DEPARTMENT OF DEFENSE

AUDIT REPORT

THE FOREIGN MILITARY SALES ADMINISTRATIVE FUND

No. 90-059

April 18, 1990

Office of the Inspector General

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

April 18, 1990

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

SUBJECT: Report on the Audit of the Foreign Military Sales Administrative Fund (Report No. 90-059)

This is our final report on the Audit of the Foreign Military Sales Administrative Fund (the Fund) for your information and use. The comments provided to the draft of this report were considered in preparing the final report. The audit was made from July 1988 to March 1989. The objective of the audit was to evaluate the solvency of the Fund by determining if administrative and logistics support surcharges were sufficient to pay current and anticipated administrative expenses. We also evaluated the adequacy of internal controls established for Fund administration. As of December 31, 1988, the Foreign Military Sales Program (the Program) comprised 17,449 open cases (contracts between the U.S. Government and foreign countries) written for $148.6 billion of which $60.1 billion of articles and services remain to be delivered. Original administrative surcharges on these open cases totaled $4.0 billion including $518.7 million remaining to complete the delivery of ordered articles and services.

The audit showed that, on December 31, 1988, the Program was operating at a deficit to the U. S. Government because internal controls were not adequate to provide responsible financial management. Internal control weaknesses allowed management to: issue expenditure authority above earned revenues, refund assessed surcharges and cancellation penalties, and prepare costly Price and Availability Analyses that did not generate sales. In addition, Blanket Order Agreements (Agreements) were not used to process low-dollar-value sales, and the Fund was absorbing case management costs directly identifiable, and therefore chargeable, to specific cases. The results of the audit are summarized in the following paragraphs, and the details, audit recommendations, and management comments are provided in Part II of this report.

The Defense Security Assistance Agency (the Agency) did not limit administrative expenditure authority to cumulative earned revenues (earned administrative surcharges) in the Fund. The Agency liquidated current expenses with surcharges that were not

yet earned. As a result, the Fund had a deficit of $537.8 million as of December 31, 1988. We recommended that annual expenditure authority be limited to revenues earned on performance. We also recommended establishing internal controls to ensure that expenditure authority does not exceed revenues and to prevent further deficits in the Fund. Since issuance of the draft report, Congress passed the Fair Pricing Initiative to improve the solvency of the Program. Therefore, for the final report, we added a recommendation requiring that the surcharge rate be raised if the Fair Pricing Initiative does not reduce the deficit in the Fund (page 5).

The Security Assistance Accounting Center (the Center) refunded administrative surcharges associated with partial cancellations and cases closed with zero deliveries. If this condition is not corrected, we project an additional loss of $60.2 million during FY 1989 through FY 1993. We recommended in the draft report that financial systems to process surcharge refunds be brought into compliance with the DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," (the Financial Manual) and that collection of excess refunds totaling $169.6 million be initiated. Further, we recommended that DoD 5105.38-M, "Security Assistance Management Manual," be revised. Since issuance of the draft report, the Comptroller of the Department of Defense proposed revising the Financial Manual to assess cancellation penalties only on cases canceled in their entirety. We, therefore, added a recommendation in the final report that, in the future, the Comptroller require collections of penalties on partial cancellations (page 11).

The Fund reimbursed DoD Components for costs incurred in preparing Price and Availability Analyses (Analyses) that did not result in sales. These costs drained the Fund by $18 million annually. We project that the Fund will experience a $91 million drain to provide Analyses during FY 1990 through FY 1994. We recommended revising the Financial Manual to provide procedures for establishing management cases to recover preparation costs of Analyses and for reducing the administrative surcharges when Analyses result in sales. In addition, we recommended that the Agency reduce baseline budgets to reflect the transfer of Analyses preparation to management cases (page 21).

Agreements were not efficiently used in processing low-dollar-value cases. Using Agreements that are centralized for sales less than $135,000 will eliminate 53 percent of the individual cases written and avoid unnecessary costs totaling $27.5 million during FY 1990 through FY 1994. We recommended that DoD Components be required to establish centralized Agreements for cases less than $135,000 and that budgets for those FY's be reduced by $5.5 million (page 27).

DoD Components did not consistently charge management effort to cases although the effort was directly identifiable to specific cases. As a result, the Fund was charged approximately $52 million in FY 1988 for costs appropriately chargeable to cases. We project that during FY 1990 through FY 1994, these avoidable charges will total $260 million. We recommended that management costs identifiable to cases be charged as direct costs. We also recommended reducing baseline budgets to reflect the transfer of management efforts to direct cost reimbursement procedures (page 31).

The audit identified internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. Controls were not established or effective to: limit expenditure authority to earned revenues, prevent or detect erroneous surcharge refunds, and ensure that refund procedures were properly implemented. All recommendations of Findings A and B, if implemented, will correct these weaknesses. We have determined that monetary benefits will not be realized by implementing the recommendations of Finding A. We have determined that monetary benefits of $63.8 million can be realized by implementing the recommendations of Finding B. The senior officials responsible for internal controls within your Department or agency will be provided a copy of this final report.

On August 5, 1989, a draft of this report was provided to the Comptroller of the Department of Defense (the Comptroller); the Assistant Secretary of the Air Force (Financial Management and Comptroller) (the Assistant Secretary) and the Director, Defense Security Assistance Agency (the Director), for consideration and comments. Management comments were received from the Comptroller on November 21, 1989; from the Assistant Secretary on October 4, 1989; and from the Director on November 16, 1989. The complete texts of managements' comments are included in Appendixes G, H, and I. We delayed issuance of the final report to allow management to respond to the draft report.

Management comments on the draft report did not fully comply with the requirements of DoD Directive 7650.3. The Comptroller concurred with Recommendation A.1.b. which requires surcharges to be adequate to fund anticipated administrative costs and Recommendation C.1.a., which addressed the use of management cases, but did not provide time frames for coordinating changes with the DoD Components and the Agency. Therefore, we request that the Comptroller provide the time frames in response to the final report. The Comptroller nonconcurred with Recommendation A.1.a. to limit budget authority to surcharges earned on performance, and Recommendations E.1.a. and E.1.b., which addressed charging management efforts as direct costs. He

proposed to leave policy on administrative budgets unchanged and stated that we had misunderstood direct cost recovery guidance contained in the DoD Accounting Manual. We do not agree with the Comptroller's conclusions, and we have stated our reasons in Part II of this report. The Comptroller withheld comment on Recommendation C.1.b. because he did not understand why a credit would be applicable to administrative surcharges since case management cost is a direct charge and does not flow through the administrative account. For the final report, we added Recommendation B.1. that the Comptroller reconsider his position on partial cancellations, and we clarified the intent of Recommendation C.1.b. to show that credits are needed to preclude customers from incurring a new charge without receiving a new benefit. Recommendations B.1.a., B.1.b., and B.1.c. in the draft report have, therefore, been renumbered Recommendations B.2.a., B.2.b., and B.2.c. We ask that the Comptroller review our reasons for maintaining that corrective actions are required and provide comments on Recommendations A.1.a., B.1., C.1.b., E.1.a. and E.1.b. in response to this final report. The Comptroller also recommended changes to wording in the draft report. We made all necessary changes. The details of those changes are provided in Part II of the report.

The Deputy Assistant Secretary of the Air Force, Accounting and Finance, partially concurred with Recommendation B.3.a. to revise accounting systems, and B.3.c. to initiate collections, and concurred with Recommendation B.3.b. to provide oversight stating that guidance was needed from the Comptroller and Director before systems changes and collections can be undertaken. However, the Deputy Assistant Secretary did not specify what actions will be taken to obtain guidance and did not provide time frames for accomplishing corrective actions. We ask that this information be provided in response to this final report.

The Director, Defense Security Assistance Agency, concurred with Recommendation A.2.b. to ensure the adequacy of surcharge rates; however, we ask that the Director clarify his intended actions in response to the final report. The Director partially concurred with Recommendations D.1.a. and D.1.b. agreeing to limit budget authority to revenues and to encourage expanded use of Agreements. The Director did not specify what actions will be taken to implement recommendations and did not provide time frames for accomplishing corrective actions. He nonconcurred with Recommendation A.2.a. to limit budgets to revenues, Recommendations B.2.a., b., and c., which address collecting excessive refunds, and Recommendations C.2.a., b., and c. for using management cases to recover the cost of preparing Analyses. He also nonconcurred with Recommendations E.2.a., b., and c. to charge management efforts as direct costs. The Director stated that sufficient internal controls are in place to limit cumulative budget authority to cumulative revenues; assessment of

cancellation penalties should not be automatic; no excessive refunds were made; and monetary benefits were based on unused case values and a misunderstanding of Comptroller cancellation criteria that should be changed to agree with his position. Although he acknowledged the cash deficit in the Fund, he maintained that the cost to prepare Analyses and manage cases should be borne by the Fund as a cost of doing business instead of being directly recouped from the purchaser. We agreed that some of the cancellation penalties included in our computation can be waived, and we have recomputed monetary benefits associated with Finding B. However, we do not agree with the Director's conclusions and detail our reasons in Part II of this report. In the final report, we revised Recommendation A.2.a. to specify that budgets be limited to earned revenues and revised Recommendation B.2.c. (old B.1.c.) to quantify recommended collections. We also added Recommendation A.2.c. to require raising the surcharge rate if the Fair Pricing Initiative does not reduce the deficit. We ask the Director to review our reasons for maintaining that corrective actions are required and to provide comments on Recommendations A.2.a., A.2.c., B.2.a., b., and c.; C.2.a., b., and c.; and E.2.a., b., and c. in response to this final report.

Concerning monetary benefits identified in the draft report, we revised collection of penalties on partial cancellations in Finding B and reduced the amount of monetary benefits from $608.3 million to $442.3 million. We request that the Director, Defense Security Assistance Agency, comment on the $442.3 million worth of monetary benefits identified in Appendix F in response to the final report. If you nonconcur with the estimated savings or any part thereof, you must state the amount you nonconcur with and the basis for your nonconcurrence. Potential monetary benefits are subject to resolution in the event of nonconcurrence or failure to comment.

DoD Directive 7650.3 requires that all audit recommendations be resolved within 6 months of the date of the final report. Accordingly, final comments on the unresolved issues in this report should be provided within 60 days of the date of this memorandum.

The courtesies extended to the audit staff are appreciated. A list of audit team members is in Appendix J. If you have any questions on this audit, please contact Mr. Raymond A. Spencer on (202) 694-3995 (AUTOVON 224-3995) or Mr. J. Steven Hughes on (202) 693-0362 (AUTOVON 223-0362). Copies of this report are being provided to the activities listed in Appendix K.

Stephen A. Trodden
Assistant Inspector General
for Auditing

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

REPORT ON THE AUDIT OF
THE FOREIGN MILITARY SALES ADMINISTRATIVE FUND

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Prepared by:
Financial Management Directorate
Project No. 8FB-0056

REPORT ON THE AUDIT OF THE FOREIGN MILITARY SALES ADMINISTRATIVE FUND

PART I - INTRODUCTION

Background

The Arms Export Control Act (the Act) provides the basic authority for the Foreign Military Sales Program (the Program). Within DoD, the Defense Security Assistance Agency (the Agency) is responsible for the Program's management and oversight. Actual sales are negotiated and executed by 14 DoD implementing agencies (DoD Components). As of December 31, 1988, the Program comprised 17,449 open cases (contracts between the U.S. Government and foreign countries) written for $148.6 billion and had $60.1 billion worth of articles and services remaining to be delivered.

To ensure that the Program is operated at no cost to the U.S. Government, the Act provides for levying administrative surcharges on cases to recover expenses not charged directly to sales. The DoD uses surcharges to recover such expenses as sales negotiations, case implementation, program control, material management, procurement, computer programming, accounting, and budgeting. The surcharges assessed at case acceptance on open cases totaled $4.0 billion, of which $518.7 million remains to complete delivery of ordered articles and services. These surcharges are deposited in the Foreign Military Sales Trust Fund (the Trust) with the United States Treasury and transferred to the Administrative Expense Cost Clearing Account as they are earned. Surcharges are earned in two distinct phases; one-half at case acceptance, and the remainder as deliveries are made. Cumulative surcharges levied on sales are tracked and internally referred to as the Foreign Military Sales Administrative Fund (the Fund).

The Fund had a deficit of $537.8 million on December 31, 1988. Prior attempts to correct deficit conditions included: raising surcharge rates, collecting a portion of surcharges at case implementation, borrowing from other trust fund accounts, reducing operating budgets, and changing accounting policy concerning budget authority and cash availability. In 1984, a working group consisting of representatives from various DoD agencies reviewed the adequacy of the 3-percent surcharge for FY 1984 through FY 1986. The group concluded that the rate would be adequate, providing projected sales levels were met. However, actual sales were $12.9 billion less than projected for that period. Having failed to meet projected sales levels, the Agency imposed a 3.1-percent logistics support surcharge on certain line items in FY 1987. Program sales peaked at $22 billion in FY 1982, declined to $7 billion in FY 1986 and FY 1987, and were $12 billion in FY 1988. While sales were declining, administrative budgets were not experiencing commensurate decreases.

Objective and Scope

Our objective was to evaluate the solvency of the the Fund by determining if administrative and logistics support surcharges were sufficient to pay current and anticipated administrative expenses. In addition, we were to evaluate the adequacy of internal controls established for Fund administration.

We reviewed policy and procedures provided in the Act, the DoD Accounting Manual, the Foreign Military Sales Financial Management Manual (the Financial Manual), the Security Assistance Management Manual (the Security Manual), and mission statements of the Agency and the Security Assistance Accounting Center (the Center) to determine if the Program was implemented and operating as authorized.

We limited our review of case records to the Army, Navy, and Air Force because those DoD Components were responsible for 99 percent of the Program's sales activity. We statistically sampled cases implemented from FY 1980 through FY 1988 to test surcharge assessments and refund procedures. We selected 395 cases (290 open cases with partial deliveries and 105 cases closed that had no deliveries) from 14,714 cases having surcharge refunds totaling $482 million.

We examined Price and Availability Analyses (Analyses) prepared by the DoD Components between FY's 1986 and 1989 to assess the monetary impact of rejected Analyses on the Fund.

We analyzed sales for FY 1986 through FY 1988 to determine the extent that Blanket Order Agreements (Agreements) were used by the DoD Components. We determined the break-even value required for Agreements and quantified the loss sustained by the Fund as a result of individually processing cases under that value.

We evaluated policy and procedures for charging management costs to the Fund. We determined management costs identifiable to specific cases thereby chargeable as a direct cost in lieu of charging the Fund.

We analyzed the conditions that adversely affected the solvency of the Fund to identify material weaknesses in internal controls. Internal controls were not established or effective to: limit expenditure authority to earned revenues, prevent or detect erroneous surcharge refunds, and ensure that refund procedures were properly implemented.

This performance audit was made from July 1988 to March 1989 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector

General, DoD, and accordingly included such tests of internal controls as were considered necessary. Activities visited or contacted are shown in Appendix E.

Prior Audit Coverage

The Inspector General, DoD, issued three reports related to the Fund within the past 5 years. No other related reports were issued on this subject. The audit of "Foreign Military Sales Administrative Budget and Costs - U.S. Air Force," Report No. 88-042, October 28, 1987, concluded that the Fund was inappropriately charged for administering foreign military sales cases where the surcharge had been waived. The report recommended that the Assistant Secretary of Defense (Comptroller) (now Comptroller of the Department of Defense) require implementing agencies to obligate their own operation and maintenance funds for the full amount of waived administrative fund surcharge upon implementation of the case. This recommendation was implemented in DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," paragraph 70505.

The "Review of the Foreign Military Sales Administrative Account," Report No. 87-181, June 24, 1987, found that the unobligated balance of the Fund was inadequate to meet the expense of delivering open foreign military sales cases by approximately $409 million. No recommendation was made because the impact of the newly implemented logistics support surcharge could not be determined.

"The Audit of Direct Case Management Charges Billed to Foreign Military Sales," Report No. 87-018, October 21, 1986, concluded that the Military Departments had not consistently applied direct case management labor costs to foreign military sales because guidance was insufficient to differentiate between direct and indirect costs. Navy charged all administrative costs as direct costs, Army charged them as indirect costs, and the Air Force charged them either way. The report recommended that the Office of the Comptroller of the Department of Defense issue guidance to properly differentiate between administrative expenses and case management direct charges.

PART II - FINDINGS AND RECOMMENDATIONS

A. Limiting Administrative Expenditure Authority

FINDING

The Defense Security Assistance Agency (the Agency) did not limit administrative expenditure authority to earned surcharges on contracts between the U.S. Government and foreign countries (cases). We attribute the unlimited expenditure authority to the lack of internal controls to ensure responsible financial management. As a result, the Foreign Military Sales Administrative Fund (the Fund), which should operate at or near a zero balance, closed in FY 1988 with a negative balance of $537.8 million. We estimate that the deficit, after all deliveries have been made on cases that were open on December 31, 1988, will be between $194 million and $471 million.

DISCUSSION OF DETAILS

Background. Costs identified in cases are divided into two categories: direct costs, which are recovered as charges identified to specific case line items; and indirect costs, which are recovered as a percentage of sales through administrative surcharges. When a case is accepted, the foreign customer deposits a specified portion of the estimated direct costs and 50 percent of the total assessed administrative surcharge into the Foreign Military Sales Trust Fund (the Trust) with the United States Treasury.

According to the DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," (Financial Manual) administrative surcharges are earned in two phases; a 50 percent initial deposit at case acceptance, and the remaining 50 percent applied to performance billings. The Agency determined that 50 percent of the surcharge is earned when a case is accepted to recover the costs of defining requirements and of negotiating and establishing the contract. Thus, the customer is required to deposit 50 percent of the surcharge levied on a case at the time the case is accepted. The Agency determined that the remainder of the surcharge is earned through managing the contract and by effecting delivery of the ordered articles and services. This policy was provided to ensure that the Fund operated at or near a zero cash balance. However, 100 percent of the surcharge levied on a case is made available for administrative expenditure authority at case acceptance, regardless of the amount of cash deposited or when the surcharge will be earned. In addition, obligation authority and expenditure authority are issued concurrently, and expenditure authority is issued for the full amount of obligation authority provided.

Criteria. The Arms Export Control Act requires that the Foreign Military Sales Program (the Program) operate at no cost to the U.S. Government and provides for assessment of surcharges on cases to recover costs not charged directly to cases. Funds deposited in the Trust are subject to the obligations and expenditures prohibitions defined in U.S.C., Title 31, Sec. 1517 (a) (2), the "Anti-Deficiency Act." The Financial Manual states that Program funds are subject to the same financial controls as appropriated funds. According to the Financial Manual, expenditure authority is created when three conditions are met: contracts (or contract amendments) are accepted; requests for obligation authority, consistent with contracts, are received; and the country has deposited the specified advances in the Trust. On March 25, 1988, the Comptroller of the Department of Defense (the Comptroller) issued policy that permits the Agency to issue expenditure authority up to the full amount of surcharges associated with all open cases regardless of cash on hand to liquidate administrative obligations.

Administrative Expenditure Authority. Administrative expenditure authority that the Agency issued to the DoD Components was not limited to surcharges earned through performance (consisting of earnings at case acceptance and a percentage of deliveries made). Instead, the Agency issued annual administrative budgets based on prior year funding levels plus an inflation factor. This procedure does not promote economies of operation because it does not respond to declining sales and diminishing revenues. For example, between FY's 1982 and 1986, annual sales declined from $22 billion to $7 billion with deliveries peaking in FY 1983, yet annual Program administrative budgets steadily increased from $342 million to $397 million. Unconstrained budgets resulted in prior deficits that the Agency attempted to alleviate by: borrowing from other funds, collecting a greater portion of the surcharge when a case is implemented, increasing the surcharge rate, adding a new surcharge, and changing accounting policy.

Internal Controls. The administrative budget process lacks internal controls to ensure that the Fund operates at or near a zero cash balance and that the Program operates at no cost to the U.S. Government. The administrative surcharge is a percentage of case value and cannot be entirely earned until the case is fully executed. However, the budget process used to make surcharges available to liquidate administrative obligations arising from Program operations was not consistent with the budget process used to fund case execution. The Comptroller provided inconsistent budgetary guidance concerning the availability of funds for direct and indirect Program expenses. Direct expenditure authority, used to fund the cost of ordered articles and services, is limited to the amount of deposits in the Trust. On the other hand, indirect administrative expenditure authority,

used to recover the cost of administering the Program, is equal to 100 percent of the administrative and logistics support surcharges levied on cases, regardless of cash deposits or when the surcharge will be earned. As a result, the Agency meets current cash requirements by using customer funds deposited to cover future obligations.

Fund Balance. We compared the $1.5 billion of expenditure authority issued between FY's 1985 and 1988 to surcharges levied on sales and to collections on performance. We found that surcharges levied on sales totaled approximately $.9 billion, $.6 billion (38.9 percent) less than the expenditure authority issued. Collections on performance (includes the 50 percent earned when cases are accepted plus surcharges earned on deliveries) totaled approximately $1.1 billion, $.4 billion (23.7 percent) less than the expenditure authority issued. As a result, the Fund had a negative balance of $537.8 million on December 31, 1988.

Administrative Surcharges Remaining. To compute the surcharges required to fully execute open cases, we developed a rate based on the historical cost to deliver goods. We applied this rate to undelivered articles and services to quantify the anticipated cost of completing open cases. We determined that, over an 11-year period, expenditure authority equaled 3.7 percent of the value of articles and services delivered. If one-half of the cost associated with the Program is incurred before the cases are accepted, then one-half, or 1.85 percent, of the historical cost was associated with executing cases. We applied this historical rate to the value of undelivered articles and services as of December 31, 1988. Thus, the cost to complete these cases would be between $691 million and $968 million depending upon work-in-process. Available administrative and logistics support surcharges totaled $497 million, leaving a deficit of between $194 million and $471 million. See Appendix A for details. It is not possible to determine the amount of administrative cost yet to be incurred in effecting delivery of those items. Therefore, the deficit is stated as a range covering the two possibilities with the true administrative costs yet to be incurred somewhere in between.

Current Efforts to Correct the Deficit Balance. The "Fair Pricing Initiative" (the Initiative) was drafted by the Agency in FY 1988 as an attempt to reduce the Fund deficit. The Initiative was not adopted by Congress because it was too costly. The Agency revised the Initiative, and it passed in its entirety as a part of the FY 1990 Defense Appropriations Bill and again as Section 1606 of the FY 1990 Armed Services Appropriations Bill (G.R. 3072). Passage of the Initiative amends, among other legislation, the Arms Export Control Act. These bills include military personnel costs associated with the Program as part of the military mission paid from appropriated funds. Civilian

payroll expenses will continue to be reimbursed from administrative funds. The fact that military payroll costs will no longer be borne by the Fund should mean a significant reduction in administrative budgets which, in turn, will offset the deficit. However, some managers have already indicated that they will replace military personnel with civilian personnel to avoid budget reductions. Should this be permitted to occur, benefits envisioned in the Initiative will not be realized. The Agency has also indicated that the basic administrative fee may be increased to 4.5 percent of sales if the Initiative fails to alleviate the deficit.

Conclusion. The budget process used by the Agency neither recognizes the Fund's deficit nor promotes economies of operation to preclude its growth. Therefore, the Comptroller should impose limitations that ensure responsible financial management. Limiting administrative expenditure authority to surcharges earned through performance would preclude the Agency from spending future dollars to liquidate current obligations and would prevent future deficits. We also believe that the Director should devise a plan to eliminate the deficit by FY 1999 and, if necessary, raise the surcharge rate to ensure that the goal is achieved.

RECOMMENDATIONS FOR CORRECTIVE ACTIONS

1. We recommend that the Comptroller of the Department of Defense provide the following internal controls by revising DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," to:

a. Require that the Defense Security Assistance Agency limit the annual administrative expenditure authority to surcharges earned on performance.

b. Require that cumulative administrative surcharges are adequate to fully fund anticipated administrative costs.

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

a. Limit annual budgets to revenues earned on performance.

b. Review, and if necessary, adjust surcharge rates at least annually to ensure that they are adequate to fully recover anticipated administrative costs.

c. Devise a plan to eliminate the deficit by FY 1999 and, if necessary, increase the administrative surcharge rate to ensure that the goal is achieved.

MANAGEMENT COMMENTS

Recommendation A.1.a. The Comptroller nonconcurred with the Recommendation stating that an alternative approach would be to limit administrative allotments (expenditure authority) to the total of ordered administrative values (cumulative ordered surcharges).

Recommendation A.1.b. The Comptroller concurred with the Recommendation stating that implementation would have to be coordinated with the Defense Security Assistance Agency and the DoD Components.

Recommendation A.2.a. The Director nonconcurred with the Recommendation stating that cumulative annual expenditure authority that is issued cannot exceed cumulative revenues earned on performance. The Director also stated that sufficient internal controls are in place to accomplish this, but since revenues are highly dependent on levels of sales and deliveries, it is not feasible or practical to annually balance budgets to revenues. The Director further stated that a problem occurs because budgets are prepared at the beginning of the year, but revenues are not known until the year is over. His objective is to ensure that budgets do not exceed revenues over time.

Recommendation A.2.b. The Director concurred with the Recommendation stating that, in conjunction with a recently completed thorough review of FY 1990 estimated revenues, he determined that budget adjustments could be made to ensure that budgets did not exceed revenues. The Director stated that a rate increase would be required in FY 1991 if Congress does not pass the Fair Pricing Initiative.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Recommendation A.1.a. The Comptroller's alternative approach suggests that there be no distinction between revenues from earned surcharges and ordered surcharges and perpetuates spending future dollars to pay for current expenses. Ensuring that deposits in excess of revenues earned on performance, during the budget year, are held in the Fund to pay for administrative costs associated with performance on cases in subsequent years provides a vital internal control to prevent future deficits. Therefore, we believe the Recommendation is still valid.

Recommendation A.1.b. Although the Comptroller concurred with the intent of this Recommendation, no milestones were provided to indicate when corrective action will be taken. The Comptroller needs to establish time frames for coordinating with the Defense Security Assistance Agency and for implementing changes to the "Foreign Military Sales Financial Management Manual," DoD 7290.3-M.

Recommendation A.2.a. As indicated in Finding A, annual administrative budgets (which equate to expenditure authority) do not exceed surcharges, but they do exceed revenues from earned surcharges. Although we agree with the Director that these budgets should be based on levels of sales and deliveries, they are not. We do not agree with the Director's position that it is not feasible or practical to balance budgets to revenues. Administrative budgets can be projected based on a combination of the status of negotiations for sales, which are tracked and reported by the Agency, and anticipated deliveries for the budget year. These estimated budgets can be monitored and adjusted if projected revenues do not materialize. Further, excess earnings from prior years will be available to augment shortfalls in revenues. The internal controls currently in place merely prevent the Agency from issuing budget authority in excess of cumulative revenues. The controls do not safeguard the revenues of foreign countries deposited for out year performance from being used to pay current year expenses. We revised this Recommendation from "Establish internal controls to ensure that annual budgets do not exceed revenues earned on performance" to "Limit annual budgets to revenues earned on performance." For the above reasons, the Recommendation is still valid.

Recommendation A.2.b. Concurrence with this Recommendation will rectify the condition provided that the Director's intent is to limit budget authority to cumulative earned revenues on performance instead of cumulative ordered surcharges. We ask that the Director clarify his intended actions in response to this report.

B. Collecting Administrative Surcharges and Penalties

FINDING

The Security Assistance Accounting Center (the Center) did not collect and retain in the Fund earned administrative surcharges and cancellation penalties. This condition occurred because the Defense Security Assistance Agency issued financial guidance in DoD 5105.30-M, "Security Assistance Management Manual," (the Security Manual) that conflicts with the mandatory guidance provided in the Financial Manual. As a result of this conflict, an internal control weakness, the Fund lost revenues totaling $3.6 million between FY 1980 and FY 1988 with an additional $60.2 million loss expected between FY 1989 and FY 1993.

DISCUSSION OF DETAILS

Background. Foreign military sales cases are contracts between the U.S. Government and foreign countries for delivery of specific articles or services. The U.S. Government, to fulfill its commitment to the foreign country, negotiates contracts with private industry to supply articles or services. Large cases often involve the negotiation of multiple contracts with a variety of contractors. For example, one case required the U.S. Government to provide diverse items, such as radar systems, trucks, generators, telephone switchboards, radio sets, and shelters. This particular case identified 98 distinct requirements. The foreign country pays the initial cost to negotiate these contracts through surcharges applied to the value of the articles or services ordered. A 1984 Joint DoD Study Group determined that 50 percent of the surcharges should be collected at case acceptance to recover the cost of establishing cases and that the amount is not refundable. Subsequent costs incurred for renegotiating contracts (because foreign countries modify or cancel their requirements) are recovered by assessing additional surcharges or cancellation penalties.

Conflicting Guidance. The Comptroller provides mandatory financial guidance in the Financial Manual. Heads of DoD Components may issue, with Comptroller approval, supplementary instructions to this guidance only when necessary to provide unique requirements within their respective commands. However, the Agency considered Financial Manual requirements for retaining surcharges based on estimated values and assessing cancellation fees on case reductions as unacceptable to customers and as damaging to the Program. As a result, the Agency issued conflicting financial guidance in its Security Manual. The differences between the two manuals are shown in Appendix B. The Center, when incorporating the Agency's guidance into its automated system, omitted a part of that guidance, resulting in yet another procedure for computing surcharges retained on closed or canceled cases. The Center charges the specified

surcharge, usually 3 percent, on deliveries without retaining earned surcharges or assessing penalties. A brief summary of each procedure follows.

Financial Manual. The U.S. Government assesses a surcharge based on the estimated value of articles and services ordered. This surcharge, assessed when a case is accepted, is usually 3 percent. If the articles and services value is reduced, the foreign country is entitled a partial refund. However, one-half of this surcharge is not refundable and shall be retained by the U.S. Government. In addition, the U.S. Government shall retain the higher of two values: 1.5 percent of delivered articles and services or .75 percent of the estimated value of articles and services before the order is reduced.

Security Manual. The surcharge to be retained is the greater of 3 percent of deliveries or 1 percent of implemented case value. A recent revision to the Security Manual negates this comparison by requiring the greater of 3 percent on delivered articles and services or 1.5 percent of case closure value. At case closure, delivered articles and services are equal to closure value; thus 3 percent will always be used. The Security Manual did not address the nonrefundable portion of the earned surcharge.

The Center. The surcharge retained in the Fund is 3 percent of the value of articles and services delivered when a case is closed. The Agency did not permit the Center to automatically collect cancellation penalties. Rather, the Agency retained authority to approve or disapprove collection on a case-by-case basis. Again, the nonrefundable portion of earned surcharges was ignored.

To show the impact of varying guidance and procedures on surcharge retention, we are providing as an illustration a hypothetical case implemented for $100,000, subsequently reduced by $70,000, with a current value of $30,000. At 3 percent, the original surcharge would have been $3,000; that is, $1,500 earned when the case was implemented and $1,500 prorated to deliveries over the life of the case. Details supporting these computations are provided in Appendix C. The following illustration shows that significant amounts of the surcharge that should be retained to offset costs (such as contract renegotiation) incurred by the U.S. Government would be returned to the foreign country.

	Financial Manual	Security Manual	Center Procedures
Original Surcharge	$ 3,000	$ 3,000	$3,000
Surcharge Collectable	2,250	1,000	900
Surcharge Refundable	750	2,000	2,100

The procedures provided in the Security Manual and those implemented by the Center do not collect sufficient surcharges to recover the cost of case implementation (the 50 percent incurred before a case is accepted). The only procedures that would recover the cost of implementing and executing the case were those provided in the Financial Manual.

Internal Controls. This Finding identified two internal control deficiencies. First, contrary to its mission provided in DoD Directive 5105.38, "Defense Security Assistance Agency (DSAA)," August 10, 1978, the Agency issued guidance pertaining to financial matters without obtaining the prior approval of the Comptroller. This Directive requires the Agency to conduct activities involving financial management, fiscal matters, accounting, budgeting, statistical reporting, and the international balance of payments in accordance with policies and procedures established by the Office of the Comptroller of the Department of Defense. If the Agency had concerns regarding this guidance, the Agency should have requested clarification of the Financial Manual from the Comptroller. Second, neither the Agency nor the Agency's Executive Agent, the Air Force, provided oversight to ensure that the Center complied with the Financial Manual. The Center is a distinct organization within the Air Force Accounting and Finance Center.

Administrative Surcharges. We analyzed the Center's automated records for cases having surcharge reductions recorded against ordered articles and services to assess the impact of conflicting guidance and procedures on the Fund. We limited our review to cases managed by the Army, Navy, and Air Force because they accounted for 99 percent of the Program's sales activity. We identified 14,714 cases with surcharge assessments reduced by $482 million. In the context of our review, these reduced assessments will be referred to as refunds although the assessed surcharge may or may not have been collected.

We stratified the universe and used statistical sampling procedures to arrive at the sample size necessary for detailed review and projection with a 90-percent confidence level. We concluded that 395 cases (290 with partial deliveries and 105 with no deliveries) would be sufficient for our sample. The cases were randomly selected and accounted for $238.1 million of the $482 million in refunds identified in the universe. This analysis compared actual refunds by case line item with refunds calculated in accordance with the Financial Manual. We did not compute excess refunds for Blanket Order Agreement cases or Blanket Order Agreement lines within cases, and we did not apply penalties to price adjustments.

Lost Revenues. The sample disclosed that $93 million of the $238.1 million refunded was excessive and should be recovered. We projected the sample results to the $482 million refunded in

the universe and concluded, with a 90-percent confidence level, that surcharges associated with partial cancellations ($166 million) and cases closed at zero deliveries ($3.6 million) totaling $169.6 million, plus or minus $58.4 million, were excessive refunds to customers. Extrapolation of statistical data for partial cancellations indicates that, unless current procedures are changed, an additional $60.2 million, plus or minus $15.3 million with a 90-percent confidence level, will be erroneously refunded to customers during FY 1989 through FY 1993. Details showing the audit universe, sample results, projections, and extrapolations are provided in Appendix D.

Our analysis determined that excessive refunds occurred because the earned surcharge was not retained and penalties were not assessed. For instance, we found case amendments where one line item was reduced to provide additional funding for existing lines or to fund new lines. The Center nets the added value of new case lines with the reduced value of existing case lines and does not retain the earned surcharge associated with reductions at the line item level. An example of the impact of this procedure on the Fund follows. This example is taken from a case in the sample and is the second change to that case.

Line Item	Center Procedures		Excess
	Change	Surcharge	Refund
Aircraft Modification Kits	($3,500,000)	($105,000)	$86,756
Ground Handling Equipment	3,500,000	105,000	0
Effect	$ 0	$ 0	$86,756

The excess refund was computed in accordance with the Financial Manual as follows:

Earned surcharge = $3,500,000 x 1.5 percent =	$52,500
Cancellation Penalty equals the greater of:	
(Value of case prior to current adjustment)	
$4,567,500 x .75 percent = $34,256, Or	
(Deliveries) $1,067,500 x 1.5 percent = 16,012	34,256
	$86,756

As shown, treating these modifications as entries, which net to zero, did not recoup costs incurred to renegotiate contracts to decrease the number of Aircraft Modification Kits and to increase the amount of Ground Handling Equipment. On the contrary, it resulted in significant losses that contributed to the Fund deficit.

Conclusion. Agency procedures ignore policy resulting from the 1984 Joint DoD Study Group, which concluded that 50 percent of the surcharge is earned at case acceptance and is not refundable. Further, Agency procedures used to compute refunds are not consistent with the DoD legal decision obtained on the audit of "Foreign Military Sales Administrative Budget and Costs-U.S. Air Force," Report No. 88-042, dated October 28, 1987. DoD counsel concluded that the Fund should not bear the cost of waived surcharges and required that operation and maintenance funds be used to reimburse the Fund when surcharges are waived. As a result, the Center now bills the implementing agencies for waived surcharge reimbursements on a quarterly basis. Yet, the Agency routinely refunds earned surcharges (in effect waiving them) with no possible means of reimbursing the Fund. Such refunds to customers contributed $169.6 million to the Fund's current deficit.

RECOMMENDATIONS FOR CORRECTIVE ACTION

1. We recommend that the Comptroller of the Department of Defense require automatic assessment of penalties on partial cancellations of ordered articles and services.

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

a. Revise DoD 5105.38-M, "Security Assistance Management Manual," to reference but not to repeat, interpret, or contradict financial guidance contained in DoD 7290.3-M, "Foreign Military Sales Financial Management Manual."

b. Require the automatic assessment of penalties when sales are canceled and include nonrefundable surcharges earned at case acceptance.

c. Direct the Air Force Accounting and Finance Center to collect excessive refunds of surcharges and penalties totaling $3.6 million on cases closed with zero deliveries given to customers for FY 1980 through FY 1988.

3. We recommend that the Commander, Air Force Accounting and Finance Center:

a. Require the Security Assistance Accounting Center to revise its financial systems for assessing administrative surcharges and cancellation fees to conform with DoD 7290.3-M, "Foreign Military Sales Financial Management Manual."

b. Provide oversight to ensure that the Security Assistance Accounting Center's financial systems for processing refunds are in compliance with DoD 7290.3-M, "Foreign Military Sales Financial Management Manual."

c. Initiate the collection process to recoup excess refunds of $3.6 million.

MANAGEMENT COMMENTS

Recommendation B.2.a. The Director nonconcurred with the Recommendation stating that a change to the DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," is needed. The Director's proposed change defines a canceled case as one that has been executed and is then canceled at the request of the purchaser or the U.S. Government:

- for a defined order, when items are on contract for delivery to the purchaser. Thus, price reductions resulting from overestimates, source of supply changes, lower actual cost, and revisions in time required for performance or shipment terms would be excluded;

- for Blanket Order Agreements, when no orders are placed against the case before the time frame for deliveries expires; and

- for service cases, when service is never used or costs less than anticipated.

Recommendation B.2.b. The Director nonconcurred with the Recommendation, acknowledging that there are costs associated with cancellations, including partial cancellations, but that the determination to recoup the costs as direct costs should not be automatic. Rather than take piecemeal action to solve the problem, the Director would, for foreign policy reasons, prefer to recover such costs through a uniform administrative rate as a cost "to do business". The Director acknowledged that there is a cash deficit in the Fund.

Recommendation B.2.b. Although this Recommendation was addressed to the Director, the Comptroller responded. The Comptroller agreed with the Director that identifying cancellations within various lines and requisitions within cases is not practicable. He proposes that cancellation charges should be made only when an entire case is canceled.

Recommendation B.2.c. The Director nonconcurred with the Recommendation disputing the audit's conclusion that excessive refunds were made. He stated that the Finding is based on a

concept of "partial cancellations" that are not addressed in DoD 7290.3-M, "Foreign Military Sales Financial Management Manual", and that "lost revenues" are calculated on unused case values. The Director's position is based on his review of 944 aircraft, tank, and missile line items ordered since FY 1980, valued at $28.9 billion. Thirty-two line items showed decreases in quantity, of which 13 had actual reductions in ordered quantity. These 13 lines totaled $113 million and represented a possible loss to the Fund of only $3.39 million.

Recommendation B.3.a. The Deputy Assistant Secretary of the Air Force, Accounting and Finance, partially concurred with the Recommendation stating that revisions will be undertaken when policy on partial cancellations is provided in the DoD 7290.3-M, "Foreign Military Sales Financial Management Manual."

Recommendation B.3.a. The Director nonconcurred with the Recommendation stating that changes to the Security Assistance Accounting Center financial systems are premature until policy is clarified and the DoD 7290.3-M, "Foreign Military Sales Financial Management Manual" is changed.

Recommendation B.3.b. The Deputy Assistant Secretary of the Air Force, Accounting and Finance, concurred with the Recommendation stating that compliance will be ensured once policy on partial cancellations is issued.

Recommendation B.3.b. The Director concurred in principle with the Recommendation stating that policy must first be clarified.

Recommendation B.3.c. The Deputy Assistant Secretary of the Air Force, Accounting and Finance, partially concurred with the Recommendation stating that collections will be made when policy on cancellation fees is provided. Also, the monetary benefits resulting from collections are subject to recalculation based on policy and may be offset by the cost of accomplishing retroactive recoupment.

Recommendation B.3.c. The Director nonconcurred with the Recommendation stating that the lost revenues cannot be substantiated.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Recommendation B.2.a. The Director's comment is nonresponsive to the Recommendation. The Recommendation requires the Defense Security Assistance Agency to recognize and yield to the authority of the Office of the Comptroller of the Department of Defense in matters of foreign military sales accounting policy and procedure. Language contained in the Financial Manual regarding cancellation policy is clear. Further, this policy was

coordinated with the Director, whose recommended changes were incorporated before issuance of the Financial Manual. If additional policy clarification is needed, procedures require the Director to seek guidance from the Office of the Comptroller of the Department of Defense and forbid the issuance of conflicting policy. Thus, the Recommendation is still valid.

Recommendation B.2.b. The Director partially concurred with the Recommendation stating that while he agrees cancellation fees must be directly recouped in certain circumstances, he disagrees that the determination should be automatic. The Comptroller revised his position regarding the assessment of penalties on partial cancellations. We agree with the Director and the Comptroller that there are conditions when cancellation penalties should not be assessed. However, we do not agree that cancellation charges should be made only when a complete case is canceled. We strongly believe that the 50 percent of the surcharge that is earned at case acceptance is not a penalty and that the surcharge should be retained in every instance. The 1984 study performed by a panel consisting of representatives from OSD; Inspector General, DoD; Defense Contract Audit Agency; and the Agency concluded that nonrefundable surcharges represent, in the aggregate, reimbursement of the cost incurred "to do business" prior to establishing cases.

As a result of that study, the Comptroller revised the Financial Manual to clearly provide that "Earned reimbursements for administrative surcharges are not refundable, i.e., the 50 percent that is earned when the case is accepted." The Comptroller further addressed partial cancellations as follows:

> ...unearned administrative surcharges may be charged in accordance with the following guidance:
>
> 1. For cases under $25 million that are canceled, SAAC [the Agency] shall retain a portion of the administrative surcharge that equals one-half of the applicable administrative percentage of the estimated articles/services ordered value, or the administrative rate times the actual articles/services delivered at closure, whichever is higher.
>
> 2. For cases over $25 million that are canceled, DSAA [the Agency] Comptroller shall determine the appropriate administrative charge; however, the charge shall normally be at least $250,000.

Although the word "partial" does not appear in the paragraph, it is implicit in the language used. Otherwise, there would be no need for distinguishing between ordered value and the actual articles/services delivered at case closure. Further, the acknowledged cash deficit belies the Fund's ability to support

the cost of doing business when revenues to recoup sunk costs are routinely refunded. In addition to the retention of nonrefundable surcharges, we believe that reductions to cases resulting from changes in scope or quantity should automatically incur cancellation penalties if a contract has been awarded to provide goods or services to the purchaser. Automatically assessing cancellation penalties will ensure that the generally accepted accounting principle of consistency is applied to preclude claims of discrimination against the U.S. Government, and force the review of waivers to provide an audit trail documenting the justification of the waiver and the amount waived. For these reasons, we have added Recommendation B.1., and we request that the Comptroller provide comments in response to the final report. We also request that the Director provide comments on the Recommendation in response to the final report.

Recommendation B.2.c. During the audit, we computed excessive refunds in accordance with cancellation procedures in the Financial Manual, the interpretation of which was supported at that time by the Office of the Comptroller of the Department of Defense and DoD's legal counsel. Cases included in determining excessive refunds were open; no unused case values were included. The Director provided the results of a study performed by his office on closed cases that showed the effect of partial cancellations and overestimates. In that study, 2,438 cases totaling $2.761 billion closed at less than 50 percent of their ordered values, or $507 million. These decreases represent a loss of anticipated revenues totaling $67.6 million and refunded earned surcharges totaling $33.8 million. These figures are based on the Director's study and have not been validated, but are representative of conditions disclosed by the audit. The Foreign Military Sales infrastructure maintained by the DoD Components and their respective budgets to support that infrastructure are based, in part, on work load and are influenced to a large degree by sales. As the Director pointed out, budgets are allocated at the beginning of the fiscal year based on anticipated revenues. When revenues fail to materialize, shortfalls occur. Refunding surcharges associated with partial cancellations and overestimates in case values of the magnitude evidenced by the Director's study and our analysis distorts the budget process and creates cash deficits. For the final report, we revised the recommendation to require collection of the $3.6 million worth of cancellation fees associated with cases that closed with zero deliveries, and we request that the Director and Comptroller reconsider their proposed policy change on partial cancellations and overestimates.

Recommendation B.3.a., B.3.b. and B.3.c. The Assistant Secretary's agreement to revise the Air Force financial systems, to provide oversight of the revision of those systems, and to initiate collection of inappropriate refunds satisfies the intent

of the Recommendation. The Assistant Secretary's request for further guidance from the Comptroller and the Agency before initiating corrective action is appropriate. However, he did not specify what actions will be taken to obtain guidance and did not provide time frames for accomplishing corrective actions. We ask that this information be provided in response to this final report.

C. Using Management Cases to Recover Costs to Prepare Price and Availability Analyses

FINDING

The Fund reimbursed DoD Components for costs of preparing Price and Availability Analyses (Analyses) that did not generate sales. This condition existed because the Financial Manual did not require the DoD Components to charge these costs directly to customers. These costs drained the Fund's limited resources by approximately $18 million annually, and unless procedures are changed, will cause a further projected loss of $91 million during FY 1990 through FY 1994.

DISCUSSION OF DETAILS

Background. Countries interested in purchasing defense articles can obtain cost data by requesting either Planning and Review data or Analyses data. Planning and Review data are rough estimates to be used by a customer for preliminary review and evaluation of the possible purchase of defense articles or services. In contrast, Analyses are detailed to a degree that information can be transferred to a Letter of Offer and Acceptance with no further modification.

Criteria. The Security Manual states that,

> In general, P&R [Planning and Review] data will be used in lieu of P&A [Price and Availability] data when the purchaser's requirement is for preliminary data rather than for an LOA [Letter of Offer and Acceptance, or case]. DoD Components will prepare P&A data only in exceptional circumstances when acceptable overriding rationale is provided by the purchaser.

Costs to Prepare Analyses. The justification required by the Security Manual does not guarantee that sales will result to recoup the costs of preparing Analyses. Although the majority of Analyses prepared result in sales of defense articles and services, the corresponding potential sales value is quite low. The following chart recaps the number of Analyses prepared and their relative values for FY's 1986 through 1988.

	Number	Percent	Potential Sales (in Billions)	Percent
Analyses Prepared	13,357	100.0	$ 40.5	100.0
Analyses Accepted	10,475	78.4	24.1	59.5
Analyses Rejected	2,882	21.6	$ 16.4	40.5

As shown, a large number of Analyses for complex, expensive articles are not accepted. Because these Analyses often involve major weapon systems, they require considerably more time and resources to prepare than the smaller dollar value Analyses that are ultimately accepted by countries.

In 1987, the DoD Joint Task Force to Streamline the Foreign Military Sales Process tasked the Navy to determine the cost to prepare Analyses. The Navy limited its review to European and African countries that submitted requests totaling $100 million or more to DoD Components. In computing the cost to prepare Analyses, the Navy considered only the cost of contractor services used to provide the data contained in Letters of Offer and Acceptance. The Navy's study determined that preparing the average analysis costs $10,182. The computations did not include Government military and civilian personnel costs, which the Navy determined to be 1.5 times that of a contractor staff year. Because the 1.5 factor was unverified and applies to Navy alone, we used the $10,182 as the average cost to prepare Analyses. We applied this cost to our review and factored in the case value rejection rate of .405; we calculated this rate in the preceding chart as the percent of potential sales for which Analyses had been rejected. Based on the Navy study, we calculated the cost to the Fund to be $18.3 million annually for Analyses rejected by customers. Our computations are as follows.

Average Cost to Prepare	$ 10,182
Analyses Prepared (FY's 1986 through 1988)	X 13,357
Total Cost to Prepare	136,000,974
Case Value Rejection Rate	X .405
Cost to Prepare Rejected Analyses	55,080,394
Divided by Number of Years Reviewed	3
Average Annual Cost	$ 18,360,131

The Fund absorbs these costs in the annual budgets given to DoD Components. We estimate, based on the above computations, that the Fund will incur charges exceeding $91 million over the next 5 years for Analyses rejected by customers.

Financial Manual. Management cases, though not used by the DoD Components, were proposed by the Comptroller for inclusion in Change II of the Financial Manual. A management case can function as either an individual case or a Blanket Order Agreement. The purpose of using management cases would be: to recoup the cost of preparing Analyses, to segregate those costs from other transactions, and to provide an audit trail to accommodate budgeting and accounting requirements.

The proposal was not included in Change II, and we were not able to ascertain why it was dismissed. We believe that opposition to the proposal centered on charging customers a new cost without providing an added benefit. This concern is legitimate. However, we also believe that customers who enter into sales agreements with the U.S. Government should not pay, through surcharges levied on their purchases, for Analyses provided to customers who decide not to buy. Therefore, we propose the establishment of a management case for each Analysis with a provision that, if the Analysis results in a sales agreement, the cost of the Analysis would be returned to the customer. This would be accomplished either as a direct refund or as a credit against surcharges levied on the sales agreement. Thus, customers who purchase through the Program would not be penalized by paying for Analyses provided to others.

Conclusion. Establishing management cases provides an equitable means of ensuring that the U.S. Government is reimbursed for costs of preparing Analyses. The impact to the customer is minimized by granting credits against surcharges levied when sales agreements are finalized. In addition, customer relations should improve by alleviating the concern about paying for services provided to other customers.

RECOMMENDATIONS FOR CORRECTIVE ACTION

1. We recommend that the Comptroller of the Department of Defense revise DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," to:

a. Provide for the establishment of management cases to recover the cost of preparing Price and Availability Analyses.

b. Allow credits against administrative surcharges for the cost of Price and Availability Analyses that result in sales to preclude the purchaser from incurring a new charge without receiving a new benefit.

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

a. Require the DoD Components to establish management cases with Foreign Military Sales customers to recover costs of preparing Price and Availability Analyses.

b. Provide the procedures for crediting the cost to prepare Price and Availability Analyses against surcharges when they result in implemented cases.

c. Adjust the Foreign Military Sales Administrative baseline budget to reflect the transfer of Price and Availability Analyses effort to management cases.

MANAGEMENT COMMENTS

Recommendation C.1.a. The Comptroller concurred with the intent of the Recommendation stating that revision to the DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," would have to be coordinated with the Defense Security Assistance Agency and the DoD Components.

Recommendation C.1.b. The Comptroller withheld comment on the Recommendation, stating that it was not clear why a credit would be applicable to the administrative surcharge on a case. Current procedures provide that case management costs are direct charges to cases (above the line charges) and do not flow through the administrative account.

Recommendations C.2.a., b., and c. The Director nonconcurred with the Recommendations stating that developing analyses is a cost of doing business and should be recouped from the administrative surcharge applied to sales. The Director further stated that management cases would be unacceptable because our Foreign Military Sales relationships with purchasing countries would be degraded and because not all implementing agencies have the "manpower/manhour systems to identify the charges."

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Recommendation C.1.a. The Comptroller's agreement to revise the Financial Manual will correct the condition. However, no milestones were provided to indicate when corrective actions will be taken. The Comptroller needs to establish time frames for coordinating with the DoD Components planned revision in his response to the final report.

Recommendation C.1.b. The Comptroller is confusing case management with management cases. Case management is an above the line charge currently included in established cases to recover the cost of the day-to-day management. A management case on the other hand, is intended to be a means of recovering the administrative cost of services provided where no established case exists. Credits against administrative surcharges for Price and Availability Analyses that result in sales will be made as any other transfers between cases are currently made. Where no sale occurs, monies collected against management cases will reimburse the Fund for costs incurred in preparing Price and Availability Analyses. For the final report, we clarified the recommendation by adding "... to preclude the purchaser from incurring a new charge without receiving a new benefit."

Recommendation C.2.a., b., and c. Given the insolvency of the Fund, we do not understand how the Director envisions it can absorb the "cost of doing business" that does not generate revenues. We are sensitive to the Director's concerns regarding management cases that provide additional charges without providing a new benefit. However, a major concern voiced to us during the audit was that customer countries have a perception of paying for services provided to "favored nations" or to other customers. These Recommendations will ensure consistent and equitable cost recovery, thereby improving customer relations. Further, the systems required to identify the "manpower/manhours" chargeable to management cases can be as basic as having employees maintain charge sheets, allocating their hours to each project worked during a given period, and providing this information to the billing department. If a more complex system is desired, each DoD Component has a system for tracking and allocating direct case management charges to individual cases that can be readily adapted for this purpose. For the reasons cited, the Recommendations are still valid.

D. Using Blanket Order Agreements

FINDING

The Program's cost to administer one-half of the foreign military sales cases accepted during FY's 1985 through 1988 exceeded revenues earned from surcharges. This condition occurred because the Agency did not require DoD Components to use centralized Blanket Order Agreements (Agreements) when processing cases less than $135,000. As a result, the Fund incurred avoidable personnel cost of $5.5 million annually to process and maintain unnecessary cases. We project that these costs will drain the Fund's resources approximately $27.5 million during FY 1990 through FY 1994.

DISCUSSION OF DETAILS

Background and Criteria. Agreements are a customer's estimated requirements for a category of materiel or service with no definite listing of items or quantities provided when the case is implemented. As such, they generally do not require costly Price and Availability data. Agreements facilitate and simplify procedures for purchasers, reduce lead time, and can be used to obtain a wide variety of articles and services including: spare and repair parts, publications, support equipment, minor modifications or alterations performed at U.S. installations, technical assistance services, training, training aid devices, and repair of reparable items. Agreements serve much the same purpose as Blanket Purchase Orders in use throughout the U.S. Government. Further, the Security Manual provides for the use of Agreements as an effective tool for meeting undefined customer requirements. However, it does not address using centralized Agreements to efficiently process low-dollar sales.

The Program's Cost. Preparing individual cases for low-dollar requirements is both time-consuming and expensive. In a recent study, the U.S. Army Security Affairs Command found that it takes the Army approximately 20 staff hours to prepare and process paperwork associated with the average case. Cognizant Agency personnel stated that they require an additional 52 staff hours to review and approve an Army case. The average hourly labor rate was $21.22 at the U.S. Army Security Affairs Command and $30.09 at the Agency. Thus, the cost to process the average Army case was approximately $2,000. The Naval Office of Technology Transfer and Security Assistance reported that it takes approximately 232 staff hours to prepare the average Navy case. Navy cases cost approximately $8,000 to process including the time required by the Agency. The Air Force had not conducted a study to determine the amount of time required to process its cases. We concluded from these studies and interviews with

cognizant DoD personnel that $2,000 was a more realistic cost to process paperwork associated with cases.

We applied the Agency's premise that 50 percent of the cost to execute a case is incurred prior to acceptance and that the remaining 50 percent is incurred in delivery. Therefore, if the $2,000 associated with processing paperwork is the preacceptance cost of a low-dollar case, then an additional $2,000 is required to deliver, reconcile, and close it. Thus, each case must generate $4,000 in surcharges to break even (point at which cost incurred equals revenue received from surcharges). Therefore, the minimum case value at which the break-even point can be attained is $135,000 ($4,000 divided by 3 percent equals $133,333, rounded to $135,000).

Avoidance Cost. Fifty-three percent of all cases (7,394 of 13,987) processed between FY's 1985 and 1988 were valued at, or less than $135,000. The following chart summarizes the results of our analysis.

	Cases Less Than $135,000		Cases More Than $135,000	
FY	Number	Sales (000)	Number	Sales (000)
1985	1,918	$ 63,778	1,621	$10,785,441
1986	1,973	66,700	1,748	6,352,714
1987	1,802	66,773	1,576	6,063,146
1988	1,701	67,854	1,648	9,481,038
Totals	7,394	$265,105	6,593	$32,682,339

The Fund incurred a loss of approximately $22 million because the majority of cases processed during this period could not generate sufficient income to offset the cost of executing them. We computed the loss as follows:

Cost to Process Cases to Closure	$ 4,000
Cases Less Than $135,000	X 7,394
Total Cost Incurred	29,576,000
Less Actual Surcharges Levied	7,628,000
Loss Incurred	$21,948,000

We estimate that for FY's 1990 through 1994 losses resulting from processing low-dollar cases will be $27.5 million ($5.5 million per year times 5 years equals $27.5 million).

Conclusion. Using centrally maintained Blanket Order Agreements for multiple sales less than $135,000 will significantly reduce the number of cases prepared by DoD Components. This reduction in the number of cases processed will benefit the Program and the customer. The Program benefits because less resources are required to manage, reconcile, and close cases; and the customer benefits because administrative lead time is reduced, and deliveries are accelerated. The overall effect will be a streamlined Program that efficiently uses limited funds and resources.

RECOMMENDATIONS FOR CORRECTIVE ACTION

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

a. Require that the DoD Components establish centrally maintained Blanket Order Agreements for use when processing cases less than $135,000.

b. Reduce the DoD Components' foreign military sales administrative budgets by $5.5 million annually to reflect the use of centrally maintained Blanket Order Agreements.

MANAGEMENT COMMENTS

Recommendation D.1.a. The Director concurred in part with the Recommendation stating that expanded use of Blanket Order Agreements will be encouraged. However, the Director stated that their use could not be mandated across the board, because purchasers may resist commingling their funds, combining sales from more than one in-country activity in a single case, and delaying the reconciliation process for case closure. The Director suggested the use of specific criteria such as publications, support equipment, and spare and repair parts as an alternative to a dollar threshold.

Recommendation D.1.b. The Director concurred in part with the Recommendation stating that some savings should be realized if the use of Agreements is expanded. However, the Director stated that increased reconciliation effort at case closure would offset savings in case development and that variables in addition to dollar value affect the work load and staff hours involved in case preparation.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Recommendation D.1.a. The expanded use of Agreements will correct this condition. We agree with the Director's comment in that we recognize that there are limitations to the use of Agreements. However, we do not agree that they should not be used for disparate orders, or in instances where purchasers resist because sales encompass more than one in-country activity or purchasers' funds are commingled. These concerns can be readily accommodated under Agreement procedures.

Recommendation D.1.b. The monetary benefits associated with this Recommendation represent the cost to prepare case documentation and staff it through the various channels for approval. Since these cases will no longer be written or approved, these costs will not be incurred. Further, reconciliation of Agreements should not pose a problem since the process is similar to that of Blanket Purchase Orders used throughout the DoD.

E. Funding Management Efforts

FINDING

The Agency used the Fund to reimburse DoD Components for management effort that was directly identifiable to specific cases and programs. This condition existed because the Comptroller did not define program and extraordinary case management effort in the Financial Manual in accordance with the principles contained in DoD 7220.9-M, "Department of Defense Accounting Manual," (the Accounting Manual) and because the Agency was inconsistent in approving direct charge requests for these efforts. Charging this effort as indirect costs contributed to the Fund's current deficit and will result in a further drain that we estimate will total $260 million during FY 1990 through FY 1994.

DISCUSSION OF DETAILS

Background. Management efforts include contract negotiation and modification, day-to-day management and oversight, problem solving, case review, and customer interface. Within the Program, management costs are recovered through one of two means: routine management effort is reimbursed from the Fund (as an indirect cost), and extraordinary management effort is charged to the case (as a direct cost). However, the Comptroller's overriding factor in determining whether management efforts are charged as a direct or indirect cost is the degree to which the DoD Component must commit resources to successfully deliver the articles or services. In an effort to ensure consistent application of cost methods, the Air Force developed, with Agency approval, a matrix specifying how management effort should be charged. The Navy is in the process of preparing a similar matrix for its management efforts.

Accounting Principles. The Arms Export Control Act provides for surcharges to "... recover costs not charged to cases." The Financial Manual provides for charging extraordinary management effort to cases as a direct cost, but requires charging routine management effort to the Fund as an indirect cost. However, the Financial Manual does not define extraordinary management. The Accounting Manual provides that costs that can be specifically identified to a single end item should be a direct charge to that end item. Costs not specifically identifiable to an end item are collected in a pool and prorated to the end items.

Management Efforts. An average of 23 percent of the Program's annual administrative budget, approximately $52 million in FY 1988, was devoted to management effort that can be directly identified to specific cases (end items). This percentage was not readily available because the DoD Components did not uniformly segregate and track management costs. Therefore, we

selected eight offices to represent management effort typical throughout the Program and determined the percentage of their administrative budgets devoted to management effort. We relied on staff listings, budget reports containing staff-year requirements, and interviews with Program managers to determine the cost of case specific management effort.

Army. We interviewed managers and obtained budget reports identifying management costs for the Army Security Assistance Command and Army Materiel Command. We determined that approximately 22.1 percent of the Army's foreign military sales budget was devoted to management effort.

Navy. We obtained staff listings identifying personnel devoted to specific cases, computed their costs from budget documents, and interviewed managers at the Naval Supply Systems Command, Navy International Logistics Command, Navy Office of Technology Transfer and Security Assistance Agency, Naval Air Systems Command, and Naval Sea Systems Command. We found that approximately 22.8 percent of the Navy's foreign military sales budget was consumed in management effort.

Air Force. The Air Force did not provide reports identifying management effort or cost. Consequently, we relied on interviews with managers of five divisions of the Air Force Systems Command's Policy and Resources International Management Office. We found that the Air Force devotes approximately 25 percent of its foreign military sales budget to management efforts.

We interviewed Program managers within DoD Components to solicit their concerns and opinions regarding the feasibility of charging management efforts to cases rather than to the Fund. The majority of the DoD managers we interviewed wanted to charge management costs directly to the case. However, the Agency's decision process frequently precluded this. We learned that the Agency's decisions on approving case management costs as direct charges were politically influenced and often were not timely or consistent with approved procedures. To illustrate, the Peace Shield Program Office was established for the sole support of the Peace Shield Program. The Agency allowed the Air Force to charge less than one-half of the Peace Shield Program's staff as a direct cost. The Fund absorbed the remaining costs. Further, the Agency was not timely in approving case management costs as direct charges, which resulted in delay and improper charges to the Fund. For example, the Agency ignored the Air Force's approved matrix when it reviewed Air Force requests for direct funding and arbitrarily decided the type and level of direct effort permissible on a case-by-case basis. The Agency has delayed approval by as much as 7 months while the funding source was negotiated. Thus, management costs that should have been

direct charges were charged to the Fund. Since these costs are not tracked, the Air Force cannot reimburse the Fund when approval is finally obtained.

Agency Concerns. The Agency identified three concerns with approving case management cost as a direct charge. First, the Agency indicated that the sophisticated tracking system necessary to accommodate direct cost distribution for management effort did not exist and would not be cost-effective to provide. However, the Navy had a tracking system in use before 1987. That system could readily and economically be exported to the other DoD Components. Second, the Agency raised the issue of controlling direct funding to protect the purchaser from exorbitant charges. Since direct funding is not a new concept, basic management and oversight controls should already be in place. Further, the Agency already approves charging some management costs directly to cases. Thus, the proposed change should require only expanding those controls to include all management costs as opposed to a portion of them. Finally, the Agency believed that customers would perceive the change as a new charge for which they receive no new benefit, in that the surcharge rate could not be reduced concurrently. The Agency feels this perception would damage customer relations. However, imposing new charges without providing added benefits is not new to the Program. For example, the logistics support surcharge did not increase customer benefits. The Fund previously paid the costs recovered by the logistics support surcharge. But the Fund was becoming insolvent and was unable to continue paying costs without a rate increase. Rather than raise the rate, the Agency opted to establish the logistics support surcharge. The Fund is again becoming insolvent because it is paying management costs that should be charged directly to cases.

Conclusion. The Fund is deficient and cannot continue to reimburse avoidable costs. Charging management costs to cases is consistent with direct cost reimbursement procedures provided in the Accounting Manual and will prevent a further avoidable drain on the Fund of $260 million during FY 1990 through FY 1994.

RECOMMENDATIONS FOR CORRECTIVE ACTIONS

1. We recommend that the Comptroller of the Department of Defense, revise DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," to:

a. Require DoD Components to recover case management costs that can be identified to a specific case as a direct cost in accordance with DoD 7220.9-M, "Department of Defense Accounting Manual."

b. Prohibit the use of administrative surcharges to recoup case management expenses that can be identified to a specific case.

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

a. Require case management lines on all Foreign Military Sales cases.

b. Require the DoD Components to cite case management lines for all case management efforts that can be identified to specific cases.

c. Reduce DoD Components' administrative budgets to reflect the transfer of management costs to direct cost recovery procedures.

MANAGEMENT COMMENTS

Recommendations E.1.a. and E.1.b. The Comptroller nonconcurred with the Recommendations stating that there is a misunderstanding of the requirements in the Accounting Manual. The Comptroller further stated that the Recommendation was inconsistent with recommendations in our audit report, "Audit of Direct Case Management Charges Billed to Foreign Military Sales" Report No. 87-018, dated October 21, 1986. The Comptroller stated that there should be a consistent classification and costing by the type of effort performed and not by the concentration of effort performed.

Recommendations E.2.a., b., and c. The Director nonconcurred with the Recommendations stating that the principle in the Accounting Manual which specifies that costs identifiable directly to a single end item should be a direct charge to that end item does not apply to foreign military sales. The Director further stated that the Accounting Manual cites the Financial Manual as an alternative on reimbursement policies. The Financial Manual authorizes recoupment of costs from the Fund for sales negotiations, case implementation, program control, computer programming, accounting and budgeting, and case management performed at routine levels. The Director believes this policy should continue because; no accounting system exists to track and charge all case management costs, similar effort to charge foreign military sales procurement management costs directly to cases was unsuccessful because a system to identify the costs was not available, and customers would perceive these new charges as a means of increasing the administrative fee if there was not a corresponding benefit to decrease the administrative fee. Finally, the Director did not agree with the estimated cost avoidance of $260 million because there would be

some offset costs associated with developing an accounting system to track the management costs, and the estimated cost avoidance is predicated on a constant level of sales that could drop if customers reacted adversely to the policy of charging case management as direct costs.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Recommendations E.1.a and b. The Recommendations do not suggest that management costs charged directly to cases be based on a concentration of effort. Also, the Recommendations do not preclude the consistent classification of charges by the type of effort performed. The management efforts comprising the monetary benefits envisioned from implementation of these Recommendations are the type consistently provided on all cases by the highest levels of the DoD Components, i.e., negotiating sales, oversight, and case reviews. Further, there are no inconsistencies between these Recommendations and recommendations in our report "Audit of Direct Case Management Charges Billed to Foreign Military Sales." That report addressed the inconsistencies between how each DoD Component recouped management costs and the need for guidance to ensure consistent recovery. This report concludes that the cost recovery method currently used is neither in the best interest of the Fund nor consistently applied. For these reasons, the Recommendations are still valid.

Recommendations E.2.a., b., and c. We do not contend that the cost recovery method cited in the Accounting Manual is mandatory. Rather, the method is cited as an acceptable and reasonable solution to the deficit in lieu of an undesirable increase in the administrative surcharge rate. Our response cannot address the success or failure of an accounting system to identify and track procurement costs because that accounting system was not included in our audit. However, an adequate system to track and charge management costs as direct costs to cases did exist within the foreign military sales arena and is evidenced in the Finding. Management's response does not contest this. Also the insolvent condition of the Fund and our analysis of the histories cost to deliver articles and services indicates that customers have not been charged the full cost of operating the Program. Increases in the cost to administer the Program have not been reflected in increases to surcharges, but have been paid from advance deposits. Lastly, we understand the Director's concerns regarding the possible loss of sales, but we strongly believe that customers will recognize this increase as being commensurate with the cost of doing business and respond accordingly. Should this policy result in a loss of sales, the estimated cost avoidances will decrease by corresponding amounts. However, the estimated cost avoidance is based on a sustained low sales period, and indications are that sales are increasing significantly. Thus, we are not adjusting the estimated monetary benefits.

ANALYSIS OF ADMINISTRATIVE SURCHARGES REQUIRED TO DELIVER OPEN CASES as of December 31, 1988

Assume Work-in-Process Will Require Future Administrative Expenditure

Ordered A/S 1/ 2/	$140,341,300,031	
Less Delivered A/S	- 88,001,828,715	
Undelivered A/S	$ 52,339,471,316	
Times 3/	1.85	percent
Cost to Deliver A/S	$ 968,280,219	
Less Available Administrative Surcharge/LSC 4/	- 497,193,786	
Deficit 5/	$ 471,086,433	

Assume Work-in-Process Was Already An Administrative Expense

Ordered A/S	$140,341,300,031	
Less Reported Expenditures 6/	-103,009,842,879	
Undelivered A/S	$ 37,331,457,152	
Times 3/	x 1.85	percent
Cost to Deliver	$ 690,631,957	
Less Available Administrative Surcharge/LSC 4/	- 497,193,786	
Deficit	$ 193,438,171	

1/ A/S Articles and Services.

2/ Adjusted to reflect Security Assistance Accounting Center allowance for doubtful accounts resulting from price adjustments and cancellations.

3/ Historical data shows 3.7 percent of deliveries that was spent in administering the Foreign Military Sales Program. One-half of this percentage (1.85 percent) recovers costs incurred for delivering the articles and services.

4/ Adjusted to reflect Security Assistance Accounting Center allowance for doubtful accounts resulting from price adjustments and cancellations - includes potential income from all sources.

5/ Presumes that 100 percent of postimplementation costs associated with undelivered articles and services is yet to be incurred.

6/ Deliveries plus progress payments for work-in-process.

COMPARISON OF SURCHARGE AND CANCELLATION PENALTY PROCEDURES

Requirement	Financial Manual 1/	Security Manual 2/
Earned Surcharge Not Refundable	1.5 percent	0
Unearned Surcharge Fee or Cancellation Penalty		
Partial Deliveries:		
- Case Value Under $25 Million	.75 percent of Implemented Case Value or 1.5 percent of Closure Value	1 percent of Implemented Value or 3 percent of Closure Value
- Case Value Over $25 Million	Agency Determines; Must Be At Least $250,000	1 percent Implemented Value or 3 percent of Closure Value
Closed At Zero Deliveries	.75 percent of Implemented Case Value	0 3/

1/ DoD 7290.3-M, "Foreign Military Sales Financial Management Manual."

2/ DoD 5105.38-M, "Security Assistance Management Manual."

3/ Defense Security Assistance Agency automatically waives the normal cancellation fee of 1 percent of the implemented value.

COMPARISON OF METHODOLOGIES FOR CALCULATING REFUNDS

Hypothetical case where: original case value is $100,000, surcharge is 3 percent or $3,000, case is reduced by $70,000, and deliveries are $30,000.

	Effect of Each Criterion or Procedure		
Description	Financial Manual	Security Manual	Center Procedures
Original Surcharge	$ 3,000	$ 3,000	$ 3,000
Less Cancellation Fee and Surcharge	2,250 1/	1,000 2/	900 3/
Refundable Surcharge	$ 750	$ 2,000	$ 2,100
Less Proper Refund		750	750
Excess Refund		$ 1,250	$ 1,350

1/ DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," provides:

$100,000 x .03 x .5 = $1,500, plus the higher of
$30,000 x .015 = $450, or
$100,000 x .0075 = $750, that is $2,250

2/ DoD 5105.38-M, "Security Assistance Management Manual," provides:

The greater of:
$30,000 x .03 = $900 or
$100,000 x .01 = $1,000, that is $1,000

3/ Security Assistance Accounting Center:

No earned surcharge
No cancellation fee
$30,000 x .03 = $900

AUDIT UNIVERSE, SAMPLING METHODOLOGY, AND PROJECTIONS

Audit Results

	Universe		Summary of Stratified Sample		Sample Results	Projected	Precision with 90-percent
	Cases	Refunds	Cases	Refunds	Excess Refunds	Excess Refunds	Confidence
Partial Deliveries							
Cases: 02/85 - 09/88	2,695	$ 46,776,377	172	$ 15,644,461	$ 5,493,921	$ 15,750,119	+/- $8,457,866
Cases: 10/80 - 01/85	11,355	426,273,949	118	216,261,042	84,878,486	150,256,323	+/- $49,657,313
Subtotals	14,050	$473,050,326	290	231,905,503	90,372,407	$166,006,442	$58,115,179
Zero Deliveries	664	$ 9,379,382	105	6,219,397	2,676,751	3,588,372	+/- $318,665
Totals	14,714	$482,429,708	395	$238,124,900	$93,049,158	$169,594,814	+/- $58,433,844

Extrapolation of Results to Future Years 1/

	Average Annual Refund	Experience Factor	Extrapolated Excess Refund	
Army	$7,604,429	.5388	$ 4,097,266	
Navy	9,351,178	.5683	$ 5,314,274	
Air Force	7,489,263	.3497	$ 2,618,995	
Annual Excess Refund			$12,030,536 2/	+/- $ 3,061,715
Multiplied by 5-year Period:			5	5
Estimated Excess Refund (FY 1989 - FY 1993):			$60,152,680	$15,308,575

1/ This extrapolation is based on average annual refunds during FY 1982 - FY 1988. We applied an experience factor, i.e., the percentage of sampled refunds that were excessive, to this average refund.

2/ Column total does not add because of rounding.

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Comptroller of the Department of Defense, Washington, DC

Other Defense Activities

Defense Security Assistance Agency, Washington, DC

Department of the Army

U.S. Army Materiel Command, Alexandria, VA
U.S. Army Security Affairs Command, Alexandria, VA
U.S. Army Security Affairs Command, New Cumberland Army Depot, PA

Department of the Navy

Comptroller of the Navy, Washington, DC
Naval Office of Technology Transfer and Security Assistance, Washington, DC
Naval Air Systems Command, Washington, DC
Naval Sea Systems Command, Washington, DC
Naval Supply Systems Command, Washington, DC
Space and Naval Warfare Systems Command, Washington, DC
Navy International Logistics Control Office, Philadelphia, PA
Aviation Supply Office, Philadelphia, PA
Navy Ships Parts Control Center, Mechanicsburg, PA

Department of the Air Force

Headquarters, U.S. Air Force, Washington, DC
Headquarters, Air Force Systems Command, Andrews Air Force Base, MD
U.S. Air Force Accounting and Finance Center, Denver, CO
Air Force Logistics Command, Wright-Patterson Air Force Base, OH
2750th Air Force Wing, Wright-Patterson Air Force Base, OH
International Logistics Center, Wright-Patterson Air Force Base, OH
Sacramento Air Logistics Center, McClellan Air Force Base, CA
Security Assistance Accounting Center, Denver, CO

SUMMARY OF POTENTIAL MONETARY AND OTHER BENEFITS RESULTING FROM AUDIT

Recommendation Reference	Description of Benefit	Fiscal Year	Benefit Type	Benefit Amount (Millions)
A.1.a.	Internal Control -- Limit expenditures to earned revenues.		Nonmonetary	
A.1.b. and A.2.b.	Internal Control -- Require that administrative surcharges are adequate to fund open cases.		Nonmonetary	
A.2.a.	Internal Control -- Establish controls to ensure annual budgets do not exceed earned revenues.		Nonmonetary	
B.1.	Internal Control -- Require automatic assessment of penalties on all reductions resulting from change in scope or quantity of ordered articles and services.		Nonmonetary	
B.2.a.	Internal Control and Compliance with Regulations -- Revise DoD 5105.38-M to comply with the DoD 7290.3-M.		Nonmonetary	
B.2.b.	Internal Control and Compliance with Regulations -- Require the automatic assessment of penalties when cancellations occur on cases to include nonrefundable surcharges earned at case acceptance.	1989-1993 1/	Cost Avoidance	$60.2
B.2.c.	Internal Control and Compliance with Regulations -- Collection of excess refunds to foreign customers.	1980-1988	Collections	3.6
B.3.a.	Internal Control and Compliance with Regulations -- Revise financial systems for assessment of administrative surcharges and cancellation fees to conform with the DoD 7290.3-M.		Nonmonetary	

See footnotes at end of table.

SUMMARY OF POTENTIAL MONETARY AND OTHER BENEFITS RESULTING FROM AUDIT (Continued)

Recommendation Reference	Description of Benefit	Fiscal Year	Benefit Type	Benefit Amount (Millions)
B.3.b.	Internal Control and Compliance with Regulations -- Provide oversight to ensure that the Security Assistance Accounting Center's financial systems for processing refunds is in compliance with the DoD 7290.3-M.		Nonmonetary	
B.3.c.	Internal Control and Compliance with Regulations -- Initiate collection process to recoup excess funds.	1980-1988	Collections (see B.2.c.)	
C.1.a. and C.2.a.	Economy and Efficiency -- Establish management cases to recoup the cost of preparing Price and Availability Analyses.	1990-1994	Cost Avoidance (see C.2.c.)	
C.1.b. and C.2.b.	Economy and Efficiency -- Issue guidance allowing credits against administrative surcharges for cost of Price and Availability Analyses that result in implemented cases.		Nonmonetary	
C.2.c.	Economy and Efficiency -- Adjust administrative budgets to reflect the transfer of funding responsibility for Price and Availability Analyses to management cases.	1990-1994	Cost Avoidance	91.0
D.1.a.	Economy and Efficiency -- Streamline processing of cases by establishing Blanket Order Agreements for low-dollar cases. This change promotes efficient use of limited resources.	1990-1994	Cost Avoidance (see D.1.b.)	
D.1.b.	Economy and Efficiency -- Adjust budgets to reflect the use of centrally maintained Blanket Order Agreements.	1990-1994	Cost Avoidance	27.5

See footnotes at end of table.

SUMMARY OF POTENTIAL MONETARY AND OTHER BENEFITS RESULTING FROM AUDIT (Continued)

Recommendation Reference	Description of Benefit	Fiscal Year	Benefit Type	Benefit Amount
E.1.a. and E.2.b.	Economy and Efficiency -- Require DoD Components to recover case management costs that can be identified to a specific case as a direct cost to that case.	1990-1994	Cost Avoidance (see E.2.c.)	
E.1.b.	Economy and Efficiency -- Prohibit use of administrative surcharges to recoup case management expenses identifiable to a specific cases.		Nonmonetary	
E.2.a.	Economy and Efficiency -- Require a case management line on all cases.	1990-1994	Cost Avoidance (see E.2.c.)	
E.2.c.	Economy and Efficiency -- Adjust DoD Components' administrative budgets to reflect the direct charge of management costs to a case management line.	1990-1994	Cost Avoidance	260.0
Total Cash Collections ($3.6 million) and Cost Avoidances ($438.7 million) 2/				$442.3

1/ Audit work for Finding B covered the period FY 1980 to FY 1988, and we identified collections for this period in Recommendation B.1.c. Accordingly, Recommendation B.1.b. recognizes that cost avoidances for this Finding will begin in FY 1989. Cost-avoidance recommendations for Findings C, D, and E apply only to future fiscal years.

2/ Monetary benefits are all one-time benefits and have been identified to the Trust Fund Revolving Account, 97-11X8242, "Advances, Foreign Military Sales, Executive." This account is funded by foreign customers and not by funds appropriated by Congress. Therefore, appropriated funds will not receive these monetary benefits.

OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

NOV 21 1989

(Management Systems)

MEMORANDUM FOR DIRECTOR, FINANCIAL MANAGEMENT, INSPECTOR GENERAL, DOD

SUBJECT: Draft Report on the Audit of the Foreign Military Sales Administrative Fund (Project 8FB-0056)

An August 5, 1989, memorandum requested the DoD Comptroller's comments and/or concurrence on the subject draft report. The report contained six recommendations for the DoD Comptroller. The recommendations concerned revising the Foreign Military Sales Financial Management Manual, DoD 7290.3-M.

Enclosed are the initial comments to the draft audit report. The comments include: (a) suggested alternatives to several of the recommendations, (b) concurrence with intent with two recommendations, and (c) technical corrections to related findings in the report.

With respect to Finding B in the draft audit report, I have agreed after further discussions with DSAA that identifying cancellations within various lines and requisitions within cases is not practicable. Therefore, cancellation charges should be made only when a complete case is cancelled. I believe that the best remedy to the deficit in the administrative expenses cost clearing account is to increase the surcharge rate rather than make miscellaneous peripheral charges.

Alvin Tucker
Deputy Comptroller
(Management Systems)

Enclosure

DOD COMPTROLLER COMMENTS
ON
DRAFT REPORT ON THE AUDIT OF THE FOREIGN MILITARY SALES
ADMINISTRATIVE FUND SALES CASES

Final Report
Page No.

A. COMMENTS ON RECOMMENDATIONS TO THE DOD COMPTROLLER

1. Recommendation A.1.

"We recommend that the Comptroller of the DoD provide internal controls by revising DoD 7290.3-M, 'Foreign Military Sales Financial Management Manual,' to:

"a. Require that the Defense Security Assistance Agency limit the annual administrative expenditure authority to surcharges earned on performance."

COMMENT: A recommended alternative approach is that administrative allotments should not exceed the total of ordered administrative values.

"b. Require that available administrative surcharges are adequate to fund anticipated administrative costs."

COMMENT: Concur with intent. Coordination is required with the DoD Components, including the Defense Security Assistance Agency.

2. Recommendation C.1.

"We recommend that the Comptroller of the DoD revise DoD 7290.3-M, 'Foreign Military Sales Financial Management,' to:

"a. Provide for the establishment of management cases to recover the cost of preparing Price and Availability Analyses."

COMMENT: Concur with intent. Coordination is required with the DoD Components, including the Defense Security Assistance Agency.

"b. Allow credits against administrative surcharges for the cost of Price and Availability Analyses that result in sales."

COMMENT: Comment withheld at this time because the recommendation is not clear. Current procedures provide that costs incurred on management cases are direct charges to cases (i.e., above the line charge); applicable costs do not flow through the administrative account. Thus, it is unclear why a credit would be applicable to the administrative surcharges on a case.

3. Recommendation E.1.

"We recommend that the Comptroller of the DoD, revise DoD 7290.3-M, 'Foreign Military Sales Financial Management,' to:

"a. Require DoD Components to recover case and program management costs that can be identified to a specific case or program as a direct cost in accordance with DoD 7220.9-M, 'Department of Defense Accounting Manual.'"

COMMENT: There is a misunderstanding of the requirements in the DoD Accounting Manual. The recommendation should be revised to be consistent with DoDIG audit report on the Audit of Direct Case Management Charges Billed to Foreign Military Sales (Report NO. 87-018) of October 21, 1986. There should be a consistent classification and costing by the type of effort performed. The fact that some countries with large programs have a concentration of effort is not a basis for charging effort that is an administrative charge for smaller countries.

"b. Prohibit the use of administrative surcharges to recoup case and program management expenses that can be identified to a specific case or program."

COMMENT: Revise to be consistent with the comments identified above for recommendation E.1.a.

B. TECHNICAL CORRECTIONS TO THE REPORT

1. The term "administrative fund" should be identified as a cost clearing account. The term is used in the DoDIG Memorandum and throughout the report.

COMMENT: There is only one fund. This fund is Advances Foreign Military Sales, Executive, commonly referred to as the FMS trust fund. The report consistently calls a cost clearing account a Fund. This cost clearing account is general ledger account 5010, Administrative Expenses. DoD 7220.9-M defines a cost clearing account as an account used when standard rates are employed. The actual expenses are debited to the cost clearing account and the amounts billed to customers are credited to the account. At the end of the fiscal year, the account should be closed to equity with analysis performed to determine if rates require adjustment. The cost clearing account does not have a cash balance.

2. DoDIG Memorandum, First page, second paragraph, second sentence, "Internal control weaknesses allowed management to issue expenditure authority above earned revenue...."

COMMENT: Section 22 of the Arms Export Control Act authorizes dependable undertakings in which countries are "to make funds available in such amounts and at such times as may be required to meet the payments required by the contract...in

advance of the time such payments...are due...." Expenditure authority is issued by the SAAC to the Military Departments prior to disbursement of funds. The limitation of the amount of expenditure authority that can be issued is constrained by the available cash balance in the FMS trust fund and not earned revenues. Disbursement for administrative expense budgets follows the same concept in that obligational authority may be created with the cash necessary to liquidate obligations obtained through subsequent collections from FMS customers.

3. DoDIG Memorandum, Page ii, first paragraph, line five, "...and the Fund was absorbing case management costs directly identifiable, and therefore chargeable to specific cases." i

COMMENT: This finding conflicts with DoDIG Report on the Audit of Direct Case Management Charges Billed to Foreign Military Sales (Report No. 87-018 of October 21, 1986). The objectives of that report were to determine if case management charges were consistently priced and accurately billed. Change 1 to DoD 7290.3-M, Section 719, was issued to provide guidance for consistent charges to FMS case and program management lines. In order to be consistent in pricing, case management charges should be based on type of effort as outlined in Section 719 of DoD 7190.3-M.

4. DoDIG Memorandum, page ii, second paragraph, line four, "As a result, the Program was operating at a loss of between $193 million and $471 million as of December 31, 1988." i, ii

COMMENT: The exact amount of loss should be specified. Such amounts are identified in Standard Form 220, "Statement of Financial Conditions." The trust fund financial statements show a loss of $170.9M on December 31, 1988 (the equity amount). If the fund was operating on a break-even basis, equity would be zero.

5. DoDIG Memorandum, page iv, second paragraph, line three, "Controls were not established or effective to: limit expenditure authority to earned revenues,...." iii

COMMENT: As mentioned in paragraph 2 above, expenditure authority is authorized by the Arms Export Control Act. When the Administrative expense budget is issued to the Military Departments, both obligational authority and expenditure authority are issued. The expenditure authority is issued in the amount of the approved administrative expense budget. It would be unproductive to require the Military Departments to request expenditure authority for each administrative expense disbursement due to the number of transactions involved.

6. Draft Report, page 1, second paragraph, line nine, "These surcharges are deposited in the Foreign Military Sales Trust Fund (The Trust) with the United States Treasury and transferred to the Administrative Fund (the Fund) as they are earned." 1

COMMENT: This statement needs clarification because there is a misconception. Payments by foreign countries are deposited into the Foreign Military Sales Trust Fund with the U.S. Treasury. These payments (initially identified in the payment schedule and based on need for obligational authority) include funds for execution against case line items and for estimated administrative surcharges. These payments remain with the U.S. Treasury and are not further transferred. Instead, entries are made to a general ledger cost clearing account that is debited based on actual expenses incurred and credited with amounts earned.

7. Draft Report, page 4, second paragraph, line three, "Internal controls were not established or effective to: limit expenditure authority to earned revenues,...." 2

COMMENT: Expenditure authority is authorized by the Arms Export Control Act and is limited to available cash balances in the FMS trust fund. An earned revenue occurs when performance takes place. It would be inappropriate to limit expenditure authority to this amount when the Arms Export Control Act requires that customers provide the cash necessary to liquidate obligations.

8. Draft Report, page 4, last paragraph, Prior Audit Coverage. 3

COMMENT: There is an additional report which has a major bearing on reported conditions that has not been identified in the report. That report is "Report on the Audit of Direct Case Management Charges Billed to Foreign Military Sales (Report No. 87-018) of October 21, 1986." The objectives of this report were to determine if case management charges were consistently priced and accurately billed.

9. Draft Report, page 7, first paragraph, line five, "As a result, the Foreign Military Sales Administrative Fund (the Fund), which should operate at or near a zero balance, closed FY 1988 with a negative cash balance between $389 million and $743 million." 5

COMMENT: There is some confusion between the FMS trust fund and a cost clearing account. The cost clearing account, 5010 Administrative Expenses, is one of many general ledger accounts used to account for and control FMS trust fund financial operations. Also, there is not a negative cash balance in the FMS trust fund. However, there were unfavorable variances in one of the six cost clearing accounts as of December 31, 1988. The cost clearing account with an unfavorable variance at that time was account 5010 Administrative Expenses. Both favorable and unfavorable variances need to be analyzed for possible management action.

10. Draft Report, page 8, first paragraph, first line "According to the DoD 7290.3-M,...administrative surcharges are earned as administrative costs are incurred.' 5

COMMENT: Paragraph 70504 of DoD 7290.3-M, provides that 50% of the administrative surcharge is earned when the case is accepted. Paragraph 80304.E., requires that the administrative surcharge be applied by SAAC based on delivery source codes indicating performance against the case. The delivery source codes are reported by the Military Departments to SAAC on DD COMP(M) 1517, FMS Detail Billing Report. Thus, surcharges are not earned as actual costs are incurred but rather as a surcharge is applied to performance.

11. Draft Report, page 9, first paragraph, line nine, "According to the Financial Manual, expenditure authority is created when three conditions are met: (1) contracts (or contract amendments) are accepted; (2) requests for obligation authority, consistent with contracts, are received; and (3) the country has deposited the specified advances in the Trust." 6

COMMENT: Paragraph 20004.B. of DoD 7290.3-M cites these three conditions as prerequisites for FMS trust fund budgetary authority, not expenditure authority.

12. Draft Report, page 10, first paragraph, line 14, "On the other hand, indirect administrative expenditure authority, used to recover the cost of administering the Program, is equal to 100 percent of the administrative and logistics support surcharges levied on cases, regardless of cash deposits or when the surcharge will be earned. As a result, the Agency meets current cash requirements by using customer funds deposited to cover obligations." 6,7

COMMENT: It would not be cost effective to require Military Departments to request expenditure authority for each administrative expense disbursement. Therefore, the expenditure authority issued is equal to the approved Administrative expense budget and has no direct relation to the estimated surcharges at case inception.

13. Draft Report, Page 11, first paragraph, line 9, "As a result, the Fund had a negative cash balance of between $389 million (expenditure authority reported as expensed by the DoD Components) and $743 million (the amount by which expenditure authority exceeded collections)." 7

COMMENT: The balance of the cost clearing account is a definitive figure and should be specified. A more appropriate statement would be that as of December 31, 1988, an analysis of the administrative cost clearing account shows a cumulative unfavorable variance of $537.8M.

DEPARTMENT OF THE AIR FORCE
WASHINGTON DC 20330-1000

OFFICE OF THE ASSISTANT SECRETARY
(Financial Management)

OCT 0 4 1999

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

SUBJECT: Management Comments, DODIG Draft Report of Audit, of the Foreign Military Sales Administrative Fund (Project 8FB-0056)

This is in reply to your memorandum for Comptroller of the Air Force requesting comments on the findings and recommendations made in subject report. Air Force comments are contained in attachment 1. Point of contact is John Williams, SAF/FMABD, ext. 76410.

GARY W. AMLIN
Deputy Assistant Secretary
(Accounting and Finance)

1 Attachment
Comments

DOD(IG) DRAFT REPORT ON THE AUDIT OF FOREIGN MILITARY SALES ADMINISTRATIVE FUND SALES CASES PROJECT No. 8FB-0056

RECOMMENDATIONS AND MANAGEMENT COMMENTS

SECTION A: LIMITING ADMINISTRATIVE EXPENDITURE AUTHORITY

1. We recommend that the Comptroller of the Department of Defense provide internal controls by revising DoD 7290.3-M "Foreign Military Sales Financial Management," to:

a. Require that the Defense Security Assistance Agency limit the annual administrative expenditure authority to surcharges earned on performance.

Management Comment. Partially concur. The Air Force agrees with the concept of aligning the expenses of executing the FMS program with revenues where revenues are defined to include all applicable sources of funds. According to paragraph 30301 of DoD 7290.3-M, actual administrative expense is controlled by allotment and expenditure authority is requested in thirty day increments. Limiting expenditure authority to earnings on performance will be difficult since earnings occur after the expense that generated the earnings.

There is also a strong indication that the administrative surcharge rate is too low. The rate since October 1, 1977 has been 3 percent and prior to that was 2 percent. As of August 18, 1989 the total direct cost (aggregate value of line 21 of all LOAs) recorded in the Defense Integrated Financial System (DIFS) for all implemented cases on that date was $152.4 billion. On that same date the DIFS reflects a total of $3.7 billion administrative costs recorded on the LOAs for those same cases. If the current rate of three percent were applied to the direct cost the amount of administrative cost recorded should have been over $4.5 billion, a difference of $800 million. Thus, the "effective rate" of the administrative surcharge is considerably less than three percent. The difference can be attributed to a combination of waived costs, the two percent rate prior to October 1977, and the fact that the Army Corps of Engineers typically records the administrative cost as direct ("above line 21 on the LOA").

By 1982 the Administrative fund was reported to be in a deficit position by the DoD Comptroller. It was during this period that a decision was made to transfer one third of the administrative surcharge to the administrative cost clearing account upon case implementation. This decision was based on a study which determined that one third of the administrative work was completed upon case implementation. For a short while the fund had a positive balance and then it returned to a deficit position.

Another study was conducted which concluded that "fifty percent" of the administrative surcharge was earned upon case implementation and payment of the initial progress payments to the contractors. Again, for a short while following the increase to fifty percent of the administrative surcharge being assessed upon case implementation, the fund contained a positive balance but shortly thereafter reverted to a deficit position.

In 1987 the Logistics Support Charge (LSC) was instituted to relieve pressure on the administrative fund. However, this "cost increase" which was established at 3.1 percent for selected logistics support articles and services applied to only 20 percent of the dollar value of the program thus revenues from this source have been insufficient to offset the deficit.

During the period that the FMS program has been in existence, the administrative surcharge percentage has been based upon a combination of intuitive judgement of what it costs to administer the program and the perception of what the FMS customers will bear. No analysis has been conducted to ascertain the amount that it should cost to administer the FMS program. The studies that have been conducted have focused on the distribution of earnings, not on the percentage to be applied. Considering the content of this and previous audits and the state of the account it is recommended that a study be performed as a basis for decisions on how costs are to be recovered and earnings are to be applied.

The Arms Export Control Act (AECA) and the policy that has emanated from the law have not required the administrative costs to be fully supported by the surcharge. Section 21(e)1 states:

> ..."shall include appropriate charges for- (A) administrative services, calculated on an average percentage basis to recover the full estimated costs (excluding a pro rata share of fixed base operations) of administration of sales made under this Act to all purchasers of such articles and services ..."

In a following section (3) A of the Act it states:

> " The President may waive the charges for administrative services that would otherwise be required by paragraph (1)(A) in connection with any sale to the Maintenance and Supply Agency of the North Atlantic Treaty Organization in support of-..."

Under section 132 of P.L. 99-83 the provisions authorize the Secretary of Defense to:

> "(1) waive any surcharge for administrative service otherwise chargeable under Section 21(e)(1)(A) of the AECA"

In this instance the provision is in reference to the sale of the Patriot missile system to Germany.

These provisions for cost exclusions which are funded from DoD appropriations counter a full cost recovery concept relative to the administrative fund. This was confirmed in a 1987 DODIG audit of the Foreign Military Sales Administrative Budget and Costs - U.S. Air Force (Project No. 6FA-089). The legal opinion from the Assistant General Counsel (Fiscal and Inspector General) concerning an interpretation of section 43(a) of the Act was:

> " Thus, where the administrative surcharge has been waived, the military department should use its own Operation and Maintenance appropriation to fund the administrative expense it incurs in connection with a foreign military sale."

DoD policy concerning the use of appropriations that administer the FMS program is contained in DoD 7290.3M. Paragraph, 70505A states:

> " Cost of administrative effort applicable to FMS cases on which the normal administrative surcharge has been waived or reduced, pursuant to statute, must be reimbursed, to the FMS administrative fee cost clearing account. Therefore, the IA which is the proponent of the case on which the charge has been waived shall obligate its current operations and maintenance appropriations for the full amount being waived."

While the law and the DoD policy allow for some latitude in supporting the administration of the FMS program using the appropriations, the interpretation of the law and the policy have been that the surcharge is supposed to totally support the program. Obviously, the earnings resulting from the application of the surcharge have not done this. Moreover, DODD 5132.3 states that the Security Assistance Program is an integral element of the DoD mission and shall be accorded the same high degree of attention and efficiency as other DoD programs. Thus, as a matter of policy, an Implementing Activity (IA) is not permitted to neglect the management of the Security Assistance Program, not withstanding the inadequacy of resources.

While there has been a lack of analysis relative to how the cost of administering the FMS program are to be earned, there has been considerable justification of the labor involved in executing the program. The DoD personnel function has routinely performed desk audits of positions and the positions have either been allowed or denied based on their analysis. Managers have submitted budgets in accordance with the guidance and these budgets have been approved by authorized authorities. To conclude and to suggest that outlays should be limited to earnings is premature and should be delayed until a study is conducted that conclusively determines

whether it is possible to administer the FMS program with the revenues generated from a three percent surcharge, or, a decision is made to augment the cost from the appropriations in a manner similar to what is done when the administrative surcharge is waived, or, a decision is made to reduce the current level of effort to stay within the bounds of the available revenues.

b. Require that available administrative surcharges are adequate to fund anticipated administrative costs.

Management Comment. Partially concur. As above, it is recommended that an analysis be performed to determine the rate to charge to administer the FMS program. If the rate is changed the change should be based on a combination of what it costs to administer the program and the impact a change in the administrative surcharge rate would have on FMS customers.

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

a. Establish internal controls to ensure that annual budgets do not exceed revenues earned on performance.

Management Comments. Partially concur. The Air Force agrees with the concept of aligning expenses with revenues where revenues are defined to include all sources as discussed above and where the concept is based on an analysis of what is required to support the program. In as much as the actual workload is relatively constant over three to five year phases, due to the number of cases implemented and being executed, it is imperative that the security assistance workforce not be subjected to annual "up and down" swings. It takes almost one year of formal and informal on the job training to get a DoD member adequately familiar with FMS rules and procedures. It should be noted, as a general rule, administrative expense precedes earnings generated by performance.

b. Review, and if necessary, adjust surcharge rates at least annually to ensure that they are adequate to fully recover anticipated administrative costs.

Management Comments. Concur with qualifications as stated above. An annual review is required by paragraph 30103F of DoD 7290.3M.

SECTION B: COLLECTING ADMINISTRATIVE SURCHARGES AND PENALTIES

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

a. Revise DoD 5105.38-M, "Security Assistance Management Manual," to reference but not repeat, interpret, or contradict

financial guidance contained in DoD 7290.3-M, "Foreign Military Sales Financial Management Manual."

Management Comments. Concur. It is important that the policy and procedures concerning the collection of administrative surcharges and penalties be consistent.

b. Require the automatic assessment of penalties when sales are canceled and include nonrefundable surcharges earned at case acceptance.

Management Comments. Partially concur. For a case to be canceled it must first be implemented by receipt of a signed LOA and an initial deposit by the Security Assistance Accounting Center (SAAC). Cancellation can consist of canceling a total case, or, it can involve only a portion of a case. While policy and procedures concerning total cancellation are contained in the DoD 7290.3-M, they are still being developed for partial cancellations by the DoD Comptroller. Once the policy for partial cancellations is developed and direction is received from DSAA relative to customer countries, action will be taken to comply.

c. Direct the Air Force Accounting and Finance Center to collect excessive refunds of surcharges and penalties given customers for FY 1980 through FY 1988.

Management Comments. Partially concur. The determination of what a partial cancellation is and precisely what the DoD policy is hasn't been determined. Consequently, it is premature to determine the extent to which refunds may have been excessive. It should be noted, a policy decision on what a partial cancellation is will be new, and typically in the past new policy has been effective on the date of issuance. Thus, retroactive adjustments to the accounting records may not be appropriate.

2. We recommend that the Commander, Air Force Accounting and Finance Center:

a. Require the Security Assistance Accounting Center to revise its financial systems for assessing administrative surcharges and cancellation fees to conform with DoD 7290.3-M, "Foreign Military Sales Financial Management Manual."

Management Comment. Partially concur. However, the current policy set forth in section 705 of the DoD 7290.3M does not address the partial cancellations that form the basis for the findings and recommendations made in this section of the audit. System changes will be undertaken when a revised policy is issued by the DoD Comptroller and in accordance with direction provided by DSAA under paragraph 70504 of DoD 7290.3-M.

b. Provide oversight to ensure that the Security Assistance

Accounting Center's financial systems for processing refunds are in compliance with DoD 7290.3-M, "Foreign Military Sales Financial Management Manual."

Management Comment. Concur. Oversight of compliance with accounting policy is a part of the Air Force internal review process. Compliance will be ensured once policy on partial cancellation is issued.

c. Initiate the collection process to recoup excess refunds.

Management Comment. Partially concur. Retroactive recoupment will depend upon clarification of cancellation fee policies and DSAA direction on collecting previous refunds. Completion of actions are dependent upon the direction that is provided by DoD Comptroller and DSAA. Monetary benefit, if any, resulting from these findings are subject to recomputation depending on clarification of policies and retroactive applicability. It may be determined, depending on the policy that develops, that the cost of accomplishing the retroactive recoupment offsets the benefits derived.

SECTION C: USING MANAGEMENT CASES TO RECOVER COSTS TO PREPARE PRICE AND AVAILABILITY ANALYSES

1. We recommend that the Comptroller of the Department of Defense, revise DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," to:

a. Provide for the establishment of management cases to recover the cost of preparing Price and Availability Analyses.

Management Comment: Nonconcur. We agree that there are costs incurred for preparing detailed price and availability estimates and that a proportion of these estimates do not result in sales. We also do not dispute the critical state of the Administrative Fund and the need for management action to reduce the deficit in the account. A consistent calculation of effort on an hourly basis using actual costs requires an appropriate DoD directed manpower/manhour system to track O&M, MAP, IMET, FMS administration and FMS case expenses and a clear definition of costs to be charged to each category.

The traditional explanation for the administrative surcharge has been that there is no accounting system for accumulating administrative costs against individual FMS cases or lines and that the cost of doing so would be prohibitive. While we have experimented with manhour accounting systems in the past in limited areas, we have no uniform system in place for documenting these costs. We could expect only limited success in segregating these

costs from the rest of the administrative effort. In addition if this recommendation is implemented as a result of this audit, the immediate impact would be a requirement for additional resources to organize, track, and account for this effort in new management systems.

The charges for "pre-LOA" activity are similar to costs for marketing experienced in the commercial environment. A federal regulation requiring that all marketing expenses be paid in advance by the purchaser on a separate order would not be tolerated, even if the contractor had a detailed manhour accounting system to allocate all marketing costs to individual sales. As a somewhat parallel corollary it is unlikely that Congress and DoD would support a Federal Acquisition Regulation change suggesting that contractors be paid the cost of preparing bids and proposals. The concept does not conform to good business practice and is likely to further antagonize our FMS customers. We believe that charges for "pre-LOA" activity are properly described as indirect or overhead costs and allocable to all sales.

b. Allow credits against administrative surcharges for the cost of Price and Availability Analyses that result in sales.

Management Comment. Nonconcur for the reasons stated in 1a above.

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

a. Require the DoD Components to establish management cases with Foreign Military Sales customers to recover costs of preparing Price and Availability Analyses.

Management Comment. Nonconcur for the reasons stated in 1a above.

b. Provide the procedures for crediting the cost to prepare Price and Availability Analyses against surcharges when they result in implemented cases.

Management Comment. Nonconcur for the reasons stated in 1a above.

c. Adjust the Foreign Military Sales Administrative base line budget to reflect the transfer of Price and Availability Analyses effort to management cases.

Management Comment. Nonconcur for the reasons stated in 1a above.

SECTION D: USING BLANKET ORDER AGREEMENTS

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

a. Require that the DoD components establish centrally maintained blanket order agreements for use when processing cases under $135,000.

Management Comment. Partially concur. In the last two years the Air Force has experienced some success in encouraging the use of blanket order agreements particularly on training cases. It is agreed that there have been savings in administrative costs as a result of using these agreements. Some additional savings may be possible. Use of blanket orders, however, would not result in the return of 100 percent of "pre-LOA" administrative costs for an additional order unless the manpower to perform these same administrative features is funded within the line value of the blanket order line. To this extent, additional changes to current policy definitions are recommended. We can anticipate increased difficulties in closing out this type of case. Specific limitations in the definition of what may be ordered under these agreements are necessary if new orders under these agreements are to be processed in a manner compatible with Air Force requirements.

Also, recommend that recurring efforts that are of greater value be considered candidates for blanket order-type cases. For example, a maintenance program that is on a 5-year DoD contract, but the customer is issued yearly Letter of Offers, DD Forms 1513. Five year cases must be held open until the five year contract is closed whereas, if a blanket order-type case is used, one case could be administered through several DoD contracts, eliminating much administrative management. As a minimum, it is recommended that the threshold be determined annually as a result of a study of the costs to process cases to closure. Otherwise, inflation may overcome the proposed $135,000 threshold.

b. Reduce the DoD Component's foreign military sales administrative budgets by $5.5 million annually to reflect the use of centrally maintained blanket order agreements.

Management comment: Partially concur. The use of blanket ordering agreements should be directed. Once this is done and implemented the amount of the savings to the administrative surcharge budget may be determined.

SECTION E: FUNDING MANAGEMENT EFFORTS

1. We recommend that the Comptroller of the Department of Defense, revise DoD 7290.3-M, "Foreign Military Sales Financial Management Manual," to:

a. Require DoD components to recover case and program management costs that can be identified to a specific case or program as a direct cost in accordance with DoD 7220.9-M, "Department of Defense Accounting Manual."

Management Comments: Nonconcur. As mentioned in the discussion of details on page 37 of the audit, to ensure consistent application of cost methods, the Air Force developed, with Agency approval (and OASD(MS) review), a matrix specifying how management effort should be charged. For this reason, we believe that there is agreement on the definitions of what should be charged to FMS cases. Consistent application on the part of the Military Departments cannot be demonstrated unless the definitions of what is to be charged are settled. Over the past fifteen years, this area of management costs has been one of the most difficult to deal with because of the constant change that has occurred. Just as field level activities adjust to a new definition of what is charged, a revised definition is issued redefining the terms. The auditors, in their opinion, concluded that routine management costs should be treated as direct costs based on their interpretation of the Accounting Manual that these costs are, therefore, chargeable to management case lines on LOAs. This is achieved, in their view, by collecting costs, not specifically identifiable to an end item, in pools and prorating them to FMS cases. By this definition, we could allocate all administrative efforts to FMS cases.

The methodology advocated by the auditors was tried recently by the introduction of the procurement management charge under change 1 to DoD 7290.3M. The change directed that IAs prorate the costs of all procurement managers directly to FMS cases. The Air Force was unsuccessful in implementing this policy due to being unable to find a reliable method for accumulating and prorating these charges to all FMS cases.

The requirements of DoD 7220.9-M are met because the administrative surcharge, by its current definition, allows for the proration of the routine management costs to all FMS cases based on the value of the end items.

b. Prohibit the use of administrative surcharges to recoup case and program management expenses that can be identified to a specific case or program.

Management Comment. Nonconcur based on the same rationale used in the above comment.

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

a. Require case and program management lines on all Foreign Military Sales cases.

Management Comment. Nonconcur based on the same rationale used in 1a above.

b. Require the DoD Components to cite case management lines for all case and program management efforts that can be identified to specific cases or programs.

Management Comment. Nonconcur based on the same rationale used in 1a above.

c. Reduce DoD Components' administrative budgets to reflect the transfer of management costs to direct cost recovery procedures.

Management Comment. Nonconcur based on the same rationale used in 1a above.

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DEFENSE SECURITY ASSISTANCE AGENCY

WASHINGTON, DC 20301-2800

16 NOV 1989

In reply refer to:
I-62067/89

MEMORANDUM FOR MR. STEVE TRODDEN
ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

SUBJECT: Draft Report on the Audit of the Foreign Military Sales (FMS) Administrative Fund (Project No. 8FB-0056) August 5, 1989

Reference: DSAA memo I-62008/89, dated 20 October 1989

DSAA comments on Section B of the draft report are attached.

Although we nonconcur with the Finding and Recommendations, we agree that under certain circumstances there should be a specified cancellation charge for cases which truly are cancelled. Our proposal is to levy one-half of the administrative rate times case value at time of cancellation plus one-half the administrative rate times delivered costs. We would impose such charges for major program cancellations or for case cancellations that occur when countries significantly change relations with the U.S. However, for foreign policy reasons, we need the authority to waive such charges for friendly customers with on-going programs.

We also acknowledge that partial cancellations incur costs. As a matter of policy, we want to recover any costs deriving from partial cancellations from within the established administrative rate. As indicated in our previous response to Section A of the draft report, we acknowledge a cash deficit in the administrative fund, and are prepared to raise the rate should it become necessary.

Section B is especially unfair in criticizing SAAC for making excessive refunds of cancellation charges. By any reasonable definition of cancellations, the lost revenues cited in Finding B can't be right. We performed a cursory review of $28.9 billion in aircraft, tank, and missile FMS sales since 1980. We found about $113 million in quantity reductions that at most would have represented a loss of only $3.39 million from FY 1980 to the present. The audit bases the Finding on unused case value and pricing reductions, not actual cancellations. Either the audit should be reaccomplished to address actual cancellations, or Finding B should be deleted. We recommend the latter, but certainly are prepared to cooperate with, or even assist in, a new audit on the subject.

Finally, the proposal for assessing administrative fees would result in a different administrative rate for every FMS case. To implement these recommendations, SAAC would have to put in a very costly change to the FMS accounting and billing system.

CHARLES W. BROWN
LIEUTENANT GENERAL, USA
DIRECTOR

Attachment
As stated

Copy to:
Mr. Al Tucker, Dep Compt(Mgmt Sys)

SECTION B. COLLECTING ADMINISTRATIVE SURCHARGES AND PENALTIES

FINDING:

The Security Assistance Accounting Center (the Center) did not collect and retain in the Fund earned administrative surcharges and cancellation penalties. This condition occurred because the Defense Security Assistance Agency issued financial guidance in DOD 5105.30-M, "Security Assistance Management Manual," (the Security Manual). That conflicts with the mandatory guidance provided in the Comptroller's Financial Manual. As a result of this conflict, an internal control weakness, the Fund lost revenues totaling $169.6 million between FY 1980 and FY 1988 with an additional $60.2 million loss expected between FY 1989 and FY 1993.

DSAA COMMENT:

Nonconcur. Finding B is based on a concept of "partial cancellations" that is nowhere addressed in the Financial Manual. The Finding calculates "lost revenues" based on unused case value and price reductions, not actual cancellations, and unjustly castigates SAAC for failure to collect and retain $169.9 million in revenues that cannot be substantiated. We performed a cursory review of aircraft, missile, and tank cases since 1980. There were 944 line items of orders, totaling $28.9 billion. Of these, 32 lines showed decreases in quantity, some of which were made prior to purchaser acceptance of the offer. Others represented changes made during pre-contract requirements definitization and were offset by identical increases to other lines of the same case (for example, a change in the mix of aircraft models, e.g., F-16E/F, with no decrease in total number of aircraft ordered on the case), or shifted from one case to another with no decrease in total quantity. Eliminating those lines, there remained 13 lines valued at $113 million with actual reductions in ordered quantity. We cannot confirm that these were true cancellations in the sense that DOD had written contracts for the items. We doubt that they were. Even if they were, though, reductions on these lines lowered administrative receipts by a total of only $3.39 million since 1980.

While we nonconcur with Finding B, we acknowledge that we incur costs when a partial cancellation occurs. However, for foreign policy reasons, we do not want to recover the costs of partial cancellations through a separate charge, but prefer to treat the occasional partial cancellation as a cost of doing business and recoup the costs through a uniform administrative rate.

As stated in our comments on Section A, we acknowledge that the administrative fund has a cash deficit and recognize that action must be taken to rectify the situation. However, as a policy matter, we want to minimize the number of different charges

applied to FMS cases. Rather than take piecemeal actions to solve the problem, i.e., a variety of surcharges to try to recover each cost as it is incurred, we are prepared to raise the uniform administrative rate, if necessary.

We also agree that if a case is cancelled, there should be a specified charge, particularly in the event of major program cancellations, such as when countries significantly change relations with the U.S. Government. However, we must have the authority to waive cancellation fees on case cancellations for friendly and allied countries with on-going programs, so long as the cancellation was an isolated occurrence and did not involve an extraordinary amount of administrative expense associated with the cancellation.

Our proposed change to paragraph 70504, Administrative Charges on Cancelled Cases, DOD 7290.3-M, is attached.

RECOMMENDATIONS FOR CORRECTIVE ACTIONS:

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

a. Revise DOD 5105.38-M, "Security Assistance Management Manual," to reference but not repeat, interpret, or contradict financial guidance contained in DOD 7290.3-M, "Foreign Military Sales Financial Management Manual."

DSAA COMMENT:

Nonconcur. We recommend a change to DOD 7290.3-M. See attachment.

b. Require the automatic assessment of penalties when sales are cancelled and include nonrefundable surcharges earned at case acceptance.

DSAA COMMENT:

Nonconcur. We agree that case cancellation costs must be directly recouped in certain circumstances, but disagree that this determination should be automatic.

c. Direct the Air Force Accounting and Finance Center to collect excessive refunds of surcharges and penalties given customers for FY 1980 though FY 1988.

DSAA COMMENT:

Nonconcur. As indicated in our response to the Finding, we dispute the audit's contention that excessive refunds were made.

2. We recommend that the Commander, Air Force Accounting and Finance Center:

a. Require the Security Assistance Accounting Center to revise its financial systems for assessing administrative surcharges and cancellation fees to conform with DOD 7290.3-M, "Foreign Military Sales Financial Management Manual."

DSAA COMMENT:

Nonconcur. Systems changes are premature until policy is clarified and the Financial Manual changed.

b. Provide oversight to ensure that the Security Assistance Accounting Center's financial systems for processing refunds are in compliance with DOD 7290.3-M, "Foreign Military Sales Financial Management Manual."

DSAA COMMENT:

Concur in principle, once policy is clarified.

c. Initiate the collection process to recoup excess refunds.

DSAA COMMENT:

Nonconcur for reasons given in our response to Finding.

70504 Administrative Charges on Cancelled Cases

A. GENERAL. A cancelled case is an executed FMS case that is cancelled at the express request of either the purchaser or the U.S. Government.

B. CANCELLED CASE CRITERIA. When a case is accepted, a down-payment is received and obligational authority is issued by SAAC, it is considered an executed case. A cancellation of an FMS case occurs under the following conditions:

1. For a defined order FMS case, a cancellation occurs when the purchaser or USG cancels the case after the items are on contract for delivery to the purchaser. Cancellation does not occur when the case value is adjusted solely for a price reduction. Such pricing adjustments include: an overestimate in pricing, price change due to different source of supply, lower actual cost incurred, revision in time required for performance, revision in shipment terms.

2. For a blanket order FMS case, a cancellation occurs when either the purchaser or the USG cancels the case when there is material on contract for delivery to the purchaser. There is no cancellation if requisitions have not been received and the case is closed at a zero balance because the time frame for submitting requisitons has expired.

3. For a service case, a cancellation occurs when either the purchaser or the USG cancels the case when services are on contract (or there are ongoing DOD services being performed) for delivery to the purchaser. There is no cancellation when the line is never used or the service costs less than originally estimated.

C. CALCULATION OF ADMINISTRATIVE CHARGES ON CANCELLED CASES

1. As a general rule, the administrative charge on FMS case cancellations will be one-half of the applicable administrative percentage of the estimated articles/services ordered value at time of cancellation, plus one-half the administrative rate times the actual articles/services delivered value.
Examples:

a. Cancellation of a Defined Order case.

GIVEN: At time of cancellation, case provides for delivery of one vehicle at a value of $1,000,000. Purchaser cancelled the case after contract had been let. Accrued expenditures on the case are $100,000.

Articles/Svcs Ordered Value $1,000,000 @ 1.5 % = $15,000

Articles/Svcs Delivered Value $100,000 @ 1.5 % = $1,500

Total administrative charge on the case: = $16,500

b. Cancellation of a Blanket Order Case.

GIVEN: At time of cancellation, case provides for a one-year ordering period for undefinitized spare parts at a value of $1,000,000. The purchaser cancelled requisitions totalling $600,000 for material on contract. A total of $400,000 is delivered on the case.

Articles/Svcs Ordered Value $1,000,000 x 1.5 % = $15,000

Articles/Svcs Delivered Value $400,000 x 1.5 % = $6,000

Total administrative charge on the case: $21,000

c. Cancellation of a Service Case.

GIVEN: At time of cancellation, case provides for one year of technical assistance at a value of $1,000,000. After DOD contracted for this service but prior its completion, the purchaser requested the service be terminated. Services totalling $900,000 were performed on the case.

Articles/Svcs Ordered Value $1,000,000 x 1.5 % = $15,000

Articles/Svcs Delivered Value $900,000 x 1.5 % = $13,500

Total administrative charge on the case: $28,500

2. On a case-by-case or program-wide basis, DSAA may approve alternative methods of assessing cancellation charges, or may waive or reduce the charges if circumstances dictate. The reasons for such exceptions shall be fully documented. Administrative costs incurred will be recouped from the uniform administrative surcharge on the FMS program as a whole.

DEFENSE SECURITY ASSISTANCE AGENCY

WASHINGTON, DC 20301-2800

20 OCT 1989

In reply refer to:
I-62008/89

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

SUBJECT: Draft Report on the Audit of the Foreign Military Sales (FMS) Administrative Fund (Project No. 8FB-0056), August 5, 1989

We have reviewed the draft report as requested and our comments on the Findings and Recommendations addressed to the Director, DSAA, are provided at the attachment.

We are still reviewing, with DOD Comptroller, the text, Finding, and Recommendations of Section B. We will provide comments on Section B within ten days. As indicated in the attachment, we disagree with the Findings and Recommendations in Sections C and E.

CHARLES W. BROWN
LIEUTENANT GENERAL, USA
DIRECTOR

Attachment
As stated

SECTION A. LIMITING ADMINISTRATIVE EXPENDITURE AUTHORITY

FINDING:

The Defense Security Assistance Agency (the Agency) did not limit administrative expenditure authority to earned surcharges on contracts between the U.S. Government and foreign countries (cases). We attribute this to the lack of internal controls to ensure responsible financial management. As a result, the Foreign Military Sales Administrative Fund (the Fund), which should operate at or near a zero balance, closed FY 1988 with a negative cash balance between $389 million and $743 million. Further administrative surcharges remaining to execute open cases were deficient between $193 million and $471 million on December 31, 1988.

DSAA COMMENT:

Concur in part. We concur that the balance of the combined Administrative Fund/Logistics Support Charge (LSC) cost clearing account was a negative $389 million as of end FY 1988. The report does not note, however, that this is only one of several U.S. Government owned cost clearing accounts which relate to the FMS Program. Cost clearing accounts for contract administration, audit, and quality assurance (CAS), transportation, and attrition had positive cash balances (i.e., revenues exceed costs) of approximately $278 million as of end FY 1988. Consequently, the overall cash position of U.S. equity accounts was a negative $111 million as of end FY 1988.

We do not agree that DSAA lacks the internal controls to address the issue of the deficit in the FMS Administrative Fund. About $309 million of the deficit in the combined FMS Administrative Fund/LSC cost clearing account is attributable to events before FY 1987. During FY 1987, DSAA reduced the worldwide FMS Administrative Budget by about $60 million and only adjusted the FY 1988 levels from FY 1987 levels to cover inflation. DSAA also imposed the 3.1% Logistics Support Charge effective 1 April 1987 on certain supply transactions in order to produce additional revenue for program administration. Notwithstanding these actions, administrative costs exceeded revenues by approximately $80 million during the FY 1987-FY 1988 period, primarily due to declining sales during the FY 1986-early FY 1988 period. Recognizing that additional actions were necessary, DSAA developed fair pricing legislation, which was approved by the Secretary of Defense and submitted as a legislative proposal to the Congress. This legislation, if passed, will result in FMS budget cost savings of approximately $78 million a year. We are confident that the actions previously taken, coupled with fair pricing legislation, will result in a gradual reduction to the fund deficit.

The negative balance in the combined Administrative Fund/LSC cost clearing account is approximately $372 million at the end of FY 1989. This is a slight reduction from the $389 million end FY 1988 level, and is attributable primarily to strong sales in the latter part of FY 1988 (for which some revenues were credited in FY 1989) and during FY 1989. We are dedicated to assuring that the FMS Administrative Budget for FY 1990 will not exceed projected earnings of $334 million during FY 1990. We recognize that this will require a cut in the worldwide administrative budget from FY 1989 levels. We also project that, should fair pricing legislation not pass the Congress, we will have to raise the administrative rate from 3% to 4%-5%, effective FY 1991.

We concur in theory that the FMS Administrative Fund/LSC cost clearing account should operate at or near a zero balance. So, in theory, should the cost clearing accounts for CAS, transportation, and attrition. Thus, our primary objective is to assure that the overall cash position of the aggregate U.S. equity accounts is at or near a zero balance. As indicated above, the aggregate position of the accounts was a negative $111 million as of end FY 1988 and a negative $90 million at the end of FY 1989. We estimate that the actions that we have taken, coupled with those planned for FY 1990 will reduce this deficit from $111 million to approximately $65 million at the end of FY 1990. As indicated previously, the deficit in the FMS Administrative Fund/LSC cost clearing account will be reduced further if fair pricing legislation is approved by Congress or if we raise the administrative surcharge rate effective FY 1991. Recognizing that our primary objective is to assure that the aggregate of U.S. equity accounts be at or near zero balances, it is possible that offsetting surcharge rate reductions may be necessary in the CAS, transportation, and attrition accounts.

RECOMMENDATIONS FOR CORRECTIVE ACTIONS:

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

a. Establish internal controls to ensure that annual budgets do not exceed revenues earned on performance.

DSAA COMMENT:

Concur in part. We concur that, over time, cumulative annual administrative/LSC expenditure authority issued cannot exceed cumulative revenues earned on performance. We believe that DSAA has sufficient internal controls in place to accomplish this. However, since revenues into the Fund are highly dependent on levels of annual sales and deliveries, it is not feasible or practical to balance budgets to revenues each and every year. The

budgets must be determined at the beginning of the fiscal year, but revenues are not known until the year is over. Consequently, there will be years when budgets exceed revenues, depending on levels of sales and deliveries. It is our objective to assure that budgets do not exceed revenues over time.

b. Review, and if necessary, adjust surcharge rates at least annually to ensure that they are adequate to fully recover anticipated administrative costs.

DSAA COMMENT:

Concur. As indicated previously, we have completed a thorough review to determine estimated revenues during FY 1990, based on a 3% surcharge rate. We have determined that budget adjustments can be made to assure that budgets will not exceed projected revenues during FY 1990, and that no rate increase is necessary to achieve this result. However, we do anticipate the need for a rate increase beginning in FY 1991, unless Congress passes fair pricing legislation.

SECTION C. USING MANAGEMENT CASES TO RECOVER COSTS TO PREPARE PRICE AND AVAILABILITY ANALYSES

FINDING:

The Fund reimbursed DOD Components for costs of preparing Price and Availability Analyses (Analyses) that did not generate sales. This condition existed because the Financial Manual did not require the DOD Components to charge these costs directly to customers. These costs drained the Fund's limited resources by approximately $18 million annually, and unless procedures are changed, will cause a further projected loss of $91 million during FY 1990 through FY 1994.

DSAA COMMENT:

Nonconcur. We believe that developing P&A estimates is a cost of doing business. The charges for P&A activity are properly described as indirect or overhead costs and should be recouped via the uniform administrative charge on all sales. The charges for this "pre-LOA" activity are similar to costs for marketing sales experienced by contractors in the private sector. A federal regulation requiring that all marketing expenses be paid in advance by the purchaser on a separate order would not be tolerated, even if the contractor had a detailed manhour accounting system to allocate all marketing costs to individual sales. The concept of charging for P&A does not conform to good business practices and would degrade our FMS relationships with purchasing countries. We would not favor using management cases to recover costs of P&A even if all of the Implementing Agencies had manpower/manhour systems to identify the charges (which they do not).

RECOMMENDATIONS FOR CORRECTIVE ACTIONS:

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

a. Require the DOD Components to establish management cases with Foreign Military Sales customers to recover costs of preparing Price and Availability Analyses.

DSAA COMMENT:

Nonconcur. As indicated in response to Finding, we believe that "pre-LOA" costs are properly described as indirect or overhead costs and allocable to all sales.

b. Provide the procedures for crediting the cost to prepare Price and Availability Analyses against surcharges when they result in implemented cases.

DSAA COMMENT:

Nonconcur for reasons stated in response to Finding.

c. Adjust the Foreign Military Sales Administrative base line budget to reflect the transfer of Price and Availability Analyses effort to management cases.

DSAA COMMENT:

Nonconcur for the reasons stated in response to Finding.

SECTION D: USING BLANKET ORDER AGREEMENTS

FINDING:

The Program's cost to administer one-half of the foreign military sales cases accepted during FYs 1985 through 1988 exceeded revenues earned from surcharges. This condition occurred because the Agency did not require DOD Components to use centralized Blanket Order Agreements (Agreements) when processing cases under $135,000. As a result, the Fund incurred avoidable personnel cost of $5.5 million annually to process and maintain unnecessary cases. We project that these costs will drain the Fund's resources approximately $27.5 million during FY 1990 through FY 1994.

DSAA COMMENT:

Concur in part. We support the expanded use of Blanket Order Agreements (BOAs) and will continue to encourage their use. However, we cannot "require" their exclusive use as some purchaser Governments will not commingle funding for disparate orders on a single FMS case. Likewise, many purchasers are expected to resist BOAs that would encompass sales to more than one in-country activity in a single case. In addition, some purchasers may prefer smaller, defined order cases rather than larger, blanket order cases, which are harder to close due to the increased volume of logistical and financial transactions that must be reconciled prior to case closure. Likewise, an arbitrary dollar threshold would be inappropriate for every purchaser because of wide variances in volume, content, and magnitude of sales programs. It might be preferable to establish specific criteria such as common spare and repair parts, publications, support equipment, minor modifications and repairs performed at U.S. installations, technical assistance, training, etc., and encourage purchasers to establish BOAs for such articles and services.

RECOMMENDATIONS FOR CORRECTIVE ACTION:

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

a. Require that the DOD components establish centrally maintained Blanket Order Agreements for use when processing cases under $135,000.

DSAA COMMENT:

Concur in part. As indicated in our response to Finding, we support the expanded use of Blanket Order Agreements but recognize there are limitations in mandating their use across the board.

b. Reduce the DOD Component's foreign military sales administrative budgets by $5.5 million annually to reflect the use of centrally maintained Blanket Order Agreements.

DSAA COMMENT:

Concur in part. Some savings to the administrative surcharge should be realized if use of Blanket Order Agreements is expanded. To some extent, however, savings in case development would be offset by increased reconciliation effort at case closure. We also challenge the idea of reducing the budget based solely on the number of cases processed. There are variables in addition to dollar value that affect the workload and manpower involved in case preparation.

SECTION E. FUNDING MANAGEMENT EFFORT

FINDING:

The Agency used the Fund to reimburse DOD Components for management effort that was directly identifiable to specific cases and programs. This condition existed because the Comptroller did not define program and extraordinary case management effort in the Financial Manual in accordance with the principles contained in DOD 7220.9-M, "Department of Defense Accounting Manual," (the Accounting Manual) and the Agency's inconsistency in approving direct charge requests for these efforts. Charging this effort as indirect costs contributed to the Fund's current deficit and will result in a further drain that we estimate will total $260 million during FY 1990 through FY 1994.

DSAA COMMENT:

Nonconcur. We do not agree with the Finding nor the Recommendations as noted below. The original intent of the administrative fee was to avoid the establishment and operation of a costly accounting system to identify routine management costs to each case. FMS customers would view the recommended departure as an added charge without any additional benefit and could result in a spiral of reduced sales and increased management costs. The current administrative charge policy is proper and should be continued. More specific comments are contained in our reply to the recommendations.

RECOMMENDATIONS FOR CORRECTIVE ACTIONS:

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

a. Require case and program management lines on all Foreign Military Sales cases.

b. Require the DOD components to cite case management lines for all case and program management efforts that can be identified to specific cases or programs.

DSAA COMMENT:

Nonconcur. The foregoing recommendations are based on the premise that reimbursements for FMS must be accomplished strictly in accordance with principles contained in the DOD Accounting Manual, DOD 7220.9-M, and specifically that costs that can be identified directly to a single end item should be a direct charge to that end item. This premise is false. Chapter 26, Reimbursements, of the Accounting Manual clearly states that it provides guidance for reimbursements unless a specific directive has been

issued to authorize alternative reimbursement policies. It further cites as the first exception, DOD 7290.3-M, the FMS Financial Management Manual which authorizes (para 70501) recoupment of sales negotiations, case implementation, program control, computer programming, accounting and budgeting, etc. from the administrative surcharge. Case management, performed at routine levels, is properly chargeable to administrative funds. This policy should be continued for the following reasons:

a. There is no cost accounting system in existence within the military departments to track costs to the degree necessary to charge all case management costs directly to each FMS case. To establish such a system would require significant resources and costs which would increase demands upon administrative funds. The operation of such a system would also make significant demands upon constrained resources.

b. A similar, recent effort (change 1 to DOD 7290.3-M) to charge FMS procurement management costs directly to FMS cases was unsuccessful, in large part, because there is no system for the identification and charging of these costs directly to an appropriate line item of the case.

c. Customers would correctly perceive these new charges simply as a method of increasing the administrative fee without any new benefit to the purchaser. The administrative fee was originated to recover those costs which could not be directly charged to individual FMS cases and to avoid the development and operation of costly accounting systems to charge certain costs directly to cases. A case manager often is responsible for numerous routine FMS cases simultaneously. A determination had been made to allocate these types of costs to FMS cases via the administrative charge and avoid the accounting cost. Customers are well aware of this historical allocation of routine case management costs to the administrative fund and would object to directly charging these costs to cases without a corresponding decrease to the administrative fee.

d. We do not agree with the estimated cost avoidance of $260 million predicted for these recommendations. To accomplish the recommendations the avoidance would have to be reduced by the costs to develop and operate a system to account for and directly charge routine case management costs to FMS cases. This avoidance is also predicated on a relatively constant level of sales. We believe sales could drop as a result of customers' adverse reactions thereby reducing administrative fund proceeds as well as case management proceeds.

RECOMMENDATIONS CONTINUED:

2. c. Reduce DOD components' administrative budgets to reflect the transfer of management costs to direct cost recovery procedures.

DSAA COMMENT:

Nonconcur for reasons stated in response to Recommendations 2. a. and 2. b..

We examined planes, missiles, and tank cases since 1980. There were 944 line items of orders. Of these, 32 of the lines showed decreases in quantities. Further analysis showed that some of the "decreases" were made subsequent to the original offer but prior to purchaser acceptance of the LOA; others represented changes made during pre-contract requirements definitization and were offset by identical increases to other lines of the same case-- for example, a change in the mix of aircraft models (F-16A/B) with no decrease in total number of aircraft ordered on the case. Several others involved deletion of items from one case and ordering them on another. Eliminating those lines, there remain 13 of the 32 lines that represent actual reductions in ordered quantity. We found no instances of reductions after contract award.

The 944 line items aggregate to $28,915.9 Mil; the 13 line reductions aggregate to $113 million (0.39%). However, there were $1.2 billion in price reductions ~~no~~ WITHOUT change in quantity.

DOLLAR REDUCTIONS WITH NO REDUCTIONS IN QUANTITY

	AIRCRAFT	MISSILES	TANKS	TOTAL
$ VALUE	629,896,933	277,873,194	332,056,131	$1,239,826,258
NR LINES	47	237	8	292

MD Sept 6, 1989

PLANE/MISSILE/TANK LINES SINCE 1980	944
TOTAL VALUE OF THESE LINES ($ MIL)	28,915.9
TOTAL NR LINES WITH QTY REDUCTIONS (NOT OFFSET OR PRIOR TO ACCEPT)	13
VALUE OF QTY REDUCTIONS ($ MIL)	113.0
PERCENTAGE OF TOTAL	0.39%

A. LINES W/QUANTITY REDUCTIONS NOT OFFSET

CASE/LINE	QTY REDUCED	VALUE OF REDUCTION	REMAINING LINE VALUE
N4-B-QWN 028	177	277,147	280,278
SW-B-UNH 002	100	669,580	15,245,590
TW-B-XXF 001	5	622,454	6,762,883
TK-Q JAW 002	72	5,419,058	2,881,410
EG B UEY 001	48	7,418,112	35,938,944
EG B UEY 003	1	9,357,600	64,867,975
SR B VES 001	5	37,115	111,345
EG D SNA SOD	118	11,355,458	11,471,542
IS B YAU YAY	126	4,308,933	15,091,067
KS P AEI A02	2	29,146	325,214
TU D SNA SOF	45	4,460,840	3,988,500
SN P LAU A01	54	54,960,137	22,219,231
TH B VIS 001	30	14,111,198	4,453,526
	13	$113,026,778	$183,637,505

B. QUANTITY REDUCTIONS OFFSET BY LIKE INCREASES TO SAME CASE, ANOTHER CASE, OR PRIOR TO CASE IMPLEMENTATION

CASE	QUANTITY DECREASED	VALUE	REMAINING LINE VALUE	REASON
BR D SDA 001	2	582,558	7,184,882	Bought on other line same case
EG D SPA SNB	2	101,394,104	539,441,907	Bought on other line same case
F1 D SVI SVB	4	174,468,000	500,316,000	Bought on other line same case
PK D SEA SEB	4	110,247,394	300,062,606	Bought on other line same case
SP P SBQ*	12	288,151,348	1,847,897,045	Option not accepted by purchaser
TU D SNA	2	23,869,422	36,400,578	Bought on other line same case
BA B UAD	190	1,054,500	1,332,000	Bought on other line same case
HO B UMA	68	550,460	13,372,940	Bought on other line same case
TH B VIT	215	1,889,850	2,012,830	Bought on other line same case
TH B XXF	5	622,454	3,372,242	Bought on other line same case
JO B VAZ	4	31,310,509	95,105,346	Bought on other line same case
SR-B-VFE 001	1,196	11,694,268	9,958,857	Bought on another case.
SR-B-VFE 002	18	175,312	153,816	Bought on another case.
IS B XJI 001	70	4,082,514	13,663,736	P&I chg before acceptance.
AT P AAZ G03	88	226,052	415,243	Navy says no reduction.
TW P LDG 7G1	28	10,369,420	43,106,690	Navy says no reduction.
BA D SDA SEQ	30	1,932,530	1,395,430	Bought AIM-9P4 on other case.
EG P AAF BA1	294	58,298,007	22,436,976	Bought M Model on other case.
PK P ABO A01	16	7,676,291	18,423,933	Bought on another case.
	19	$828,594,993	$3,456,053,057	

CASE CLOSURE STATISTICS $ IN MILLIONS

1. Cases with deliveries	Ordered Cost at Closure	Original Ordered Cost	Difference	# Cases
A. Over 100% of original ordered cost:	6,837	4,834	2,003	3,894
B. Over 50% but under 100% of original ordered cost:	10,622	12,492	(1,870)	8,112
C. Less than 50% of original ordered cost, but greater than 0.	507	2,761	(2,254)	2,438
TOTAL CASES WITH DELIVERIES:	17,966	20,087	(2,121)	14,444
2. Cases with no deliveries (closed at 0 value):	989	1,047	(58)	1,358

WORLDWIDE
FOREIGN MILITARY SALES AND
FOREIGN MILITARY CONSTRUCTIONS SALES
(DOLLARS IN THOUSANDS)

	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	FY88	PERCENTAGE OF DECREASE
FY 1979	12,983,931	12,977,654	10,830,125	11,183,641	11,918,367	11,661,947	11,360,932	11,024,105	11,169,015	11,117,589	14.37%
FY 1980		15,276,995	13,972,223	13,662,159	13,410,940	13,340,422	13,113,883	12,712,912	12,645,266	12,510,155	18.11%
FY 1981			6,921,101	7,334,745	7,222,894	6,888,703	6,765,284	6,506,419	6,609,479	6,525,168	5.72%
FY 1982				19,611,469	19,065,589	18,765,360	18,403,072	18,046,804	17,694,157	17,373,383	11.41%
FY 1983					17,567,428	17,296,983	15,909,324	15,325,866	15,029,222	14,856,111	15.43%
FY 1984						14,291,404	14,080,421	13,933,430	13,790,642	13,622,802	4.68%
FY 1985							11,718,970	11,538,730	11,383,246	10,944,651	6.61%
FY 1986								7,122,460	7,093,581	6,920,520	2.84%
FY 1987									7,077,717	7,133,564	
FY 1988										12,467,545	

AVERAGE % DECREASE FY79 - FY83: 13.01%

1. Data only from FY79 vs FY77 because FACTS book rolls up data after ten years.
2. Deleted all sales for Iran -- only impacted FMS agreements for FY79.
3. Deleted all Construction sales for Saudi Arabia.

NOTE: FY79 and FY80 FACTS books do not break out FMS Agreements and FMS Construction Agreements. Therefore, could not adjust for Saudi Arabia Construction Sales.

Prepared by: Ann Amlin, DSAA/COMPT/FMD, X41173

AUDIT TEAM MEMBERS

Nancy L. Butler	Director, Financial Management Directorate
Raymond A. Spencer	Program Director
J. Steven Hughes	Project Manager
Addie M. Beima	Team Leader
James B. Elmore	Auditor
James R. Casey	Auditor
Frank Giordano	Auditor
Sheela Dodeja	Auditor
Jennifer Wilson	Auditor

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