

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

**IMPACT OF FLUCTUATING FOREIGN EXCHANGE RATES
ON CONTRACT PRICES**

Report Number 92-090

May 14, 1992

Department of Defense

The following acronyms are used in this report.

AFLC.....Air Force Logistics Command
DFARS.....Defense Federal Acquisition Regulation Supplement
FAR.....Federal Acquisition Regulation
GAO.....General Accounting Office
O&M.....Operation & Maintenance
USEUCOM.....U.S. European Command



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



May 14, 1992

MEMORANDUM FOR DIRECTOR OF DEFENSE PROCUREMENT
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL
MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)
U.S. COMMANDER IN CHIEF EUROPE

SUBJECT: Audit Report on the Audit of Impact of Fluctuating
Foreign Exchange Rates on Contract Prices
(Report No. 92-090)

We are providing this final report for your information and use. Comments on a draft of this report were considered in preparing the final report.

Management comments on a draft of this report conformed to the requirements of DoD Directive 7650.3, and there are no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the audit staff. If you have any questions on this audit, please contact Mr. Richard Jolliffe, Program Director, at (703) 614-6260 (DSN 224-6260). The planned distribution of this report is listed in Appendix C.

Edward R. Jones
Deputy Assistant Inspector General
for Auditing

cc:
Secretary of the Army
Secretary of the Navy
Secretary of the Air Force
Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, Defense Acquisition Regulations Council

Office of the Inspector General, DoD

AUDIT REPORT NO. 92-090
(Project No. OCA-0046)

May 14, 1992

IMPACT OF FLUCTUATING FOREIGN EXCHANGE RATES
ON CONTRACT PRICES

EXECUTIVE SUMMARY

Introduction. The total FYs 1988 and 1989 reported value of DoD prime contracts awarded to foreign contractors was \$8.8 billion and the value awarded to subcontractors was \$3.2 billion. Prior audits by the General Accounting Office and the Inspector General, DoD, reported overpricing of contracts and subcontracts caused by the use of inaccurate and noncurrent exchange rate data. Federal and DoD acquisition regulations require that foreign contracts be priced and paid in local foreign currency with certain exceptions.

Objectives. The audit objectives were to: evaluate the impact of fluctuating foreign exchange rates on pricing of DoD contracts and subcontracts awarded to foreign contractors, determine if current guidance is effective, and to assess the adequacy of DoD internal control procedures for minimizing the potential increased costs due to currency fluctuation.

Audit Results. The audit showed that contracting officers were using varied and potentially ineffective practices in the evaluation of foreign exchange rates for pricing contracts and subcontracts awarded to foreign contractors. This condition occurred because the Defense Federal Acquisition Regulation Supplement (DFARS) and other supplemental regulations provide conflicting guidance and are inadequate for minimizing the potential increased cost due to currency fluctuations on DoD contracts. See the finding in Part II for details.

Internal Controls. DoD internal control practices and procedures for contracting with foreign businesses did not provide assurance for minimizing the impact of fluctuating currency rates on contract prices primarily due to the lack of established guidance. We did not consider this weakness to be material. See page 2 Part I of the report for details on the internal control weakness identified during the audit.

Potential Benefits of Audit. The improved and streamlined procedures recommended in this report should strengthen internal controls through reduced risks of contract overpricing. We identified no monetary benefits. See Appendix A.

Summary of Recommendations. We recommended that provisions of DFARS relating to the pricing of contracts and subcontracts awarded to foreign contractors be revised, and that the Air Force Logistics Command eliminate the portion of its DFARS implementing guidance pertaining to foreign currency payment.

Management Comments. The Office of the Assistant Secretary of the Air Force (Acquisition) concurred with the recommendation to eliminate the section on payments in foreign currency in the Air Force Systems Command DFARS Supplement that conflicts with the DFARS.

The Director of Defense Procurement conceptually shared our concerns related to foreign currency rate evaluations; however, the Director expressed concern that the report overstated any problems related to a preference for use of local currency in foreign contracts. The Director agreed to consider our recommendation and stated that upon issuance of the final report, the Defense Acquisition Regulations Council will be directed to establish a case to consider the proposed changes to the DFARS.

The U.S. Commander in Chief, Europe, nonconcurred with the recommendation in the draft report on the elimination of U.S. European Command Supplement subpart 22.5 related to foreign currency evaluation and payment. In view of the concurrence of the Director of Defense Procurement to establish a Defense Acquisition Regulation case to address foreign exchange rate issues, we have deleted the draft report recommendation.

A full discussion of management comments and audit responses is summarized in Part II of this report, and the complete text of management comments is in Part IV of the report.

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This final report was prepared by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD. Copies of the report can be obtained from the Information Officer, Audit Planning and Technical Support Directorate, (703) 614-6303.

PART I - INTRODUCTION

Background

The total FYs 1988 and 1989 reported value of DoD prime contracts awarded to foreign contractors was \$8.8 billion and the value awarded to subcontractors was \$3.2 billion. The pricing of these contracts can have a significant impact on the DoD because of the tendency of foreign currency rates to fluctuate against the dollar. The decision to award a contract in either foreign (local) currency or U.S. dollars can affect whether DoD or the contractor assumes the risk for the currency fluctuation. Contracts awarded in the local currency of the foreign contractor or subcontractor place the risk of fluctuation on DoD. The DoD must ensure the availability of adequate funds to be able to purchase local currency at the time payments are made. However, when contracts are awarded to foreign contractors in U.S. dollars, the contractor must assume the risk for rate fluctuation between negotiation and the award of the contract and payment. Therefore, the foreign contractor or subcontractor usually includes a factor for this risk. Prior audits by the U.S. General Accounting Office (GAO) and the Inspector General, DoD, reported overpricing of contracts and subcontracts because of the use of inaccurate and noncurrent currency exchange rates in proposals submitted in U.S. dollars.

Objectives

The audit objectives were to:

- o evaluate the impact of fluctuating foreign exchange rates on pricing of DoD contracts and subcontracts awarded to foreign contractors,

- o determine if current guidance regarding exchange rates is effective for contracting with foreign contractors and whether more guidance is needed, and

- o assess the adequacy of DoD internal control procedures for minimizing the potential increase in costs due to the effect of currency fluctuation on the pricing of contracts and subcontracts.

Scope

Locations and contracts reviewed. The audit universe consisted of DoD contracting offices involved in pricing and awarding contracts to foreign contractors and subcontractors during FYs 1988 and 1989. Prime contracts totaled \$8.8 billion awarded to foreign contractors in FYs 1988 and 1989. Also, DoD contractors reported subcontracts, valued at \$3.2 billion, awarded to foreign businesses during FYs 1988 and 1989.

We evaluated the practices of 20 statistically selected DoD contracting offices in pricing contracts and subcontracts awarded to foreign contractors. We also evaluated the adequacy of those practices to minimize the potential increased cost due to currency fluctuation. The review included coverage of the practices relating to 26 randomly selected prime contracts and 20 randomly selected subcontracts valued at more than \$1 million each. An additional 14 judgmentally selected contracts and subcontracts were reviewed at the selected contracting offices to fully assess the practices of these offices.

Auditing standards. This economy and efficiency audit was made from February 1990 through May 1991 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, we included such tests of internal controls as were considered necessary. We relied on the DoD contract reporting system data base (based on DD Form 350, "Individual Contracting Action Report") in determining the audit universe for prime contracts. Nothing came to our attention as a result of specified procedures that caused us to doubt the acceptability of the computer-generated data. By using other data and information, we concluded that the DD Form 350 data base could be relied on to achieve the audit objectives. We also relied on the DoD subcontract reporting data base (based on DD Form 2139, "Subcontract Report of Foreign Purchases") for determining the audit universe for subcontracts. The DD Form 2139 data were considered sufficient for the purpose of identifying DoD procurement offices that had significant involvement with the pricing of subcontracts awarded to foreign businesses. The activities visited or contacted during the audit are listed in Appendix B.

Internal Controls

Controls assessed. The audit evaluated internal control practices and procedures as required by the Federal Managers' Financial Integrity Act. Specifically, we reviewed the internal control objectives for minimizing the potential increased cost due to currency fluctuation on contracts awarded to foreign contractors at the 20 contracting offices we selected for evaluation. The audit included a review of current policies and procedures to be used by contracting officers in the pricing and evaluation of contracts and subcontracts with foreign contractors.

Internal control weakness. The audit found that contracting officers used varied and potentially ineffective practices in adjusting for foreign currency fluctuation when awarding contracts to foreign businesses. This condition existed because no specific DoD-wide internal control guidance had been

established to minimize the potential effect of increased cost of currency fluctuation on the pricing of contracts and subcontracts. The internal control weakness, which is addressed in the Finding in Part II of this report, could result in overpricing of contracts. Both recommendations in this report, if implemented, will correct the weakness and reduce the risks of contract overpricing. However, we identified no monetary benefits related to the internal control weakness. Copies of the final report will be provided to the senior officials responsible for internal controls within DoD.

Prior Audits and Other Reviews

Inspector General, DoD, Report No. 89-090, "Field Pricing Support and Post Award Audits of Contracts With Foreign Companies," July 6, 1989, reported contract overpricing of about \$3 million on 16 contracts awarded to the Canadian Commercial Corporation because inaccurate and noncurrent exchange rates were used in pricing contracts. This condition occurred because no guidance existed on the exchange rate to be used when Canadian proposals were submitted to the DoD in U.S. currency. A recommendation was made to the Assistant Secretary of Defense (Production and Logistics) to renegotiate the Canadian agreement and to revise the Defense Federal Acquisition Regulation Supplement (DFARS) to require that currency conversion rates used by Canadian contractors be disclosed and certified when negotiating a fixed-price contract subject to approval by the U.S. contracting officer. An agreement was reached with the Canadian Commercial Corporation to provide U.S. contracting officers the exchange rate used in converting Canadian dollars to U.S. dollars in proposals for fixed-price negotiated contracts. Formal changes to the U.S./Canadian procurement agreement are expected to be accomplished in calendar year 1992.

GAO Report No. NSIAD-86-156, (OSD Case No. 7119), "Contract Pricing: Material Prices Overstated on T-56 Engine Contracts," August 26, 1986, reported defective pricing of \$357,879 because of the use of inaccurate foreign exchange rates by General Motors Corporation, Allison Turbine Division in pricing subcontracts with United Kingdom firms. GAO presented the condition to the buying office, Aeronautical Systems Division, Wright-Patterson Air Force Base, Ohio, with a recommendation to initiate action to recover the amount of overpricing. Allison officials agreed with the findings. The T-56 engine contracts were reduced in price by \$357,879 on June 30, 1987.

There were other audits that dealt with foreign currency; however, those audits primarily dealt with the operation of the foreign currency fluctuation accounts and not with the pricing of contracts and subcontracts. Deficiencies relating to the fluctuation accounts are described in GAO Report No. NSIAD-86-173, (OSD Case No. 7112), "DoD Financial Management: Improper Use of

Foreign Currency Fluctuations Account," July 11, 1986; and Air Force Audit Agency, Report No. 9265310, "Foreign Currency Fluctuation Centrally Managed Allotment," December 28, 1989.

PART II - FINDING AND RECOMMENDATIONS

CURRENCY FLUCTUATION ON DOD CONTRACTS

DoD contracting officers were using varied and potentially ineffective practices in the evaluation of foreign exchange rates used in the pricing of contracts and subcontracts awarded to foreign contractors. This condition occurred because the DFARS and supplemental regulations provide conflicting guidance and are inadequate for minimizing the potential increased cost caused by currency fluctuations on DoD contracts. As a result, contracts and subcontracts (valued at \$12.0 billion in FYs 1988 and 1989) awarded to foreign contractors were vulnerable to overpricing from currency fluctuations.

DISCUSSION OF DETAILS

Background

Foreign exchange rates can affect the cost of DoD goods and services acquired from foreign contractors throughout the entire acquisition process. Foreign exchange rates can also affect the solicitation, pricing, evaluation, budgetary, and payment phases of the procurement process, depending on the extent of competition, and the type of contract award.

Foreign currency awards. For competitive contracts involving multiple currencies, DoD contracting officers must convert bids into U.S. dollars or a local currency to evaluate the offers. Therefore, accurate and current exchange rate pricing data are needed to ensure that the contract is awarded to the lowest bidder. Inaccurate exchange rate data could distort the ranking of prospective bidders and could result in the award of a contract to other than the lowest bidder.

All contracts priced in local foreign currency are vulnerable to currency fluctuation during the payment phase of the contract performance. Since any fluctuation in exchange rates could impact the cost to acquire currency to pay a contractor, DoD could experience either a budget shortfall or a windfall at the time of payment. However, the shortfall or windfall would be a budgetary issue and was not within the scope of this audit.

U.S. dollar awards. For negotiated contracts priced in U.S. dollars, the contracting officer should determine the reasonableness of the exchange rate used by the foreign contractor to convert prices to U.S. dollars. An unreasonable rate that is not determined during negotiation can result in contract overpricing.

The Federal Acquisition Regulation (FAR) subpart 25.5 and DFARS 225.5, "Payment in Local Foreign Currency," require contracts entered into and performed outside the United States with foreign firms to be priced and paid in local currency, unless otherwise stated by international agreement or determined by the contracting officer. Foreign currency fluctuation related to contract pricing is not specifically addressed in any other FAR or DFARS section or DoD directives and instructions. However, the U.S. European Command and the Air Force established supplemental guidance to the DFARS to address contracts with foreign contractors.

Minimizing the Potential Increased Cost Due to Currency Fluctuation

Contracting officers used varied and potentially ineffective practices in evaluating foreign exchange rates for pricing contracts and subcontracts with foreign contractors. The audit disclosed that the contracting officers:

- o relied on inadequate exchange rate data when evaluating contracts with foreign contractors, and

- o did not evaluate the reasonableness of exchange rates applied by contractors converting foreign prices to U.S. dollars.

These conditions existed because policies and procedures were not adequate for minimizing the potential increased cost due to currency fluctuations on contracts and subcontracts awarded to foreign contractors. Specifically, we found:

- o DoD had not established adequate guidance to ensure that current foreign exchange rate data were used by contracting officers in the evaluation and pricing of contracts and subcontracts with foreign contractors,

- o DFARS does not specifically address the use of both U.S. dollars and foreign currency in the pricing and award of contracts to foreign businesses, and

- o USEUCOM and Air Force supplemental regulations conflict, or partially conflict, with the DFARS.

Current foreign exchange rates for pricing contracts.

Contracting officers relied on various sources including rates established by the Government for disbursements and budgetary purposes. However, those rates were unsatisfactory for contract pricing purposes because they did not adequately estimate the contract cost for the period of contract performance.

Two competitively awarded Navy contracts in our sample involved multiple currencies that were evaluated using the "Foreign

Currency Execution Rates for Operation and Maintenance (O&M) Appropriations." These rates were also referred to as the DoD budget rate. The contracting officers used the budget rates to evaluate the proposed contract prices and the lowest bidder. The DoD budget rate is an artificial exchange rate intended for obligating funds and is not intended for use in pricing contracts. The budget rate rarely reflects the actual exchange rates experienced in the marketplace. Although foreign currencies fluctuated significantly over time, the DoD budget rate remained unchanged for 2 years (FY 1988 and FY 1989) adding to the inaccuracy of the rates for pricing purposes. Nevertheless, a contracting officer used the DoD budget rate to evaluate bids in multiple currencies. Using the budget rates, the Navy converted each bid price into U.S. dollars to determine the lowest bidder. Use of the budget rate in this manner could have distorted the ranking of prospective bidders and caused the selection of a bid that was not the most competitive or favorable to the Government. Fortunately, in the cases discussed, the spread between bid prices was far enough apart that a distortion in the ranking of bidders did not occur. However, if the price spread between bidders had been closer, a different contractor could have been selected as the lowest bidder.

Current market exchange rates. In lieu of the various exchange rates and budget rates used throughout the DoD, current market exchange rates from commercial sources would be more accurate for use in pricing DoD contracts. In addition to current market rates published by banks and newspapers, several commercial firms maintain foreign exchange rate information that is widely used by the Government and industry. Foreign exchange rate data can be obtained from approximately 50 sources nationwide. The following list shows available sources.

- o Wharton Econometrics, Philadelphia, Pennsylvania
- o Data Resources, Inc., Cambridge, Massachusetts
- o PREDEX, New York, New York
- o Business International, New York, New York
- o Currency Forecasters Digest, White Plains, New York
- o Multinational Computer Models, Montclair, New Jersey

Current foreign exchange rate data would assist contracting officers in pricing negotiated contracts, to prevent overpricing and to ensure selection of the most favorable bid in competitive awards.

Evaluation of exchange rates. Contracting officers did not consistently evaluate the reasonableness of exchange rates used by contractors to convert foreign costs into U.S. dollars for pricing purposes. Our review disclosed three contracts (one with a prime contractor and two with subcontractors) awarded to foreign businesses in which the contractor did not disclose the

exchange rate used to convert proposed costs into U.S. dollars. We were unable to determine the exchange rate the contractor and subcontractor had used in the proposals because pricing documentation was inadequate. In none of the three cases did the contracting officers consider currency fluctuation when awarding the contracts.

For example, the Air Force awarded contract F19628-87-C-0228 to a U.S. firm without determining the reasonableness of the exchange rate used by the firm's foreign subcontractor. The subcontractor's proposal was separately priced in U.S. dollars. An audit performed by the British Ministry of Defence on behalf of the DoD stated that the subcontractor applied a "commercial risk factor" to cover exchange rate fluctuation. The contracting officer did not determine the reasonableness of the exchange rate or the commercial risk factor applied by the subcontractor when converting costs to U.S. dollars. No further consideration was given to the exchange rates during negotiation. As a result, there was no assurance that the subcontract was reasonably priced.

This condition occurred because contracting officers did not always know if foreign subcontractors would be used by prime contractors. Therefore, contracting officers did not consider the reasonableness of exchange rates and, when made aware of foreign subcontractors, contracting officers did not determine the reasonableness of exchange rates when evaluating the prime contractor price. Subcontracts that are competitively awarded are not affected by this condition.

Pricing in U.S. dollars or foreign currency. The FAR and DFARS require contracts entered into and performed outside the United States with foreign firms to be priced and paid in local currency, unless determined otherwise by the contracting officer. The contracting officers may decide to solicit and award contracts in U.S. dollars for various reasons. Contracting officers award contracts in U.S. dollars in order to eliminate any budgetary increases associated with currency fluctuation, to ensure that competitive bids can be equitably evaluated, and to eliminate any administrative burden to monitor foreign currency fluctuation. We believe the FAR and DFARS guidance on foreign contracts implies a preference for pricing and award in local foreign currency and causes confusion to contracting officers attempting to minimize the impact of fluctuating currencies. This condition is aggravated by the contradictory supplemental guidance issued by the U.S. European Command and the Air Force, which also conflicts with the FAR and DFARS.

An example of how the guidelines were interpreted was illustrated by one Navy contract award. The Navy contracting officer held negotiations with a foreign contractor in his Crystal City office in order to award a contract in U.S. dollars

rather than in local foreign currency. By finalizing negotiations in the United States, the Navy could award the contract in U.S. dollars, thereby eliminating any risk of increased costs due to foreign currency fluctuation.

Supplemental Guidance. The U.S. European Command and the Air Force have developed supplements to the existing DFARS to provide contracting officers with additional guidance for contracts with foreign businesses. However, in our opinion, the supplements conflict with the basic guidance outlined in the DFARS, which states that contracts be priced and paid in local currency.

For example, the U.S. European Command (USEUCOM) developed supplement subpart 25.501 to the DFARS that applies to all DoD contracting offices in Europe and Africa within the USEUCOM area of responsibility. The USEUCOM supplement partially conflicts with the FAR and DFARS because it allows contractor offers to be submitted in either U.S. dollars or local currency, and it states that offers will be evaluated by converting all foreign currencies to U.S. dollars using the official U.S. Government finance and accounting disbursing rate.

The Air Force Logistics Command (AFLC) developed a supplemental regulation that adds guidance on currency fluctuation, but it conflicts with the DFARS. The AFLC FAR supplement subpart 25.5 requires that contracting officers insert a clause into all solicitations and contracts when bidders and source lists contain firms from more than one country. The clause states:

This contract will be evaluated, awarded, and paid in U.S. dollars. No fluctuation or revaluation is authorized. Therefore, possible fluctuation between the value of U.S. dollar and the value of the offeror's currency must be taken into consideration before submitting firm fixed price proposals.

Further confusion was generated with the issuance of Federal Acquisition Circular 90-4, April 15, 1991, which provides for the use of the provision in FAR 52.214.35, "Submission of Offers in U.S. Currency." Although the FAR and DFARS contain guidance for pricing and payment of contracts to foreign contractors in local foreign currency, the new clause is provided for use in solicitations in which the contracting officer decides to award in U.S. dollars. To avoid confusion, we believe the DFARS should not specify the type of currency for pricing and award of contracts. Contracting officers should be allowed to award contracts in either local foreign currency or U.S. dollars depending on the type of procurement and currency situation. However, certain precautions should be taken to ensure that

exchange rates used by U.S. and foreign contractors are reasonable and adequately evaluated.

Summary of DoD Guidance

Existing DFARS guidance does not adequately require contracting officers to consider foreign currency fluctuation when awarding contracts to foreign contractors. Current DFARS guidance:

- o does not address current market exchange rates for use in pricing contracts with foreign business concerns, and

- o does not specifically address the use of both U.S. dollars and foreign currency in the pricing and award of contracts to foreign businesses.

In addition, USECOM and Air Force implementing guidance were not consistent with the DFARS.

RECOMMENDATIONS, MANAGEMENT COMMENTS, AND AUDIT RESPONSE

1. We recommend that the Commander, Air Force Logistics Command, eliminate the Air Force Logistics Command, DoD, Federal Acquisition Regulation Supplement subpart 25.5, "Payment in Local Foreign Currency."

2. We recommend that the Director of Defense Procurement direct the Defense Acquisition Regulations Council to retitle and revise Defense Federal Acquisition Regulation Supplement subpart 225.5, "Payment in Local Foreign Currency," as follows:

"Pricing and Payment of Contracts With Foreign Contractors"

225.501 Policy. Contracting officers will determine whether solicitations involving offshore contracts will permit submission of offers in and contracts to be paid in either U.S. dollars, local currency, or both, unless stated otherwise by international agreement. The contracting officer will determine the most equitable currency to be used based on risk of fluctuation, availability of currency, availability of current exchange rate information, impact on competition, or other considerations.

225.502 Evaluations of Offers Received in Multiple Foreign Currencies. Evaluations shall be accomplished by converting all foreign currencies to U.S. dollars using a current market foreign exchange rate from commercially available sources.

225.503 Pricing Support for Contracts Awarded in U.S. dollars. The contracting officer shall require that proposals for offshore contracts in U.S. dollars, that are subject to the requirement for submission of cost and pricing data contained in Federal Acquisition Regulation 15.804, "Cost and Pricing Data," contain specific disclosure of the exchange rate used by the foreign contractor to convert local currencies to U.S. dollars. The contracting officer shall use a current market foreign exchange rate from commercially available sources for evaluation purposes.

225.504 Subcontracts. The contracting officer shall require that proposals containing offshore subcontractors, that are subject to the requirements for submission of cost and pricing data contained in Federal Acquisition Regulation 15.804, "Cost and Pricing Data," contain specific disclosure of exchange rates used in pricing subcontract cost. The contracting officer shall evaluate the reasonableness of the exchange rates using a current market foreign exchange rate from commercially available sources.

Management Comments. The Associate Deputy Assistant Secretary of the Air Force (Contracting) concurred with Recommendation 1. to eliminate the Air Force Logistics Command DFARS Supplement language, which conflicted with the DFARS. He questioned our sample of contracting offices that included those located in the United States because the FAR 25.5 and DFARS 225.5 only applied to contracts awarded and performed overseas.

The Director of Defense Procurement shared our concerns related to foreign currency rate evaluations. However, she expressed concern that the draft report overstated any problems related to a preference for use of local currency in foreign contracts. The Director was also troubled by statements that contracting officers went to great lengths to award contracts in U.S. dollars and emphasized that the policy only applied to contracts entered into and performed outside the United States. The Director also stated that exchange rates used in converting foreign currency to U.S. dollars are considered to be cost or pricing data that should be disclosed in accordance with the Truth in Negotiations Act. The Director believes that any deficiencies in this area resulted from a failure to follow existing guidance rather than from inadequate guidance. The Director agreed to direct the DAR Council, upon issuance of the final report, to establish a case to consider DFARS changes related to exchange rate concerns.

The U.S. Commander in Chief, Europe, concurred in part with the finding and draft report Recommendation 1., that there was a need

for a common foreign currency evaluation basis for the DoD. However, he nonconcurrent with that portion of the recommendation to eliminate the USEUCOM Supplement subpart 225.5. He stated that the use of the finance and accounting office disbursing rate was an accurate basis to use for foreign currency conversions. Also, the subpart wording had been approved by the Defense Acquisition Regulations Council. He also had reservations with the proposed revisions to the DFARS in the report.

Audit Response. The Air Force actions are responsive and meet the intent of Recommendation 1. We agree with the Air Force that the FAR 25.5 and DFARS 225.5 requirements only apply to contracts awarded and performed overseas. Our review was concerned with DoD consideration of the impact of fluctuating foreign exchange rates on all types of awards to foreign contractors. Therefore, our sample included contracts and subcontracts under prime contractors awarded by U.S. contracting offices where the impact of exchange rates should have been considered. For example, we reviewed sole-source contracts awarded in U.S. dollars with foreign contractors at both U.S. and overseas contracting offices. We have revised the final report to delete portions that may have caused confusion as to the application of the FAR 25.5 and DFARS 225.5 policy to all our sample contracts.

The Director of Defense Procurement response meets the intent of Recommendation 2. We revised the final report to address the Director's concerns that the draft report possibly overstated the problem and the lengths that contracting officers went to award in U.S. dollars.

After considering the comments of the U.S. Commander in Chief, Europe, and the agreement of the Director of Defense Procurement to establish a DAR case on the issue, we have deleted draft report Recommendation 1. to eliminate USEUCOM Supplement subpart 225.5. Therefore, we renumbered the remaining recommendations accordingly. The USEUCOM subpart currently allows the submission of offers in either U.S. dollars or local currency and, therefore, conforms with the implied intent of the FAR and DFARS policy. The USEUCOM comments, related to our proposed DFARS changes, should be addressed by the DAR council in their consideration of the DFARS changes.

PART III - ADDITIONAL INFORMATION

APPENDIX A - Summary of Potential Benefits Resulting From
Audit

APPENDIX B - Activities Visited or Contacted

APPENDIX C - Final Report Distribution

APPENDIX A - SUMMARY OF POTENTIAL BENEFITS RESULTING FROM AUDIT

<u>Recommendation Reference</u>	<u>Description of Benefit</u>	<u>Amount and Type of Benefit</u>
1.	Nonmonetary Elimination of conflicting regulation.	Nonmonetary
2.	Internal Control. Use of current exchange rates from commercial sources and revision to the DFARS will minimize the effect of fluctuating currency exchange rates and overpricing on DoD contracts.	Nonmonetary

APPENDIX B - ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Washington, DC
Assistant Secretary of Defense (Production and Logistics),
Washington, DC
Director of Defense Procurement, Washington, DC

Unified Commands

Commander in Chief, U.S. European Command, Vaihingen, Germany
Commander in Chief, U.S. Pacific Command, Honolulu, HI
Commander, U.S. Forces Japan, Yokota, Japan
Commander, U.S. Forces Korea, Seoul, South Korea

Department of the Army

Assistant Secretary of the Army (Financial Management),
Washington, DC
U.S. Army Europe, Heidelberg, Germany
Army Aviation Systems Command, St. Louis, MO
Army Communications and Electronics Command, Ft. Monmouth, NJ
Army Tank-Automotive Command, Warren, MI
Army Armament Munition Chemical Command, Rock Island, IL
Army Missile Command, Redstone Arsenal, AL
Army Engineer District Far East, Yongsan, South Korea
Army Engineer Division Europe, Frankfurt, Germany
Army Contracting Center Europe, Frankfurt, Germany

Department of the Navy

Assistant Secretary of the Navy (Financial Management),
Arlington, VA
Commander in Chief U.S. Navy Europe, London, England
Naval Air Systems Command, Arlington, VA
Naval Sea Systems Command, Arlington, VA
Naval Regional Contracting Center, Naples, Italy
Naval Avionics Center, Indianapolis, IN

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and
Comptroller), Washington, DC
Headquarters, U.S. Air Forces Europe, Ramstein Air Force Base,
Germany
Air Force Aeronautical Systems Division, Dayton, OH
Air Force Electronics Systems Division, Bedford, MA
Air Force Contracting Center Pacific, Yokota, Japan
Warner Robins Air Logistics Center, Macon, GA

APPENDIX B - ACTIVITIES VISITED OR CONTACTED (Cont'd)

Department of the Air Force (cont'd)

Ogden Air Logistics Center, Ogden, UT
Air Force Logistics Command Support Group Europe, Kemble, England
3d Space Support Wing/Detachment 1, Copenhagen, Denmark

Defense Agency

Headquarters, Defense Logistics Agency, Alexandria, VA
Defense Fuel Supply Center, Alexandria, VA
Defense Plant Representative Office, Needham, MA

Defense Contract Audit Agency

Headquarters, Alexandria, VA
GTE Resident Office, Needham, MA

APPENDIX C - REPORT DISTRIBUTION

Office of the Secretary of Defense

Assistant Secretary of Defense (Production and Logistics)
Director of Defense Procurement
Director, Defense Acquisition Regulations System
Comptroller of the Department of Defense

Department of the Army

Secretary of the Army
Assistant Secretary of the Army (Financial Management)
Assistant Secretary of the Army (Procurement)
Commander In Chief, U.S. Army, Europe
Commander, U.S. Army Contracting Command, Europe
Commander, U.S. Army Corps of Engineers
Auditor General, U.S. Army Audit Agency
U.S. Army Engineer Division, Europe

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Assistant Secretary of the Navy (Research, Development and
Acquisition)
Comptroller of the Navy
Auditor General, Naval Audit Service
Commander, Naval Air Systems Command
Commander, Naval Sea Systems Command
Commander, Naval Regional Contracting Center, Naples, Italy

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and
Comptroller)
Deputy Chief of Staff, Logistics and Engineering
Auditor General, Air Force Audit Agency

Other Defense Activities

U.S. Commander In Chief, Europe
U.S. Commander In Chief, Pacific
Commander In Chief, U.S. Naval Forces Europe
Director, Defense Logistics Agency
Director, Defense Contract Audit Agency

APPENDIX C - REPORT DISTRIBUTION (cont'd)

Non-DoD Activities

Office of Management and Budget
U.S. General Accounting Office, NSIAD Technical Information
Center

Congressional Committees:

Senate Subcommittee on Defense, Committee on Appropriations
Ranking Minority Member, Senate Subcommittee on Defense,
Committee on Appropriations
Senate Committee on Armed Services
Ranking Minority Member, Senate Committee on Armed Services
Senate Committee on Governmental Affairs
Ranking Minority Member, Senate Committee on Governmental
Affairs
House Committee on Appropriations
Ranking Minority Member, House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
Ranking Minority Member, House Subcommittee on Defense,
Committee on Appropriations
House Committee on Armed Services
Ranking Minority Member, House Committee on Armed Services
House Committee on Government Operations
Ranking Minority Member, House Committee on Government
Operations.
House Subcommittee on Legislation and National Security,
Committee on Government Operations
Ranking Minority Member, House Subcommittee on Legislation
and National Security, Committee on Government Operations

PART IV - MANAGEMENT COMMENTS

Director of Defense Procurement

U.S. Commander in Chief, Europe

Office of the Assistant Secretary of the Air Force (Acquisition)

MANAGEMENT COMMENTS FROM DIRECTOR OF DEFENSE PROCUREMENT



ACQUISITION
DP/CPF

OFFICE OF THE UNDER SECRETARY OF DEFENSE
WASHINGTON, DC 20301-3000

DEC 19 1991

MEMORANDUM FOR DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE, OFFICE
OF THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

THRU: CHIEF, CONGRESSIONAL ACTIONS AND INTERNAL REPORTS *R. Anderson 12/2/91*

SUBJECT: Draft Audit Report on Impact of Fluctuating Foreign
Exchange Rates on Contract Prices

As requested in your memorandum of October 23, 1991, we have carefully reviewed your subject draft audit report and wish to offer the following comments regarding it.

Conceptually, we share the following three primary concerns addressed in your draft report:

- (1) Contracting officers should use a current market exchange rate from a commercially available source when evaluating offers received in multiple foreign currencies or assessing the reasonableness of the exchange rate employed by a contractor or subcontractor in converting foreign currencies to U.S. dollars.
- (2) Unless restricted by law or international agreement, contracting officers should be allowed to use their best professional judgment to determine whether offers and payments for offshore contracts are to be in U.S. dollars, local currency, or both.
- (3) The exchange rate employed by a contractor or subcontractor in converting foreign currencies to U.S. dollars is cost or pricing data which should be disclosed to the contracting officer when the contract or subcontract is subject to the provisions of the Truth in Negotiations Act.

Having said this, however, we must express our additional concern that your draft report considerably overstates any problems which may exist involving the preference for the use of local currency set out in Federal Acquisition Regulation (FAR) Subpart 25.5 and Defense Federal Acquisition Regulation Supplement (DFARS) Subpart 225.5. In particular, we are troubled by the statement: "In some

MANAGEMENT COMMENTS FROM DIRECTOR OF DEFENSE PROCUREMENT
(Continued)

instances contracting officers went to great lengths to award contracts in U.S. dollars rather than foreign currency."

It should be clearly recognized that the policy at FAR 25.5 and DFARS 225.5 applies only to contracts entered into and performed overseas. To the extent that any of the contracts in your audit sample were awarded within the United States for performance abroad, these provisions do not apply. Moreover, we believe that it is improper to categorize the FAR preference for the use of local currency as a "requirement," since the FAR provision gives the contracting officer the authority to use U.S. dollars whenever he or she "determines the use of local currency to be inequitable or inappropriate." Thus, under the FAR, the contracting officer has considerable latitude in this regard.

While it is true that the current DFARS 225.5 requires approval at a level above the contracting officer, that provision has been deleted from the new DFARS, which becomes effective on December 31, 1991. Therefore, DoD contracting officers will very shortly have the unencumbered authority to determine the most appropriate currency for an offshore contract, as advocated by your office.

In addition, we believe that it should already be quite clear under the existing coverage at FAR 15.8 that the exchange rate used by a contractor or subcontractor in converting foreign currencies to U.S. dollars is cost or pricing data which should be disclosed to the contracting officer when the contract or subcontract is subject to the provisions of the Truth in Negotiations Act. For this reason, we are confident that any problems in this regard found during your audit resulted from a failure to follow existing guidance, rather than from any inadequacy in that guidance.

We appreciate the opportunity to comment on this draft report. Upon issuance of a final report, we will direct the DAR Council to establish a case to carefully consider the DFARS changes which you have recommended in response to the above cited areas of mutual concern.



Eleanor R. Spector
Director, Defense Procurement

MANAGEMENT COMMENTS FROM U.S. COMMANDER IN CHIEF, EUROPE

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JOINT STAFF
IMP SERVICE CENTER

PRIORITY
P 301408Z DEC 91
FM USCINCEUR VAHINGEN GE//ECCS//
TO SECDEF WASHINGTON DC//IG/DOO/AIG/AUD//
INFO JOINT STAFF WASHINGTON DC//OJS/J4-SUSD//
HQ USEUCOM LO WASH DC OIG INV LINDSEY AS GE//AUD//
CINCUSNAVEUR LONDON UK//IG/OL2/M4/M42//
HQ USAFE RAMSTEIN AB GE//LG/AC/LGC/ACCC//
HQ FMFEUR DESIGNATE LONDON UK//G4//
CDR US ARMY COMT CMD EUR HEIDELBERG//AEUCC/AEUCC-0//
CDR USAEDE FRANKFURT GE//EUDCT//
CDR DSRE ZWEIBRUEKEM GE//OSRE-P//
CDR DFR EUR VAHINGEN GE HQ AAFES-EUR MUNICH GE//PL/SA//
USCINCEUR VAHINGEN E//SPACOS//

UNCLAS
MSGID/ECJ4-LIL//
AMPN/SUBJECT: DODIG DRAFT REPORT - IMPACT OF FLUCTUATING FOREIGN
CURRENCY EXCHANGE RATES ON CONTRACT PRICES - PROJECT OCA-0046//
REF/A/DOC/DODIG/23OCT91//
NARR/REF A: DODIG REQUEST FOR COMMENTS ON DRAFT AUDIT//
REF MESSAGE TEXT FOLLOWS/
1. THE FOLLOWING COMMENTS RESPOND TO REF A.
2. FINDING/RECOMMENDATION FOR CORRECTIVE ACTION 1. CONCUR IN PART.
WE CONCUR THERE IS A NEED FOR A COMMON FOREIGN CURRENCY EVALUATION
BASIS FOR THE DOD. WE NONCONCUR WITH THE RECOMMENDATION TO
ELIMINATE THE USEUCOM SUPPLEMENT SUBPART 225.5. THE USE OF THE
FINANCE AND ACCOUNTING OFFICE (FAO) DISBURSING RATE IN SUBPART
225.5 IS AN ACCURATE FOREIGN CURRENCY CONVERSION MEDIUM BASED ON
THE DAILY COST OF EACH FOREIGN CURRENCY. THE WORDING OF SUBPART
225.5 COMPLIES WITH THE INTENT OF THE FEDERAL ACQUISITION
REGULATION AND DEFENSE FEDERAL ACQUISITION REGULATION SUPPLEMENT
AND WAS PUBLISHED PER THE APPROVAL OF THE DEFENSE ACQUISITION
REGULATION COUNCIL.
3. THE PROPOSED REVISIONS TO FAR SUPPLEMENT 225.5 CONTAIN DISCRE
TIONARY EVALUATION CRITERIA TO BE USED BY CONTRACTING OFFICERS IN
SELECTION OF THE MOST EQUITABLE CONTRACT OFFER OR PAYMENT CURRENCY
AND MAY RESULT IN AN INCREASE IN THE NUMBER OF CONTRACT AWARD
PROTESTS OR PAYMENT DISPUTES.
4. POC IS MAJOR BOTTS, DSM 430-7475/8467.// BT

Draft Report
Recommendation
1. deleted from
final report.

NO FURTHER DISTRO FOR JCS PER MAJ MCCLELLAN/SJS

ACTION IG(1) (M,C)
INFO CJCS(1) MIDS(1) J4(7) USCINCSO LO(1) EUCOMLO(1)
SECDEF-N(1) USDA:P&L(1) OASIS(1)

MCN=91364/02850 TOR=91364/14582 TAD=91364/18032 CDSN=MA2326
PAGE 1 OF 1
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UNCLASSIFIED

MANAGEMENT COMMENTS FROM OFFICE OF THE ASSISTANT SECRETARY OF
THE AIR FORCE (ACQUISITION)



DEPARTMENT OF THE AIR FORCE
WASHINGTON DC 20330-1000

OFFICE OF THE ASSISTANT SECRETARY

JAN 17 1992

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL

SUBJECT: Draft Report on the Audit of Impact of Fluctuation Foreign Exchange Rates on
Contract Prices (Project No. OCA-0046) (Your Memo, Oct 23, 91) -
INFORMATION MEMORANDUM

We have reviewed the subject audit report and our comments regarding its
recommendations are as follows:

We are concerned with the sampling selected for review. It is unclear to us if the
sampling included contracting offices located in the U.S., offices located in foreign countries, or
both. However, from a review of Appendix A, "Activities Visited or Contacted," it appears that
the team visited both. The distinction is critical. The policy at FAR 25.5 and DFARS 225.5
only applies to contracts awarded and performed overseas.

Recommendation 2. Concur. In accordance with a Defense Management Review
recommendation, HQ AFLC deleted the language outlined in this report.

Our point of contact is Mr. J.P. McCusker, SAF/AQCO, The Pentagon, (703) 614-1648.

IRA L. MCHENRY
Assistant Secretary (Acquisition)
Secretary (Acquisition)
Assistant Secretary (Acquisition)

cc: SAF/FMPF

Renumbered
Recommendation 1
in the final
report.

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William H. Zeh, Auditor
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Velma L. Johnson, Administrative Support