

FMS PRICING POLICY IMPLEMENTATION: TAKING THE BULL BY THE HORNS

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There is nothing permanent except change.
Heraclitus, 6th Century B.C.

INTRODUCTION

It is occasionally said with some degree of nostalgia that prior to the shift in U.S. foreign policy from grant aid to sales, financial support of our allies involved relatively simple concepts and procedures. Congress passed a grant aid appropriation to be used to purchase services and materials from DOD components. These services and materiel were then provided to our allies on a gratis basis. The reimbursement to DOD components was essentially a bookkeeping operation and the old adage "close enough for government work" applied. After all, the U.S. taxpayer ultimately paid all the bills and the development of precise measurements of the amounts to be reimbursed could not be justified on the basis of cost effectiveness.

The grant aid procedures for computing reimbursements were basically extended to the pricing of services and materials sold under the Foreign Military Sales (FMS) program until 1975. However, Congressional review of the DOD FY 1974 supplemental appropriation request resulted in criticism of DOD for selling items from inventory at less than replacement cost and then requesting appropriated funds to make up the difference. This failure to recoup inventory replacement cost resulted, in part, in passage of the International Security Assistance and Arms Export Control Act of 1976, which was in turn signed into law by President Ford on 30 June 1976. In addition to changing the title of the then Foreign Military Sales Act (FMSA) to the Arms Export Control Act (AECA), this amendatory legislation revised some of the methodology under which the Department of Defense (DOD) priced FMS materiel and services. In essence, the expressed intent of the Congress was to place greater emphasis on putting FMS generally on a "no profit - no loss" basis, at least as far as the U.S. Government was concerned in its capacity as the "middleman" between the foreign purchaser and the supply source or contractor community. Unfortunately, this renewed mandate, however equitable and logical, was much easier in concept than in practice. Still, it was and is a legal mandate which the DOD must positively implement.

TRANSLATING THE AECA INTO DOD POLICY

POLICY DIRECTIVES

Based upon the Congressional criticism received at the time of the FY 1974 supplemental budget request, DOD reissued DOD Instruction 2140.1

(Subject: Pricing of Sales of Defense Articles and Defense Services to Foreign Countries and International Organizations) on June 17, 1975, thereby superceding its prior version dated January 29, 1970. Additional changes were necessary to meet the new pricing requirements of the AECA; therefore, another revision of DOD Instruction 2140.1 was published on March 9, 1977. Also, on January 5, 1977, DOD Directive 2140.2 (Subject: Recoupment of Nonrecurring Costs on Sales of USG Products and Technology) was similarly revised and reissued. With this guidance in place, the ball was effectively in the court of the Military Departments and other DOD implementing agencies to modify their systems and organizational structures as necessary and "come on line."

PRICING PRINCIPLES

Although overall FMS pricing provisions are a matter of law, there are certain principles which either explicitly or implicitly underlie these legal provisions:

a. Fairness. First, the policy is based on the concept of fairness -- both from the standpoint of the foreign customer and the USG. Many people, some of whom work for the USG, tend to focus primarily on what they see as the negative aspects of the policy, e.g., the prices are too high, the USG is adding on too many surcharges, and so forth. A basic point that needs to be made is that the USG, through its FMS pricing policies, is not "ripping off" our foreign customers; on the contrary, every applicable FMS charge is a systematically arrived at and legitimate cost of doing business. When procuring for a foreign government under FMS, the USG applies the same contract clauses and contract administration as it would in procuring for itself, unless exceptions are authorized by the Defense Acquisition Regulation.

In expanding on the above, two fallacies are occasionally cited as contradictions to the "fairness principle." First, there is the contention that indirect (overhead) costs, pro-rata RDT&E shared costs, or certain surcharges (e.g., asset use) are not "real costs" because the DOD has experienced or would experience these costs in any event in the conduct of its internal programs. What apparently is overlooked or dismissed as insignificant by the proponents of this contention is that the foreign purchaser actually "benefits" from the U.S. taxpayer's outlay of funds to build various plant assets, etc. Were these charges not collected, it would be like a thrifty shopper walking into a retail department store demanding to pay only the marginal materiel cost of the product -- without any contribution toward the administrative overhead or maintenance expenses of the store...since, he might argue, these costs would exist in any event! The point is: these indirect, pro-rata, and other additive costs are, in fact, legitimate costs and the USG is correct in collecting them under a "no profit-no loss" FMS concept. And, the foreign purchaser is receiving something in return for these costs.

A second fallacy is the contention that the USG is morally wrong in upwardly revising the initial estimated price shown on the DD Form 1513. Support for this contention generally centers around the arguments that:

"Any commercial business would cease to have customers if they raised the price after the initial purchase agreement.... The foreign purchaser, notwithstanding the conditions of Annex A to DD Form 1513, considers the initial price to be firm.... Such price increases cause embarrassment to the USG and a loss of credibility for our FMS system...." Granted, these arguments have some substance and should not be highhandedly dismissed. Still, we contend the USG is not acting improperly in revising its price estimates as more current cost information becomes available. As noted in Annex A to the DD Form 1513: "...the USG in procuring and furnishing the items specified in this Offer and Acceptance does so on a nonprofit basis for the benefit of the Purchaser.... [and the Purchaser agrees to] ...pay to the USG the total cost to the USG of the items, even if the final total cost exceeds the amounts estimated...." Accordingly, due to this nonprofit pricing procedure, the USG does not have the means to build up a special contingency fund from which to pay unforeseen costs or cover "business risks." In this regard, it is important to recognize that the USG is not a "seller" in the traditional and commercial sense of the term. Rather, the USG, through FMS, seeks to recover its legitimate costs -- no more, no less.

b. Understandability. A second principle is that FMS pricing policy should be applied in an understandable manner. This simply means that the foreign customer should know what he is being charged for. This principle is accomplished, in practice, through use of the DD Form 1513 (Letter of Offer and Acceptance) and the DD Form 645 (FMS Billing Statement). The former document provides the price estimates and financial schedule of payments, which are useful for the foreign customer's budgetary planning; the latter document lists the actual performance/deliveries, work in process, and forecasted billing costs.

c. Consistency. Finally, there is the principle that the policy should be applied in a consistent manner through use of standardized DOD pricing, financial and billing procedures. This third principle further underscores the first two principles, and helps insure that the intent of the AECA is being carried out by means of overall policy guidance coming out of one DOD office instead of several. The office which is responsible for developing and promulgating DOD FMS pricing, financial and billing policy is the Office of the Assistant Secretary of Defense (Comptroller).

Notwithstanding that these general principles are, for the most part, operative, we still are faced with what we shall refer to as our "traditional FMS pricing dilemma": foreign countries frequently feel the prices are too high and the U.S. General Accounting Office (GAO) often reports prices are too low. As we shall develop subsequently in this article, this latter criticism may be founded more on how FMS pricing policy is implemented rather than on shortcomings in the policy itself. In other situations, it may just be a matter of reasonable people disagreeing on reasonable approaches to management problems.

THE TRANSITIONAL YEARS: 1976-1979

NEED FOR RE-EDUCATION

Given the magnitude of the changed policies and the momentum of the older, ingrained ways of doing business, it was not surprising to find that problems soon were uncovered. One major problem was that of the need for re-education of the DOD FMS work force. Fortunately, at about the time these changes in law and policy came about, the DOD was well on its way toward the establishment of the Defense Institute of Security Assistance Management (DISAM) at Wright-Patterson AFB, Ohio, which had as its central mission the education and training of DOD, foreign purchaser, and U.S. Contractor personnel in security assistance management topical areas, including FMS pricing and financial policies. Although DISAM could assume part of this education effort, other educational and policy clarification workshops were needed. In this latter regard, OASD(C), in conjunction with DISAM, sponsored several pricing and financial management workshops at various locations during the spring and summer of 1978.

IMPLEMENTATION FEEDBACK

Long before the incorporation of the recent pricing guidance into the AECA, the GAO and other audit agencies routinely provided DOD with "feedback" on FMS pricing matters. For instance, as early as September 1972, there was a GAO report entitled "Action Needed to Recover Full Costs to the Government of Producing Weapons for Sale to Foreign Governments." Reports having similar themes during the pre-AECA years could also be listed.

In September 1978, two years following the passage of the AECA pricing provisions, the GAO published a report entitled "Summary of Efforts to Recover U.S. Government Costs in Foreign Military Sales." Of particular interest, this report reflected the GAO observation: "...we believe Defense has done a good job in prescribing adequate policy; the problem lies in inadequate implementation of policy by the military departments and, in our opinion, insufficient follow-up or monitoring of actual cost recovery practices by Defense policymakers." The point about inadequate implementation and follow-up was further echoed in a March 1979 GAO report (Subject: "Improperly Subsidizing the Foreign Military Sales Program -- A Continuing Problem").

In partial response to the aforementioned GAO criticisms and to the extent its resources permit, OASD(C) now conducts periodic reviews of FMS pricing policy implementation. In this regard, DOD Instruction 2140.3 dated September 6, 1979 (Subject: Foreign Military Sales Billing and Reimbursement Procedures") states: "A semiannual schedule of the pricing area to be tested [through a random statistical sample of DD-COMP(M)1517 reports selected by the Security Assistance Accounting Center (SAAC)] shall be provided to ... ASD(C) for approval."

As a recent example of the OASD(C) monitorship role, a "Study of Pricing of Procurement Secondary Items" was completed in March 1980. The study effort was chaired by OASD(C) with representation from OASD (MRA&L),

the Office of Management and Budget (OMB), and the Military Departments. A statistical sample of procurement secondary items sold to FMS customers and reported as delivered to SAAC during the first seven months of fiscal year 1979 was selected with the assistance of the Defense Contract Audit Agency and the Defense Audit Service. DISAM developed the software necessary to analyze the raw data and provided a management report on the results. This report is still under review.

THE "REAL PROBLEM"

Considering the seemingly endless number of GAO and other audit agency reports on the subject of FMS pricing - some of which were mentioned above - does this mean more and better DOD pricing policies are what is really needed? Not necessarily. As an aforementioned GAO report attested, a great part of the difficulty lies not in the policies themselves but in the implementation thereof. We feel this situation exists for a couple of reasons.

-- The first reason is perhaps more visible, yet easier to correct. It involves getting implementing agency management control systems established to carry out certain rather straightforward policies. Examples in this category include the application of the one percent asset use surcharge on sales from DOD inventories (this is presently accomplished by SAAC), addition of the current procurement account inflation rate to the standard inventory price of procurement appropriation secondary items, and so forth. As simple as these may be in concept, procedural breakdowns can and do occur. For instance, the one percent asset use charge was not systematically implemented until calendar year 1979, despite the fact that such charges were applicable as of 1 October 1976. As a consequence, it was necessary for the DOD to collect these costs retroactively -- much to the dismay of many FMS customers.

-- A second reason involves the very nature of the entire pricing algorithm and defies simplistic solutions. Essentially, FMS pricing policies in themselves are relatively straightforward in concept: find the basic cost of the article/service, apply designated surcharges or other add-on costs ... and you're on your way. However, in the "real world," we all know it is not that easy. It can be a major effort at times to initially find the "basic article/service cost" to apply the various FMS surcharges to. It seems one may now ask: given this situation, is this a pricing policy problem or an accounting and cost allocation problem? We suggest it is the latter. Furthermore, accounting and cost allocation -- and cost growth -- difficulties are not peculiar to FMS; rather, they can be a source of considerable frustration to DOD "internal" program managers as well. In recognition of the basic legislative requirement to identify and bill total costs to the FMS customer, we need to make available to the FMS manager cost gathering and allocation systems which are at least as sophisticated as those which are available to the internal DOD manager. And, all the FMS pricing policy directives and instructions one can reasonably imagine are not going to make this accounting and cost allocation effort magically disappear.

LOOKING AHEAD: THE 1980s

Although the DOD must always be flexible enough to adjust to new and necessary changes, there are certain FMS pricing/financial management initiatives which are likely to be further developed or perpetuated. These include:

a. Continued OASD(C) Monitorship. Consistent with the above excerpt from DOD Instruction 2140.3, OASD(C) will continue to test the validity of, and degree of compliance with, prescribed policies and procedures through use of statistical samples. Following in the wake of the procurement secondary item study could be a study regarding sales of stock fund materiel to FMS customers.

b. Improved Performance/Delivery Reporting Methodology. Although the management emphasis is often on the "up-front" pricing computations which are reflected in the DD Form 1513, this pricing effort has little meaning if there are breakdowns in the performance/ delivery reporting phase which allows these charges to be properly reflected in foreign customer's FMS Billing Statement. In this regard, the ongoing transition to the use of the standard DD-COMP(M) 1517 performance/delivery report should prove to be a major step in the right direction. Certain refinements affecting the 1517 report are already under advisement. For example, DOD Instruction 2140.3 is in the process of being revised to reflect new FMS Delivery Source Codes, which should facilitate the source identification of certain charges as well as the application of applicable surcharges. Also under review is the modified use of certain interfund billings card fields as a means of reflecting essential FMS coding.

c. Expanded Use of Surcharge Percentage Estimates. In the past, there has been a continuing problem with the collection and timely reporting of contract administration charges attendant to a given FMS case. A in-process change to DOD Instruction 2140.1, which has been approved by an OASD(C) memorandum, treats contract administration as a percentage surcharge to all disbursements which are reported to SAAC as made to contractors for FMS procurements on which applicable cost waivers are not in effect. This initiative ties in with the aforementioned Delivery Source Code changes, the latter of which provide part of the means of identifying the applicability of these contract administration charges. Hopefully, the use of contract administration surcharges will expedite the reporting of such charges to the FMS customer and further facilitate the case closure effort.

d. FMS Financial Management Manual. Although the DOD 2140 series of directives and instructions, supplemented by other policy memoranda, address most aspects of FMS pricing, financial management, and billing areas, there has been an understandable desire from the DOD FMS community for consolidated, simplified and illustrated guidance in the form of a handbook. In this regard, OASD(C) has completed an initial draft of the budgeting and accounting requirements to be included in the FMS Financial Management Manual, which incorporates and updates the guidance contained

in DOD Instruction 2110.29 and ASD(C) memorandum dated June 17, 1977. Other sections covering pricing, billing/reimbursement and collection procedures are currently being drafted.

e. FMS Pricing/Financial Management Workshops. Depending on the needs as expressed by headquarters and field activities, it may at some point in time be appropriate to again schedule FMS Pricing/Financial Management workshops, similar in concept to those conducted in 1978. To a limited degree, this is already being done on a Military Department basis; for example, in November 1979, the Army sponsored a Pricing Workshop in Indianapolis. Further, DISAM, in conducting "refresher seminars" such as that provided for Navy personnel in Washington DC in September 1980, addresses new and forthcoming changes to pricing and financial policies.

In closing, much has been done in improving the way in which DOD manages the security assistance program but much remains to be done. Optimistically, the policy foundation for FMS pricing and financial management has already been established; the next few years should be a period characterized by refinements in lieu of the dramatic upsurges which have so characterized the immediate past.

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