Audit Report

OFFICE OF THE INSPECTOR GENERAL

FOREIGN MILITARY FINANCING OF DIRECT COMMERCIAL CONTRACTS FOR ISRAEL

Report No. 97-029

November 22, 1996

This special version of the report has been revised to omit contractor proprietary data.

Department of Defense

Additional Copies

To obtain additional copies of this audit report, contact the Secondary Reports Distribution Unit of the Analysis, 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 of the Analysis, 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:

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

Defense Hotline

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to Hotline@DODIG.OSD.MIL; or by writing the Defense Hotline, The Pentagon, Washington, D.C. 20301-1900. The identity of each writer and caller is fully protected.

Acronyms

DFAS-DE	Defense Finance and Accounting Service Denver Center
DSAA	Defense Security Assistance Agency
FMF	Foreign Military Financing

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

November 22, 1996

MEMORANDUM FOR DIRECTOR, DEFENSE SECURITY ASSISTANCE AGENCY

SUBJECT: Audit Report on Foreign Military Financing of Direct Commercial Contracts for Israel (Report No. 97-029)

We are providing this report for review and comment. This report is the second report of two issued as a result of the audit of Foreign Military Financing Grants for Israel.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Because the Defense Security Assistance Agency did not comment on a draft of this report, we request that the Defense Security Assistance Agency provide comments on the final report by January 10, 1997.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Ms. Evelyn R. Klemstine, Audit Program Director, at (703) 604-9172 (DSN 664-9172) or Ms. Carolyn B. Jones, Acting Audit Project Manager, at (703) 604-9611 (DSN 664-9611). If management requests, we will provide a formal briefing on the audit results. See Appendix D for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

This special version of the report has been revised to omit contractor proprietary data.

Office of the Inspector General, DoD

Report No. 97-029 **November 22, 1996**
(Project No. 5LG-0069.01)

Foreign Military Financing of Direct Commercial Contracts for Israel

Executive Summary

Introduction. Foreign military financing is a program to carry out the provisions of Public Law 90-629, "Arms Export Control Act," section 23, "Credit Sales." The foreign military financing program is a program of nonrepayable grants and of repayable and nonrepayable loans and credits to enable U.S. Allies to improve their defense capabilities through the acquisition of Defense articles and services. Each year since 1988, Congress has appropriated $1.8 billion for Israel as nonrepayable foreign military financing grants, which it uses to procure Defense articles and services through direct commercial contracts with U.S. contractors; foreign military sales that are government to government agreements; and procurements in Israel, commonly referred to as offshore procurements. From the $1.8 billion foreign military financing grant, Israel spends about $900,000 annually through direct commercial contracts. This report discusses Israeli direct commercial contracts.

Audit Objectives. The primary audit objective was to review the policies and procedures related to the execution of the foreign military financing program for Israel. The specific audit objective for this report was to determine the adequacy of policies and procedures used for approving and disbursing foreign military financing grants for direct commercial contracts. Inspector General, DoD, Report No. 97-028, "Israeli Use of Offshore Procurement Funds," November 22, 1996, discusses the adequacy of support for Israeli requests for offshore procurement fund disbursements. We also reviewed the management control program as applicable to the specific audit objective.

Audit Results. The Defense Security Assistance Agency did not provide adequate controls over the authorization of $331 million in FY 1995 disbursements of foreign military financing grant funds for direct commercial contracts. As a result, $688,780 in disbursements from foreign military financing grant funds were made to Israel for contracts never submitted to the Defense Security Assistance Agency for approval. Additionally, Israel received a payment of $59 million for contract escalation costs that the Defense Security Assistance Agency had not approved (Finding A).

The Defense Security Assistance Agency did not adequately review profit rates on Israeli direct commercial contracts over $500,000, including basic ordering agreements. As a result, Israel paid a Defense contractor about $ * profit (* percent) more than the DoD procurement price for 17 purchase orders issued under the basic ordering agreement, valued at about $4.5 million. However, during the audit, the Defense contractor renegotiated the prices on 4 of the 17 purchase orders and agreed to refund $450,190 to Israel, thereby reducing the profit rate (Finding B).

The management control program could be improved because we identified material weaknesses applicable to the specific audit objectives (Appendix A).

---

*Contractor proprietary data omitted.

Summary of Recommendations. We recommend that the Director, Defense Security Assistance Agency, establish procedures for validating disbursements made to Israel from foreign military financing grant funds. We also recommend that the Director, Defense Security Assistance Agency, amend the Contractor's Certification and Agreement with the Defense Security Assistance Agency to include a requirement for contractors to certify that profit rates do not exceed a reasonable percentage of contract costs and reestablish the Security Assistance Management Manual requirement to periodically perform price comparisons on selective Israeli direct commercial contracts.

Management Comments and Audit Response. The Defense Security Assistance Agency did not respond to a draft of this report. Therefore, we request the Defense Security Assistance Agency to provide comments by January 10, 1997.

Table of Contents

Executive Summary i

Part I - Audit Results

Audit Background 2
Audit Objectives 3
Finding A. Disbursements of Foreign Military Financing Funds 4
Finding B. Profit Rates for Direct Commercial Contracts 10

Part II - Additional Information

Appendix A. Audit Process
Scope and Methodology 18
Management Control Program 19
Appendix B. Prior Audits and Other Reviews 20
Appendix C. Organizations Visited or Contacted 21
Appendix D. Report Distribution 22

Part I - Audit Results

Audit Background

Foreign Military Financing Grants for the Government of Israel. Foreign military financing (FMF) is a program to carry out the provisions of Public Law 90-629, "Arms Export Control Act," section 23, "Credit Sales." The FMF program is a program of nonrepayable grants and of repayable and nonrepayable loans and credits to enable U.S. Allies to improve their defense capabilities through the acquisition of Defense articles and services. Each year since 1988, Congress has appropriated $1.8 billion for Israel as nonrepayable FMF grants, which it uses to procure Defense articles and services through direct commercial contracts with U.S. contractors; foreign military sales that are government to government agreements; and procurements in Israel, commonly referred to as offshore procurements. From the $1.8 billion FMF grant, Israel spends about $900 million annually through direct commercial contracts with U.S. contractors.

Direct Commercial Contracts. A direct commercial contract is the sale of a Defense article or service, by a U.S. contractor directly to a foreign customer, and is not administered by DoD through the foreign military sales program. Contracts awarded under the direct commercial contracts process are not subject to the provisions of the Federal Acquisition Regulation.

Grant Agreement. In October 1994, the United States and Israel signed a Grant Agreement (the Agreement), with the Defense Security Assistance Agency (DSAA) acting as the U.S. representative for the Agreement. The Agreement allows Israel to enter into a direct commercial contract with a U.S. contractor to procure Defense articles and services, of United States origin, using FMF grant funds. Additionally, the Agreement requires Israel to request DSAA approval for the use of FMF grants to finance the direct commercial contract. The Agreement also states that DSAA policies pertinent to the approval of grant financing for direct commercial contracts are those policies included in DoD Manual 5105.38-M, "Security Assistance Management Manual," (the Security Assistance Manual).

Managing Direct Commercial Contracts for Israel. The DSAA is responsible for managing the Israeli FMF grant program, to include: establishing policies and procedures for the program, approving the use of FMF grants for direct commercial contracts, and approving the Defense Finance and Accounting Service, Denver Center (DFAS-DE) disbursements to Israel for payments Israel made to U.S. contractors. Israel established a mission in New York (Israeli Mission) to manage direct commercial contracts under the FMF grant program. The Israeli Mission negotiates and awards the direct commercial contracts, submits those contracts to DSAA for approval to use FMF grants, makes payments to U.S. contractors for those contracts, and submits request for FMF grant reimbursements to DFAS-DE and DSAA for those payments it has made to U.S. contractors.

Audit Objectives

The primary audit objective was to review the policies and procedures related to the execution of the FMF program for Israel. The specific audit objective for this report was to determine the adequacy of policies and procedures used for approving and disbursing FMF grants for direct commercial contracts. Inspector General, DoD, Report No. 97-028, "Israeli Use of Offshore Procurement Funds," November 22, 1996, discusses the adequacy of support for Israeli requests for offshore procurement fund disbursements. We also reviewed the management control program as applicable to the specific audit objective. See Appendix A for a discussion of the audit scope and methodology and a discussion of the results of our review of the management control program. See Appendix B for a summary of prior coverage related to the audit objectives.

Finding A. Disbursements of Foreign Military Financing Funds

The DSAA did not provide adequate controls over the authorization of $331 million in FY 1995 disbursements of FMF grant funds for direct commercial contracts. The controls were inadequate because DSAA had not implemented a financial system to match approved contracts with Israeli disbursement requests. Additionally, DSAA did not match disbursement requests with supporting contract invoices. As a result, $688,780 in disbursements from FMF grant funds were made to Israel for contracts never submitted to DSAA for approval. Additionally, Israel received a payment of $59 million for contract escalation costs that DSAA had not approved.

Guidance Establishing the FMF Programs

Provisions of the Agreement. The Agreement establishes policy and procedures for the approval and disbursement of FMF grant funds made available to Israel. Specifically, sections 1.2 and 1.3 of the Agreement establish the approval process for grant financing of direct commercial contracts and the required authorization for disbursements made from FMF grant funds.

Provisions of Section 1.2. According to the provisions of section 1.2, grant proceeds are to be made available to finance direct commercial contracts for Defense items upon DSAA approval. Section 1.2 requires Israel to provide DSAA a copy of each contract to be financed with FMF grant funds for review, preferably before Israel obligates itself to the contractor. Further, section 1.2 requires DSAA to prepare a separate, written grant-financing approval letter for each contract to be financed with FMF grant funds. Finally, section 1.2 states that the U.S. Government is under no obligation to approve FMF grant financing for any specific direct commercial contract. However, on October 26, 1994, the same day the Agreement was signed, DSAA issued a modification to that Agreement relieving Israel from the requirement to obtain DSAA advance approval of grant financing for purchases of Defense articles and services from commercial contracts, valued less than $100,000.

Provisions of Section 1.3. According to the provisions of section 1.3, DSAA is responsible for authorizing disbursements from the FMF grant funds to reimburse Israel for procurement of Defense articles and services. A disbursement from FMF grant funds may consist of payments to more than one U.S. contractor; however, Israel cannot request DSAA approval for disbursements more than two times per month. Israel must provide DSAA a standard request letter for each disbursement request, not less than 15 business days before the disbursement date. Additionally, section 1.3 requires Israel to provide DSAA invoices to support the disbursement request. However, on

October 26, 1994, the same day the Agreement was signed, DSAA issued a modification to that Agreement relieving Israel from submitting invoices for all contracts, before or concurrently with disbursement requests.

Financial Management Controls. The Office of Management and Budget Financial Management Systems Circular No. A-127-Revised (Circular No. A-127), July 1993, establishes policies and standards for agencies of the Federal Government to follow in developing, operating, evaluating, and reporting on financial management systems. According to Circular No. A-127, financial management in the Federal Government requires financial and program managers to be accountable for the financial results of actions taken, to provide control over the Federal Government's financial resources and to protect Federal assets. Additionally, Circular No. A-127 requires management to establish government-wide financial systems and compatible agency systems, with standardized information and electronic data exchange between central management agency and individual operating agency systems, to meet the requirements of good financial management. The systems shall provide complete, reliable, consistent, timely, and useful financial management information on Federal Government operations to enable central management agencies, individual operating agencies, divisions, bureaus, and other subunits to carry out their fiduciary responsibilities. The systems shall also provide a deterrent to fraud, waste, and abuse of Federal Government resources.

Approval and Disbursement Procedures

Approval Requirements for Contracts Less Than $100,000. The DSAA used a manual filing system to track contracts valued less than $100,000, submitted by the Israeli Mission for FMF grant financing approval. Instead of obtaining prior approval to use FMF grant funds, Israel submitted copies of those contracts, with a contract summary sheet and a cover letter, that were awarded since the last submission of contracts. In October 1994, when DSAA exempted Israel from section 1.2 of the Agreement, DSAA no longer provided Israel a written approval letter for each contract valued less than $100,000, submitted for FMF grant financing approval. As a result, Israel obtained defacto approval for all contracts valued less than $100,000, assuming the risk that DSAA may not approve the use of FMF funds for a given contract.

Approval Requirements for Contracts Greater than $100,000. The DSAA used an automated system, the Direct Commercial Contract Application System, to track contracts valued at more than $100,000, submitted by the Israeli Mission for FMF grant financing. Unlike the requirements for contracts valued less than $100,000, DSAA required Israel to obtain DSAA advance written approval of grant financing for purchases of Defense articles and services for contracts, valued more than $100,000. After DSAA has received the contract,

DSAA enters the contract into the Direct Commercial Contract Application System along with the contractor's name, the item procured, the contract and approval amount, and recommendation for approval or disapproval.

DSAA Disbursement Approval Procedures. The Israeli Mission used national funds to pay U.S. contractors and after it paid the contractors requested DSAA approval for disbursement from FMF grant funds for reimbursement of those payments. Israel initiated the reimbursement process by submitting a disbursement request to DSAA and to DFAS-DE with a supporting check register. When DSAA received the disbursement requests, it reviewed them for mathematical errors. DSAA did not match contracts listed on the disbursement request with a listing of those contracts approved for FMF grant financing. If it found no mathematical errors, DSAA authorized DFAS-DE to disburse FMF grant funds to Israel for the disbursement request amount. DFAS-DE then disbursed those funds.

Disbursement Controls

The DSAA did not provide adequate controls over $331 million in FY 1995 disbursements for all direct commercial contracts. DSAA is accountable for approving the disbursement of FMF grant funds. Circular No. A-127 requires DSAA to establish a system, with standardized information and electronic data exchange, to meet the requirements of good financial management. However, DSAA had not implemented a financial system to match contracts listed on the disbursement request with contracts submitted by the Israeli Mission for FMF grant financing approval.

Contracts Valued Less Than $100,000. The DSAA did not have an automated tracking system for contracts valued less than $100,000 submitted for FMF grant financing. For those contracts, DSAA did not attempt to match manual contract files with FMF grant fund disbursement requests submitted by the Israeli Mission. Additionally, DSAA did not input contract file information for contracts valued less than $100,000, into the Direct Commercial Contract Application System. As a result, a mechanism did not exist to readily match approved contracts with disbursement requests.

Contracts Valued Greater Than $100,000. For contracts valued greater than $100,000, DSAA used the Direct Commercial Contract Application System to track contracts submitted for FMF grant financing approval. However, although a mechanism was in place to readily match approved contracts in the automated system with disbursement requests, DSAA did not do so. DSAA officials stated that they did not consider the disbursement process, to include validating Israeli disbursement requests, as part of their fiduciary responsibilities for oversight of the FMF grant program.

Matching Disbursement Requests With Contractor Invoices. The DSAA did not match disbursement requests with supporting contractor invoices. In October 1994, when DSAA exempted Israel from section 1.3 of the Agreement

requiring Israel to submit all contractor invoices to support disbursement requests, DSAA no longer had a mechanism to validate disbursement requests with contractor invoices.

Although DSAA no longer requires Israel to submit contractor invoices, Israel has a system that can provide the information necessary for DSAA to match disbursement requests with contractor invoices. The Israeli Mission maintains a financial management system, the Israeli Accounts Payable System, that contains contractor invoice information. Rather than requiring Israel to submit actual invoices, DSAA should have required Israel to submit a computer generated listing of invoice numbers and payment information so that DSAA could validate that Israel made payments to contractors for contracts approved for FMF grant financing. Additionally, DSAA should have used those computer generated listings to develop a statistical sample of invoices to match with disbursement requests.

Disbursements from FMF Grant Funds

During FY 1995, Israel received $688,780 in disbursements from FMF grant funds for direct commercial contracts that were never submitted to DSAA for approval. Additionally, Israel received a payment of $59 million for contract escalation costs that DSAA had not approved.

Disbursements Before Contracts Submitted for DSAA Approval. As of July 1996, nine contracts, valued at about $772,591 had not been submitted to DSAA for FMF grant financing approval. Table 1 illustrates the nine contracts and the amount disbursed for each contract.

Table 1. Disbursements Made Before DSAA Approval
(as of July 1996)

Contract	Period of Disbursement	Total Value of Contract	Disbursement on Contract
706/42558-01-A-154	July 1995	$ 99,950	$ 99,950
706/42772-01-A-154	Oct 1995	72,164	72,164
210/31174-26-A-114	Nov 1995-Apr 1996	95,459	21,312
610/41935-03-N-854	May-Nov 1995	83,411	83,141
725/51120-01-B-234	Oct 1995	86,162	76,768
425/54139-01-A-221	Aug 1995	84,001	84,001
837/19732-01-N-631	Aug 1995	89,335	89,335
525/54482-01-B-221	Sep 1995-Apr 1996	88,009	88,009
610/41935-05-B-854	Oct 1995-Feb 1996	74,100	74,100
Total		**$772,591**	**$688,780**

As of July 1996, Israel had received FMF grant funds of $688,780 for those nine contracts. As a result, DSAA authorized reimbursements for contracts never submitted to DSAA for FMF grant financing approval.

Disbursement for Contractor Escalation Costs. The DSAA authorized DFAS-DE to disburse $59 million to Israel for contract escalation costs that DSAA had not approved. In June 1995, DSAA issued a letter to Israel approving the use of FMF grants to purchase three SAAR V Class Corvette ships, valued at about $322 million, from Ingalls Shipbuilding Incorporated. According to the approval letter and supporting documentation in the DSAA contract files, the $322 million that DSAA approved did not include funds for contract escalation costs; however, Israel received disbursement for $381 million from DFAS-DE, which included $59 million in escalation costs. Had DSAA matched the disbursement requests with the approved contract and contract amount, the discrepancy would have been identified.

DFAS-DE Semiannual Reviews of the Israeli Mission

The DFAS-DE performed semiannual reviews of FMF grant disbursements at the Israeli Mission. The objectives of the reviews were to evaluate management controls over disbursements to commercial contractors by Israeli Mission personnel, determine the propriety of those disbursements, and verify that DSAA approval to use FMF grant funds had been obtained. For FY 1995, DFAS-DE reviewed all disbursements of $500,000 or greater, and 30 randomly selected disbursements of less than $500,000. DFAS-DE reviewed about 1 percent (229 of 20,576) of the total disbursements. Because DFAS-DE used attribute sampling, we could not determine the value of the sample. For the two reviews conducted in FY 1995, DFAS-DE identified disbursements made to Israel, valued between $500,000 and $1 million, that showed no evidence that DSAA had approved the use of FMF grant funds for financing those contracts. The December 1994 review stated that DFAS-DE continued to have a repeat finding from past reports that identified no evidence that DSAA had approved contracts of less than $500,000.

Recommendations for Corrective Action

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

1. Input all direct commercial contracts valued less than $100,000 into the Direct Commercial Contract Application System.

2. Match disbursement requests with those contracts in the Direct Commercial Contract System to ensure that the disbursements are for approved contracts and do not exceed approved contract amounts.

3. Require Israel to provide computer generated listings from the Israeli Accounts Payable System of contractor invoice information when submitting disbursement requests for approval.

4. Using a statistical sample, match invoices provided by the Israeli Mission with disbursement requests, before approval of those requests.

Management Comments Required

The Director, Defense Security Assistance Agency, did not respond to the draft of this report in time for comments to be incorporated into the final report. If comments are received, we will consider them as comments to the final report.

Finding B. Profit Rates for Direct Commercial Contracts

The DSAA did not adequately review profit rates on Israeli direct commercial contracts over $500,000, including basic ordering agreements.[1] DSAA did not provide adequate review because it did not require Defense contractors to certify that direct commercial contracts financed with FMF grant funds contained a reasonable profit rate.[2] Additionally, the Security Assistance Manual does not require that DSAA perform price comparisons on noncompetitively awarded contracts over $500,000 and basic ordering agreements that will be funded with FMF grants. As a result, Israel paid a Defense contractor about $ [3] profit ([3] percent) more than the DoD procurement price for 17 purchase orders issued under the basic ordering agreement, valued at about $4.5 million. However, during the audit, the Defense contractor renegotiated the prices on 4 of the 17 purchase orders and agreed to refund $450,190 to Israel, thereby reducing the profit rate.

DSAA Pricing Review Procedures

Contractor's Certification Requirement. Provisions of section 1.2 and Exhibit A of the Agreement, "Procedures for Obtaining DSAA Approval for Grant Financing of Purchase Orders," requires that before DSAA can give its final approval for FMF grant financing, the commercial supplier must submit to DSAA a Contractor's Certification and Agreement with DSAA, (the contractor's certification). The contractor's certification states:

> The Contractor named above, in entering into a agreement to sell defense articles, defense services, or design and construction services to the foreign government listed above as purchaser, hereby acknowledges that the sum to be claimed as due and owing under the contract or pro forma invoice identified above (hereafter sometimes referred to as the "Purchase Agreement") is to be paid, in whole or in part, to the Contractor from U.S. Government funds made available to the foreign government under the provisions of the Arms Export Control Act, as amended.

---

[1]A basic ordering agreement is a written instrument of understanding, negotiated between a contracting activity and a contractor that contains the terms for future orders between the parties.

[2]The Defense Federal Acquisition Regulation Supplement outlines criteria for determining a reasonable profit rate based on the type of contract under negotiation.

[3]Contractor proprietary data omitted.

The contractor's certification requires the contractor to certify that the company is not on the U.S. Government listing of suspended or debarred contractors; employees will not except bribes, kickbacks, or rebates; and contract prices do not include unallowable costs such as commissions and agents fees that exert improper influence to obtain the contract. However, the contractor's certification is silent on requirements for contractors to certify reasonableness of prices for direct commercial contracts funded with FMF grants.

Price Comparisons. The November 1992 version of the Security Assistance Manual required that DSAA perform price comparisons on a selective basis as part of the contract review process for approving FMF grant financing. The purpose of performing the price comparisons was to maximize the benefits of limited FMF funds by identifying excessive contract prices and profits and notifying the contractor for resolution. The November 1992 version of the manual stated:

> Pricing comparisons are being performed [by DSAA] on a selective basis as part of the contract review process. Current DoD procurement prices will be used as a source of comparison prices to assure a valid comparison . . . .When prices are discovered which appear to be excessive in comparison to new acquisition of comparable items for DoD or domestic purchase, the contractor will be advised. Our objective is to maximize the benefits of limited FMF funds; however, we recognize that certain circumstances, especially delivery schedules, may justify paying higher prices. Unjustified excessive prices may be cause for disapproval of FMF.

In January 1996, that section of the Security Assistance Manual was revised deleting the requirement for DSAA to perform price comparisons on a selective basis. The new version of the manual requires the Defense Contract Management Command, with Defense Contract Audit Agency assistance, to perform price comparisons for sole-source contracts over $500,000 that will be funded with FMF grants.

Procurement Guidelines and Oversight for Direct Commercial Contracts. The Federal Acquisition Regulation does not provide Israel with protection against Defense contractors charging excessive profit rates for direct commercial contracts. Direct commercial contracts are not subject to the Federal Acquisition Regulation and other DoD procurement guidelines that provide oversight of contractor profit rates. A decision made by the Comptroller General of the United States in April 1986, "Matter of Environmental Tectonics Corporation," states that direct commercial contracts between the contractor and the foreign government are not subject to Federal agency acquisition regulations because the U.S. Government is not a party to direct commercial contracts.

Noncompetitive (Sole-Source) Selection for Direct Commercial Contracts. The Federal Acquisition Regulation defines a noncompetitive contract as a contract for the purchase of Defense articles or services entered into or proposed to be entered into after soliciting and negotiating with only one source. The organization issuing a noncompetitive contract does not have the benefit of competition among contractors to reduce the price and to help ensure a more

reasonable profit rate. Additionally, the purchasing organization does not have the benefit of comparing prices of two or more prospective contractors to reduce the risk of being charged excessive prices.

DSAA Review of Direct Commercial Contract Pricing

The DSAA did not adequately review pricing and profit rates on Israeli direct commercial contracts over $500,000, including basic ordering agreements. Unlike DoD procurements under the Federal Acquisition Regulation, no requirement existed for contractors to submit cost or pricing data for noncompetitively awarded contracts over $500,000 and basic ordering agreements. Under a DoD contract, when a contracting officer identified an overstated contract price, DoD could receive a price reduction for that contract because the contract was under the protection of the Federal Acquisition Regulation. The Federal Acquisition Regulation provides for the inclusion of clauses in contracts between the U.S. Government and contractors that require contractors to make price adjustments when contract prices are overstated. However, foreign customers using FMF grants to finance direct commercial contracts had less recourse for excessive contract prices because those contracts did not include the Federal Acquisition Regulation clauses.

Profit Rates on Direct Commercial Contracts. We reviewed 11 direct commercial contracts and one basic ordering agreement, valued at $192 million; and we identified excess profits for the one basic ordering agreement, valued at $90.8 million. Specifically, Israel paid a Defense contractor about $ [3] profit ([3] percent) more than the DoD procurement price for 17 purchase orders, valued at about $4.5 million.

Procuring Standard F110 Engine Spare Parts. In February 1993 the Israeli Mission awarded a Defense contractor a basic ordering agreement for spare parts and support equipment for the F110 engine. The basic ordering agreement was awarded sole source so that the warranty for the F110 engines Israel had previously procured from a Defense contractor could be maintained. Between April 1994 and May 1995, Israel issued 17 purchase orders totaling about $4.5 million to procure 10 standard F110 engine spare parts for its F-16 aircraft. The purchase order unit prices for those spare parts ranged from $ [3] to $ [3] per unit. We performed a price comparison between the purchase order unit price for Israel and the DoD procurement unit prices for those same parts by reviewing DoD firm fixed price contract cost data for F110 engine spare parts available at the Defense Contract Audit Agency located at the Defense contractor. According to the price reports, DoD unit prices for the 10 standard

[3]Contractor proprietary data omitted.

spare parts purchased within the preceding 12 month period ranged from $263 to $105,700, totaling about $3.4 million for those same items Israel had procured. Table 2 illustrates the difference when comparing the contract price with the Air Force procurement price.[3]

Based on the information in Table 2, the Defense contractor received about $ [3] ([3] percent) more in profits than the Air Force negotiated price for the same spare parts. During the audit, Israel and the Defense contractor informed us that purchase order prices issued under the basic ordering agreement were being renegotiated. In an April 18, 1996, Defense contractor letter to Israel, the Defense contractor agreed to refund $450,190 on 4 of the 17 purchase orders.

DSAA Pricing Reviews

Certifying Contractor Profit Rates for Direct Commercial Contracts. The DSAA did not require Defense contractors to certify that direct commercial contracts financed with FMF grant funds contained a reasonable profit rate. The contractor's certification did not address contractor profit rates. As a result, grant recipients had no protection against contractors charging excessive profit rates on direct commercial contracts. Direct commercial contracts financed with FMF grants were usually firm-fixed price contracts negotiated based on the total contract value. Contractors were not required to provide

[3]Contractor proprietary data omitted.

foreign customers access to their financial records and contractors did not provide detailed cost breakdowns for FMF recipients to review before entering into the direct commercial contract. Therefore, the grant recipient did not know the profit percentage in the contract. If DSAA had required contractors to certify that the profit rate of the direct commercial contract was reasonable, then the grant recipient would have had assurance that the contract price was equitable.

Price Comparisons. The Security Assistance Manual does not require that DSAA perform price comparisons on noncompetitively awarded contracts over $500,000 and basic ordering agreements that will be funded with FMF grants. Prior to January 1996, the Security Assistance Manual required price comparisons on a selective basis.

November 1992 Requirement for Price Comparisons. Although the Security Assistance Manual required that DSAA perform price comparisons on direct commercial contracts on a selective basis between November 1992 and December 1995, DSAA officials stated that no price comparisons were performed on any direct commercial contracts for Israel during that period. This included the 11 contracts and one basic ordering agreement we reviewed. DSAA officials stated that limited staff and limited financial resources at DSAA and the Military Departments precluded the price comparisons, even on a selective basis. As a result, DSAA deleted the requirement for price comparisons even on a selective basis from the Security Assistance Manual.

Reestablishing a Requirement for Price Comparisons. Although we recognize the staff and financial resource limitations for performing price comparisons, DSAA should perform price comparisons on selected noncompetitively awarded contracts and basic ordering agreements to ensure that Israel is receiving reasonable profit rates. For contracts that are noncompetitively awarded and basic ordering agreements, indicators should be established to determine when a price comparison should be performed. A primary indicator for selecting a noncompetitively awarded contract or basic ordering agreement for a price comparison should be items similar to items procured by DoD or items available in the DoD supply system. Performing price comparisons will not ensure lower profit rates or provide assurance that specific contracts will be selected for review. However, if DSAA performs periodic price comparisons and requires contractors to certify that profit rates are reasonable, DSAA and Israel would have some recourse to request a price reduction from the contractor for noncompetitive contract overcharges.

Recommendations for Corrective Action

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

1. Amend the Contractor's Certification and Agreement with the Defense Security Assistance Agency to require contractors to certify that the profit rate charged in the direct commercial contract does not exceed a reasonable percentage of the total contract costs as defined in the Defense Federal Acquisition Regulation Supplement.

2. Reestablish the DoD Manual 5105.38-M, "Security Assistance Management Manual," requirement to perform periodic price comparisons on selective noncompetitively awarded direct commercial contracts over $500,000 and basic ordering agreements to ensure that contractors charge reasonable profit rates.

Management Comments Required

The Director, Defense Security Assistance Agency, did not respond to the draft of this report in time for comments to be incorporated into the final report. If comments are received, we will consider them as comments to the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope and Methodology

We reviewed the FY 1995 universe of contracts, valued less than $100,000, that the Israeli Mission submitted to DSAA for FMF grant financing approval. That universe was comprised of 638 contracts, valued at about $20 million. Additionally, we reviewed 12 contracts and one basis ordering agreement valued at more than $100,000, totaling $514 million, that the Israeli Mission submitted to DSAA for approval to use FMF grant financing. At the Israeli Mission, we reviewed the related contract files and discussed the procedures for submitting direct commercial contracts and basic ordering agreements to DSAA for FMF grant financing approval. Additionally, we discussed with the DSAA Operations Directorate, its policies and procedures for approving FMF grant financing for Israeli direct commercial contracts and basic ordering agreements. Further, we reviewed the Agreement and any amendments and the Security Assistance Manual, to determine whether DSAA and Israel complied with the provisions of the Agreement, and DoD guidance for direct commercial contracts.

Adequacy of the Approval and Disbursement Process. We evaluated the adequacy of the approval and disbursement process for 638 direct commercial contracts, valued less than $100,000. We evaluated the approval process for 11 contracts and one basic ordering agreement greater than $100,000, valued at $192 million and the disbursement process for one direct commercial contract, valued at $322 million. Additionally, we reviewed the validation process for $331 million in disbursements made to Israel for direct commercial contracts during FY 1995. For contracts of less than $100,000, we determined whether Israel received disbursements from DFAS-DE before submitting those contracts to DSAA for approval to use FMF grant financing. For the contracts valued less than $100,000 and the contract valued at $322 million, we determined whether DSAA validated disbursement requests before authorizing DFAS-DE to disburse FMF grant funds to Israel. We also discussed with DSAA, DFAS-DE, and Israeli Mission personnel the policies and procedures for approving and disbursing FMF grants funds.

Adequacy of Contract Pricing Review Procedures. To evaluate the adequacy of contract pricing review procedures, we selected 11 contracts and 1 basic ordering agreement (5 contractors) over $100,000, valued at about $192 million, for review. For each of the 11 contracts and 1 basic ordering agreement, we visited the contractor and discussed the pricing methodology with the program manager, contract administrator, and pricing personnel. Additionally, we obtained copies of actual or DoD cost reports for those items we performed cost comparisons on from the Defense Contract Audit Agency.

Audit Period and Standards. We performed this program audit from September 1995 through June 1996 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the

Inspector General, DoD. We included tests of management controls considered necessary. We did not use statistical sampling procedures or computer-processed data for this audit. See Appendix C for a list of organizations visited or contacted.

Management Control Program

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987*, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of Management Control Program. We reviewed the adequacy of DSAA management controls over the approval and disbursement processes for direct commercial contracts. Specifically, we reviewed DSAA management controls over the policies and procedures used for approving the use of FMF grants to determine whether DSAA and Israel complied with the provisions of the Agreement and the Security Assistance Manual for direct commercial contracts. Additionally, we reviewed DSAA management controls for validating disbursement requests made by Israel. Also we reviewed the DSAA management controls for ensuring the reasonableness of the direct commercial contract or basic ordering agreement prices. We also reviewed the results of any self-evaluation of those management controls.

Adequacy of Management Controls. We identified material management control weaknesses for DSAA as defined by DoD Directive 5010.38. DSAA management controls for the disbursement of FMF grants to Israel were not adequate to ensure that disbursements from FMF grants were properly authorized. Additionally, DSAA did not adequately review profit rates charged by U.S. Defense contractors on Israeli direct commercial contracts and basic ordering agreements. All recommendations, if implemented, will improve DSAA management controls. A copy of the report will be provided to the senior official responsible for management controls at DSAA.

Adequacy of Management Self-Evaluation. The DSAA identified financing of direct commercial contracts with FMF grants as an assessable unit and assigned a low level of risk to that unit. As a result, no evaluations were performed. Because DSAA did not perform evaluations, DSAA did not identify the material management control weaknesses identified by the audit.

*DoD Directive 5010.38 has been revised as "Management Control Program," August 26, 1996. The audit was performed under the April 1987 version of the directive.

Appendix B. Prior Audits and Other Reviews

General Accounting Office, Report No. NSIAD 93-184 (OSD Case No. 9496), "Military Sales to Israel and Egypt," July 1993. The report stated that DoD lacked adequate controls for managing the FMF program. It stated that DSAA was required to perform price comparisons on a selective basis as part of the contract review process; however, such comparisons were rarely performed. The report recommended that DSAA direct the Defense Contract Management Command to perform quality assurance checks on purchases over a certain dollar threshold and contractors maintain financial records in a manner that permits the U.S. Government to verify contractor compliance with DSAA certification requirements. DoD program officials generally agreed with the report's findings and recommendations.

Inspector General, DoD, Report No. 97-028, "Israeli Use of Offshore Procurement Funds," November 22, 1996. The report stated that the Israeli Ministry of Defense was not required to, and did not, maintain an adequate audit trail to allow verification of production costs and depot maintenance costs submitted to DSAA for offshore procurement fund disbursements. As a result, we were unable to verify $324.7 million of Israeli expenses reimbursed with offshore procurement funds in FY 1995. Also, the fund reviews performed by DSAA were not meaningful in the absence of supporting documentation for disbursement requests. The report recommended that DSAA either seek to include in each annual Grant Agreement with Israel the specific documentation that the Israeli Ministry of Defense must maintain to support the offshore procurement fund disbursement requests or streamline the disbursement approval process. DSAA concurred with the recommendation to streamline the disbursement approval process; and it did not dispute the finding. DSAA also stated that, while Congress had never clearly articulated its reasons for establishing the offshore procurement program, it was not the intent of Congress that the U.S. Government involve itself directly in the Israeli Ministry of Defense domestic procurement process.

Appendix C. Organizations Visited or Contacted

Defense Organizations

Defense Contract Audit Agency, Fort Belvoir, VA
- Defense Contract Audit Agency, Litton Systems, Woodland Hills, CA

Defense Contract Management Command, Fort Belvoir, VA
- Defense Contract Management District North, Boston, MA
  - Defense Contract Management Area Operations, Chicago, IL
  - Defense Contract Management Area Operations-International Logistics Office, Staten Island, NY
- Defense Contract Management District West, El Segundo, CA
  - Defense Contract Management Area Operations, Dallas, TX
  - Defense Contract Management Area Operations, San Diego, CA

Defense Finance and Accounting Service Denver Center, CO
Defense Logistics Agency, Fort Belvoir, VA
Defense Security Assistance Agency, Arlington, VA

Non-Government Organization

Government of Israel-Mission to the United States, New York, NY

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Acquisition and Technology)
  Director, Defense Procurement
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Under Secretary of Defense (Policy)

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency
Director, Defense Security Assistance Agency
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations and Individuals

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

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 Foreign Relations
  Senate Committee on Governmental Affairs
  House Committee on Appropriations

Non-Defense Federal Organizations and Individuals (cont'd)

House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
House Committee on International Relations
House Committee on National Security

Audit Team Members

This report was prepared by the Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD.

Shelton R. Young
Evelyn R. Klemstine
Catherine M. Schneiter
Carolyn B. Jones
Stephanie D. Wells
Vanessa S. Adams