Audit Report

OFFICE OF THE INSPECTOR GENERAL

PROCUREMENT PRICES PAID ON MISSILE SYSTEMS FOR FOREIGN MILITARY SALES

Report No. 94-188

September 14, 1994

Department of Defense

Additional Copies

To obtain additional copies of this report, contact the Secondary Reports Distribution Unit, Audit Planning and Technical Support Directorate, at (703) 604-8937 (DSN 664-8937) or FAX (703) 604-8932.

Suggestions for Future Audits

To suggest ideas for or to request future audits, contact the Planning and Coordination Branch, Audit Planning and Technical Support Directorate, at (703) 604-8939 (DSN 664-8939) or FAX (703) 604-8932. Ideas and requests can also be mailed to:

Inspector General, Department of Defense
OAIG-AUD (ATTN: APTS Audit Suggestions)
400 Army Navy Drive (Room 801)
Arlington, Virginia 22202-2884

DoD Hotline

To report fraud, waste, or abuse, call the DoD Hotline at (800) 424-9098 or write to the DoD Hotline, The Pentagon, Washington, D.C. 20301-1900. The identity of writers and callers is fully protected.

Acronyms

ASC	Aeronautical Systems Center
DASD	Deputy Assistant Secretary of Defense
DFAS	Defense Finance and Accounting Service
DSAA	Defense Security Assistance Agency
FMS	Foreign Military Sales
HAWK	Homing All the Way Killer
LOA	Letter of Offer and Acceptance
MICOM	Army Missile Command
NAVAIR	Naval Air Systems Command
NAVILCO	Navy International Logistics Control Office
PEO	Program Executive Office
SLAM	Standoff Land Attack Missile
SDAF	Special Defense Acquisition Fund
TOW	Tube-Launched, Optically-Tracked, Wire-Guided

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

September 14, 1994

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE SECURITY ASSISTANCE AGENCY
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Audit Report on Procurement Prices Paid on Missile Systems for Foreign Military Sales (Report No. 94-188)

We are providing this final report for your information and use. This report addresses whether the prices foreign customers paid to DoD contractors for missile procurements were comparable to prices DoD customers paid. Comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resovled promptly. Therefore, we request that the Army, the Navy, the Air Force, and the Director, Defense Security Assistance Agency, provide comments on the unresolved recommendations by November 14, 1994. Specific requirements for those comments are in a chart at the end of each finding. Recommendations are subject to resolution in accordance with DoD Directive 7650.3 in the event of nonconcurrence or failure to comment.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Alvin L. Madison, Program Director, at (703) 604-9100 (DSN 664-9100) or Mr. Ronald C. Tarlaian, Project Manager, at (703) 604-9185 (DSN 664-9185). To suggest ideas for future audits, contact the Audit Planning and Technical Support Directorate at (703) 604-8939 (DSN 664-8939). Appendix E lists the distribution of this report. The audit team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, Department of Defense

Report No. 94-188 **September 14, 1994**
(Project No. 3FA-0047)

PROCUREMENT PRICES PAID ON MISSILE SYSTEMS FOR FOREIGN MILITARY SALES

EXECUTIVE SUMMARY

Introduction. Foreign military sales (FMS) customers procure missile systems from the Military Departments through Letters of Offer and Acceptance. The Military Department contracting officers negotiate missile system procurements with contractors for DoD and FMS customers. With the exception that prices for FMS can include contractor and U.S. Government additive charges not applicable to DoD prices, the Military Departments are required to provide FMS customers the same contract pricing afforded to DoD customers. From October 1, 1989, through March 31, 1993, 148 FMS cases had missile deliveries amounting to $1.6 billion. We reviewed 45 of those FMS cases valued at $1.3 billion.

Objectives. The objectives of the audit were to determine whether prices FMS customers paid to DoD contractors for missiles were comparable to prices DoD customers paid. We also determined whether contractor and U.S. Government additive charges were valid and accurate.

Audit Results. FMS contract prices were higher than DoD contract prices for comparable procurements of missile systems. Also, contractor and U.S. Government additive charges were not valid or accurate.

o The Army did not negotiate Patriot missile contract prices for FMS customers that were comparable to prices negotiated for DoD customers. In addition, the Air Force did not report the appropriate contract prices for billing FMS customers for purchases of Sidewinder and Maverick missile systems. As a result, FMS customers paid $1.3 million more than DoD customers, and the Netherlands paid $1.7 million more than Germany did for comparable purchases of Patriot missiles. Also, the Air Force overbilled FMS customers $3.4 million and underbilled FMS customers $3.5 million for Sidewinder and Maverick missile purchases (Finding A).

o The Military Departments did not accurately bill FMS customers for contractor and U.S. Government additive charges included in contract prices. As a result, the Military Departments overbilled FMS customers $13.5 million and underbilled FMS customers $2.0 million (Finding B).

o The Navy and the Air Force recouped more than appropriate in Special Defense Acquisition Fund investment costs for modifying Harpoon and Sidewinder missile systems for sales to FMS customers. In addition, the Air Force billed customers selling prices in excess of actual costs for Maverick missiles sold from the Special Defense Acquisition Fund inventory. As a result, the Navy inappropriately billed 18 FMS customers $2.5 million for the Harpoon missile system, and the Air Force overbilled FMS customers $9.9 million for the Sidewinder missile system and $1.9 million for the Maverick missile system (Finding C).

Internal Controls. The audit identified material internal control weaknesses related to the Military Departments' administration of FMS procurements. The Army did not validate the cost elements included in FMS contract prices, and the Air Force did not use contract documents to accurately report contract prices to the Defense Finance and Accounting Service Denver Center for its use in billing FMS customers (Finding A). In addition, the Military Departments did not have effective internal control procedures for verifying the accuracy of additive charges applied to FMS contract prices (Finding B). Further, the Air Force did not have operating procedures for monitoring the collection of the Special Defense Acquisition Fund investment costs (Finding C). See Part I, "Internal Controls," for internal controls assessed. Our assessment of the Military Departments' implementation of the DoD Internal Management Control Program showed that the Military Departments did not address the weaknesses identified in this report.

Potential Benefits of Audit. All recommendations in this report, if implemented, will result in compliance with regulations and improvements in pricing and billing of missile systems for FMS. We identified no potential monetary benefits associated with the audit. For other benefits, see Appendix C, "Summary of Potential Benefits Resulting From Audit."

Summary of Recommendations. We recommended that the Army verify the accuracy of cost elements used to develop FMS contract prices and establish a time frame for procurement offices to validate the dollar amounts of negotiated cost elements. We also recommended that the Air Force use contract documents to report contract prices to the Defense Finance and Accounting Service Denver Center for its use in billing FMS customers. In addition, we recommended that the Military Departments disseminate pricing policy to appropriate personnel to exclude inappropriate cost elements from missile prices reported to the Defense Finance and Accounting Service Denver Center for customer billing and verify the accuracy of approved additive charges. Further, we recommended that the Director, Defense Security Assistance Agency, direct the Naval Air Systems Command to eliminate the collection of the Special Defense Acquisition Fund charges for the Standoff Land Attack Missile from Harpoon missile sales customers. Finally, we recommended that the Military Departments and the Defense Security Assistance Agency return overcollected charges to customers' FMS Trust Fund accounts.

Management comments. The Army and the Air Force concurred in principle with the findings and recommendations. The Navy nonconcurred with the recommendations regarding contractor rental fees. The Navy and the Defense Security Assistance Agency disagreed with the finding and the recommendations regarding the recoupment of Special Defense Acquisition Fund investment costs. A discussion of the responsiveness of management comments on the recommendations is in Part II of the report. The complete text of management comments is in Part IV of the report.

Audit Response. With the exception of specific FMS case billings, the Army and the Air Force comments were responsive. We disagree with the Navy's position regarding contractor rental fees. We also disagree with the Navy and the Defense Security Assistance Agency responses pertaining to the recoupment of Special Defense Acquisition Fund investment costs. Representatives of the Army, the Navy, the Air Force, and the Defense Security Assistance Agency are asked to comment on this report by November 14, 1994. See the chart at the end of each finding for the specific requirements for those comments.

Table of Contents

Executive Summary i

Part I - Introduction 1

Background 2
Objectives 2
Scope and Methodology 3
Internal Controls 4
Prior Audits and Other Reviews 5
Other Matters of Interest 5

Part II - Findings and Recommendations 7

Finding A. Contracting for and Pricing of Missiles 8
Finding B. Billing of Contractor and U.S. Government Additive Charges 14
Finding C. Recoupment of Special Defense Acquisition Fund Investment Costs 26

Part III - Additional Information 33

Appendix A. Contract Pricing and Reporting Discrepancies 34
Appendix B. Contractor and U.S. Government Additive Charges 39
Appendix C. Summary of Potential Benefits Resulting From Audit 44
Appendix D. Organizations Visited or Contacted 46
Appendix E. Report Distribution 47

Part IV - Management Comments 49

Army Comments 50
Navy Comments 55
Air Force Comments 61
Defense Security Assistance Agency Comments 65

This report was prepared by the Financial Management Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

Part I - Introduction

Background

Missile Procurements. Foreign military sales (FMS) customers procure missile systems from the Military Departments through Letters of Offer and Acceptance. When procuring missiles from contractors, the Military Department contracting officers are required to provide FMS customers the same pricing protection they afford DoD customers. With the exception of allowable contractor and U.S. Government additive charges (charges that apply only to FMS customers), contract prices for DoD customers and FMS customers should be comparable. Contractors may add charges to FMS contract prices to recover higher general and administrative expenses and to compensate for higher business risks associated with FMS. U.S. Government additive charges (nonrecurring and engineering support costs) may be charged to FMS customers to recoup costs incurred by the Military Departments on behalf of FMS customers. The Military Departments are required to accurately report missile charges to the Defense Finance and Accounting Service (DFAS) Denver Center for its use in billing FMS customers.

Governing Regulations. The Arms Export Control Act of 1981, as amended, governs the sale of Defense articles to eligible foreign customers and requires the DoD to manage the FMS programs. DoD Regulation 7000.14-R, "Financial Management Regulation, Security Assistance Policy and Procedures," March 18, 1993, establishes pricing and reporting policies and procedures for the Military Departments to use when procuring Defense articles for FMS customers. Further, the Defense Security Assistance Agency's "Guidance on Fair Pricing," January 1990, specifies the allowable costs that can be included in Letters of Offer and Acceptance for FMS procurements.

Objectives

The primary objective of the audit was to determine whether prices FMS customers paid to DoD contractors for missiles were comparable to prices DoD customers paid for the same missiles. Also, we reviewed the validity and accuracy of contractor and U.S. Government additive charges that FMS customers paid. We also evaluated the internal control procedures established within the Military Departments to ensure that FMS customers receive the same pricing protection afforded to DoD customers.

Scope and Methodology

Sample Selection Process. We obtained reports from the Military Departments that listed missile cases with deliveries to FMS customers from October 1, 1989, through March 31, 1993. The reports listed 148 cases with customer deliveries of $1.6 billion, of which we judgmentally selected 45 FMS cases with deliveries valued at $1.3 billion. In order to obtain a diversified sample, we selected cases for sales of various missile systems for which the delivered value for each case exceeded $1.0 million. We selected 10 Army Missile Command (MICOM) cases with delivered values of $774.8 million and 15 Naval Air Systems Command cases with delivered values of $348.3 million. Further, we selected 20 Air Force cases: 12 at Eglin Air Force Base with delivered values of $135.4 million and 8 at the Ogden Air Logistics Center with delivered values of $78.4 million.

Elements of Scope. We obtained and reviewed Letters of Offer and Acceptance, contracts, and other relevant information from logistical and financial contract and case files at DoD activities and contractor facilities. We compared FMS contract prices for each case to data on the Letter of Offer and Acceptance, the detailed delivery history search (a record of all transactions for a particular FMS case), and material inspection and receiving reports. We discussed policies and procedures with contracting, financing, and missile systems program office personnel. We reviewed pertinent DoD Directives and determined whether FMS missile sales were priced in accordance with DoD guidance. We also reviewed the application of contractor and U.S. Government additive charges to FMS contract prices and evaluated the related internal controls. We evaluated the accuracy of the Defense Integrated Financial System data obtained from the Military Departments and the DFAS Denver Center. Based on a review of the source documents and financial records, we concluded that computer-processed data were reliable.

Audit Time Period, Standards, and Locations. This program results audit was made from May 1993 through December 1993 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, Department of Defense. The audit included such tests of internal controls as were considered necessary. Appendix D lists the organizations we visited or contacted.

Internal Controls

Controls Assessed. We evaluated the Military Departments' internal control procedures to ensure that FMS customers were accurately charged for missile system procurements. Specifically, we:

o reviewed the internal controls that procurement officers and financial managers used in developing contract prices for FMS customers,

o evaluated the internal controls that pricing personnel used in applying additive charges to FMS contract prices, and

o reviewed the internal controls that the Military Departments established to report missile costs to the DFAS Denver Center for its use in billing FMS customers.

Weaknesses Identified. The audit identified material internal control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. The Army did not validate the cost elements included in FMS contract prices, and the Air Force did not use contract documents to accurately report contract prices to the DFAS Denver Center for its use in billing FMS customers (Finding A). In addition, the Military Departments did not have effective internal control procedures for validating the accuracy of those additive charges applied to FMS contract prices (Finding B). Further, the Air Force did not have operating procedures for monitoring the collection of Special Defense Acquisition Fund investment costs included in customer prices (Finding C). Recommendations A.1.a., A.1.b., and A.2.a. will correct the Army and the Air Force weakness pertaining to contract pricing. Recommendation B.4. will correct the Military Departments' weakness relating to contractor and U.S. Government additive charges. Recommendation C.2. will correct the Air Force weakness pertaining to the Special Defense Acquisition Fund. This report contains no potential monetary benefits. However, funds will be collected from FMS customers for underbillings, which will be offset by customer reimbursements for overbillings. Appendix C, "Summary of Potential Benefits Resulting From Audit," details the nonmonetary benefits associated with the audit. Copies of this report will be provided to the senior officials within the Military Departments and the Defense Security Assistance Agency responsible for internal controls for use in preparing their Annual Statements of Assurance.

We assessed the Military Departments' implementation of the DoD Internal Management Control Program related to the procurement of Defense articles. The Military Departments' internal control assessments did not address procurement pricing and other weaknesses identified in this report.

Prior Audits and Other Reviews

Inspector General, Department of Defense, Report No. 92-142, "Pricing and Billing of the F-16 for Foreign Military Sales Customers," September 30, 1992, disclosed that the Air Force did not correctly bill or recoup research and development nonrecurring costs on the sale of F-16 aircraft and spare engines to FMS customers. Aircraft and spare engine price estimates were prepared using incorrect recoupment rates or rates that did not include charges for nonrecurring costs. As a result, one FMS customer was overbilled $7.0 million on the sale of aircraft, while seven FMS customers were underbilled $17.4 million on the sale of spare engines. The Air Force generally concurred with the recommendations and is in the process of taking corrective action.

Other Matters of Interest

DoD Regulation 7000.14-R requires that the Military Departments recalculate nonrecurring cost rates as new configurations of major Defense equipment are developed. During the audit, we determined that the MICOM had not recalculated nonrecurring cost rates for new Patriot missile configurations. As a result, the nonrecurring cost rate is misstated in DoD Regulation 7000.14-R, and, if not corrected, nonrecurring costs will be incorrectly applied to future Patriot FMS sales of about 1,600 missiles. Subsequently, the MICOM developed nonrecurring cost rates for all Patriot missile configurations in accordance with DoD policy. However, at the time of the audit, the MICOM had not submitted the nonrecurring cost rates to the Defense Security Assistance Agency for approval.

Part II - Findings and Recommendations

Finding A. Contracting for and Pricing of Missiles

The Army did not negotiate Patriot missile contract prices for foreign military sales (FMS) customers that were comparable to prices negotiated for DoD customers. In addition, the Air Force did not report the appropriate contract prices for the Sidewinder and Maverick missile systems to the Defense Finance and Accounting Service (DFAS) Denver Center for its use in billing FMS customers. Those conditions occurred because the Army Missile Command (MICOM) Patriot procurement office did not validate the cost elements included in FMS contract prices, and the Air Force did not use contract documents to accurately report prices to the DFAS Denver Center. As a result, FMS customers paid $1.3 million more than DoD customers, and the Netherlands paid $1.7 million more than Germany did for comparable purchases of Patriot missiles. Also, the Air Force overbilled and underbilled FMS customers $3.4 million and $3.5 million, respectively, for Sidewinder and Maverick missiles.

Background

Policy. The Arms Export Control Act of 1981, as amended, requires that the Military Departments recover all costs associated with the sale of Defense articles to FMS customers. DoD and Federal Acquisition Regulations specify the acquisition policies and procedures the Military Departments must use for pricing missile system procurements for DoD customers and FMS customers. Additionally, DoD Regulation 7000.14-R, "Financial Management Regulation, Security Assistance Policy and Procedures," March 18, 1993, specifies that FMS contract prices shall be based on the same cost principles as DoD contract prices. DoD Regulation 7000.14-R also states that recognition shall be given to other reasonable contractor costs and risks, such as contractor profits and general and administrative expenses, to the extent permitted in the DoD and Federal Acquisition Regulations. DoD Regulation 7000.14-R further states that the Military Departments will establish a system of internal controls for validating the accuracy of FMS contract prices reported to the DFAS Denver Center for its use in billing FMS customers.

Case Selection. We judgmentally selected and reviewed 10 MICOM cases, 15 Naval Air Systems Command cases, and 20 Air Force cases. Twelve of the Air Force cases were at Eglin Air Force Base and eight were at the Ogden Air Logistics Center. The total delivered value of the sampled cases was $1.3 billion. We selected missile system cases that each had customer deliveries in excess of $1.0 million.

Contracting for Patriot Missile Systems

Validating Cost Elements. The MICOM procurement offices were responsible for negotiating DoD and FMS contract prices and validating the cost elements included in those contract prices. To accurately compare DoD and FMS contract prices, we determined the actual base price for each contract line item. To do so, we deducted cost elements that varied in dollar amounts for DoD and FMS customers, such as the economic order quantity, foreign premiums, and technical services. We used documents (price negotiation memorandums and cost worksheets) from contract DAAH01-87-C-A025 and pricing information obtained from Raytheon Corporation contracting personnel. Those comparisons showed that FMS customers paid a total of $1.3 million more on two Patriot missile cases than DoD customers paid for an equal number of missiles. Also, the Netherlands paid $1.7 million more than Germany for equal numbers of Patriot missiles. Table 1 in Appendix A summarizes the pricing discrepancies. Tables 2 through 4 in that appendix show specifics.

Customer Prices Exceed DoD Costs. The Patriot missile procurement office did not verify the accuracy of those cost elements for which the dollar amounts varied for DoD customers and FMS customers. The Patriot missile procurement office awards contracts using a total dollar concept and does not break out the costs between DoD customers and FMS customers. The MICOM operating procedures did not require cost elements to be broken out prior to contract award because that procedure would delay the contract award process and the contractor's production of the Patriot missile system. Therefore, the Patriot missile procurement office relied on the Raytheon Corporation to provide information on cost elements, such as technical services and economic order quantities, and used them for determining FMS contract prices. The MICOM and the Raytheon Corporation agreed to the contract prices before all cost elements were validated; however, the MICOM should have included a clause in the contract stipulating a time frame for the Patriot missile procurement office to validate the pricing data for FMS contract line items. Due to the lack of cost element validation, for contract DAAH01-87-C-A025 FMS customers paid a total of $1.3 million more than DoD customers for the purchase of the same number of Patriot missiles on the two FMS cases.

On January 13, 1994, we met with the Patriot procurement contracting officer and Raytheon Corporation contracting personnel to verify the accuracy of the cost elements we used to compare base prices for DoD customers and FMS customers for contract DAAH01-87-C-A025. The Patriot procurement contracting officer and the Raytheon Corporation contracting personnel agreed with the methodology, cost elements, and dollar amounts we used to compare base prices for DoD customers and FMS customers for contract DAAH01-87-C-A025. Also, the Patriot procurement contracting officer agreed with the price differences we identified between DoD contract prices and FMS contract prices. He stated that the MICOM needed to establish procedures and a time frame for validating the cost elements included in FMS contract prices.

Customer Price Variances. Comparison of contract prices on contract DAAH01-87-C-A025 showed that the Netherlands paid $1.7 million more on FMS case NE-VNW than Germany did on FMS case GY-WIA for the same number of Patriot missiles. Appendix A shows the details of that comparison. That pricing difference occurred because the Patriot procurement office did not validate the cost elements included in FMS contract prices, as required by DoD regulations. To develop an accurate comparison between the Netherlands' and Germany's contract prices, we determined the base price for each missile. To do so, the cost of warheads and safing and arming devices was deducted from the Netherlands' base price because those items were provided as U.S. Government-furnished materiel for the Netherlands' missiles. Based on the audit results, the MICOM was in the process of reviewing the pricing discrepancies for the Netherlands, and Germany and will correct the appropriate line items on contract DAAH01-87-C-A025 to avoid further overpricing of missiles procured for the Netherlands.

Reporting of Contract Prices for Customer Billings

Air Force. The Air Force did not report accurate contract prices to the DFAS Denver Center for its use in billing FMS customers for the Sidewinder and Maverick missile systems.

Eglin Air Force Base. Eglin Air Force Base was responsible for procuring and managing the Sidewinder missile program. The financial manager at the Sidewinder systems program office was responsible for validating the accuracy of contract prices reported to the DFAS Denver Center for its use in billing FMS customers. Although the contract prices for Sidewinder missiles for contract F08635-86-C-0207 were comparable among FMS customers, the financial manager reported inaccurate contract prices to the DFAS Denver Center for its use in billing FMS customers. The reporting inaccuracies occurred because the financial manager did not use contract documents to report FMS contract prices to the DFAS Denver Center. Instead, the financial manager used estimated prices from the Letter of Offer and Acceptance, case file documentation, or other documentation. For example, for FMS case TW-YBS with Taiwan, the contract price was $31,790, based on the latest contract modification and current materiel inspection and receiving reports. However, the financial manager reported a $32,875 contract price to the DFAS Denver Center, which he could not substantiate with supporting documentation. Therefore, the DFAS Denver Center overbilled the FMS customer $1,085 per missile, which resulted in a total overbilling of $1,271,973. The financial manager stated that Air Force operating procedures did not require the validation of contract prices reported to the DFAS Denver Center for its use in billing. We informed the financial manager that validating contract prices reported to the DFAS Denver Center was required by DoD regulations. Overall, FMS customers were overbilled a total of $2.9 million on 6 of 12 Sidewinder missile cases. Those overbillings could have been avoided

had the financial manager verified that the contract prices reported to the DFAS Denver Center for its use in billing FMS customers matched those on contract documents, as shown by Appendix A, Table 5.

Ogden Air Logistics Center. Prior to July 1992, the Aeronautical Systems Center (ASC) was responsible for managing the Maverick missile system. The ASC reported contract prices to the DFAS Denver Center for its use in billing FMS customers and was responsible for verifying the accuracy of contract prices. Although the ASC made numerous adjustments to the reported contract prices, five Maverick missile cases were billed a total of $500,000 in excess of the contract prices, and one Maverick missile case was billed $3.5 million less than the contract price. The ASC case managers did not use contract documents to report Maverick prices to the DFAS Denver Center for its use in billing FMS customers. The ASC managers used contract prices from cost statement worksheets without verifying the accuracy of prices on those worksheets, as required by DoD regulations. FMS customers would not have been underbilled a total of $3.0 million for Maverick missiles had the ASC used contract documents to report contract prices to the DFAS Denver Center for its use in billing. Subsequent to July 1992, the management responsibility for the Maverick missile transferred from the ASC to the Ogden Air Logistics Center. Therefore, any adjustments to FMS customers' Trust Fund accounts would have to be accomplished by the Ogden Air Logistics Center.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Commander, Army Missile Command:

a. Require procurement offices to verify the accuracy of cost elements used in negotiating missile contract prices for foreign military sales customers, as required by DoD regulations.

b. Establish a time frame in which the procurement offices must validate the dollar amounts of those contract cost elements that differ between DoD customers and foreign military sales customers.

c. Verify the accuracy of cost elements in the Army's contract with the Raytheon Corporation (DAAH01-87-C-A025) for Patriot missiles being procured for foreign military sales, amend any overpriced contract line items, and adjust the customers' Trust Fund accounts accordingly.

Management Comments. The Army concurred in principle with Recommendation A.1.a. and with the understanding that the report's use of the wording verification of cost elements could be used synonymously with the term evaluation. The Army stated that prior to contract negotiations, various contracting and engineering specialists evaluate the contractor's proposal, including individual cost elements, to establish the U.S. Government's negotiation position. The results of the contract negotiations are documented in

the business clearance memorandum and reviewed by procurement officials. The Army also stated that the MICOM Acquisition Center will issue a memorandum to its personnel emphasizing the need to identify differences in cost elements between DoD and FMS requirements and document those differences in the business clearance memorandum.

The Army concurred in principle with Recommendation A.1.b., again using the term evaluation rather than verification. The Army stated that the MICOM Acquisition Center personnel will be instructed to ensure that within the time frames between the contractor's proposal and the contract award, contract cost elements that differ between DoD and FMS customers will be evaluated and negotiated. Further, the Army stated that the cost element differences that remain after the contract negotiations conclude will be documented in the business clearance memorandum and reviewed by procurement officials.

Regarding Recommendation A.1.c., the Army stated that the MICOM Acquisition Center will complete a review within 90 days to determine the accuracy of the cost elements for contract DAAH01-87-C-A025, as shown in the audit report. Upon completion of that review, the Army stated, the MICOM will decide whether any repricing or renegotiation of contract line items is necessary and will adjust customers' Trust Fund accounts accordingly.

Audit Response. The Army's proposed actions to the recommendations are considered responsive. The Army's use of the word "evaluate" (Recommendations A.1.a. and A.1.b.) instead of "verification" is acceptable, provided the Army identifies and documents the differences in the cost elements between DoD and FMS customer requirements as part of its evaluation.

2. We recommend the Commander, Air Force Materiel Command:

a. Require subordinate commands to use contract documents to report missile prices to the Defense Finance and Accounting Service-Denver Center for its use in billing foreign military sales customers.

b. Correct the erroneous billings to foreign military sales customers by the amounts shown in Appendix A and adjust the customers' Trust Fund accounts accordingly.

Management Comments. The Air Force concurred with Recommendation A.2.a., stating that contract documents should be the source of establishing the price charged to FMS customers and that the validation of contract prices reported to the DFAS Denver Center is the responsibility of the financial manager. Therefore, the Air Force will issue a memorandum to the field activities stating the policy on the use of contract prices and the need to validate those prices prior to reporting deliveries to the DFAS Denver Center. The memorandum will be issued by September 30, 1994.

The Air Force partially concurred with Recommendation A.2.b. The Air Force did not agree with the variances shown in Appendix A, Table 5, for the Eglin Air Force Base cases. The Air Force stated that for FMS cases BA-YAA, JO-YFC, TW-YBS, and TW-YCR, the FMS price was correct and that the

variance of $1,085 between the contract price and the FMS price occurred for special tooling and testing, which did not have separate national stock numbers. Therefore, those items were added to the price of the guidance control section and not shown as separate case lines. For FMS cases MU-YEC and GR-YDP, the Air Force stated that the unit variance in the audit report occurred due to a modification to the guidance control section. For the Ogden Air Logistics Center cases, the Air Force concurred and stated that the billings are being reviewed and any necessary corrections will be made. The Air Force stated that those actions should be completed by September 30, 1994.

Audit Response. The Air Force comments to Recommendation A.2.a. are considered fully responsive.

We disagree with the Air Force comments to Recommendation A.2.b. pertaining to the Eglin Air Force Base cases. For FMS cases BA-YAA, JO-YFC, TW-YBS, TW-YCR, and MU-YEC, the contractor's material inspection and receiving report (billing copy) identified a contract price of $31,790 as shown in Appendix A, Table 5. In addition, DoD Regulation 7000.14-R considers special tooling and test equipment costs as nonrecurring costs, which would have been included in the Special Defense Acquisition Fund recoupment charge of $5,636, developed by the Defense Security Assistance Agency, for the modification of the guidance control section. As a result, it was inappropriate for the financial manager to include the special tooling and testing costs of $1,085 in the FMS price. For FMS case GR-YDP, the financial manager could not provide a source or justification for the amount charged to the FMS customer. As a result, we used the contract price as shown on the contractor's material inspection and receiving report. Therefore, we request that the Air Force reconsider its position regarding the cases at the Eglin Air Force Base when responding to the final report.

Response Requirements for Each Recommendation

Responses to the final report are required from the Air Force for the items indicated with an "X" in the chart below.

		Response Should Cover:		
Number	Addressee	Concur/ Nonconcur	Proposed Action	Completion Date
A.2.b.	Air Force	X	X	X

Finding B. Billing of Contractor and U.S. Government Additive Charges

The Military Departments did not accurately bill foreign military sales (FMS) customers for contractor and U.S. Government additive charges. That condition occurred because the Military Departments did not comply with the Defense Security Assistance Agency (DSAA) pricing policy: the Army did not communicate that policy to its organizational elements; the Navy had not effectively implemented that policy; and the Air Force had an ineffective method of distributing that policy. Also, that condition occurred because the Military Departments had ineffective internal control procedures for verifying the accuracy of those additive charges reported to the Defense Finance and Accounting Service (DFAS) Denver Center for its use in billing FMS customers. As a result, the Military Departments overbilled FMS customers $13.5 million and underbilled FMS customers $2.0 million for additive charges.

Background

Policy. DoD Federal Acquisition Regulations specify the contractor additive charges applicable to FMS sales, such as general and administrative expenses, that can be included in contract prices. Also, DoD Regulation 7000.14-R, "Financial Management Regulation, Security Assistance Policy and Procedures," March 18, 1993, specifies the U.S. Government additive charges, such as nonrecurring costs, Special Defense Acquisition Fund (SDAF) recoupment charges, and management augmentation fees, that can be included in FMS contract prices.

Public Law 101-165, "Fair Pricing," November 21, 1989, eliminated clauses in the Arms Export Control Act that allowed rent to be charged for Government-furnished plant and production equipment provided to contractors for use in producing Defense articles. Also, that Public Law eliminated nonrecurring costs for FMS cases that were wholly financed with nonrepayable FMS credits; that is, U.S. Government loans (grants) to FMS customers that do not require repayment. Pursuant to the Public Law, the DSAA established pricing policy in January 1990, that eliminated contractor rental fees and nonrecurring costs for FMS cases that were wholly financed with nonrepayable FMS credits for transactions reported to the DFAS Denver Center after November 21, 1989. In accordance with that policy, the Military Departments must eliminate contractor rental fees and nonrecurring costs from contract prices reported to the DFAS Denver Center for its use in billing FMS customers.

Case Selection. We judgmentally selected and reviewed 45 FMS missile cases that each had deliveries to FMS customers in excess of $1.0 million. We focused our efforts on determining whether contractor rental fees and nonrecurring costs had been eliminated, as well as on examining whether general and administrative expenses, SDAF recoupment charges, and management augmentation fees were being billed appropriately.

Additive Charges Applied to Customer Billings

FMS customers were inaccurately billed for contractor and U.S. Government additive charges because the Military Departments did not comply with the DSAA policy regarding the elimination of contractor rental fees and nonrecurring costs in customer billings. Also, the Military Departments' pricing personnel and financial managers did not verify the accuracy of those additive charges reported to the DFAS Denver Center for its use in billing FMS customers. As a result, FMS customers were overbilled $13.5 million for various additive costs and underbilled $2.0 million for nonrecurring costs. The overbillings of $13.5 million included $7.4 million for contractor rental fees, $381,000 for general and administrative expenses, $4.7 million for SDAF recoupment charges, $693,000 for nonrecurring costs, and $360,000 for management augmentation fees (program support costs for the Maverick missile system). Appendix B, Table 1, identifies the discrepancies by activity.

Army. The Army Missile Command (MICOM) did not comply with the DSAA policy to exclude contractor rental fees from FMS missile prices reported to the DFAS Denver Center for its use in billing FMS customers. In addition, the MICOM used an inappropriate rate in applying general and administrative expenses to Tube-Launched, Optically Tracked, Wire Guided (TOW) missile prices. As a result, the MICOM overbilled FMS customers $4.0 million for contractor rental fees and $381,000 for general and administrative expenses. Appendix B, Table 2, identifies the discrepancies by FMS case.

Cases Reviewed. We reviewed 10 Army missile cases, consisting of 5 TOW missile cases, 2 Homing All the Way Killer (HAWK) missile cases, 2 Patriot missile cases, and 1 Chaparral missile case.

Policy on Contractor Rental Fees. The MICOM program executive office (PEO) is responsible for determining the total FMS missile price to list on documents called price, availability, and serviceability worksheets. In order to have available accurate prices to list on the worksheets, PEOs are dependent on the MICOM procurement offices to prepare and submit accurate contract prices. The PEOs apply contractor and U.S. Government additive charges to contract prices in determining the total FMS missile price.

According to the DSAA pricing policy, all FMS missile prices reported after November 21, 1989, to the DFAS Denver Center for its use in billing FMS customers should have excluded contractor rental fees. The MICOM did not comply with that policy and inappropriately included those charges in the missile prices reported to the DFAS Denver Center. As a result, FMS customers were overbilled $4.0 million on 8 of 10 missile cases.

In January 1990, the MICOM finance and accounting office distributed the DSAA memorandum to various MICOM organizations concerning contractor rental fees. One of those organizations, the MICOM Acquisition Center, received the DSAA policy, but did not disseminate that policy to the MICOM procurement offices responsible for determining FMS contract prices. Since procurement personnel were unaware of the revised policy to disallow charging contractor rental fees, those fees were not excluded from FMS contract prices. Also, PEOs did not have visibility over the cost elements included in FMS contract prices by procurement personnel; therefore, PEOs could not adjust the total FMS missile price on the price, availability, and serviceability worksheets. Thus, the lack of proper communication between the MICOM Acquisition Center and the Patriot missile procurement office resulted in inappropriate contractor rental fees being included in billings to FMS customers. The Inspector General, Department of Defense, Audit Report No. 91-055, "Pricing and Billing of Stinger Missiles Sold to Foreign Military Sales Customers," also disclosed that the MICOM improperly billed FMS customers for asset use charges, also because of a breakdown in communications.

To avoid overbillings to FMS customers in the future, the MICOM procurement personnel must be provided proper guidance in the development of FMS contract prices. Also, without effective communication between the MICOM organizational elements, PEOs will continue to develop price, availability, and serviceability worksheets that will include inappropriate additive charges.

Verifying General and Administrative Expenses. A MICOM procurement contracting officer did not verify through contract documents that valid cost elements were used to determine FMS contract prices. The procurement contracting officer used an inaccurate general and administrative rate for pricing the TOW missile system acquisitions, resulting in overbillings of $381,000 on all five TOW missile cases. The overbilling occurred because the procurement contracting officer applied the actual contractor general and administrative rate to the total FMS missile price rather than using a composite rate developed by the MICOM contract pricing office. The composite rate was developed to prevent applying general and administrative expenses to certain FMS cost elements, such as contractor profit and selling expenses, that are a part of FMS contract prices, but should not be subject to a general and administrative surcharge. For FMS customers to be accurately charged for missile purchases, procurement contracting officers need to use the composite general and administrative rate in the determination of FMS contract prices.

Navy. The Naval Air Systems Command (NAVAIR) did not comply with the DSAA policy to exclude contractor rental fees from missile prices reported to the DFAS Denver Center for its use in billing after November 21, 1989, and nonrecurring costs from FMS cases that were wholly financed with

nonrepayable FMS credits. In addition, the NAVAIR case managers did not verify that nonrecurring costs were properly billed to FMS customers. For 10 Harpoon missile cases and 1 Sparrow missile case, FMS customers were overbilled $3.2 million for contractor rental fees. In addition, FMS customers were overbilled $628,000 for nonrecurring costs on one Harpoon missile case and underbilled $2.0 million for nonrecurring costs on three Harpoon missile cases. Appendix B, Table 3, identifies the discrepancies by FMS case.

Cases Reviewed. We reviewed 15 Navy missile cases consisting of 10 Harpoon, 3 Sparrow, and 2 Harm missile cases.

Policy on Contractor Rental Fees. The Contracts Policy and Management Division within the NAVAIR established policy in April 1991 that required contractor rental fees to be eliminated from contracts awarded after November 21, 1989. However, the DSAA policy eliminated contractor rental fees for missile prices reported to the DFAS Denver Center after November 21, 1989, regardless of the contract award date. Based on the NAVAIR's misinterpretation of the DSAA policy, the NAVAIR contracting officers continued reporting contractor rental fees to the DFAS Denver Center for missile contracts awarded prior to November 21, 1989. As a result, FMS customers were overbilled $3.2 million on 11 of the 15 missile cases we reviewed. The NAVAIR needs to issue guidance that complies with the current DSAA policy on contractor rental fees. Contracting officers would then be authorized to modify existing FMS Harpoon and Sparrow missile system contracts to avoid overbilling FMS customers in the future.

Nonrecurring Costs. The NAVAIR did not comply with the current DSAA policy on nonrecurring costs, and the NAVAIR case managers did not verify the accuracy of nonrecurring costs applied to FMS customers. The case manager in the Anti-ship Weapon Systems International Programs Office at the NAVAIR is responsible for verifying the accuracy of U.S. Government additive charges included in missile prices billed to FMS customers. For nonrecurring costs to be billed, the NAVAIR case manager must notify the Navy International Logistics Control Office (NAVILCO) to establish a nonrecurring cost requisition number and apply those costs against that requisition number. As a result of failure to follow the DSAA policy and to verify the appropriateness of nonrecurring costs, FMS customers were overbilled nonrecurring costs of $628,000 on one Harpoon missile case and underbilled nonrecurring costs of $2.0 million on three Harpoon missile cases.

Policy. The overbilling of $628,000 occurred because the NAVAIR did not comply with the DSAA policy and inappropriately applied nonrecurring costs to an FMS case that was wholly financed with nonrepayable FMS credits. The NAVILCO justified the billing of the nonrecurring costs, stating that funds were collected from the FMS customer as progress payments prior to the November 21, 1989, implementation of the DSAA policy. However, the DSAA policy stated that missile prices reported to the DFAS Denver Center after November 21, 1989, would not include nonrecurring costs for cases that were wholly financed with nonrepayable FMS credits, regardless

of when the funds were collected. The NAVAIR case manager should initiate an amendment to the customer's case to eliminate the nonrecurring costs to be in compliance with current DSAA policy.

Verifying Charges for Billing. Three cases were underbilled a total of $2.0 million. For two cases, the case manager did not properly notify the NAVILCO to establish nonrecurring cost requisitions in the system. For the other case, the NAVILCO did not establish the nonrecurring cost requisition, even though the case manager had properly notified the NAVILCO to do so. By reviewing the detailed delivery history search, a record of all transactions reported by the NAVILCO to the DFAS Denver Center for its use in billing, the case managers could have verified that the NAVILCO established the required requisitions for billing nonrecurring costs to FMS customers. As a result, nonrecurring costs of $2.0 million were not billed to FMS customers as required. The NAVAIR's inadequate procedures for verifying the accuracy of FMS billings caused the Navy not to recoup nonrecurring costs of $2.0 million from three FMS Harpoon missile customers.

Air Force. The financial manager in the Sidewinder systems program office did not comply with the DSAA policy to exclude contractor rental fees from FMS missile prices. In addition, the Sidewinder and the Maverick missile systems program offices did not verify the accuracy of U.S. Government additive charges reported to the DFAS Denver Center for its use in billing FMS customers. As a result, FMS customers were overbilled $5.3 million for the Sidewinder and Maverick missile systems. The overbillings of $4.9 million for the Sidewinder missile included contractor rental fees of $191,000, duplicate nonrecurring costs of $65,000, and duplicate SDAF recoupment charges of $4.7 million. For the Maverick missile system, customer overbillings of $360,000 were for management augmentation fees. Appendix B, Table 4, identifies the discrepancies by FMS case.

Cases Reviewed. We reviewed 20 Air Force missile cases, 12 Sidewinder missile cases at Eglin Air Force Base and 8 Maverick missile cases at the Ogden Air Logistics Center.

Policy on Contractor Rental Fees. The financial manager in the Sidewinder systems program office at Eglin Air Force Base was responsible for preparing detailed delivery reports, which identified charges for a particular missile system. The financial manager was also required to accurately report those charges to the DFAS Denver Center for its use in billing FMS customers. The DSAA eliminated contractor rental fees from FMS missile prices reported to the DFAS Denver Center after November 21, 1989; however, the financial manager did not exclude those charges from missile prices reported to the DFAS Denver Center. As a result, FMS customers were overbilled $191,000 on 12 Sidewinder missile cases. The financial manager's noncompliance with the DSAA's policy occurred because the Eglin Air Force Base policy office did not disseminate the DSAA policy to the Sidewinder systems program office. As a result, the financial manager was unaware that contractor rental fees were to be excluded from missile prices reported to the DFAS Denver Center for its use in billing. FMS customers would not have

been billed for contractor rental fees had the policy office distributed the DSAA policy to the financial manager responsible for determining Sidewinder missile prices for FMS customers.

Verifying SDAF and Nonrecurring Costs. Duplicate billings occurred at Eglin Air Force Base because the financial manager did not verify the accuracy of the SDAF recoupment and the nonrecurring costs before reporting Sidewinder missile prices to the DFAS Denver Center for its use in billing FMS customers. In 1986, the DSAA financed the Sidewinder missile qualification and testing program costs through the SDAF because the systems program office did not have sufficient customers to finance the configuration of the Sidewinder missile for FMS. To reimburse the SDAF, the DSAA established a $5,636 SDAF recoupment charge, which included a $14 charge per missile for nonrecurring costs. For 3 of 12 Sidewinder cases, the financial manager at the Eglin Air Force Base reported the SDAF recoupment charge more than once, resulting in overbillings to customers of $4.7 million. The financial manager inappropriately reported the $14 per missile nonrecurring cost separately to the DFAS Denver Center for its use in billing, resulting in total overbillings to FMS customers of $65,000 for 11 of 12 Sidewinder cases. The financial manager stated that operating procedures did not require the validation of FMS charges before the case closure process.

Since many years can elapse between the time customers are billed and payments are made, and the time of the case closure process, the financial manager should have performed a periodic validation of cost elements included in FMS missile prices because FMS customers depend on the U.S. Government for its expertise in case management. Concurrent with the audit, to properly prepare Sidewinder missile cases for closure, the financial manager was in the process of correcting the case discrepancies identified by the auditors.

Validation of Management Augmentation Fees. In July 1992, program responsibility for the Maverick missile system transferred from the Aeronautical Systems Center (ASC) to Ogden Air Logistics Center. Prior to the transfer, the ASC determined and reported Maverick missile prices to the DFAS Denver Center for its use in billing FMS customers.

Although the ASC made numerous adjustments to FMS missile prices, the ASC inappropriately included management augmentation fees for $360,000 in the missile prices for six of eight Maverick missile cases. FMS customers were overbilled because management augmentation fees of $360,000 were reported to the DFAS Denver Center both in the missile price and within program management costs on the Letter of Offer and Acceptance. That occurred because the ASC did not comply with DoD Regulation 7000.14-R, which requires the allocation of those costs only on one basis. According to the ASC's pricing manual, the program management lines were automatically charged a pro rata share of management augmentation fees. Neither the ASC nor the Ogden Air Logistics Center program managers could justify the duplication of those fees both in Maverick missile prices and as part of program management costs on the Letter of Offer and Acceptance.

The ASC and the Ogden Air Logistics Center program managers should have reviewed detailed delivery reports for the cases to verify the accuracy of the missile prices reported to the DFAS Denver Center for its use in billing FMS customers. That would have prevented FMS customers being billed duplicate management augmentation fees.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Commander, Army Missile Command, require the Acquisition Center to disseminate the Defense Security Assistance Agency policy, effective November 21, 1989, to all procurement personnel to preclude billing foreign military sales customers for contractor rental fees.

Management Comments. The Army concurred in principle with the recommendation stating that the recommended action has been accomplished. The Army stated that the MICOM Acquisition Center has already disseminated the required documents and has communicated the Defense Federal Acquisition Regulation Supplement changes to procurement personnel. Also, the Army stated that procurement personnel were notified of any revisions through Procurement Automated Document and Data System Change notices. The Army stated that distributing the DSAA memorandum to procurement personnel would only serve as a confusing duplication of the process currently in use.

Audit Response. The Army's actions are responsive to Recommendation B.1.

2. We recommend that the Commander, Naval Air Systems Command, issue guidance to procurement personnel to comply with the Defense Security Assistance Agency policy, effective November 21, 1989, to eliminate contractor rental fees from FMS missile prices and to stop charging nonrecurring costs on FMS cases that are wholly financed with nonrepayable FMS credits.

Management Comments. The Navy nonconcurred with Finding B and Recommendation B.2., stating that the NAVAIR issued guidance to comply with the February 1991 guidance from the Deputy Assistant Secretary of Defense (DASD) for Procurement concerning Fair Pricing Legislation for contractor rental fees. The Navy also stated that guidance has not changed that stated that contract adjustments may be required and that contracting officers should pursue reimbursement actions. In March 1991, the NAVAIR revised its contract clauses to conform with the DASD policy and informed Navy contracting officers.

Audit Response. We disagree with the Navy comments to Recommendation B.2. regarding contractor rental fees. Clarification of the policy on contractor rental fees is unnecessary. The DASD (Procurement) established the contractual policy for eliminating contractor rental fees; however, the DSAA is

responsible for establishing the policy for FMS and eliminated those fees from transactions delivery reported to the DFAS Denver Center after November 21, 1989, regardless of the contract award date. Also, the DSAA policy did not require retroactive modifications to existing contracts, which would have resulted in unncessary costs. Instead of complying with the DSAA policy, the NAVAIR revised the contract clauses pertaining to contractor rental fees without a corresponding reduction in the unit prices on FMS Harpoon and Sparrow missile contracts. As a result, those rental fees were inappropriately included in the missile prices reported to the DFAS Denver Center. Therefore, we request that the Navy reconsider its position when responding to the final report.

3. We recommend that the Commander, Eglin Air Force Base, require the policy office to disseminate the Defense Security Assistance Agency policy, effective November 21, 1989, to all financial managers to preclude billing foreign military sales customers for contractor rental fees.

Management Comments. The Air Force concurred with Recommendation B.3., stating that a memorandum will be sent by September 30, 1994, to the field activities restating the DSAA policy concerning contractor rental fees.

Audit Response. The Air Force comments are considered responsive to Recommendation B.3.

4. We recommend that the Commander, Army Materiel Command; the Commander, Naval Air Systems Command; and the Commander, Air Force Materiel Command:

a. Require subordinate commands to verify the accuracy of additive charges reported to the Defense Finance and Accounting Service Denver Center for its use in billing foreign military sales customers.

b. Adjust customers' FMS Trust Fund accounts for the amounts overbilled and underbilled as shown in Appendix B.

Army Comments. The Army concurred with Recommendation B.4.a. and stated that a policy memorandum will be issued that will require contracting officers to review applicable contracts and make the necessary adjustments to ensure additive charges are accurately reported to the DFAS Denver Center. The Army stated that the memorandum will be completed by September 30, 1994.

The Army nonconcurred with Recommendation B.4.b. regarding the adjustment of customers' Trust Fund accounts. For the contractor rental fees shown in Appendix B, Table 2, the Army stated that the missiles were placed on contract before the effective date of the DSAA regulatory change and that the rental fees were valid. For the general and administrative charges, the Army stated that

the differential rate of 4.175 percent determined and used by the contracting officer was lower than the 4.385 percent recommended by the administrative contracting officer.

Audit Response. The Army comments to Recommendation B.4.a. are fully responsive.

We disagree with the Army comments to Recommendation B.4.b. that adjustments to customers' Trust Fund accounts are not necessary and that the additive charges were valid. The DSAA policy for contractor rental fees was to preclude charging FMS customers for those fees, regardless of the contract date. The DSAA did not require the Military Departments to modify existing contracts since that effort would have resulted in unnecessary costs. To comply with the DSAA policy, the Army should have excluded contractor rental fees on customer deliveries reported to the DFAS Denver Center after November 21, 1989. For the general and administrative expenses, the MICOM used a lower but inappropriate rate to apply those charges to FMS customers. As stated in the report, the MICOM pricing office developed a composite rate for the TOW missile to preclude applying general and administrative expenses to certain cost elements, such as contractor profit. Therefore, we request that the Army reconsider its position on Recommendation B.4.b. when responding to the final report.

Navy Comments. The Navy partially concurred with Recommendation B.4.a., stating that the Navy emphasizes the importance of validating the accuracy of FMS charges. The reconciliation process for case closure will reflect [the correct additive] charges, however, the case closure efforts are lagging due to a contract closeout backlog. The Navy also stated that the verification of the charges is hampered by the DFAS Denver Center's incorrect posting [of charges], which the Systems Commands and the NAVILCO must research before any corrective action can occur.

The Navy nonconcurred with Recommendation B.4.b. The Navy acknowledged the DSAA guidance on Fair Pricing Legislation concerning contractor rental fees and nonrecurring costs charges on FMS cases wholly financed with FMS credits; however, the Navy complied with the DASD guidance. The Navy's actions concerning adjustments to customers' billings will depend upon DoD's clarification of the Fair Pricing Legislation. The Navy stated that if the DoD clarifies that legislation to be effective for contract deliveries and not contracts awarded on or after November 21, 1989, the DoD will have to establish a method for reimbursing customers' billings since those rental fees were sent directly to the U.S. Treasury and not to any other account.

For Harpoon missile contract N00019-87-C-0103 (modification P00051), an ambiguity was created because the modification did not address what action should be taken with the rental fees outstanding from the FY 1990 procurement. The Navy stated that the ambiguous situation was resolved when a settlement modification was executed against that Harpoon contract to use the outstanding rent to offset antecedent liabilities in lieu of the contractor sending a check to the U.S. Treasury. The antecedent liabilities resolved by that settlement modification affected FMS Harpoon procurements. The Navy stated that, based

upon the above rationale for the FY 1990 procurement, the rental fee issue was resolved fairly for FMS customers. Since contracts for the sales of Sparrow missiles were awarded prior to November 21, 1989, the Navy considers the charges to be valid.

Audit Response. The Navy comments to Recommendation B.4.a. are considered responsive. However, the System Commands and the NAVILCO should verify the accuracy of FMS charges throughout the life of an FMS case as well as during the case closure reconciliation process to ensure customers are properly billed.

We disagree with the Navy's position regarding Recommendation B.4.b. As stated previously in response to the Navy comments to Recommendation B.2., although the Navy complied with the DASD guidance for the contractual requirements of the Fair Pricing Legislation, the Navy did not comply with the DSAA reporting requirements for FMS. According to the DoD 7000.14-R, the DSAA is authorized to establish policy for FMS, and the DSAA required that contractor rental fees be eliminated from deliveries reported after November 21, 1989, regardless of contract award date. Therefore, DoD's clarification of the Fair Pricing Legislation is unnecessary.

The Navy stated that contractor rental fees are submitted directly to the U.S. Treasury and not to any Navy appropriations. However, for the Harpoon missile contract N00019-87-C-0103, the Navy used those rental fees of $1.3 million to settle antecedent liabilities and did not deposit the funds with the U.S. Treasury. Further, the Navy could not provide documentation to support the proportionate reimbursement to FMS customers based on the modification of the contract. Therefore, the Navy should reimburse customers' billings for those rental fees included in Harpoon missile prices reported to the DFAS Denver Center after November 21, 1989. For the Sparrow missile cases, the Navy should have complied with the DSAA policy on rental fees and eliminated those fees from the contract price before reporting the deliveries to the DFAS Denver Center. Therefore, we request that the Navy reconsider its position on Recommendation B.4.b. when responding to the final report.

Air Force Comments. The Air Force concurred with Recommendation B.4.a. and stated that internal controls are needed to ensure that additive charges are validated before the billing data is submitted to the DFAS Denver Center. The Air Force will notify field activities concerning the procedures needed to verify the accuracy of the additive charges. The Air Force stated that notification should be completed by September 30, 1994.

The Air Force partially concurred with Recommendation B.4.b. Regarding the SDAF charges for FMS cases KE-YFR, KS-YFX, and TW-TCR, the Air Force stated that those charges were erroneously applied to the cases. However, the Air Force stated that the financial manager corrected those cases at the time of the audit and would have identified those errors during the case closure process.

Regarding contractor rental fees, the Air Force stated that the charges were valid because the Sidewinder contract was awarded prior to the implementation of Fair Pricing Legislation. Further, the Comptroller of the Department of

Defense informed the financial manager that the Legislation was not retroactive. However, the Air Force is in the process of obtaining the DSAA guidance regarding the delivery reporting of rental fees. When the DSAA guidance is obtained, the Air Force plans to correct the erroneous billings shown in Appendix B, Table 4. The Air Force stated that action should be completed by September 30, 1994.

Concerning the nonrecurring cost charges, the Air Force stated that the charges were valid because the financial manager included those charges in accordance with the guidance given in an Office of the Secretary of Defense message. For the management augmentation fees, the Air Force stated it received a memorandum from the Armaments Directorate at the Ogden Air Logisitcs Center that disagrees with the overcharges shown in Appendix B, Table 4. The Air Force stated that detailed rationale for the charges on each case will be provided and any errors will be corrected. The Air Force stated that action should be completed by September 30, 1994.

Audit Response. The Air Force comments to Recomendation B.4.a. are responsive.

We disagree with the Air Force comments to Recommendation B.4.b. regarding the nonrecurring costs and management augmentation fees. According to the DoD guidance in effect when the Sidewinder missiles were delivery reported to the DFAS Denver Center, the SDAF recoupment charge of $5,636 included a $14 per missile charge for nonrecurring costs. Rather than report the nonrecurring costs to the DFAS Denver Center as separate charges, the finacial manager should have reviewed the DoD guidance to avoid applying erroneous charges to customers' billings. Regarding the management augmentation fees, FMS customers were charged for those fees both in the missile price and on the program management line on the Letter of Offer and Acceptance for the sale of Maverick missiles. As stated in this report (page 19), the Air Force pricing manual required those fees to be allocated to the program management line to preclude charging FMS customers for contract administrative services that are applied by the DFAS Denver Center to the Maverick missile price. Therefore, we request that the Air Force reconsider its position on Recommendation B.4.b. regarding nonrecurring costs and management augmentation fees when responding to the final report.

Response Requirements for Each Recommendation

Responses to the final report are required from the Army, the Navy, and the Air Force for the items indicated with an "X" in the chart below.

		Response Should Cover:			
Number	Addressee	Concur/ Nonconcur	Proposed Action	Completion Date	Related Issues*
B.2.	Navy	X	X	X	IC
B.4.b.	Army	X	X	X	
B.4.b.	Navy	X	X	X	
B.4.b.	Air Force	X	X	X	

* IC = material internal control weakness.

Finding C. Recoupment of Special Defense Acquisition Fund Investment Costs

The Navy and the Air Force overrecouped Special Defense Acquisition Fund (SDAF) investment costs for modifying the Harpoon and Sidewinder missile systems for foreign military sales (FMS) customers. In addition, the Air Force charged selling prices in excess of actual costs for Maverick missiles sold from the SDAF inventory. Those conditions occurred because the Defense Security Assistance Agency (DSAA) did not comply with DoD regulations and inappropriately directed the Navy to collect the SDAF recoupment charge for the Standoff Land Attack Missile (SLAM) system from Harpoon missile system customers. Also, the DSAA directed the Air Force to include an unauthorized cost element in the price of Maverick missiles sold to FMS customers. Further, the Air Force did not have operating procedures for monitoring the collection of the SDAF recoupment charges from FMS Sidewinder missile customers to avoid overbillings. As a result, the Navy inappropriately billed 18 FMS customers $2.5 million for the Harpoon missile system, and the Air Force overbilled FMS customers $9.9 million for the Sidewinder missile system and $1.9 million for the Maverick missile system.

Background

The DSAA is responsible for managing the SDAF, which is a revolving fund that finances the procurement of Defense articles for their sale to FMS customers. The SDAF both procures Defense articles for direct sales to FMS customers and invests funds with other DoD organizations to modify existing Defense articles to meet specific FMS requirements. The SDAF operates on a full cost recovery basis, and inventory items sold to FMS customers are required to be priced in accordance with DoD Regulation 7000.14-R, "Financial Management Regulation, Security Assistance Policy and Procedures." That regulation specifies the DoD cost elements that the SDAF is allowed to include in FMS missile prices, such as the basic contract price, contract administrative services, and nonrecurring costs. Using estimated production costs and forecasted FMS sales of Defense articles, both obtained from the Military Departments, the SDAF funds the investment for a certain amount. The DSAA then develops a recoupment charge that will recover for the SDAF investments it makes to have major Defense articles modified. The Military Departments are responsible for identifying the SDAF collections and preparing vouchers to collect the SDAF recoupment charges from the customers' FMS Trust Fund accounts. The Trust Fund accounts are used for the receipt of payments from customers for FMS sales and for disbursements made to contractors for FMS customers.

Special Defense Acquisition Fund Charges

Navy. As of January 1994, the Naval Air Systems Command (NAVAIR) had inappropriately collected a total of $2.5 million from 18 FMS Harpoon missile system customers. The Deputy Program Manager in the Anti-ship Weapon Systems International Programs Office at the NAVAIR is responsible for monitoring the collection of the SDAF recoupment charges for the Harpoon missile system. The Deputy Program Manager is required to coordinate with the DSAA; however, the DSAA is the final approving authority for the determination of the SDAF recoupment charge.

In February 1991, the SDAF provided $7.0 million in investment funds to the NAVAIR for the modification of the SLAM monitor set and guidance control section in anticipation of future SLAM sales to FMS customers. In November 1990, to ensure proper reimbursement to the SDAF, the DSAA directed the NAVAIR to continue charging FMS Harpoon missile customers an SDAF recoupment charge of $14,000 per missile, until a new SDAF recoupment charge could be developed. That recoupment charge of $14,000 per missile was established to recover a 1984 SDAF investment for $7.0 million in the Harpoon missile system. In November 1990, the NAVAIR provided the DSAA with a letter that showed the $7.0 million investment in the Harpoon missile system was fully recouped from Harpoon missile customers. However, the DSAA and the NAVAIR justified charging the SDAF recoupment of $14,000 per missile to FMS Harpoon customers because those customers derived production line benefits (lower production and overhead costs) from the modification of the SLAM system.

The assessment of the $14,000 SDAF recoupment charge to FMS Harpoon customers for SLAM investment costs was not in compliance with DoD Regulation 7000.14-R, which requires the SDAF to recover only full costs. According to the November 1990 letter sent by the NAVAIR to the DSAA, the 1984 SDAF investment for $7.0 million in the Harpoon missile was fully recovered; therefore, additional SDAF recoupment charges should not have been recouped from FMS Harpoon missile customers. As of January 1994, neither the DSAA nor the NAVAIR could provide documentation to verify that production line benefits, generally considered by contracting officers during contract negotiations to reduce procurement costs, actually benefitted FMS Harpoon missile customers. Based on discussions with the Deputy Program Manager and a review of FMS contract files for missile sales, as of January 1994, FMS customers had not procured any SLAM systems. Without sales of the SLAM systems to FMS customers, it was inappropriate for the DSAA to invest $7.0 million of SDAF funds in the modification of the SLAM system and bill 18 FMS Harpoon customers $2.5 million for those investment costs.

Air Force. Since 1990, the Air Force overcollected $11.8 million in SDAF charges on the Sidewinder and Maverick missile systems. Sidewinder missile system customers were overbilled $9.9 million because the financial manager did not review the status of SDAF recoupments when processing billings to FMS customers. In addition, FMS customers purchasing the Maverick missile

system were overbilled $1.9 million in unsupported charges that were approved by the DSAA in 1990 and included in the Letter of Offer and Acceptance (LOA) selling price.

Sidewinder Missile. The financial manager in the Eglin Air Force Base systems program office is responsible for accurately reporting the SDAF recoupment charges for Sidewinder missile systems. While the DSAA ensures that recoupments collected from FMS customers are sufficient to fully reimburse the SDAF for all investments made to modify missiles for FMS, the financial manager is required to monitor the SDAF collections of the recoupments to ensure that FMS customers are properly billed.

In 1986, the SDAF financed the qualification and testing program costs for the Sidewinder missile guidance control section because the systems program office did not have enough FMS customers to authorize production of the guidance control section. The systems program office provided the DSAA with estimated production costs and forecasted sales, and the SDAF funded that investment for $28.1 million. To reimburse the SDAF for its investment, the DSAA established a recoupment charge of $5,636 per missile to be applied to sales of 5,000 Sidewinder missiles. Although the financed qualification and testing program costs totaled only $19.2 million, the financial manager recouped $29.1 million from FMS customers, causing an overcollection of $9.9 million. That overcollection occurred because operating procedures did not require the financial manager to monitor the collection of the SDAF recoupment charges. The financial manager should have used available detailed delivery reports to monitor the collection of the SDAF recoupment charges for the Sidewinder missile. In May 1990, the DSAA notified the systems program office that the SDAF was fully reimbursed for its Sidewinder investment; however, the financial manager continued to collect the SDAF recoupment charge from FMS customers.

The overbillings of $9.9 million to FMS customers could have been avoided had the financial manager verified and monitored the SDAF recoupments for Sidewinder missiles.

Maverick Missile. Since 1991, FMS customers have been overbilled $1.9 million for Maverick missile systems sold from the SDAF inventory. In April 1989, the SDAF financed the procurement of 500 Maverick missiles for sales to FMS customers. To reimburse the SDAF for those procurements, the DSAA established an LOA selling price of $115,983 per missile that included an unapproved nonrecurring cost rate of $10,207. The DSAA did not comply with DoD Regulation 7000.14-R and use the approved DoD nonrecurring cost rate of $6,331 per missile, causing a $3,876 variance in the missile selling price of each missile. In June 1992, the Aeronautical Systems Center (ASC) informed the DSAA that the LOA selling price should be changed from $115,983 to $112,107 to reflect the approved DoD nonrecurring cost rate of $6,331 per missile. In addition, the ASC stated that the correct selling price must be reported to the DFAS Denver Center for its use in billing FMS customers. In June 1992, rather than adjusting the LOA selling price of $115,983 for the inappropriate nonrecurring costs, the DSAA instructed the

financial specialist at the ASC to adjust only the cost elements on financial analysis worksheets for the Maverick missile, which in itself would not correct customer selling prices.

In June 1992, as part of the Maverick missile pricing adjustment, a new charge (an SDAF additive charge of $3,027 per missile) not included in the 1989 LOA selling price was added to the cost elements on financial analysis worksheets. The DSAA did not have any rationale or documentation to support the inclusion of the SDAF additive charge in the Maverick missile price. According to the DSAA, the LOA selling price for the SDAF is fixed, and adding the SDAF additive charge to the selling price was proper because the Arms Export Control Act requires the SDAF to remain solvent. However, the Arms Export Control Act does not authorize the DSAA to deviate from DoD Regulation 7000.14-R pricing policy without written approval from the Comptroller of the Department of Defense. As of January 1994, the DSAA had not obtained that approval. In addition, the LOA selling price should have increased had the SDAF additive charge been valid; however, the LOA selling price remained at $115,983 per missile.

FMS customers would not have been overbilled $1.9 million had the DSAA properly managed the sale of Maverick missiles from SDAF inventory and used DoD authorized cost elements (contract price, administrative charges, and NRC costs) for those sales.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Director, Defense Security Assistance Agency:

a. Have the Naval Air Systems Command stop the collection of the Special Defense Acquisition Fund recoupment charges for the Standoff Land Attack Missile on all future Harpoon missile sales.

b. Comply with the DoD Regulation 7000.14-R, "Financial Management Regulation, Security Assistance Policy and Procedures," to include only DoD authorized cost elements in the price of Defense articles sold from the Special Defense Acquisition Fund.

c. Credit the Harpoon and Sidewinder missile systems foreign military sales customers' Trust Fund accounts for the overcollections of the Special Defense Acquisition Fund recoupment charges.

DSAA Comments. The DSAA nonconcurred with Recommendation C.1.a., stating that the SLAM and Harpoon missile systems have the same basic components and are produced and assembled from the same production and assembly lines. The DSAA based the investments in those missile programs on anticipated sales to FMS customers for both systems. Further, the DSAA stated

that the production savings attributable to the SDAF investment benefits customers purchasing either missile system, and therefore, the recoupment charges are assessable to both programs.

The DSAA concurred with Recommendation C.1.b., stating that the DSAA complied with the financial management regulation.

The DSAA nonconcurred with Recommendation C.1.c., stating that overcharges for the Sidewinder and the Maverick missile systems did not occur, and therefore, credits to FMS customers are not required. Concerning the SDAF recoupment charge for the Sidewinder missile, the DSAA stated that the Military Departments are required to collect those charges until the DSAA eliminates the requirement. Although an SDAF investment is fully recouped, the DSAA continues the recoupment charge, using the policy in DoD Directive 2140.2 applicable to nonrecurring costs. The DSAA stated that in 1992, that policy changed to eliminate a charge when the investment is recouped; therefore, the SDAF charge for the Sidewinder missile was not included in any Letters of Offer and Acceptance for sales after that change. For the pricing of the Maverick missile, the DSAA is responsible for reviewing and changing SDAF prices to assure full cost recovery for the item, in accordance with DoD regulations. Therefore, the DSAA stated that Maverick missile prices were not reduced to reflect a change in the nonrecurring cost rate. The additional funds were used to reflect higher contract engineering change costs that occurred after the original Air Force estimates. Further, the DSAA stated that the continued application of the nonrecurring cost charge permitted the recoupment for engineering change costs and maintained the solvency of the SDAF. The SDAF charged a stabilized price for the missile systems in accordance with established DoD regulations.

Audit Response. We disagree with the DSAA comments to Recommendation C.1.a. As stated in the report, neither the DSAA nor the NAVAIR could provide documentation to support the production cost savings that benefitted Harpoon missile customers. Also, according to DoD Directive 2140.2, recoupment charges are eliminated when the SDAF investment is fully recouped, which occurred for the Harpoon missile in 1984. Further, DoD Regulation 7000.14-R requires FMS customers to pay the full cost of Defense articles. Although the recoupment charges could be assessable to the SLAM and Harpoon programs, recouping the entire SDAF investment from Harpoon customers precludes the DoD from applying those charges to purchasers of the SLAM system. Thus, SLAM customers will not pay the full cost for their missiles. Therefore, we request that the DSAA reconsider its position when responding to the final report.

The DSAA comments to Recommendation C.1.b. are fully responsive.

We disagree with the DSAA comments to Recommendation C.1.c. As stated in this report (page 28), although the DSAA informed the Eglin Air Force Base that the SDAF investment in the Sidewinder missile was fully recouped, the financial manager inappropriately continued collecting the charges amounting to $9.9 million from FMS customers. The DSAA's reference to changes to DoD Directive 2140.2 is irrelevant because the DoD Manual 7290.3-M (the

governing regulation effective when Sidewinder missiles were sold to FMS customers) required the SDAF only to recover the full costs of its investments, which had occurred for the Sidewinder missile. Further, the DSAA had informed the financial manager that the SDAF investment in the Sidewinder missile was fully recouped; this information provided by the DSAA to Eglin Air Force Base would have been unncessary unless the DSAA intended the financial manager to eliminate further collections of the recoupment charge. For Maverick missiles sold from the SDAF, we acknowledge that the DSAA is responsible for establishing an SDAF price that would assure full cost recovery on the sale. However, when the DSAA established the Letter of Offer and Acceptance sales price, an unapproved nonrecurring cost rate of $10,207 was included in the price rather than the DoD approved rate of $6,331 per missile. Instead of adjusting the SDAF selling price, the DSAA recalculated the cost elements included in the Letter of Offer and Acceptance to include an SDAF additive charge. That charge was not approved by the Comptroller of the Department of Defense, as required. Therefore, we request that the DSAA reconsider its position on Recommendation C.1.c. when responding to the final report.

Navy Comments. The Navy provided unsolicited comments for Finding C and Recommendations C.1.a. and C.1.c. The Navy nonconcurred with that finding and those recommendations, stating that the SLAM system monitor set (data link pod) required a modification due to releaseability contraints to FMS customers. The DSAA approved the SDAF to fund that modification to support projected FY 1991 and FY 1992 sales to FMS customers. That approval ensured the availability of the pod, ensured that the delivery leadtime for the SLAM was met, and allowed the U.S. Government to meet an important response to an FMS customer. Although the Navy acknowledged that the SLAM system has not been sold to FMS customers, the DSAA plan for the recoupment of funds is valid because all customers obtained benefit from the Harpoon and the SLAM production and support efforts.

Audit Response. We disagree with the Navy's position regarding Finding C and Recommendations C.1.a. and C.1.c. As previously stated in response to the DSAA comments for Finding C. and Recommendation C.1.a., DoD regulations require recoupment charges to be eliminated when the SDAF investment costs are fully recouped and for FMS customers to pay the full cost of Defense articles purchased. As of November 1990, the NAVAIR informed the DSAA that the Harpoon investment was fully recouped; however, the NAVAIR inappropriately continued collecting the recoupment charge from Harpoon missile customers. Although the economies of scale mentioned by the Navy would benefit an entire production line (including the DoD requirements), it is impractical to charge Harpoon customers for costs invested in the SLAM system. Since Harpoon missile customers were reimbursing the SDAF for the modification of the SLAM system, FMS customers will purchase the SLAM system at less than full cost, which is contrary to the DoD regulations.

2. We recommend that the Commander, Eglin Air Force Base, have the systems program office establish operating procedures requiring the financial manager to verify and monitor collections of Special Defense Acquisition Fund recoupment charges for the Sidewinder missile system.

Air Force Comments. The Air Force concurred with Recommendation C.2., stating that guidance will be issued to notify Eglin Air Force Base of the responsibility to monitor and verify the collection of the SDAF recoupment charges. Also, the Air Force will verify that FMS customers were billed correctly and will determine when the DSAA guidance eliminated the SDAF collection of investment costs for the Sidewinder missile. However, the Air Force stated that it acts solely as administrative manager for the Maverick program and that the DSAA approves the Letter of Offer and Acceptance sales price and the worksheets used to report costs for customer deliveries to the DFAS Denver Center.

Audit Response. The Air Force comments to Recommendation C.2. are responsive. We agree that the Air Force is the administrative manager and that the DSAA determines the SDAF recoupment charges. However, the functions of the administrative manager include monitoring and collecting the recoupment charges for the SDAF.

DSAA Comments. The DSAA provided unsolicited comments for Recommendation C.2. The DSAA concurred in part with that recommendation, stating that the verification and monitoring of the SDAF collections should occur to ensure that the price the DSAA established is charged to FMS customers and not whether the charges should discontinue as implied in the report.

Audit Response. We disagree with the DSAA comments to Recommendation C.2. The DoD regulations require the Military Departments to verify and monitor the SDAF collections for various reasons, including ensuring that FMS customers are properly charged and that the collections are made to recover only the full costs of the SDAF investments.

Response Requirements for Each Recommendation

Responses to the final report are required from the DSAA for the items indicated with an "X" in the chart below.

		Response Should Cover:			
Number	Addressee	Concur/ Nonconcur	Proposed Action	Completion Date	Related Issues*
C.1.a.	DSAA	X	X	X	IC
C.1.c.	DSAA	X	X	X	

* IC = material internal control weakness.

Part III - Additional Information

Appendix A. Contract Pricing and Reporting Discrepancies

Table 1. Summary of Missile Prices Charged to DoD Customers and FMS Customers for Contract DAAH01-87-C-A025

	Unit Variance[1]	Quantity	Total Variance[2]
DoD Price Versus Germany Price			
Buy 8	$ (9,920)	70	$ (694,400)
Buy 9	1,740	129	224,460
Buy 10	327	144	47,088
Buy 11	(242)	89	(21,538)
Buy 12	24,921	52	1,295,892
Subtotal			$ 851,502
DoD Price Versus the Netherlands Price			
Buy 8	$ 6,617	40	$ 264,680
Buy 9	13,127	40	525,080
Buy 10	(9,538)	40	(381,520)
Subtotal			$ 408,240
Total Variance			$1,259,742
Germany Price Versus the Netherlands Price			
Buy 8	$17,217	40	$ 688,680
Buy 9	25,496	40	1,019,840
Buy 10	(1,301)	40	(52,040)
Total Variance			$1,656,480

[1]For the comparison between DoD customers and FMS customers, the positive figures indicate the amount FMS customers paid in excess of DoD customers. For the comparison between Germany and the Netherlands, a positive figure indicates the amount the Netherlands paid in excess of Germany.

[2]The unit variances (identified in Tables 2, 3, and 4) multiplied by the case quantity equals the total variance.

Table 2. Missile Prices Charged to DoD and to Germany
Contract DAAH01-87-C-A025

	DoD				
	Buy 8	Buy 9	Buy 10	Buy 11	Buy 12
Contract Line Item Number	0001AB	0085AB	0149AB	0212AB	0249AA
Contract Price	$483,661	$430,947	$465,947	$459,753	$464,052
Economic Order Quantity	0	23,558	4,642	25,143	25,119
Plus: Foreign Premium	12,797	15,782	15,538	17,390	16,580
Less: Technical Services	18,089	14,105	14,265	5,829	6,453
Adjusted Selling Price	$478,369	$456,182	$471,862	$496,457	$499,298
Less: Profit	62,396	59,502	61,547	64,755	65,126
Adjusted Contract Line Item Number Price	$415,973	$396,680	$410,315	$431,702	$434,172
Less:					
General & Administrative	32,588	31,076	32,144	33,820	34,013
Other Costs	1,169	1,959	10,528	2,291	2,857
Base Price	$382,216	$363,645	$367,643	$395,591	$397,302

	Germany				
Contract Line Item Number	0063AA	00129AA	0193AA	0236AA	0273AA
Contract Price	$561,428	$516,212	$536,005	$644,814	$792,434
Economic Order Quantity	0	17,496	5,091	23,231	22,209
Less:					
Foreign Premium	65,804	51,495	40,852	156,124	264,694
Technical Services	21,037	16,486	16,263	8,113	9,330
Adjusted Selling Price	$474,587	$465,727	$483,981	$503,808	$540,619
Less: Profit	67,216	65,961	68,547	71,355	76,568
Adjusted Contract Line Item Number Price	$407,371	$399,766	$415,434	$432,453	$464,051
Less:					
General & Administrative	33,636	33,008	34,302	35,707	38,316
Other Costs*	1,439	1,373	13,162	1,397	3,512
Base Price	$372,296	$365,385	$367,970	$395,349	$422,223
Unit Price Variance	$ 9,920	$ (1,740)	$ (327)	$ 242	$ (24,921)

*Amounts consist of silver, value engineering/engineering change proposals, and economic price adjustments.

Table 3. Missile Price Charged to DoD and to the Netherlands
Contract DAAH01-87-C-A025

	DoD		
	Buy 8	Buy 9	Buy 10
Contract Line Item Number	0001AD	0085AA	0149AA
Contract Price	$471,391	$440,276	$453,025
Economic Order Quantity	0	23,558	4,642
Plus: Foreign Premium	12,488	15,367	14,824
Less: Technical Services	17,655	13,737	13,897
Adjusted Selling Price	$466,224	$465,464	$458,594
Less: Profit	60,812	60,713	59,817
Adjusted Contract Line Item Number Price	$405,412	$404,751	$398,777
Less:			
General & Administrative	31,760	31,709	31,241
Other Costs	556	1,888	1,529
Base Price	$373,096	$371,154	$366,007
	Netherlands		
Contract Line Item Number	0041AA	0116AA	0180AA
Contract Price	$562,407	$651,781	$481,750
Economic Order Quantity	0	18,448	5,931
Less:			
Foreign Premium	56,943	156,897	0
Technical Services	21,506	20,224	19,772
Adjusted Selling Price	$483,958	$493,108	$467,909
Less: Profit	68,543	69,839	66,270
Adjusted Contract Line Item Number Price	$415,415	$423,269	$401,639
Less:			
General & Administrative	34,300	34,949	33,163
Other Costs	1,402	4,039	12,007
Base Price	$379,713	$384,281	$356,469
Unit Price Variance	$ (6,617)	$ (13,127)	$ 9,538

*Amounts consist of silver, value engineering/engineering change proposals, and economic price adjustments.

Table 4. Missile Prices Charged to Germany and to the Netherlands
Contract DAAH01-87-C-A025

	Germany		
	Buy 8	Buy 9	Buy 10
Contract Line Item Number	0063AA	0129AA	0193AA
Contract Price	$561,428	$516,212	$536,005
Economic Order Quantity	0	17,496	5,091
Less:			
Foreign Premium	65,804	51,495	40,852
Technical Services	21,037	16,486	16,263
Adjusted Selling Price	$474,587	$465,727	$483,981
Less: Profit	67,216	65,961	68,547
Adjusted Contract Line Item Number Price	$407,371	$399,766	$415,434
Less:			
General & Administrative	33,636	33,008	34,302
Contractor Furnished Equipment	9,800	6,600	10,200
Other Costs	1,439	1,373	13,162
Base Price	$362,496	$358,785	$357,770

	Netherlands		
Contract Line Item Number	0041AA	0116AA	0180AA
Contract Price	$562,407	$651,781	$481,750
Economic Order Quantity	0	18,448	5,931
Less:			
Foreign Premium	56,943	156,897	0
Technical Services	21,506	20,224	19,772
Adjusted Selling Price	$483,958	$493,108	$467,909
Less: Profit	68,543	69,839	66,270
Adjusted Contract Line Item Number Price	$415,415	$423,269	$401,639
Less:			
General & Administrative	34,300	34,949	33,163
Other Costs	1,402	4,039	12,007
Base Price	$379,713	$384,281	$356,469
Unit Price Variance	$ (17,217)	$ (25,496)	$ 1,301

Appendix A. Contract Pricing and Reporting Discrepancies

Table 5. Contract Reporting Discrepancies

Activity	Case/Line	Contract Price	FMS Price	Unit Price Variance	Overbilling*	Underbilling*
AIR FORCE						
Eglin AFB						
	BA-YAA/001	$ 31,790	$ 32,875	$ 1,085	$ 69,381	$ 0
	GR-YDP/002	26,289	26,926	637	543,106	0
	JO-YFC/YFD	31,790	32,875	1,085	115,634	0
	MU-YEC/001	31,790	32,900	1,110	95,157	0
	TW-YBS/YBT	31,790	32,875	1,085	1,271,973	0
	TW-YCR/001	31,790	32,875	1,085	843,447	0
Subtotal					$2,938,698	$ 0
Ogden ALC						
	BA-SGA/042	$ 107,483	$ 111,631	$ 4,148	$ 108,413	$ 0
	DE-JAA/001	103,037	104,468	1,431	224,406	0
	KS-JAD/001	103,037	104,468	1,431	143,620	0
	KU-YBA/010	103,285	92,115	(11,170)	0	3,464,025
	PT-YAO/001	94,592	95,600	1,008	5,269	0
	SZ-YBA/001/002	99,651	100,230	579	24,058	0
Subtotal					$ 505,766	$3,464,025
Total					$3,444,464	$3,464,025

Country Codes

BA	Bahrain	KU	Kuwait
DE	Denmark	MU	Oman
GR	Greece	PT	Portugal
JO	Jordan	SZ	Switzerland
KS	Korea	TW	Taiwan

*The overbillings and underbillings include applicable charges for contract administrative services and administrative expenses.

Appendix B. Contractor and U.S. Government Additive Charges

Table 1. Summary of Contractor and U.S. Government Additive Charges

Activity	Contractor Rental	G&A[1]	Nonrecurring Costs		SDAF[2]	Mgmt. Aug.[3]
			Overbilling	Underbilling		
MICOM	$3,987,746	$380,763	$ 0	$ 0	$ 0	$ 0
NAVAIR	3,210,969	0	627,877	2,043,247	0	0
Eglin AFB	190,767	0	65,203		4,656,776	0
Ogden ALC	0	0	0	0	0	360,226
Total	$7,389,482	$380,763	$693,080	$2,043,247	$4,656,776	$360,226

[1]G&A = General and Administrative.
[2]SDAF = Special Defense Acquisition Fund.
[3]Mgmt. Aug. = Management Augmentation Fees.

Appendix B. Contractor and U.S. Government Additive Charges

Table 2. Army Contractor and U.S. Government Additive Charges

Activity	Case/Line	Contractor Rental	General & Administrative	Overbilling*
MICOM				
	DE-VGQ/001/002	$ 127,910	$ 62,434	$ 190,344
	EG-UJD/001/001	1,788,378	116,829	1,905,207
	EG-UKE/001	573,262	0	573,262
	EG-UEY/001	24,589	0	24,589
	KS-YDH/001	52,287	26,017	78,304
	PK-VFU/001/002	294,295	143,908	438,203
	SR-VJM/001/002	483,345	31,575	514,920
	TC-UBH/001/002	643,680	0	643,680
Total		$3,987,746	$380,763	$4,368,509

*The overbillings include applicable charges for contract administrative services and administrative expenses.

See the country codes at the end of Appendix B.

Table 3. Navy Contractor and U.S. Government Additive Charges

Activity	Case/Line	Contractor Rental	Nonrecurring Costs	
			Overbilling*	Underbilling*
NAVAIR				
	CN-ALK/A01	$ 350,126	$ 0	$ 0
	EG-AAG/A01	276,040	627,877	0
	JA-AJD/A01	179,838	0	635,677
	JA-AJL/A01	256,062	0	953,515
	JA-AJW/A01	200,871	0	0
	JA-AKD/A01	355,387	0	0
	JA-AKG/A01	121,934	0	454,055
	KS-LLT/A01	634,060	0	0
	KU-AAU/A01	487,738	0	0
	SP-AJH/A01	256,913	0	0
	TK-AEV/A01	92,000	0	0
Total		$3,210,969	$627,877	$2,043,247

*The overbillings and underbillings include applicable charges for contract administrative services and administrative expenses.

See the country codes at the end of Appendix B.

Table 4. Air Force Contractor and U.S. Government Additive Charges

Activity	Case/Line	SDAF	Contractor Rental	NRC	Mgmt. Aug.	Over-billing*
Eglin AFB						
	BA-YAA/001	$ 0	$ 2,814	$ 819	$ 0	$ 3,633
	GR-YDP/002	0	37,514	11,936	0	49,450
	JO-YFC/YFD	0	4,689	1,365	0	6,054
	KS-YFR/001	1,201,655	9,379	5,200	0	1,216,234
	KS-YFX/001	3,194,189	24,932	14,092	0	3,233,213
	KS-YGC/001	0	2,346	747	0	3,093
	MF-YBA/001	0	2,345	683	0	3,028
	MF-YBB/001	0	2,626	0	0	2,626
	MU-YEC/001	0	3,772	1,098	0	4,870
	TH-YJA/001	0	11,254	3,276	0	14,530
	TW-YBS/YBT	0	51,582	15,015	0	66,597
	TW-YCR/001	260,932	37,514	10,972	0	309,418
Subtotal		$4,656,776	$190,767	$65,203	$ 0	$4,912,746
Ogden ALC						
	BA-SGA/042	$ 0	$ 0	$ 0	$ 53,869	$ 53,869
	EG-STH/053	0	0	0	65,557	65,557
	KU-YBA/010	0	0	0	136,578	136,578
	PT-YAO/001	0	0	0	47,931	47,931
	SZ-YBA/001/ 002	0	0	0	2,396	2,396
	TH-SKA/SLQ	0	0	0	53,895	53,895
Subtotal		$ 0	$ 0	$ 0	$360,226	$ 360,226
Total		$4,656,776	$190,767	$65,203	$360,226	$5,272,972

*The overbillings include applicable charges for contract administrative services and administrative expenses.

See the country codes at the end of Appendix B.

Country Codes:

BA	Bahrain
CN	Canada
DE	Denmark
EG	Egypt
GR	Greece
JA	Japan
JO	Jordan
KS	Korea
KU	Kuwait
MF	Malaysia
MU	Oman
PK	Pakistan
PT	Portugal
SP	Spain
SR	Saudi Arabia
SZ	Switzerland
TC	United Arab Emirates
TH	Thailand
TK	Turkey
TW	Taiwan

Appendix C. Summary of Potential Benefits Resulting From Audit

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
A.1.a, A.1.b., A.1.c	Program Results. Validation of cost elements and dollar amounts will ensure FMS customers pay comparable prices to DoD customers and have been accurately billed for missile systems.	Nonmonetary
A.2.a.	Program Results. Use of current contract documents to report contract prices will ensure FMS customers are accurately billed by the DFAS Denver Center.	Nonmonetary
A.2.b	Program results. Correction of erroneous billings will ensure FMS customers have been accurately billed and their Trust Fund accounts credited.	Funds put to better use. Recoupment by the Air Force of $3.4 million, offset by refunds of $3.5 million for overbillings.
B.1., B.3.	Program Results. Distribution of the DSAA policy to all responsible personnel will ensure FMS customers are not billed for contractor rental fees.	Nonmonetary
B.2.	Program Results. Revising Navy guidance to comply with the DSAA policy will ensure FMS customers are billed appropriately for additive charges.	Nonmonetary

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
B.4.a.	Program Results. Validation of the additive charges reported to the DFAS Denver Center for billing will ensure accurate billings to FMS customers.	Nonmonetary
B.4.b	Program results. Refunding the applicable country's FMS Trust Fund accounts for overbillings and underbillings will ensure customers have been accurately billed.	Funds put to better use. Recoupment by the Military Departments of $2.0 million, offset by refunds of $13.5 million for overbillings.
C.1.a	Program Results. Elimination of the Special Defense Acquisition Fund recoupment charges will ensure FMS customers are accurately billed for Harpoon missiles.	Nonmonetary
C.1.b	Program Results. Adherence to DoD regulations will ensure that the Special Defense Acquisition Fund selling prices include authorized cost elements.	Nonmonetary
C.1.c	Program Results. Correction of erroneous billings will ensure FMS customers have been accurately billed.	Nonmonetary to DoD. However, refunds of $12.4 million for overbillings will benefit customer programs.
C.2.	Program Results. Establishment of operating procedures will ensure that Special Defense Acquisition Fund recoupment charges are accurately collected from FMS customers.	Nonmonetary

Appendix D. Organizations Visited or Contacted

Department of the Army

U.S. Army Materiel Command, Alexandria, VA
  U.S. Army Missile Command, Huntsville, AL
  U.S. Army Security Assistance Command, New Cumberland, PA

Department of the Navy

Naval Air Systems Command, Washington, DC
Naval Sea Systems Command, Washington, DC
Naval Supply Systems Command, Washington, DC
  Navy International Logistics Control Office, Philadelphia, PA

Department of the Air Force

Air Force Materiel Command, Wright-Patterson Air Force Base, OH
  Aeronautical Systems Center, Wright-Patterson Air Force Base, OH
  Air Force Security Assistance Center, Wright-Patterson Air Force Base, OH
  Eglin Air Force Base, FL
  Ogden Air Logistics Center, Ogden, UT

Other Defense Organizations

Headquarters, Defense Finance and Accounting Service, Washington, DC
  Defense Finance and Accounting Service Center, Denver, CO
Defense Logistics Agency, Alexandria, VA
  Defense Contract Management Area Office, Newport Beach, CA
  Defense Plant Representative Office, McDonnell Douglas, St. Louis, MO
  Defense Plant Representative Office, Raytheon, Burlington, MA
Defense Security Assistance Agency, Washington, DC

Non-Defense Organizations

Loral Corporation, Newport Beach, CA
McDonnell Douglas Corporation, St. Louis, MO
Raytheon Corporation, Burlington, MA

Appendix E. Report Distribution

Office of the Secretary of Defense

Comptroller of the Department of Defense

Department of the Army

Secretary of the Army
Auditor General, Department of the Army
Commander, Army Materiel Command

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Auditor General, Department of the Navy
Commander, Naval Air Systems Command
Commander, Naval Supply Systems Command

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force
Commander, Air Force Materiel Command

Defense Agencies

Director, Defense Finance and Accounting Service
Director, Defense Security Assistance Agency

Non-Defense Federal Organizations

Office of Management and Budget
National Security and International Affairs Division, Technical Information Center, General Accounting Office

Chairman and Ranking Minority Member of Each of the Following Congressional Committees and Subcommittees:

- Senate Committee on Appropriations
- Senate Subcommittee on Defense, Committee on Appropriations
- Senate Committee on Armed Services
- Senate Committee on Governmental Affairs
- House Committee on Appropriations
- House Subcommittee on Defense, Committee on Appropriations
- House Committee on Armed Services
- House Committee on Government Operations
- House Subcommittee on Legislation and National Security, Committee on Government Operations

American Embassies

American Embassy, Bahrain
American Embassy, Canada
American Embassy, Denmark
American Embassy, Egypt
American Embassy, Germany
American Embassy, Greece
American Embassy, Japan
American Embassy, Jordan
American Embassy, Korea
American Embassy, Kuwait
American Embassy, Malaysia
American Embassy, Netherlands
American Embassy, Oman
American Embassy, Pakistan
American Embassy, Portugal
American Embassy, Saudi Arabia
American Embassy, Spain
American Embassy, Switzerland
American Embassy, Taiwan
American Embassy, Thailand
American Embassy, Turkey
American Embassy, United Arab Emirates

Part IV - Management Comments

Army Comments

DEPARTMENT OF THE ARMY
OFFICE OF THE DEPUTY CHIEF OF STAFF FOR LOGISTICS
500 ARMY PENTAGON
WASHINGTON, DC 20310-0500

DALO-SAA

29 Jul 1994

MEMORANDUM THRU

DIRECTOR OF THE ARMY STAFF, 202 ARMY PENTAGON, WASHINGTON, D.C. 20310-0200

ASSISTANT SECRETARY OF THE ARMY (RESEARCH, DEVELOPMENT AND ACQUISITION), 103 ARMY PENTAGON, WASHINGTON, D.C. 20310-0103

FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE (AUDITING), 400 ARMY NAVY DRIVE, ARLINGTON, VA 22202-2884

SUBJECT: Draft Audit Report on Procurement Prices Paid on Missile Systems for Foreign Military Sales (Project No. 3FA-0047)

1. Reference SAAG-PRF-E memorandum, 12 May 1994, subject as above.

2. Comments as requested by reference are at Tab A.

3. The HQ DA comments were prepared from data provided by the U.S. Army Materiel Command, the U.S. Army Security Assistance Command, and the U.S. Army Missile Command.

FOR THE DEPUTY CHIEF OF STAFF FOR LOGISTICS:

FRANK S. BESSON III
Director of Security Assistance

Encl

CF:
ASA(I,L,&E)
ASA(FM)
SAAG-PRF-E

Mr. Liszewski/50390

FINDINGS AND RECOMMENDATIONS
DODIG Draft Report
Procurement Prices Paid on Missile Systems for Foreign Military Sales
(Project No. 3FA-0047)

FINDING A: Contracting For and Pricing of Missiles.

SUMMARY: "The Army did not negotiate Patriot missile contract prices for foreign military sales (FMS) customers that were comparable to prices negotiated for DOD customers. In addition, the Air Force did not report the appropriate contract prices for the Sidewinder and Maverick missile systems to the Defense Finance and Accounting Service (DFAS)-Denver Center for its use in billing FMS customers. Those conditions occurred because the Army Missile Command (MICOM) Patriot procurement office did not validate the cost elements included in FMS contract prices, and the Air Force did not use contract documents to accurately report prices to the DFAS-Denver Center. As a result, FMS customers paid $1.3 million more than DOD customers, and the Netherlands paid $1.7 million more than Germany did for comparable purchases of Patriot missiles. Also, the Air Force overcharged and undercharged FMS customers $3.4 million and $3.5 million respectively for Sidewinder and Maverick missiles."

RECOMMENDATION A-1: "We recommend that the Commander, Army Missile Command:

a. Require procurement offices to verify the accuracy of cost elements used in negotiating missile contract prices for foreign military sales customers, as required by DOD regulations.

b. Establish a timeframe in which the procurement offices must validate the dollar amounts of those contract cost elements that differ between DOD customers and foreign military sales customers.

c. Verify the accuracy of cost elements in the Army's contract with the Raytheon Corporation (DAAH01-87-C-A025) for Patriot missiles being procured for foreign military sales, amend any overpriced contract line items, and adjust the customers' Trust Fund accounts accordingly."

COMMAND COMMENTS:

a. Concur in Principle.

Concur in principle and with the understanding that the report's use of the term "verification" is synonymous with the term "evaluation". Prior to contract negotiations, the Defense Contract Audit Agency, Engineering Staff, Cost/Price Analyst and other specialists as required, evaluate the contractor's proposal to establish the Government's negotiation position, inclusive of individual cost elements. After the contract has been negotiated, the results are documented in the Business Clearance Memorandum (BCM) and reviewed by high level procurement officials. The MICOM Acquisition Center will issue a memorandum to Acquisition Center personnel emphasizing the need to pay particular attention to differences in cost elements between U.S. and FMS requirements and that such differences be fully addressed in the BCM.

b. Concur in Principle.

Concur in principle and with the understanding that the report's use of the term "verification" is synonymous with the term "evaluation". MICOM's Acquisition Center personnel will be instructed to ensure that within the time frame between receipt of contractor's proposal and contract award, contract cost elements that differ between DOD and FMS customers will be evaluated and negotiated prior to agreement on a contract price. Cost element differences that exist at conclusion of negotiations will be documented in the BCM and reviewed by high level procurement officials.

c. Concur.

The MICOM Acquisition Center will complete a review within 90 days to determine the accuracy of the cost elements challenged by the audit report. Following the review, a decision will be made on whether or not any repricing/renegotiation of any contract line items found to be overpriced is necessary. The customer's Trust Fund accounts will be adjusted to reflect any repriced/renegotiated line items.

FINDING B: Billing of Contracts and U. S. Government Additive Charges

SUMMARY: "The Military Departments did not accurately bill foreign military sales (FMS) customers for contractor and U.S Government additive charges. That condition occurred because the Military Departments did not comply with the Defense Security Assistance Agency (DSAA) pricing policy: the Army did not communicate that policy to its organizational elements; the Navy had not effectively implemented that policy; and the Air Force had an ineffective method of distributing that policy. Also, that

condition occurred because the Military Departments had ineffective internal control procedures for verifying the accuracy of those additive charges reported to the Defense Finance and Accounting Service (DFAS)-Denver Center for its use in billing FMS customers. As a result, the Military Departments overcharged FMS customers $13.5 million and undercharged FMS customers $2.0 million for additive charges."

RECOMMENDATION B-1: "We recommend that the Commander, Army Missile Command, require the Acquisition Center to disseminate the Defense Security Assistance Agency policy, effective November 21, 1989, to all procurement personnel to preclude charging foreign military sales customers for contractor rental fees."

COMMAND COMMENTS: Concur in Principle.

The recommendation has already, in effect, been accomplished. The Acquisition Center disseminated upon receipt the documents (Acquisition Letter (AL) 91-4 and DAC 88-17) that effected and communicated the DFARS changes to all procurement personnel upon their receipt. Personnel were notified of applicable clause revisions through Procurement Automated Document and Data System Change notices. To now distribute the 1989 DSAA memorandum to procurement personnel would only serve as a confusing duplication of the process utilized when the AL/DAC guidance was promulgated three years ago.

RECOMMENDATION B-4: "We recommend that the Commander, Army Materiel Command; the Commander, Naval Air Systems Command; and the Commander, Air Force Materiel Command:

a. Require subordinate commands to verify the accuracy of additive charges reported to the DFAS - Denver Center for its use in billing foreign military sales customers.

b. Adjust customers' FMS Trust Fund accounts for the amounts overbilled and underbilled as shown in Appendix B."

COMMAND COMMENTS: Partially Concur.

a. A policy memorandum will be issued requiring the Contracting Officers to review the applicable contracts, and when appropriate, make the adjustments necessary to ensure the additive charges are accurately reported to DFAS-Denver. The action will be completed by 30 Sep 94.

b. The various FMS rental charges shown in table 2, Appendix B totaling $3,987,746 were taken from FMS cases for missiles that were placed on contract before the effective date of the regulation change. These were valid charges. Specifically, the FMS cases referenced in the report for missiles for Denmark, Korea, and Pakistan were placed on letter contract DAAH01-88-C-0292 modification P00003, dated 12 Aug 88, and this was

definitized on modification P0008Z, dated 07 Feb 89, and the FMS cases for missiles for Egypt and Saudi Arabia were placed on letter contract modification P00010, 06 Mar 89, and definitized on modification P00022, 12 Sep 89. The FMS case for the United Arab Emirates (UAE) was awarded 23 Apr 83 under MICOM contract DAAH01-83-C-0448. Contract lines 001 and 002 were for HAWK missiles (including lot acceptance testing). The contract was completed 31 Mar 85. The FMS General and Administrative (G&A) Differential Rate of 4.175 percent rate used by the contracting officer was determined by the contracting officer. It was lower than the 4.385 percent recommended as an acceptable rate by the Administrative Contracting Offices (ACO) in Tucson, Arizona.

Navy Comments

THE ASSISTANT SECRETARY OF THE NAVY
(Research, Development and Acquisition)
WASHINGTON, D.C. 20350-1000

JUL 25 1994

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: DODIG DRAFT REPORT ON PROCUREMENT PRICES PAID ON MISSILE SYSTEMS FOR FOREIGN MILITARY SALES (3FA-0047)

Ref: (a) DODIG memo of 10 May 94

Encl: (1) Department of the Navy Response

I am responding to the draft audit report forwarded by reference (a) concerning Procurement Prices Paid on Missiles Systems for Foreign Military Sales.

The DASD(P) and DSAA issued conflicting guidance on the Fair Pricing Legislation. The Naval Air Systems Command received and followed DASD(P) guidance which states contracts awarded on or after 29 November 1989 may require adjustment; however, DSAA guidance includes elimination of contractor rental fees from deliveries after November 21, 1989. Therefore, DOD needs to clarify its guidance on the Fair Pricing legislation.

The Navy does not concur with the findings. Our detailed response to the audit is provided as enclosure (1).

Nora Slatkin

Copy to:
NAVINSGEN
NCB-53
COMNAVAIRSYSCOM (AIR-09G)

DEPARTMENT OF THE NAVY RESPONSE
TO
DODIG DRAFT REPORT OF MAY 10, 1994
ON
PROCUREMENT PRICES PAID ON MISSILE SYSTEMS
FOR FOREIGN MILITARY SALES
(Project No. 3FA-0047)

Finding B:

The Military Departments did not accurately bill foreign military sales (FMS) customers for contractor and U.S. Government additive charges. That condition occurred because the Military Departments did not comply with the Defense Security Assistance Agency (DSAA) pricing policy: The Army did not communicate that policy to its organizational elements; the Navy had not effectively implemented that policy; and the Air Force had an ineffective method of distributing that policy. Also, that condition occurred because the Military Departments had ineffective internal control procedures for verifying the accuracy of those additive charges reported to the Defense Finance and Accounting Service (DFAS)-Denver Center for its use in billing FMS customers. As a result, the Military Departments overcharged FMS customers $13.5 million and undercharged FMS customers $2.0 million for additive charges.

DON Position:

Do not concur. NAVAIR issued guidance based upon ASN Expedited Departmental Notice of 20 February 1991 [attachment (A)] which forwarded DASD(P) memo on DAR case 89-331 of 1 February 1991 [attachment (B)]. The policy made it a retroactive requirement for all contracts **awarded** after 21 November 1989. Although the DSAA guidance on the Fair Pricing legislation includes elimination of contractor rental fees from **deliveries** after November 21, 1989 and to stop charging nonrecurring costs on FMS cases that are wholly financed with nonrepayable FMS credits, NAVAIR complied with the DSAD(P) guidance. There have been no changes to this guidance which stated that contracts **awarded** on or after November 21, 1989 may require adjustment and that contracting officers should pursue reimbursement actions **upon request.** It is also noted that DSAA memo I-01244/91 dated 21 February 1991 also provided guidance to adjust contracts **awarded** on or after November 21, 1989 to eliminate asset use charges for the Fair Pricing legislation. Therefore, our action is dependent upon DOD clarification of the Fair Pricing Legislation guidance. In the event that DOD clarifies the Fair Pricing legislation to be effective for contract **deliveries** vice contracts **awarded** on or after November 21, 1989, then DOD must identify a mechanism whereby funds may be credited directly to FMS Cases from the U.S. Treasury since all contractor rental fees were sent directly to the U.S. Treasury and not to any other account.

*

*Attachments not included.

Recommendation B.2:

We recommend that the Commander, Naval Air Systems Command, issue guidance to procurement personnel to comply with the Defense Security Assistance Agency policy, effective November 21, 1989, to eliminate contractor rental fees from FMS missile prices and to stop charging nonrecurring costs on FMS cases that are wholly financed with nonrepayable FMS credits."

DON Position:

Do not concur. NAVAIR issued guidance based upon ASN Expedited Departmental Notice of 20 February 1991 [attachment (A)] which forwarded DASD(P) memo on DAR case 89-331 of 1 February 1991 [attachment (B)]. There have been no changes to this guidance which stated that contracts **awarded** on or after November 21, 1989 may require adjustment and that contracting officers should pursue reimbursement actions **upon request.** NAVAIR revised its clauses to conform to the DASD(P) guidance and informed the contracting officers on 29 March 1991 [attachment (C)]. *

Recommendation B.4.a:

We recommend that the Commander, Naval Air Systems Command:

a. Require subordinate commands to verify the accuracy of additive charges reported to the Defense Finance and Accounting Service-Denver Center for its use in billing foreign military sales customers.

DON Position:

Partially concur. NAVAIR disseminates policy guidelines to the FMS community emphasizing the importance of validating the accuracy of FMS additive charges. Reconciliation process for FMS case closure will reflect charges. However, case closure efforts are lagging due to contract closeout backlog and may take years to resolve. Additionally, verification of posted charges is often hampered by incorrect posting by DFAS-Denver which must be investigated and authenticated by the SYSCOMs and NAVILCO before any change or correction can take place.

Recommendation B.4.b:

Adjust customers' FM Trust Fund accounts for the amounts overbilled and underbilled as shown in Appendix B.

*Attachments not included.

DON Position:

Do not concur. NAVAIR issued guidance based upon ASN Expedited Departmental Notice of 20 February 1991 [attachment (A)] which forwarded DASD(P) memo on DAR case 89-331 of 1 February 1991 [attachment (B)]. The policy made it a retroactive requirement for all contracts awarded after 21 November 1989. Although the DSAA guidance on the Fair Pricing legislation includes elimination of contractor rental fees from **deliveries** after November 21, 1989 and to stop charging nonrecurring costs on FMS cases that are wholly financed with nonrepayable FMS credits, NAVAIR complied with the DSAD(P) guidance. As stated earlier, there have been no changes to this guidance which stated that contracts **awarded** on or after November 21, 1989 may require adjustment and that contracting officers should pursue reimbursement actions **upon request.** Therefore, our action is dependent upon DOD clarification of the Fair Pricing legislation guidance. In the event that DOD clarifies the Fair Pricing legislation to be effective for contract **deliveries** vice contracts **awarded** on or after November 21, 1989, then DOD must identify a mechanism whereby funds may be credited directly to FMS Cases from the U.S. Treasury since all contractor rental fees were sent directly to the U.S. Treasury and not to any other account.

In the case of the Harpoon missiles, modification P00051 to Contract N00019-87-C-0103 was executed to incorporate the DASD(P) policy change as of the date of the modification, 28 May 1991. As a result, an ambiguity was created in Contract N00019-87-C-0103 as the modification did not specifically address what should be done with the contract rental fees still outstanding from the FY 90 procurement. In the past, when rent was assessed, the contractor paid the amount by check to the U.S. Treasury. If the contractor did not pay the rent or provide some other consideration to the Government, it would have created a situation whereby the contractor received $1,252,018 in unexpected earnings on Contract N00019-87-C-0103. This ambiguous situation was resolved on 03 August 1993 when a "settlement modification" was executed against contract N00019-C-87-0103 to use this outstanding rent to offset various antecedent liabilities in lieu of having the contractor pay the rent via check to the U.S. Treasury. The antecedent liabilities resolved by the 03 August 1993 settlement modification included numerous issues affecting FMS Harpoon procurements. At this late date, it does not seem effective to revise contracts to reflect retroactive application of the policy to 21 November 1989. Based on the rationale above, in the case of the FY 90 Harpoon procurement, the contract rental fee issue was resolved fairly for the FMS customers.

Sparrow missile sales also complied with DASD(P) guidance. Turkey purchased 40 RIM-74 Vertical Launch Guidance and Control Systems under case TD-P-AEV on contract N00019-87-C-0140 with Raytheon (P00002, CLIN 0253). P00002 was awarded on 31 March 1988, approximately one and one half years prior to the effective date of the DASD(P) policy.

Finding C:

The Navy and the Air Force overrecouped Special Defense Acquisition Fund (SDAF) investment costs for modifying the Harpoon and Sidewinder missile systems for foreign military sales (FMS) customers. In addition, the Air Force charged selling prices in excess of actual costs for Maverick missiles sold from the SDAF inventory. Those conditions occurred because the Defense Security Assistance Agency (DSAA) did not comply with DoD regulations and inappropriately directed the Navy to collect the SDAF recoupment charge for the Standoff Land Attack Missile (SLAM) system from Harpoon missile system customers. Also, the DSAA directed the Air Force to include an unauthorized cost element in the price of Maverick missiles sold to FMS customers. Further the Air Force did not have operating procedures for monitoring the collection of the SDAF recoupment charges from FMS Sidewinder missile customers to avoid overcharges. As a result, the Navy inappropriately charged 18 FMS customers $2.5 million for the harpoon missile system, and the Air Force overcharged FMS customers $9.9 million for the Sidewinder missile system and $1.9 million for the Maverick missile system.

DON Position:

Do not concur. Per direction of the U.S. Navy Technology Transfer Security Assistance Review Board (TTSARB), the Standoff Land Attack (SLAM) Guided Weapon Control Monitor Set (data link pod) required modification due to releasability constraints.

Based on the TTSARB direction, DSAA approved Special Defense accounting fund (SDAF) funds to modify the data link pod to support projected (FY91-92) sale of SLAM missiles to FMS customers (during this period, PMA-258 had developed a Letter of Offer and Agreement for South Korea for SLAM and associated hardware to compliment an F/A-18 aircraft sale). The approval of SDA funds ensured availability of an exportable pod, helped meet the SLAM system delivery lead time and allowed the U.S. Government to respond to a request from an important ally (without pod, the USN could not sell SLAM).

Although there have been no SLAM sales to date, the Harpoon customers have benefitted from the U.S. Navy SLAM program as follows:

1. The Harpoon and SLAM are 70% common. Therefore, in any given production year, the FMS customer received the benefits ($50K-110K per missile) on economy of scale from like components and sharing infrastructure costs.

2. There have been improvements in the SLAM program which were directly applicable to Harpoon.

(a) Midcourse Guidance Unit Central Processor and Memory Cards.

(b) Component upgrade reliability

(c) All SLAM improvement are reviewed for direct applicability to the Harpoon program, thus providing customer benefit.

3. The DSAA plan for recoupment of funds for a family of weapons (A/R/UGM-84) is valid in that all customers obtained benefit from the combined Harpoon/SLAM production and support efforts.

Recommendation C.1.a:

We recommend that the Director, Defense Security Assistance Agency:

(a) Direct the Naval Air Systems Command to stop the collection of the Special Defense Acquisition Fund recoupment charges for the Standoff Land Attack Missile on all future Harpoon missile sales.

DON Position:

Do not concur. Recoupment of SDAF funds by DSAA are well founded. Comments provided for findings B and C apply.

Recommendation C.1.c:

(c) Credit the Harpoon and Sidewinder missile systems foreign military sales customers' Trust Fund accounts for the over-collections of the Special Defense Acquisition Fund recoupment charges.

DON Position:

Do not concur. Comments to finding C apply.

Air Force Comments

DEPARTMENT OF THE AIR FORCE
WASHINGTON DC

OFFICE OF THE ASSISTANT SECRETARY

1 AUG 1994

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING,
OFFICE OF THE INSPECTOR GENERAL
DEPARTMENT OF DEFENSE

FROM: SAF/FM
1130 Air Force Pentagon
Washington, DC 20330-1130

SUBJECT: Draft Audit Report, "Procurement Prices Paid On Missile Systems For Foreign Military Sales" 10 May 1994
Project No. 3FA-0047

This is in reply to your memorandum requesting the Assistant Secretary of the Air Force (Financial Management and Comptroller) provide Air Force comments on the subject audit. Information was submitted by Eglin and Hill AFBs following their review of the findings. A review of the findings and recommendations is continuing at Hill AFB and HQ AFMC. Information provided to date enables us to comment on most of the specific audit findings. A review of all findings and implementation of audit recommendations will be completed by 30 September 1994.

Comments regarding the specific findings and recommendations contained in the audit are attached.

My point of contact is Mr. John Hunt, SAF/FMBIS, commercial phone number 703-695-3980, DSN 225-3980.

Robert F. Hale

ROBERT F. HALE
Assistant Secretary of the Air Force
(Financial Management and Comptroller)

Attachment:
Specific comments

DOD(IG) Draft Audit, "Procurement Prices Paid On Missile Systems For Foreign Military Sales" (Project No. 3FA-0047)

Comments on Specific Findings and Recommendations:

Finding A. Contracting for and pricing of missiles

Concur that contract documents should be the primary source for establishing the price charged to the foreign customer. Concur also that validation of contract prices reported to DFAS Denver is the responsibility of the FMS financial manager as required by DOD Regulations.

Recommendation 2A. Concur. A memorandum will be issued by 30 September 94 to the field stating the policy on the use of contract prices and the need to validate contract prices prior to reporting deliveries to DFAS-Denver Center.

Recommendation 2B. Partial concurrence. There is a difference of opinion with regard to the cases on Appendix A at Eglin AFB. For cases BA-YAA, JO-YFC, TW-YBS, and TW-YCR, the FMS price of $32,875 is correct. The $1085 shown as a variance between the contract price and the FMS price is an added charge for special tooling and special testing. These two items do not have their own national stock number (NSN) and so were added to the price of the guidance control section (GSC) and not shown as separate case lines. For cases MU-YEC and GR-YDP, a modification was added to the GSC sold which accounts for the unit variance included in the report. Concur with regard to the cases at Ogden AFB. Actions are being taken to review and correct any billings identified in the report which were in error. Estimate action to be completed by 30 September 94.

Finding B. Billing FMS customers for additive charges

Recommendation B3. Concur. SAF and HQ AFMC will send a memorandum to the field restating the official DSAA policy on the collection of rental charges. The estimated completion date is 30 September 1994. SAF and HQ AFMC will notify subordinate centers of the need to insure the accuracy of all additive charges. Notification will be completed 30 September 1994.

Recomendation B4a. Concur. The Air Force agrees on the need for effective internal control procedures in place to insure that additive charges are properly validated before billing data is forwarded to DFAS Denver. SAF and HQ AFMC will inform the field concerning the procedures needed to verify the accuracy of additive charges. The esrimated completion date is 30 September 1994.

Recommendation B4b. Partial Concurrence. The audit stated that charges, including SDAF, contractor rental, NRC, and management augmentation were improperly added to 18 FMS cases. With regard to the SDAF charges recorded for KE-YFR, KS-YFX, and TW-TCR, these were in fact duplicate charges which were erroneously added to the cases. Action was taken to debit the cases at the time of the audit by the amount of the overcharge. The items purchased in these three cases were being delivery reported at the time of the audit. The financial manager is confident, however, that the overcharge error would have been caught during case closure procedures now in place at Eglin.

Contractor rental charges were added to the twelve cases at Eglin because the contract to manufacture Sidewinders for those same foreign customers was signed before fair pricing legislation was passed. OSD Comptroller advised the financial manager at Eglin that fair pricing legislation is not applied retroactively. SAF has contacted DSAA for a copy of the guidance to exclude rental charges when items are delivery reported after the date fair pricing legislation took effect. When DSAA responds, the Air Force will correct the errors reported of Appendix B. Table 4. Completion date is 30 September 1994.

The NRC charges reported for the twelve cases at Eglin were not duplicate charges. The financial manager at Eglin reports that the NRC charges added to each of the twelve cases is in accordance with guidance contained in SECDEF message P150005Z Feb. 89.

A memorandum dated 19 June 94 from the Armaments Directorate at Hill AFB states a disagreement with regard to the overcharges for management augmentation. Detail rationale for the charge on each of the six cases will be provided, and any errors will be corrected. Estimated completion date for this action is 30 September 1994.

Finding C. Overrecouped investment cost

Recommendation C2. Concur. Guidance will be issued to Eglin AFB by 30 September 1994 notifying them of their responsibility to monitor the collection of SDAF recoupment charges. The audit found that the Air Force over recouped SDAF investment costs and charged foreign customers more than actual costs for their purchase of the Sidewinder missile. The Air Force agrees that some of the charges referred to in the audit need to be corrected. The Air Force will verify that the foreign customer was billed the amount on the final DSAA approved FAW. The Air Force will confer with DSAA on the date guidance was issued by DSAA to stop collection of SDAF recoupment on the Sidewinder missile. HQ AFMC will insure that the International office at the missile SPO at Eglin has operating procedures in place requiring the financial manager to verify and collect SDAF recoupment charges.

The Air Force comments, however, that it acts solely as administrative manager for this program, and that all charges are approved by DSAA. DSAA approves the estimated price included on the LOA, and approves the financial analysis worksheet (FAW) used for delivery reporting the items to DFAS Denver. The Air Force will work with DSAA to correct errors .

Defense Security Assistance Agency Comments

DEFENSE SECURITY ASSISTANCE AGENCY

WASHINGTON, DC 20301-2800

12 JUL 1994

In reply refer to:
I-04276/94

MEMORANDUM FOR ACTING DIRECTOR, FINANCIAL MANAGEMENT DIRECTORATE, DOD INSPECTOR GENERAL

SUBJECT: Audit Report on Procurement Prices Paid on Missile Systems for Foreign Military Sales (Project No. 3FA-0047)

REFERENCE: ODODIG Memorandum dated 10 May 1994

This memorandum responds to the referenced document requesting comments on the subject draft audit report for inclusion in the final report.

Attached is our response to Finding C and associated recommendations concerning the Special Defense Acquisition Fund. We withhold comments on the other Findings and recommendations until the final report is issued with the other DoD Component positions.

We appreciate the opportunity to review and provide comments on the draft audit report.

H. Diehl McKalip
Acting Director

Attachment
as stated

and are continuing to accrue over original AF estimates. The continued application of the nonrecurring cost charge permitted recouping the additional nonrecurring costs incurred for engineering changes and maintaining the solvency of the SDAF. Therefore, no deviation is involved and the finding should be deleted.

Recommendations for Corrective Action

C.1.a. "Direct the Naval Air Systems Command to stop the collection of the Special Defense Acquisition Fund recoupment charges for the Standoff Land Attack Missile (SLAM) on all future Harpoon missile sales."

Response: Disagree. The SLAM and Harpoon missiles have the same basic component parts and are produced/assembled from the same production/assembly line. The investment decision was based on the potential anticipated buys for both SLAM/Harpoon FMS customers. Production cost savings attributable to the SDAF investment benefit purchasers of both the SLAM and Harpoon missiles and the recoupment charges are assessable to both programs.

C.1.b. "Comply with the DoD Regulation 7000.14-R, "Financial Management Regulation, Security Assistance Policy and Process," to include only DoD authorized cost elements in the price of Defense articles sold from the Special Defense Acquisition Fund."

Response: Concur. DSAA does comply with the financial management regulation.

C.1.c. "Credit the Harpoon and Sidewinder missile system foreign military sales customers' Trust Fund accounts for the overcollections of the Special Defense Acquisition Fund recoupment charges."

Response: Disagree. Overcharges did not take place, therefore, no credit to FMS customers is required. See the above response to the associated finding. In sum, SDAF charged a stabilized price for the SDAF items as provided for in the DoD financial management regulation.

C.2. "We recommend that the Commander, Eglin Air Force Base, have the systems program office establish operating procedures requiring the financial manager to verify and monitor collections of Special Defense Acquisition Fund recoupment charges for the Sidewinder missile system."

Response: Concur in part. The verification and monitoring of collections should occur for the purposes of ensuring that the price DSAA established is charged. It should not occur for the purposes of determining if the rate should discontinue as implied by the finding.

FINDING C. Recoupment of Special Defense Acquisition Fund Investment Costs

Special Defense Acquisition Fund Charges

Navy: "Without sales of the SLAM systems to FMS customers, it was inappropriate for the DSAA to invest $7.0 million of SDAF funds in the modification of the SLAM system and charge 18 FMS Harpoon customers $2.5 million for those investment costs."

Response: Disagree with the finding. The Standoff Land Attack Missiles and Harpoon missiles have the same basic component parts and are produced/assembled from the same production/assembly line. The investment decision was based on the potential anticipated buys for both SLAM/Harpoon FMS customers. Production cost savings attributable to the SDAF investment benefit purchasers of both the SLAM and Harpoon missiles and the recoupment charges are assessable to both programs. Therefore, the finding should be deleted.

Air Force:

Sidewinder. In brief, the finding alleges that "The overcharges of $9.9 million to FMS customers could have been avoided had the financial manager verified and monitored the SDAF recoupments for Sidewinder missiles."

Response: Disagree with the finding. When an SDAF recoupment charge is established by the DSAA, that charge is collected by the Military Departments and would cease only when DSAA eliminates the charge. While an investment may be fully recouped, DSAA continued the requirement for the charge, using the same policy for the recoupment of DoD nonrecurring costs as that contained in DoD Directive 2140.2. The policy was changed in mid-1992 to provide for eliminating a charge if the appropriate investment is recouped for an item. This recoupment charge was not included in any LOA dated after that change.

Maverick Missile. The finding opines that DSAA deviated from the pricing policies of DoD 7000.14-R without written approval and that action resulted in overcharges of $1.9 million to FMS customers. The deviation reportedly is due to DSAA adding inappropriate nonrecurring costs.

Response: Disagree with the finding. DoD 7000.14-R specifically identifies that DSAA is responsible for reviewing SDAF prices to assure full cost recovery (to the fund) and for changing any proposed SDAF prices to achieve that objective. Maverick missile prices were not reduced to recognize a subsequent (after the SDAF LOAs) change in the nonrecurring cost rate. The additional funds were used to cover contract engineering change costs that were occurring

Audit Team Members

Russell A. Rau
Alvin L. Madison
Ronald C. Tarlaian
Debra E. Alford
Carolyn B. Jones
Averel E. Gregg
Shawn L. James
Jacqueline M. Rocco
Julie A. Koth
Joan E. Fox