

FMS ACCOUNTING AND FINANCIAL MANAGEMENT

The following statement regarding improvements in Foreign Military Sales accounting and financial management was presented by Herbert Morris, Comptroller, Defense Security Assistance Agency, on 3 May 1981 in testimony before the House Appropriations Subcommittee on Defense.

Mr. Chairman and members of the Committee, I am pleased to appear before you again to discuss the progress we have made during the past year on improving our management of the Foreign Military Sales program. As was the case last year, most of the issues I will be addressing that are of concern to the committee have to do with FMS accounting and financial management. During the past seven or eight years, the General Accounting Office has issued a number of reports on these subjects, and it is well known that we have not always been in agreement with their findings and recommendations.

As the committee knows, the FMS program has experienced tremendous growth during the past five years, and I would be less than candid if I were to say that our implementing actions had been trouble-free. I believe, however, that deficiencies that do exist must be considered in light of the many significant system changes that the Department of Defense has developed and implemented in a relative short time span to respond to the rapid program expansion. Another complicating factor has been the vast amount of new legislation that has been enacted during the same period. In my testimony last year, I acknowledged that we had experienced problems in accounting and financial management. I also indicated that, in our opinion, the GAO had greatly overstated the magnitude of these problems in their reports, and that we had made much more progress toward resolving them than the GAO was willing to acknowledge. I regret to say that during the past year very little has changed with respect to the lack of objectivity in GAO reports that are issued on the Foreign Military Sales Program.

But before I address some of the specifics on the GAO reports that concern the committee, I would like to briefly summarize some of the accomplishments of the past year that I believe are indicative of the emphasis that we have placed on improving our financial management of the FMS program.

First, I know the committee is interested in the centralized accounting and financial management system that was first addressed in your fiscal year 1980 report. As you may be aware, on September 30, 1981, we completed at the Security Assistance Accounting Center, an extensive test of the centralization concept recommended by the GAO. For 18 months the test of centralized accounting and disbursing was conducted on a large sample of procurement contracts that were chargeable to the FMS Trust Fund account. At the conclusion of the test, there was general agreement that the centralization concept, as tested, was neither desirable in terms of problems it would resolve, nor in its cost effectiveness.

We remain sensitive to the concerns of this committee, however, and a decision is presently pending with the Assistant Secretary of Defense (Comptroller) on two alternatives, either of which I believe would satisfy your desire for a centralized accounting and financial management system. The alternatives under consideration are: (1) a centralized data base management system, and (2) centralized FMS case management. We expect the Comptroller will make his decision within the next few weeks, and we will, of course, discuss the decision with members of your staff before taking any implementing action.

In addition to the progress made toward an overall centralized financial management system, the U.S. Army has made significant advances with its FMS customer order control system. On June 30, 1981, the GAO approved the system design and in so doing validated the adequacy of the system's internal controls, audit trails, data integrity, and consistency with accounting specifications.

The Air Force and Navy are working on similar customer order control systems, and, when fully implemented, the Defense Customer Order Control System will offer a management tool that, among other things, will facilitate case pricing as well as resolve many of the problems we have experienced in reconciling case level cash records with the Treasury's record of FMS Trust Fund.

Another important step taken in 1981, which we believe will contribute significantly to the overall financial management of the program, was the issuance of a new Foreign Military Sales Financial Management Manual (DoD 7290.3M). This document consolidates a number of separate instructions and guidance letters that have been issued over the years. It also contains pricing illustrations that reinforce the narrative pricing instructions. Since the GAO generally agrees that our pricing policies are adequate, we believe this manual will be a major factor in reducing the possibility that inadvertent pricing deviations caused by human error will turn up from time to time at the installation level. The manual also serves as the text book for a new FMS financial management course that has been developed to train our operating personnel in pricing and other related topics. The first class was conducted in February 1982, and we are optimistic that the combination of the course and the new manual will solve most of our problems in the area of FMS pricing. [The course referred to here is the new DISAM Security Assistance Management - Financial Management (SAM-CF) Course.]

Now I would like to turn to some of the GAO reports that have been issued during the past year that I know have raised some concern among committee members; and to preclude any misunderstanding of our position, I would like to reiterate what I said last year concerning the GAO's role. We completely agree that there is a need to evaluate and improve our procedures to ensure the full recovery of FMS costs in accordance with existing law, and, in many respects, the GAO has been very helpful to us in doing this. We remain concerned, however, that most of the reports issued by the GAO on the subject of FMS financial management continue to

grossly overstate the basic problems and issues at hand. After spending hundreds of hours with their auditors in interviews and assisting them as requested with their detail audit work, we continue to be amazed at the lack of perception that is displayed in their reports. There is every indication that they still do not fully comprehend the complexities, or the subtleties, of our FMS financial systems. To the casual reader, most of the GAO reports appear to contain substantive findings. We have found, however, after careful examination of the audit work that in many instances the GAO reports contain serious flaws. Since the GAO is normally reluctant to correct their reports once they are in draft form, especially if the correction involves the downgrading of what would otherwise be significant findings, the reports are routinely published with major errors.

It is very easy, then, to understand why the average reader could very easily gather from the reports a completely unbalanced, if not erroneous, picture of the actual situation. To illustrate how GAO reports can easily mislead the reader, I would like to address two specific GAO reports that were released this past year. Even the report titles appear to be designed to attract headlines in the media. The first report is number AFMD 81-62 entitled: Millions in Losses Continue on Defense Stock Fund Sales to Foreign Customers. This report alleges that the Department of Defense continues to subsidize the FMS program by not charging foreign governments, as required by law, the estimated replacement cost of equipment and spares sold from DoD stock fund inventories. GAO estimates that, because of weaknesses in our pricing policies and practices, millions of dollars were not recovered from foreign governments in fiscal year 1980. As an example, the report cites underpricing of \$17 million by the Air Force on sales of \$43 million. Before GAO issued their final report, we requested and were given the opportunity to review the draft report and audit work papers. In so doing, we discovered that most of the findings included in the draft report were incorrect and unsupported by the facts. Specifically, over 76 percent of the stock fund transactions randomly selected by the GAO to test our replacement pricing compliance were not even subject to the legal requirement for replacement pricing. Therefore, to begin with, the audit sample itself was invalid. Then, of the remaining items in the sample that were subject to replacement pricing, actual replacement contracts had been awarded for only 21. The GAO's own work papers showed that the selling price of these items was actually 2 percent more than the total replacement contract cost. Therefore, the millions of dollars in losses headlined in the title of this report turned out to be only an extrapolation that, in fact, represented only the difference between the GAO estimate of replacement cost on their invalid audit sample and the DoD estimate of replacement cost for the same sample. There were specific examples of underpricing discussed in the report, however, these were "worst case" examples of errors that can occur in any large system and were not even included in the audit sample. They could not, therefore, be construed as representative of the typical actual transaction as was implied in the report. These deficiencies were called to the attention of the auditors prior to issuance of the report but were ignored.

The second report I would like to briefly mention is AFMD 81-105, entitled: Defense Continues to Subsidize Sales of Secondary Items to Foreign Governments Because of Poor Pricing Policies. Again we have a report where the GAO findings are not supported by their audit work. In their audit, the GAO selected and reviewed a random sample of FY 1979 sales transactions, and, based on the sample, estimated that DoD had undercharged about \$8 million because the sales prices were too low to replace the items sold. The report states that the prices were too low because inflation factors were not compounded for the items remaining in inventory for one or more years. They also estimated that about \$3.3 million in subsidies will occur because prices of secondary items sold to FMS customers not participating in Cooperative Logistics Supply Support Arrangements did not include an equitable share of normal inventory losses. We reviewed GAO's work papers and determined that they had again developed erroneous and incomplete data in connection with their sample, and used these data to project the \$8 million loss. The correct data for the sample showed that our sales prices had actually recouped 116 percent of the replacement cost of the items. With regard to the second finding having to do with inventory losses, the Arms Export Control Act clearly states that inventory losses should be charged only to the FMS customers for whom defense articles are being stored. Our position is, and we are supported by the law, that it would be inappropriate to charge FMS customers costs which they neither cause nor benefit from. The GAO, from their report, would have us do this despite the law.

Although I have taken exception to certain of the GAO's methods of operation and specific reports they have issued, we do appreciate their help in identifying problem areas that need attention. We remain concerned, however, that the Congress and the public are not always being provided reports that accurately portray a given situation. GAO's failure in this respect contributes to misunderstandings all around that result in the loss of confidence in the Department of Defense, the FMS program, and ultimately the U.S. Government.

Finally, I would like to briefly comment on a theme that runs through most GAO reports that deal with FMS financial management. I also expect it will be a major topic in this hearing today. What I am referring to is the notion that the U.S. Government and/or the U.S. taxpayers are in some way subsidizing the FMS program. If one believes everything that is contained in the GAO's reports, it would not be difficult to conclude that there probably is an element of subsidy. I believe we have shown today, however, just as I endeavored to show last year, GAO reports on this subject are not the most reliable form of public information on which to base a valid judgement regarding the subsidization issue.

I am not suggesting that from time to time we do not underprice an item we sell, or credit a wrong account, or make any number of errors that can be expected in an enterprise or business as large as the FMS program. On the other hand, we never read in GAO

reports or in the press about the same kind of human errors when they go in the other direction; what I am suggesting here is that, as in most human endeavors, errors do occur, and with respect to pricing, there could be overcharges just as easily as there could be undercharges.

We believe it is about time some balanced reporting is brought to bear on this issue of whether the FMS program is being subsidized. I, therefore, would like to very quickly itemize some areas where the U.S. taxpayers and the U.S. Government are significantly benefiting from the FMS program. We believe these benefits more than offset even the questionable estimated undercharges that appear in some GAO reports:

- (1) The Congressional Budget Office has estimated in a published study that an \$8 billion sales program generates an average \$560 million in federal budget savings each year.
- (2) DoD receives from FMS contracts, millions of dollars annually to pay for operations and maintenance costs which otherwise would have to be paid from DoD appropriations. As an example, FMS purchasers paid over \$500 million during FY 73 to 79 to defray training base support costs that would otherwise have had to be paid from DoD appropriations.
- (3) The U.S. Treasury is a significant beneficiary in terms of reduced interest payments on the federal debt as a result of FMS deposits in the FMS Trust Fund account. This item alone accounts for \$600-700 million annually.

In addition, there are many examples where the U.S. taxpayer benefits significantly from the FMS program, but where we are unable to put a good price tag on the benefit. These include major contributions to the U.S. balance of payments and an estimated 395,000 jobs created in American industry as a result of the FMS program. I could go on further, but I believe that the point has been made that the U.S. taxpayer is not subsidizing the FMS program. On the contrary, the U.S. taxpayer, the Department of Defense and the U.S. Government are all benefiting significantly from the FMS program.