0	Operates DOD's centralized FMS billing, collecting, and trust fund accounting system.
Defense Security Cooperation Agency	14.87	4.2	Manages the overall FMS program. Acts as the DOD focal point for tracking arms transfers, budgetary, legislative, and other security assistance issues.
Defense Security Assistance Management System	15.08	4.3	Contractor development cost of a single, centralized security assistance management system.
Defense Information Systems Agency	12.28	3.5	Hosts the FMS legacy system database with which the Defense Security Assistance Management System interfaces.
Defense Security Assistance Development Center	8.05	2.3	DSCA organization tasked with developing the single, centralized security assistance management system—the Defense Security Assistance Management System.
Defense Institute of Security Assistance Management	4.69	1.3	Centralized DOD school for security assistance management. Provides instruction for U.S. government, foreign government, and industry personnel.
Security assistance organizations—overseas	23.75	6.8	DOD elements, regardless of actual title, located in a foreign country with assigned responsibilities for carrying out security assistance management.
Management Reserve	10.65	3.0	Reserve held by DSCA.
Reimbursements	-1.05	-0.30	
American Institute in Taiwan	1.06	0.30	A nonprofit organization established to conduct FMS administrative functions.
Sale implementing activities			
Air Force	87.39	25.0	The military services and defense agencies are responsible for the execution of military assistance programs. For the FMS program, the military service or defense agency is responsible for preparing a Letter of Offer and Acceptance and implementing foreign military sales. The implementing agency is responsible for the overall management of actions that will result in delivery of the materials or services set forth in the Letter of Offer and Acceptance that was accepted by a foreign country or international organization.
Army	80.50	23.0	
Navy	52.73	15.1	
National Security Agency	0.63	0.2	
Defense Logistics Agency	0.59	0.2	
National Imagery and Mapping Agency	0.40	0.1	

Figure 5: DOD Organizations That Receive FMS Funding



Comments From the Department of Defense

DEFENSE SECURITY COOPERATION AGENCY

WASHINGTON, DC 20301-2800

25 OCT 1999

In reply refer to:
I-99-012954-RT

Ms. Katherine V. Schinasi, Associate Director
Defense Acquisitions Issues
National Security and International Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

SUBJECT: GAO Draft Report, "DEFENSE TRADE: DoD Efforts To Improve Foreign Military Sales Administration Hampered By Insufficient Information," September 10, 1999 (GAO Code 707426/OSD Case 1891)

This is the Department of Defense (DoD) response to the GAO draft report "DEFENSE TRADE: DoD Efforts to Improve Foreign Military Sales Administration Hampered by Insufficient Information," dated September 10, 1999 (GAO Code 707426/OSD Case 1891)".

We concur with Recommendations 1, 2 and 3, but nonconcur with Recommendation 4. We are certain that on-going reinvention efforts will address the majority of the audit recommendations; however, the DoD believes the report misrepresents important facts in several areas. Our detailed comments on audit recommendations are attached.

Thank you for the opportunity to comment on the draft report.

MSDavison

MICHAEL S. DAVISON, JR.
LIEUTENANT GENERAL, USA
DIRECTOR

Attachment:
As Stated

GAO DRAFT REPORT DATED SEPTEMBER 10, 1999
(GAO CODE 707426) OSD CASE 1891

"DEFENSE TRADE: DoD EFFORTS TO IMPROVE FOREIGN MILITARY SALES ADMINISTRATION HAMPERED BY INSUFFICIENT INFORMATION"

DEPARTMENT OF DEFENSE GENERAL COMMENTS

*****

Now on p. 3.

Now on pp. 7-11.

FMS COST INFORMATION: The draft report (page 3 and subsequent) indicates that the DoD lacks sufficient cost information to manage the Foreign Military Sales (FMS) program, and determine whether it is fully recovering administrative costs associated with the FMS program. Further, the draft report (pages 6-8) infers a connection between this lack of cost information, the annual FMS Administrative budgets provided to the Military Departments (MILDEPs), and the use of Program Management Lines (PMLs) by the MILDEPs. The draft report overstates the position that DoD lacks adequate cost information to manage the FMS program or insure full cost recovery..

Now on pp. 4,12-13.

FMS SALES PROJECTIONS: The draft report (pages 2-3 and 10-11) indicates that the annual sales estimates are largely "judgmental estimates" on the part of the DSCA country desk officers. It also states that country desk officers lack guidance or criteria in formulating these estimates, and that the estimates are later adjusted at the discretion of DSCA management. Further, the draft report infers that DSCA arbitrarily adjusts its sales estimates to justify management decisions as circumstances warrant. The draft report incorrectly describes the nature of activities at DSCA associated with preparing the annual sales estimates.

FMS ADMIN ACCOUNT BALANCE/ADJUSTMENTS TO COST STRUCTURE: The draft report unfairly suggests that DSCA's only tool for managing the FMS program is the FMS Administrative fund balance. In support of its assertion, the GAO notes that DSCA lowered the FMS Administrative rate in June 1999 from 3% to 2.5% in part because of the positive balance in the Fund.

*****

DOD COMMENTS ON TECHNICAL ACCURACY

Now on p. 3.

See comment 1.

1. Page 1, paragraph 1, sentence 2. The AECA does not require accumulation of actual full costs for defense articles and services transferred under the foreign military sales program. This is quite apparent in section 21 of the AECA (22 U.S.C. 2761) which provides for a number of bases for pricing defense articles, including actual value, estimated cost of replacement to include contract or production cost less any depreciation of the item. The basis of pricing defense services is full cost except for training for which the statute provides that in certain cases only those additional costs that are incurred by the United States Government are to be charged.

Now on p. 3.
See comment 2.

2. Page 1, paragraph 1, the last sentence. Suggest that the word "perceived" be used to describe "program inefficiencies" since the GAO report does not identify nor describe any such inefficiencies.

Now on p. 3.
See comment 3.

3. Page 1, paragraph 2, sentence one. Section 21(e)(1) of the AECA (22 U.S.C. 2761(e)(1)(A)) requires appropriate charges for "administrative services, calculated on an average percentage basis to recover the full estimated costs (excluding a pro rata share of fixed base operations costs) of administration of sales made under this Act to all purchasers of such articles and services as specified in section 43(b) and section 43(c) of this Act." (Emphasis added).

Now on pp. 3-4.

See comment 4.

4. Page 2, paragraph 1. The GAO faults the DoD for not having sufficient information to determine whether it is fully recovering all administrative costs associated with the FMS program. The DoD is not required to fully recover all actual administrative costs. See comment 3 above. Additionally, some costs are excluded from recovery by law.

Now on pp. 3-4.
See comment 5.

5. Page 2, paragraph 1. To be accurate this sentence should also state, "as required by section 21(e)(1) of the AECA."

Now on p. 4.

6. Page 2, paragraph 1. Program management charges are direct charges for specific defense services provided to the Purchaser. Without regard to whether the criteria for these charges may be poorly defined, such charges are not part of the administrative charges imposed on an average percentage basis and should not be confused with administrative charges.

Now on p. 4.

7. Page 2, paragraph 2, sentence 3. In 1989, when actions were taken to remedy the negative administrative account balances, a number of changes to the Act followed, primarily in 1990, including the provision in section 43(b)(3) that excluded salaries of the Armed Forces and unfunded estimate costs of civilian retirement and other benefits from amounts to be collected. However, section 43 of the AECA (22 U.S.C. 2792(a)) already included the provision that "Funds made available under other law for the operations of United States Government agencies carrying out functions under this Act shall be available for the administrative expenses incurred by such agencies under this Act."

Now on p. 5.

8. Page 3, paragraph 3, sentence 1. In line 2, immediately after the word "cash" add the words "and credit" and change the word "sale" to "sales". The revised wording will read "cash and credit sales. . . ."

Now on p. 5.

9. Page 3, paragraph 3, last sentence. For clarification purposes the word "transactions" should be changed to "sales".

Now on p. 5.

See comment 6.

10. Page 3, paragraph 4, sentence 1. This sentence is wrong in stating that the AECA requires recovery of the "full estimated cost of administering sales." Again, section 21 of the AECA requires recovery of the full estimated costs (excluding a pro rata share of

Page 2 of 6

fixed base operations costs) and section 43(b) also excludes recovery of the salaries of the Armed Forces and unfunded civilian retirement and other benefits.

Now on p. 8.

11. Page 6, paragraph 2, sentence 6 states "In 1987, DOD created a 3.1 percent logistic support charge on certain spare parts, supply and maintenance items. This charge was intended to increase administrative revenue from smaller sales and offset the program's reliance on the largest sales." This latter sentence is an inaccurate statement. The intent of LSC was not necessarily to target smaller sales, but to target sales of logistic type items.

Now on p. 8.
See comment 7.

12. Page 7. Last sentence of paragraph on the top of the page - Air Force's FY 99 budget has actually decreased by 21% after adjusting for inflation since 1995 not 18 percent.

Now on p. 12.

13. Page 10, BASIS FOR ADJUSTING THE ADMINISTRATIVE BUDGET, does not address that FMS Administrative funding supports pre-LOA work required to generate new sales.

Now on p. 15.

14. Page 12, Figure 3, first bullet. The term "fixed base-operating support" is incorrect. The statutory term in section 21 of the AECA is "pro rata share of fixed base operations costs." The last three words of sentence 2 under this bullet also should read "base operations costs."

Now on pp. 16-17.
See comment 8.

15. Pages 14-15, The paragraph as currently written does not properly reflect Air Force's outsourcing initiative. Recommend the following revised paragraph:

"The Air Force has begun an initiative to identify candidates for competitive sourcing and prioritization (CS&P) of some FMS workload. The goal of the initiative is to be responsive to the customer in the management of case execution workload, decrease the time required to execute and close cases, provide timely case reconciliation, reduce cost to the customer and charge fee for service. Under the Air Force initiative, any skills/expertise required to execute the case will be considered as a candidate for CS&P. The Air Force initiative does not apply to inherently governmental expertise/ skills--such as exercising program decision authority, contracting officer authority, and financial authority requiring funds certification. The Air Force initiative will consolidate personnel and travel costs required for managing case execution and charge these costs directly on the program management lines. As a result, Air Force sales will be charging some personnel costs previously funded through the administrative budget directly to the case. The Air Force initiative is an effort to be more transparent for all manpower and travel cost associated with case execution. "

Now on p. 29

16. Page 22, Table I.1, the $15.08M reflected for Defense Security Assistance Management System is for contractor development portion of DSAMS, which is different from the DSADC line that includes legacy system maintenance and the government portion of DSAMS development.

Page 3 of 6

Now on p. 29.

17. Page 22, Table I.1, organization "Defense Security Assistance Design Center" should read "Defense Security Assistance Development Center".

Now on p. 29.

18. Page 22, Table I.1, the $12.28M reflected for DISA is to operate Legacy system databases, not DSAMS.

* * * *

DEPARTMENT OF DEFENSE COMMENTS
TO THE GAO RECOMMENDATIONS

Now on p. 20.

RECOMMENDATION 1. The GAO recommended that the Secretary of Defense direct that current efforts to identify and collect cost information use a comprehensive and consistent definition of administrative tasks to make certain that future program decisions are made on the basis of adequate information. (p. 17/Draft Report)

DoD RESPONSE: Concur.

The Department is coordinating reinvention efforts in this, as well as otherareas, among the military services, DLA, and USD(C) to share information and consolidate approaches. DSCA, under a contract with the Institute for Defense Analyses (IDA), is currently reviewing the cost structure that supports the use of the FMS Administrative funds that are budgeted annually. The Department is also reviewing the work done by the U.S. Army to provide a detailed functional breakout of its cost structure supporting the Security Cooperation program. These and other variants of Activity Based Costing/ Management (ABC/M), which DSCA has committed to review as part of its Strategic Plan, will be used as alternative models that may be applied to the entire program. Using the IDA information, DSCA is conducting ABC analysis to determine recommendations for change.

Now on p. 20.

RECOMMENDATION 2. The GAO recommended that the Secretary of Defense develop and communicate to the military services guidance that requires consistent application of program management charges to enhance the value of the administrative budget as a management tool. (p. 18/Draft Report)

DoD RESPONSE: Concur

The Department recognizes that guidelines could be tightened, both to better distinguish the circumstances in which it is appropriate to use program management lines vice FMS administrative funds, as well as to insure that program management lines are used consistently by the MILDEPs and Defense Agencies. In the next revision to the DoD regulations, guidance will be revised to clarify charging for program management services.

Now on p. 20.

RECOMMENDATION 3. The GAO recommended that the Under Secretary of Defense (Comptroller) assess the amount of funds needed to complete existing sales commitments to assure that the current foreign military sales administrative account balance is appropriate. (p. 18/Draft Report)

DoD RESPONSE: Concur.

The Department will determine the appropriate level of funds to be maintained at all times in the FMS Administrative Account -- the so called "safety level".

Page 5 of 6

Now on p. 20.

RECOMMENDATION 4. The GAO recommended that if the current administrative account balance exceeds the needed funds, the Secretary of Defense identify alternative program uses for the excess funds. (p.18/Draft Report)

DoD RESPONSE: Nonconcur.

DoD cannot legally implement this recommendation under the current law. Trust fund administrative account balances have not been appropriated by the Congress and are not available for other than the purposes for which collected. Fees collected pursuant to section 21(e)(1)(A) of the Arms Export Control Act (AECA) are only available for the purposes of paying expenses incurred by the DoD pursuant to section 43(b) of the AECA. Each year, in the Foreign Operations, Export Financing and Related Appropriations Act, the Congress specifically identifies a specific amount of the funds realized pursuant to section 21(e)(1)(A) of the AECA that may be obligated for expenses incurred by the DoD during the fiscal year.

Page 6 of 6

GAO Comments

The following are our comments on the Department of Defense's letter dated October 25, 1999.

1. Our report does not state that the Arms Export Control Act requires the accumulation of actual full cost for defense articles and services transferred under the Foreign Military Sales program. This sentence that DOD refers to describes the Arms Export Control Act requirement that the United States government not sell items under the FMS program at a loss. This sentence also describes that the act generally requires the program to recover costs associated with the implementation of the FMS program. We have adjusted language in this report to more precisely characterize the act, and clearly state that there are exceptions to the requirement of full cost recovery.

2. DOD's comment is referring to our report's reference to customer complaints concerning program inefficiencies. We do not believe that FMS program inefficiencies are only perceived. The Deputy Secretary of Defense, in October 1998, stated that "One of the things we've noticed is that there's been a definite trend of countries wanting to abandon foreign military sales as an approach and going to direct commercial sales as an alternative. In large measure, I think that's being driven by the inefficiencies that come with foreign military sales. It's cumbersome, it's time consuming, it's heavily rule bound."

3. We agree with DOD's characterization of the law and believe the sentence accurately reflects that characterization. Our statement notes that we evaluated "whether the foreign military sales program has achieved full recovery of its administrative costs" and explains the scope of our review by defining the objectives of our audit. These objectives were derived from the requester's initial request letter and in consultation with committee staff. Based on the requester's concern regarding the future viability of the program, we examined how the FMS program has recovered its costs, including certain costs such as military pay for which the program has sought and obtained legislative relief.

4. Our report did not state that DOD was required to fully recover all actual administrative costs. However, the Arms Export Control Act requires the FMS program to recover certain costs. Our report faults DOD for not having sufficient information to determine whether it is recovering these costs. Furthermore, the federal financial accounting standard for cost accounting concepts and standards explains that collecting cost

information is essential to managing federal government programs in the areas of budgeting and control, performance measurement, determination of reimbursements and setting of fees and prices, program evaluations, and economic choice decisions. These accounting standards require agencies to accumulate the full cost of outputs through appropriate costing methodologies or cost finding techniques. While DOD is not required by law to fully recover cost, identifying the full cost of administering the FMS program is a good business practice identified in federal financial accounting standards.

5. We have changed the context of this sentence to add clarity to our message. DOD's comment noted that we should cite the Arms Export Control Act when stating that the Department lacks sufficient information to determine if it is fully recovering FMS administrative costs. The scope of our work was to assess the future viability of the program and not just to assess DOD's compliance with the act. Our work demonstrates that DOD does not have sufficient information related to the costs of the FMS program, whether these costs are required to be recovered by the Arms Export Control Act or not.

6. We agree with DOD's characterization of the law that there are exclusions to full cost recovery. As noted on page 3 of this report, "the Arms Export Control Act provides a number of ways to price defense articles and services transferred under the Foreign Military Sales program, including actual value, replacement value, and full cost, and requires that the Department of Defense recover, with specified exceptions, the full estimated cost of administrating such sales."

7. The DOD comment reflects Air Force budget planning levels for fiscal year 1995. Our report uses actual fiscal year 1995 FMS administrative spending by the military services as provided by DSCA budgeting officials. The figures in our report remain accurate as of August 3, 1999.

8. We have updated the report to include this new information provided by DOD.

(707426)