INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

REPORT
NO. 90-109

September 18, 1990

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION
ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on the Audit of Foreign Direct Selling Costs (Project 0CA-0013)

## Introduction

This is our final report on the Audit of Foreign Direct Selling Costs. The Contract Management Directorate made the audit from October 1989 to January 1990 in response to a requirement in U.S.C., title 10, sec. 2324(f)(5) (as amended by the FY 1989 Appropriations Act) (the Act), allowing foreign direct selling costs to be recovered on DoD contracts. Foreign direct selling costs are those costs related to direct selling efforts of contractors for selling their products to foreign customers. The Act required the Inspector General, DoD and the Comptroller General of the United States to submit reports, within 2 years after enactment of the Act, to the Committees on Armed Services and Appropriations of the Senate and House of Representatives.

The objective of the audit was to assess whether DoD regulations provided the appropriate incentives to stimulate exports by the U.S. Defense industry as required by the cost recovery provision of the Appropriations Act of FY 1989. We also assessed whether DoD regulations provided appropriate criteria to ensure that allowed costs would provide future cost savings to the U.S. Government. Further, we determined whether adequate internal controls were in place to ensure that procedures were effective for identifying foreign direct selling costs that were allowable, allocable, and reasonable.

## Discussion

The audit showed that the Defense Acquisition Regulatory (DAR) Council revised DFARS 231.205-38, as required by the Act to allow recovery of foreign direct selling costs, but Part 31 of the Federal Acquisition regulation has not yet been revised to do so.

It was too early in the 3-year trial period to conclude that the allowability of foreign selling costs would have a significant impact on stimulating exports by the U.S. Defense industry. In their forward pricing rate proposals covering 1989 through 1993, six Defense contractors had not projected significant increases in foreign selling costs or foreign sales. Two contractors had already projected significant increases in foreign sales and selling costs before enactment of the Act allowing recovery of foreign direct selling costs. In addition, one Defense contractor refused to claim foreign selling costs on its Government contracts during the 3-year trial period because any change in its current accounting practices would have required a cost impact statement. This contractor had previously submitted a cost impact statement on separate foreign and domestic cost pools that resulted in a cost reduction of only $586,000 over a total cost base of $995 million. At seven Defense contractor locations reviewed, the DFARS change would allow contractors to recover approximately $31 million of additional annual indirect costs (based on FY 1988 expenditure levels). For one contractor, we were unable to obtain foreign selling cost information for FY 1988 due to an ongoing criminal investigation.

Industry and Government officials indicated that many factors other than the allowability of foreign selling costs were required to stimulate the export of Defense products. Certain contractors commented that other incentives are needed (i.e., changes in foreign offset agreements, foreign recoupment policies, foreign tax incentives, and reduction of foreign trade barriers). Government contract administration representatives added that it is the responsibility of both DoD and the U.S. Government to provide contractors appropriate incentives to stimulate these exports. Finally, we observed that recovery of foreign selling costs on Government contracts may make Defense contractors more competitive on their foreign rates and sales.

The revised DFARS allowing recovery of foreign selling costs does not appropriately address cost savings and advantages accruing to the United States. For the costs to be allowable, the Act required that the Secretary of Defense determine that the costs are likely to result in future cost advantages to the United States. The revised DFARS does not provide such criteria. However, because of the numerous factors affecting foreign sales, neither we nor the OSD officials have been able to

determine how to establish adequate criteria that would identify future cost savings to the Government as a direct result of the allowability of foreign selling costs.

Internal control procedures had been or were being established at the audit locations to ensure that allowed foreign selling costs are properly identified and did not exceed the ceiling of 110 percent of previous fiscal year cost, as specified in the revised regulations.

## Scope of Audit

We selected eight Government contract administration offices (located at major DoD contractor sites) for review based on discussions with various Government contract administration and audit offices. Our discussions indicated that these contractor locations had significant amounts of foreign sales and related foreign selling costs, a high percentage of Government sales compared to total sales, and problems with identifying and segregating foreign selling costs. We coordinated our review with representatives of the General Accounting Office, as necessary, to avoid duplication of audit effort.

Criteria used in the survey were U.S.C., title 10, sec. 2324(f)(5) (as amended) and Defense Acquisition Circular (DAC) 88-3, December 15, 1988, which revised subpart 231.205-38 of the Defense Federal Acquisition Regulation Supplement (DFARS) to allow Defense contractors to recover foreign direct selling costs under U.S. Government contracts. This DFARS change was an interim rule that was issued as a final rule without any changes by DAC 88-13, January 30, 1990.

We reviewed audit and investigations coverage regarding foreign selling costs and evaluated regulatory requirements since 1979 on the allowability, allocability, and reasonableness of foreign selling costs. At each location, we determined whether DoD had provided guidance required by law and whether internal controls were in place to monitor foreign selling costs; we evaluated contractors' treatment of foreign selling costs in proposal and rate submissions before and after enactment of the law; and we evaluated contractors' views on the regulatory change, with emphasis on incentives and cost savings. We reviewed negotiation files on forward pricing rate proposals and Defense Contract Audit Agency reports related to foreign selling costs for FY's 1979 through 1989. We also reviewed contractor proposals and forward pricing rate agreements for FY's 1987 through 1989 and contractor projections of current and future sales for FY's 1987 through 1995.

This performance audit was made in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, we included such tests of internal controls as were considered necessary. The activities and contractors visited or contacted during the audit are listed in Enclosure 1.

## Background

The Act provides that Defense contractors may recover foreign direct selling costs on Government contracts, provided the costs are not otherwise prohibited from recovery. Foreign direct selling costs are costs to promote the export of Defense products overseas, including costs of exhibiting or demonstrating the products. Prior to 1979, most foreign selling costs on Government contracts were recoverable, provided they were allocable, reasonable, and not otherwise unallowable. DAC 76-18, March 12, 1979, first made these costs unallocable on Government contracts. Federal Acquisition Circular (FAC) 84-12, January 20, 1986, specifically made these costs unallowable. Also, FAC 84-26, effective July 30, 1987, modified Federal Acquisition Regulation (FAR) 31.205-38(f) to limit the restriction associated with foreign sales to "direct selling efforts" as defined in FAR 31.205-38(c). The Act established a 3-year trial period (October 1, 1988, through September 28, 1991) to allow recovery of foreign direct selling costs. Recovery of foreign direct selling costs was limited to 110 percent of the costs incurred during the previous fiscal year by those business segments that allocated $2.5 million or more annually of foreign direct selling costs to DoD contracts. Another requirement for the costs to be allowable was a determination by the Secretary of Defense that future cost advantages would likely accrue to the U.S. Government.

## Prior Audit Coverage

Inspector General, DoD, Report Number 88-152, "Allocation of Marketing Expenses to Defense Contracts," May 20, 1988, concluded that 7 of 12 selected Defense contractors violated various Federal Acquisition Regulations and standards by recovering unallocable and unallowable foreign selling expenses under U.S. Government contracts. In addition, that report disclosed that 3 of 12 contractors overallocated selling and other corporate (home office) expenses to Government contracts. The report recommended that appropriate Government representatives require the contractors to identify and delete all expressly unallowable and directly associated unallocable and unallowable foreign marketing and selling expenses from their unsettled overhead claims and that Government surveillance be increased in this area. The report also recommended that certain contractors be required to identify and monitor auditable documentation in support of their corporate expenses and allocation methods. The report specifically identified monetary savings of over $29 million. The Navy and the Defense Logistics Agency fully concurred with the report recommendations, and the Air Force and the Defense Contract Audit Agency concurred with the majority of the recommendations.

**Report Staffing**

We provided a draft of this report to the addressees on May 24, 1990. Because there were no recommendations, no comments were required from management, and none were received.

We appreciate the courtesies and cooperation extended to the audit staff. The names and titles of the audit team members are shown in Enclosure 2. The distribution of this report is shown in Enclosure 3. Please contact Mr. Richard Jolliffe, Program Director, at (202) 694-6260 or Mr. Timothy Staehling, Project Manager, at (202) 694-6248 if you have any questions concerning this report.

Edward R. Jones
Deputy Assistant Inspector General
for Auditing

Enclosures

cc:
Secretary of the Army
Secretary of the Navy
Secretary of the Air Force

## ACTIVITIES VISITED OR CONTACTED

### Office of the Secretary of Defense

Assistant Secretary of Defense (Production and Logistics), Washington, DC
Defense Acquisition Regulatory Council, Arlington, VA

### Air Force

Air Force Plant Representative Office, General Electric Company, Aircraft Engine Group, Cincinnati, OH
Air Force Plant Representative Office, Boeing Aerospace Company, Seattle, WA
Air Force Plant Representative Office, TRW, Incorporated, Redondo Beach, CA
Air Force Plant Representative Office, Northrop Corporation, Hawthorne, CA
Air Force Plant Representative Office, Westinghouse Electric Corporation, Baltimore, MD

### Navy

Navy Plant Representative Office, Grumman Aerospace Corporation, Bethpage, Long Island, NY

### Defense Agencies

Defense Logistics Agency, Alexandria, VA
- Defense Contract Administration Services Plant Representative Office, Texas Instruments Corporation, Richardson, TX
- Defense Contract Administration Services Plant Representative Office, Honeywell, Incorporated, Minneapolis, MN

Headquarters, Defense Contract Audit Agency, Alexandria, VA
- Resident Office, Grumman Aerospace Corporation, Bethpage, Long Island, NY
- Resident Office, General Electric Company, Aircraft Engine Group, Cincinnati, OH
- Resident Office, Texas Instruments Corporation, Richardson, TX
- Resident Office, Honeywell, Incorporated, Minneapolis, MN
- Resident Office, Boeing Aerospace Company, Seattle, WA
- Resident Office, TRW, Incorporated, Redondo Beach, CA
- Resident Office, Northrop Corporation, Hawthorne, CA
- Resident Office, Westinghouse Electric Corporation, Baltimore, MD

## ACTIVITIES VISITED OR CONTACTED (continued)

### Non-DoD Activities

General Accounting Office, Washington, DC

### Non-Government Activities

Grumman Aerospace Corporation, Bethpage, Long Island, NY
General Electric Company, Aircraft Engine Group, Cincinnati, OH
Texas Instruments Corporation, Richardson, TX
Honeywell, Incorporated, Minneapolis, MN
Boeing Aerospace Corporation, Seattle, WA
TRW, Incorporated, Redondo Beach, CA
Northrop Corporation, Hawthorne, CA
Westinghouse Electric Corporation, Baltimore, MD

## AUDIT TEAM MEMBERS

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Richard B. Jolliffe, Program Director
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## FINAL REPORT DISTRIBUTION

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Assistant Secretary of Defense (Production and Logistics)
Comptroller, Department of Defense
Deputy Assistant Secretary of Defense (Procurement)

Department of the Army

Secretary of the Army
Assistant Secretary of the Army (Financial Management)
Auditor General, U.S. Army Audit Agency

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Director, Naval Audit Service

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Air Force Audit Agency

Other Defense Activities

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, Defense Acquisition Regulatory Council

Non-DoD

Office of Management and Budget
United States General Accounting Office, NSIAD Technical Information Center

Congressional Committees:

Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
Senate Ranking Minority Member, Committee on Armed Services
House Committee On Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Ranking Minority Member, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security, Committee on Government Operations