

RELEASED

RESTRICTED — Not to be released outside the General Accounting Office except on the basis of specific approval by the Office of Congressional Relations.

111642

12672

REPORT BY THE

Comptroller General

OF THE UNITED STATES

How Military Sales Trust Funds Operate: Saudi Arabian And Iranian Funds Compared

This report answers questions concerning the Saudi Arabian trust fund, the operation of all U.S. military sales trust funds, and the need for a central clearinghouse controlling disbursements from these trust funds.

Acting on a recommendation in our July 25, 1979, report (FGMSD-79-47), Defense is requiring the military departments to estimate potential termination liability reserves for foreign military sales agreements. This requirement, however, is not uniformly implemented. In addition, Defense has established procedures for pricing items diverted to second buyers but these procedures are not always followed. As a result, Defense cannot be certain that all funds transferred into the Iranian trust fund account from second buyers are valid.

GAO is recommending that the Secretary of Defense ensure that the military services (1) uniformly implement Defense's procedures for computing termination liability reserves, (2) collect such amounts promptly, and (3) ensure that these amounts are unavailable for routine contractor payments.



111642



508486

FGMSD-80-26
JANUARY 28, 1980





COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON, D.C. 20548

B-196926

The Honorable Max Baucus
Chairman, Subcommittee on Limitations
of Contracted and Delegated Authority
Committee on the Judiciary
United States Senate

SEN02518
DN AGC00001
DAF AGC00035
DOD AGC00005
DA-CE AGC00305

Dear Senator Baucus:

Your letters of April 30, 1979, and May 7, 1979, and subsequent discussions with your office raised several questions on (1) the activities and current status of the Saudi Arabian trust fund, (2) the operation of all trust funds, (3) the need for a central clearinghouse controlling disbursements from these trust funds, and (4) ways to improve accounting for foreign military sales. In response to your request, we are providing financial information on the Saudi Arabian trust fund; answers to the legal questions raised; and an explanation of how all foreign military sales trust funds operate. (See app. I.)

This report also contains information on the current status of the Iranian trust fund. In our July 25, 1979, report to you, "Financial and Legal Implications of Iran's Cancellation of Arms Purchase Agreements" (FGMSD-79-47), we recommended certain actions to protect the financial interests of the United States should future cancellations occur. Also, on October 11, 1979, we provided your office with specific language which could be used to amend the Arms Export Control Act to ensure that liability does not fall on the United States in the event of future cancellations of foreign sales agreements.

Although since 1970 Defense has normally required foreign customers to pay, in advance, an amount sufficient to cover, at all times, all costs and damages associated with a sales agreement including potential termination costs, the military services have not uniformly implemented that policy. In August 1979, Defense reaffirmed the policy and directed the military services to provide worksheets showing the estimated termination liability reserves for selected sales agreements.

This action by Defense to compute termination liability reserves is the initial step in determining the amount of funds necessary to protect the financial interest of the United States

should future cancellations occur. The financial interests of the United States, however, will not be fully protected until such funds are collected from the foreign countries. Defense must ensure that the policy is uniformly implemented by the military departments and that the termination liability reserves are promptly billed to foreign governments. In addition, we believe that segregating such amounts in the trust fund and making these amounts unavailable for contractor payments would improve financial management.

To correct the deficiencies disclosed during our review, we are recommending that the Secretary of Defense ensure that:

- The military departments uniformly implement the Defense procedures for computing termination liability reserves.
- Payment schedules include adequate termination liability reserves and foreign governments are promptly billed.
- Collections for possible contract termination be segregated in the trust fund and not used for routine contractor payments.

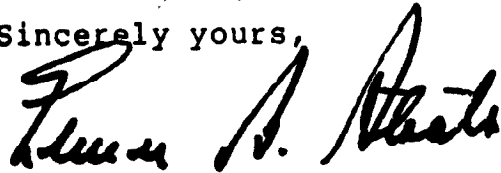
Also, in reviewing the actions taken since Iran cancelled its foreign military sales agreements in February 1979, we found that Defense procedures for pricing items diverted to other buyers were not always followed. As a result, excess funds may have been transferred into the Iranian account. To protect the United States' interest, we are recommending that the Secretary of Defense ensure that established procedures for pricing items diverted to second buyers are followed before funds are transferred to the Iranian trust fund.

Your April 30, 1979, and May 7, 1979, letters are attached as appendix II. Financial information requested on deposits, disbursements, and trust fund balances for the Saudi Arabian foreign military sales program is in appendix III. Appendix IV contains updated financial data on the status of the Iranian foreign military sales trust fund account. The scope of our review is in appendix V.

The financial information in this report is based, for the most part, on Department of Defense accounting records and information provided by Defense officials. Because of the amount of information requested in your letters, the number of accounting systems involved, and the short time frame provided to prepare this report, we were not always able to verify the information.

As requested by your office, we did not discuss our findings, conclusions, and recommendations with Defense officials. Further, your office asked that unless you publicly announce its contents earlier, we will make no further distribution of this report until 30 days from its date. At that time, we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

A handwritten signature in black ink, appearing to read "James A. Abate". The signature is written in a cursive style with a large initial "J" and a long, sweeping underline.

Comptroller General
of the United States

The following information is provided for your information:
 The total number of units in the project is 100 units.
 The total number of units currently under construction is 50 units.
 The total number of units currently occupied is 25 units.
 The total number of units currently vacant is 25 units.

The following information is provided for your information:
 The total number of units in the project is 100 units.
 The total number of units currently under construction is 50 units.
 The total number of units currently occupied is 25 units.
 The total number of units currently vacant is 25 units.

C o n t e n t s

APPENDIX

Page

- | | |
|---|----|
| I Findings and recommendations on how military sales trust funds operate: Saudi Arabian and Iranian funds compared | 1 |
| 1-What is the value of the Saudi Arabian foreign sales program, and what type of Defense articles and services are being purchased? | 1 |
| 2-What was the average monthly balance of the Saudi Arabian foreign military sales trust fund for the past 2 years, and how much was in the fund at any one time? | 2 |
| 3-How do the foreign military sales trust funds function? | 2 |
| 4-Does the Saudi Arabian trust fund operation differ in any substantive manner from the Iranian trust fund? This includes the terms of payment and the like. | 3 |
| 5-What would happen if a situation regarding the Saudi Arabian trust fund developed similar to the situation with the trust fund set up between the United States and Iran? | 5 |
| 6-Do the individual U.S. military services make disbursements or does a central clearinghouse control such disbursements from the fund? | 7 |
| 7-Since Iran cancelled the majority of its arms purchase agreements, what actions has the Department of Defense taken to assure that financial liability does not fall on the United States in the event that foreign sales agreements are cancelled in the future? | 8 |
| 8-Have the military services properly implemented Defense's policy for computing termination liability reserves? | 9 |
| 9-What is the current financial status of the Iranian foreign military sales trust fund? | 11 |

APPENDIX

Page

10-Have the military services consistently implemented the Defense policy on pricing items diverted to second buyers?	12
11-Since Iran cancelled its foreign military sales agreements in February 1979, have shipments of Defense articles continued? Further, has the Iranian Government expressed any interest in revitalizing its foreign sales program?	14
Conclusions and recommendations	15
II April 30, 1979, and May 7, 1979, letters from the Chairman, Subcommittee on Limitations of Contracted and Delegated Authority, Senate Committee on the Judiciary	17
III Schedule of Saudi Arabian trust fund activity for the 24-month period ended September 30, 1979	21
IV Schedule of Iranian trust fund activity for the 30-month period ended September 30, 1979	22
V Scope of review	23

FINDINGS AND RECOMMENDATIONS ON HOW MILITARYSALES TRUST FUNDS OPERATE: SAUDI ARABIANAND IRANIAN FUNDS COMPARED

Following are our answers to the questions raised by the Chairman, Subcommittee on Limitations of Contracted and Delegated Authority, Senate Committee on the Judiciary, on (1) the activities and current status of the Saudi Arabian trust fund, (2) the operation of all trust funds, (3) the need for a central clearinghouse controlling disbursements from these trust funds, (4) ways to improve the accounting for foreign military sales, and (5) the current status of the Iranian trust fund.

Question 1. What is the value of the Saudi Arabian foreign sales program, and what type of Defense articles and services are being purchased?

Response:

During the past 3 fiscal years (1977-79), the Saudi Arabian Government has signed sales agreements (Department of Defense Form 1513), valued at \$1.9 billion, \$4.1 billion, and \$6.4 billion, respectively. As of September 30, 1979, the Saudi Arabian Government had \$22.2 billion of undelivered foreign military sales orders. These sales agreements represented the value of signed agreements between the United States and Saudi Arabia and not the value of contracts entered into by the United States with its contractors on behalf of Saudi Arabia.

The sales agreements are for the purchase of weapons systems, such as the F-5 aircraft, F-15 aircraft, TOW, Dragon, and Maverick missiles. These sales agreements also generally include the logistical support, such as spare and repair parts, and training associated with these systems.

The Saudi Arabian construction program administered by the U.S. Army Corps of Engineers has a current program value of approximately \$13.5 billion, and a projected total program value of about \$21 billion. The sales agreements signed between the Corps of Engineers and the Saudi Arabian Government were valued at \$700 million in fiscal 1977 and have increased to about \$2 billion in fiscal 1978 and 1979. The construction program includes the design and construction of naval port facilities, military airbases, infantry and artillery centers, and family housing and medical facilities. Under this program, the Corps of Engineers contracts for all the construction work but does not do the actual construction.

Question 2. What was the average monthly balance of the Saudi Arabian foreign military sales trust fund for the past 2 years, and how much was in the fund at any one time?

Response:

Appendix IV shows a monthly breakdown on deposits, disbursements, and trust fund balances for the 24-month period ended September 30, 1979.

The daily balance in the trust fund varies depending on the value of deposits and the rate of disbursement. During fiscal 1978, the average monthly balance of the trust fund was \$1.5 billion. The average monthly balance for fiscal 1979 increased to over \$2 billion.

Question 3. How do the foreign military sales trust funds function?

Response:

The International Security Assistance and Arms Export Control Act of 1976, which amended and revised the Foreign Military Sales Act of 1968, gives the Department of Defense authority to sell Defense articles and services to foreign countries at no cost to the U.S. Government. Foreign military sales agreements and Defense policy require foreign governments to deposit funds in a trust fund held by the U.S. Treasury in advance of the time the money is needed to pay contractors on behalf of the foreign government. Defense also requires that sufficient funds be on hand to cover potential termination costs.

Accounting and financial management activities of the trust fund involve more than 40 Defense organizations. The Security Assistance Accounting Center (Center) in Denver, Colorado, was established in November 1976, and is Defense's central foreign military sales billing and collecting organization. The Center is responsible for providing foreign customers an accounting of their deposits to and disbursements from the trust fund. Further, the Center prepares foreign customer bills and reimburses the military departments' appropriations for expenses incurred. The military departments are responsible for detailed accounting and for paying contractors.

At the present time, with the exception of Saudi Arabia, foreign governments' funds are deposited into the trust fund account maintained by the Treasury. Treasury records show the consolidated available cash balance in the trust fund by military service. In fiscal 1978 and 1979, between \$8 billion and

\$9 billion was deposited in and disbursed from the trust fund annually. The average trust fund balance was about \$6 billion. The Center also records the amount of funds received from the foreign government in the individual country trust fund ledgers.

The amount of funds that should be provided by the foreign government is based on the billing statement provided by the Center, which bills the foreign countries quarterly.

The quarterly statement represents the United States' official claim for payment from the foreign countries. This request also represents the amount of funds needed by the United States to continue the sales program for the quarter beginning 90 days after the billing date. For example, the funds requested by the September 30, 1979, billing statement were for costs expected to be incurred on behalf of the foreign country for the quarter beginning January 1, 1980. Further, the quarterly statement provides each foreign country with a detailed accounting of all costs incurred under each sales agreement.

The military departments prepare monthly statements of transactions and forward them to the Treasury and the Center. These statements report monthly disbursements by country. Both the Treasury and the Center record these disbursements along with any collections that are received during the month. The Treasury sends the Center a monthly report which shows total disbursements by military service and the Center reconciles its cash balance to the Treasury's cash balance at the service level.

Question 4. Does the Saudi Arabian trust fund operation differ in any substantive manner from the Iranian trust fund? This includes the terms of payment and the like.

Response:

Generally, the foreign military sales trust funds operate similarly. As stated above, Treasury maintains the trust fund balance for each country at the military service level. The Center maintains records of individual trust fund balances at the country level. Each month the Center reconciles its accounting records with Treasury records to determine an overall trust fund cash balance.

There are three basic differences between the operation of the Saudi Arabian trust fund and other trust funds, including the Iranian trust fund. Saudi Arabia (1) finances a part of its foreign sales program through letter-of-credit arrangements with a major commercial bank, (2) has additional funds

on deposit in an interest-bearing account at a Federal Reserve Bank, and (3) guarantees payments for other foreign customers who participate in the foreign military sales program.

The letter-of-credit arrangements do not directly affect the Saudi Arabian balance. Under these arrangements, work done in conjunction with or by the U.S. Army Corps of Engineers is financed by letters of credit with a commercial bank. Saudi Arabia deposits funds in the commercial bank and the Corps draws on the letters of credit as costs are incurred and reports this to the Center. As of September 30, 1979, the letter of credit to cover the Engineering Assistance Agreement program was valued at over \$3.4 billion, and the Corps had drawn down more than \$2.7 billion. Other letters of credit valued at about \$737 million were available for the Saudi Arabian naval expansion program and the construction management program.

Although the Saudi Arabian letter-of-credit arrangement is irrevocable, a Defense Security Assistance Agency (Agency) official informed us that this arrangement may not fully protect the United States if Saudi Arabia should decide to cancel its foreign sales agreements. For example, if the Saudi Government cancelled its program and sufficient funds were not on deposit under the letter-of-credit arrangement to pay for all costs incurred, there is no absolute assurance that funds would be forthcoming to cover the additional expenditures. If this occurred, the United States could be liable to the contractors for any unpaid costs, as was the case with Iran, even though the contract requires Saudi Arabia to pay these costs.

Besides the letters of credit, Saudi Arabia recently established an investment account with a Federal Reserve Bank. In June 1979, the Saudi Arabian Government requested that the United States transfer from its trust fund account moneys not currently needed to meet its obligations into an interest-bearing account. In August 1979, President Carter approved the Saudi Arabian request, and Defense transferred about \$478 million.

In October 1979, approximately \$1.45 billion remained in the Saudi Arabian foreign military sales trust fund. This trust fund money was available to cover working fund requirements, amounts held back to ensure contractor performance, and termination liability reserves.

The trust fund balance will be reduced over time. Payments for Saudi Arabian contracts will be made from the trust fund while payments by Saudi Arabia will be deposited into the

interest-bearing account. When the trust fund balance reaches a working fund level of about \$300 million, a system of monthly withdrawals from the interest-bearing account will be implemented to replenish the trust fund. Thus, the amounts held back to ensure contractor performance and the amounts collected as termination liability reserves will be maintained in an interest-bearing account.

Although the transfer of funds to the investment account will reduce the trust fund balance, it should not adversely affect the financial interests of the United States. Future funds deposited in the interest-bearing account and those already on deposit cannot be withdrawn by Saudi Arabia without the United States' permission. However, the United States can withdraw these funds without Saudi Arabia's permission.

In addition to the letters of credit and interest-bearing account, the Saudi Arabian Government has another unique financial arrangement in that it guarantees payment by other foreign countries. As of September 30, 1979, Saudi Arabia had guaranteed payments of over \$680 million for sales agreements signed with Jordan and Yemen. However, the trust fund balance at that time was only \$145 million for Jordan and \$137 million for Yemen. Thus, the amount of risk assumed by Saudi Arabia under this guarantee arrangement is relatively small in relation to the size of the Saudi program.

Question 5. What would happen if a situation regarding the Saudi Arabian trust fund developed similar to the situation with the trust fund set up between the United States and Iran?

Response:

Except for differences in the size of the program, if Saudi Arabia would cancel its arms sales agreements, the financial situation between the United States and Saudi Arabia would not be significantly different than that between the United States and Iran. If the Saudi Arabian program is cancelled, funds would be needed to pay for (1) work completed but not yet charged to the Saudi Arabian trust fund, (2) anticipated contract progress payments, and (3) potential termination costs. Also, such costs associated with the cancellations as the movement of contractor personnel and personal belongings from Saudi Arabia would have to be paid.

On September 30, 1979, the Saudi Arabian Government's trust fund balance was over \$1.9 billion and another \$1.4 billion was on deposit under the letter-of-credit arrangements. Further, the Saudi Government had undelivered foreign military sales orders of \$22.2 billion. By comparison, when the

Iranian Government cancelled its sales agreements, its trust fund balance was about \$640 million and its undelivered foreign military sales orders were valued at \$12.6 billion.

At the time of our review, Defense had not established a separate termination liability reserve account to cover anticipated costs in the event of project cancellation by the Saudi Arabian Government. Also, since estimates on contract termination costs had not been developed, we were unable to determine the amount of disbursements from the trust fund needed to cover all costs should Saudi Arabia cancel its foreign sales agreements.

Saudi Arabia would be responsible for paying any contract cancellation costs in the event the trust fund amounts prove insufficient. Under a procurement for cash sale transaction pursuant to section 22 (a) of the Arms Export Control Act, the United States secures a "dependable undertaking" from the foreign country (evidenced by a letter of offer and acceptance). Under that letter, the foreign country essentially agrees to pay the full amount of the procurement contract, including any damages and costs that may result from the cancellation of such contracts, thus ensuring the United States against any loss on the contract. The situation where a foreign government does not pay costs incurred on its behalf has never been the subject of litigation.

Under section 22 (a), procurement for cash sales, the Department normally uses a standard form contract to procure the Defense articles from Defense contractors for the foreign country concerned. Such contracts generally do not contain any provisions specifying the extent of the United States' liability in the event of a default by a foreign country under its letter of offer and acceptance. That is, the contracts do not specifically guarantee, limit, or disclaim the United States' liability. Therefore, the United States' liability or nonliability remains to be resolved. The fact remains that only the United States enters into the procurement contracts with the Defense contractors--not the foreign country concerned--and the United States maintains control over both the performance of and the payments to those contractors. Therefore, it would appear that a court may well hold the United States liable to the contractors for their unpaid costs.

In addition, based on Defense's action in the Iranian situation, should another foreign government cancel its arms sales agreements under the same or similar cataclysmic circumstances, Defense would likely attempt to find second buyers, including the United States. We believe that the reasonableness of such actions would depend on the circumstance involved. The authorities provided in the Arms Export Control Act should

be read as contemplating some period of time to allow the executive and legislative branches to resolve the situation satisfactorily.

Question 6. Do the individual U.S. military services make disbursements or does a central clearinghouse control such disbursements from the fund?

Response:

The individual military departments are responsible for paying contractors and assuring that proper reimbursement is obtained from the trust fund. The military departments are also responsible for detailed obligation, expenditure, and cost accounting, and for reporting disbursements as well as other financial information to the Center. The Center is dependent upon the military services' input--which is nonstandard--to prepare foreign customer bills, reimburse the departments' appropriations, and account for trust fund expenditures.

In establishing the Center, Defense sought to centralize billing and collecting. Although the Center has provided a standardized bill and certain other financial management controls, it is still dependent upon the military departments' accounting systems for its financial information and serves, for the most part, as a central clearinghouse reporting to foreign customers only what it is told.

In our report entitled "Centralization: Best Long-Range Solution to Financial Management Problems of the Foreign Military Sales Program" (FGMSD-79-33, May 17, 1979), we recommended that Defense develop a plan for centralizing accounting and financial management of the foreign military sales program. This plan should include obligation and expenditure accounting and disbursing of funds and should assure that all costs properly chargeable to the program are fully recovered.

The current accounting systems used by the Department of Defense for foreign military sales have not been submitted for approval to the Comptroller General as required. The Budget and Accounting Procedures Act of 1950 requires the head of each agency to establish and maintain systems of internal control over and accountability for all funds, property, and other assets for which the agency is responsible. The act also requires agencies to conform their accounting systems to the accounting principles and standards prescribed by the Comptroller General. The new system should be developed and designed in accordance with the Comptroller General's accounting principles and standards and submitted to him for formal approval. We reiterated this recommendation in our July 25, 1979, report to you.

In its September 20, 1979, report (H.R. 96-450), the House Committee on Appropriations agreed with our recommendation to centralize foreign military sales accounting and financial management. Because of the seriousness of the problems in terms of the amounts involved and the need to properly account to our foreign customers, the Committee asked Defense to develop a plan for centralizing foreign military sales accounting by March 1980.

Question 7. Since Iran cancelled the majority of its arms purchase agreements, what actions has the Department of Defense taken to assure that financial liability does not fall on the United States in the event that foreign sales agreements are cancelled in the future?

Response:

In our report entitled "Financial and Legal Implications of Iran's Cancellation of Arms Purchase Agreements" (FGMSD-79-47, July 25, 1979), we recommended that the Congress consider amending the Arms Export Control Act to assure that liability does not fall on the United States in the case of future cancellations of foreign sales agreements. The proposed amendment would require foreign customers to pay, in advance, an amount sufficient to cover, at all times, all costs and damages associated with a sales agreement, including potential termination costs. In considering the proposed amendment, the Congress may wish to provide for waivers or exceptions when in the national interest. On October 11, 1979, specific language amending the Arms Export Control Act was provided to your office. We further recommended that, until the Congress has had an opportunity to consider legislative changes, the Secretary of Defense (1) assure that adequate termination costs are included in foreign government payment schedules and (2) direct that amounts collected for potential contract termination costs be segregated in the trust fund.

Acting on our recommendations, the Defense Security Assistance Agency in August 1979 directed the military services to provide worksheets showing the estimated termination liability reserves for selected sales agreements. This action by Defense in computing termination liability reserves is the initial step in determining the amount of funds necessary to protect the financial interest of the United States should future cancellations occur. However, the financial interests of the United States will not be fully protected until such funds are collected from the foreign countries.

Also, we believe that these collections should be segregated in the trust fund account and not be used for normal

contract expenditures. This will help ensure that the necessary funds are on hand at all times should contracts be terminated. This method of separate accounting for termination liability reserves will provide the needed visibility for improved financial management of the foreign military sales trust fund.

The Agency's guidance, if properly implemented, will help protect the financial interest of the United States if other cancellations occur. The Agency, however, must ensure that the guidance is uniformly implemented by the military services. Clear and definitive procedures and methodologies for computing termination liability reserves should be issued by the Agency to ensure that adequate amounts are determined consistently by all services. The Director, Security Assistance Accounting Center was assigned the responsibility for monitoring the compliance with the Agency's instructions and also for determining the adequacy and validity of estimated termination liability reserves computed by the military departments. As part of the validation process, Center personnel plan to visit the military departments and review the supporting documentation for the estimates.

The Center plans to include termination liability costs in the billing statements when (1) revised payment schedules are received from the military departments and (2) the accounting system being developed by the Center becomes operational. As of January 18, 1980, the Center planned to have the accounting system operational during the third quarter of fiscal 1980. Center officials stated that termination liability reserves billed before the third quarter would have to be prepared manually because the current automated system is not capable of billing these costs. In addition, as of January 18, 1980, the military departments had not provided the revised payment schedules.

If Defense delays billing the foreign countries until the third quarter statements are prepared, the foreign governments will not have to deposit the requested funds until September 15, 1980. We realize that Defense policy requires that the foreign countries be notified and acknowledge receipt of an amendment to a sales agreement when the payment schedule changes. However, considering the magnitude of the problem and the urgency to protect the financial interests of the United States, we believe the Center should immediately bill the foreign governments for termination liability reserves simultaneously with notification of payment schedule changes.

Question 8. Have the military services properly implemented Defense's policy for computing termination liability reserves?

Response:

Since January 1970, the Department of Defense has normally required foreign customers to pay, in advance, an amount sufficient to cover, at all times, all costs and damages, including termination costs. However, the military services have not uniformly implemented this policy.

In August 1979, Defense reaffirmed this policy to the military services in its guidance for including termination liability reserves in payment schedules. According to military service officials, however, the guidance lacked a methodology for computing reserves. As a result, each service used a different means for determining termination liability reserves and there is no assurance that the reserves, when collected, will be adequate to protect the financial interests of the United States.

Before August 1979, the Air Force was generally the only military department that included potential termination costs within its payment schedules. These amounts, when collected, were deposited into the foreign countries' trust fund but were not separately identified. The Air Force's methodology of computing termination liability reserves, in accordance with the guidance, was based on the use of computerized expenditure curves and termination liability factors. This method enables the total termination cost to be spread over the entire foreign sales agreement rather than requiring the foreign government to deposit the entire amount of termination cost in advance.

Until August 1979, the Army generally was not including potential termination costs in its payment schedules. The Army Missile Readiness Command, however, did include potential termination costs based on cost curves in its payment schedules between July 1976 and June 1977. The Missile Command did not include such costs since that time because, according to Command officials, the required computations were too cumbersome and time consuming.

In complying with the August 1979 guidance, the Army's estimates provided that all anticipated termination costs be included in the initial payments received and not spread over the contract, as the Air Force is doing. This computation method does not adequately consider changes in termination liability requirements as work progresses, purchaser payments are received, and deliveries are made.

Before September 1978, the Navy had not included estimates of potential termination costs in its payment schedules. In September 1978, the Naval Material Command instructed its subordinate commands to recompute payment schedules for all sales

agreements valued at over \$5 million and ensure that adequate termination costs were included. However, as of August 1979, the Navy had not revised all of its payment schedules.

Upon receiving the August 1979 guidance, the Chief of Naval Operations, through the Chief of Naval Material, instructed his commands to determine termination liability reserves. The naval commands generally used termination liability curves that resulted in the total termination reserves being included in the initial payments received from the foreign country. According to naval officials, however, a formal policy regarding this computation did not exist, and each command used its own method to determine the reserve figures.

This lack of uniform implementation of Defense policies by the military services has been a recurring problem with the foreign military sales program. Defense must ensure that the policy is uniformly implemented and should provide the military services with additional guidance on the computation of termination liability reserves. Until Defense can ensure that its policy is uniformly implemented, there is no assurance that the termination liability estimates and funds to be collected are adequate to protect the financial interests of the United States.

Question 9. What is the current financial status of the Iranian foreign military sales trust fund?

Response:

As of September 30, 1979, Defense records indicated that the Iranian trust fund had a balance of \$485 million. This is an increase of \$373 million from the June 30, 1979, fund balance of \$112 million reflected in our July 25, 1979, report. This increase was primarily due to trust fund reimbursements resulting from the diversion of Iranian items to other buyers. Since March 1979, over \$640 million has been credited to the trust fund. Of this amount, over \$612 million has resulted from diversion. The diversion of Iranian items to other buyers, including the United States, has not only increased the trust fund balance, it has reduced the reserve requirements for final contract termination costs. Until all items are diverted, the Iranian trust fund is liable for any costs incurred. As discussed in our response to question 5, contractors continue to incur costs and, if funds are not available in the trust fund to pay the contractors, the United States could be liable for the unpaid bills.

The Navy's purchase of the Spruance class destroyers represents the most significant transfer of funds to the Iranian trust fund. In July 1979, the Navy transferred about

\$491 million to the Iranian account, and according to Defense officials, another \$70 million will be transferred in fiscal 1980. In addition to the Spruance, the Navy has diverted and/or purchased about \$36 million of items originally ordered by Iran. Those funds have been credited to the Iranian account.

The Army has reimbursed the trust fund for diverted and purchased items valued at approximately \$29 million.

Since our July 25, 1979, report, the Air Force has not transferred any significant amounts of money to the Iranian trust fund. In April 1979, however, the Air Force transferred over \$56 million for the diversion of F-16 aircraft, (\$37.6 million) and the purchase of inventory items (\$19 million) originally ordered by Iran.

In addition to the credits that have already been made to the Iranian trust fund as of September 30, 1979, Defense officials have estimated that an additional \$200 million will be credited to the Iranian trust fund as a result of diversions to other foreign countries and purchases by the military departments. At the present time, Defense can only estimate future credits to the Iranian trust fund because prospective diversions to other buyers are not yet supported by signed sales agreements. Further, the estimated credits also depend upon the military services' ability to reprogram their fiscal 1980 budget. For example, the Navy is currently reprogramming its fiscal 1980 budget to purchase 105 Harpoon missiles and 258 Standard missiles.

The total Iranian equity in the foreign military sales program has not been determined and, according to Defense officials, may not be determined for years. At present, several factors make such a determination difficult. For example, Defense is not aware of the final price of Iranian items still being procured, and the value of future diversions and other credits to the Iranian trust fund is still uncertain. In light of these uncertainties, Defense is estimating that \$80 million will remain in the trust fund after all appropriate expenditures.

Until the uncertainties discussed above have been resolved, Defense cannot be sure that the trust fund balance will cover all costs. If Defense ultimately determines that the trust fund balance cannot cover these costs, it should consider making up this shortfall by proceeding against the Iranian assets recently frozen by the President.

Question 10. Have the military services consistently implemented the Defense policy on pricing items diverted to second buyers?

Response:

The military services have not consistently implemented the Defense Security Assistance Agency's policy on pricing Iranian items sold to second buyers and for reimbursing the trust fund. Although the Agency is responsible for ensuring that its guidance is properly implemented, we found that this responsibility was left to each services' subordinate commands. Neither the Agency nor the military services' headquarters monitored the accounting transactions to ensure that the Iranian trust fund was properly credited or charged.

Under the Agency's procedures, the second buyer does not have to reimburse the Iranian trust fund for (1) items peculiar to Iran which have no value to the new purchaser and/or (2) certain administrative expenses. In cases where the item must be modified to meet the second buyer's requirements, the new buyer is only required to pay for modification costs to the extent that the combined cost of the item and its modification would not exceed what it would cost to buy the item today. The Iranian trust fund must bear any excess cost.

We agree with these procedures in concept and, as stated in our July 1979 report, we believe that the policy, if properly implemented, is equitable to both Iran and to the new purchaser. However, we found that the Agency and military services' headquarters were not ensuring that the guidance was properly implemented.

For example, in late April 1979 the Air Force transferred over \$37.6 million into the Iranian trust fund from a second buyer for the purchase of F-16 aircraft. At the time of transfer, Air Force officials were aware that the trust fund would be liable for costs of peculiar items, anticipated modifications, and termination costs associated with the cancellation of the program. In May 1979, the Air Force estimated that these costs could total over \$18 million.

Air Force and Agency officials have acknowledged that the Iranian fund is still liable for additional costs on the contract. The latest Air Force estimates show the Iranian liability to be about \$3.4 million. However, until the exact amount of these costs is known, no drawdown on the fund will be made. Since Defense was aware that the entire \$37.6 million was not a valid credit, the total amount should not have been transferred. Rather, approximately \$18 million for additional combined costs should have been held in reserve and subsequent adjustments made to the trust fund.

Because of the large sums of money involved, consistent implementation of the Defense policy is critical. For example,

Iran had peculiar item costs of about \$263 million invested in the Spruance. Since these costs were for items not desired by the second buyer, the Navy will not be required to reimburse Iran. For instance, about \$50 million in nonrefundable costs were incurred for an Iranian-based computer center with navigational capabilities.

To ensure that the Iranian trust fund is properly credited and/or charged, we believe the Agency should closely monitor the implementation of the pricing policy. If the policy is not implemented uniformly, there is no assurance that the price of the diverted item charged to the new purchaser is equitable or that the financial interests of the United States have been fully protected.

Question 11. Since Iran cancelled its foreign military sales agreements in February 1979, have shipments of Defense articles continued? Further, has the Iranian Government expressed any interest in revitalizing its foreign sales program?

Response:

In February 1979, when Iran cancelled the majority of its foreign military sales agreements, Defense suspended shipments of military items to Iran. Items already produced for delivery to Iran were held by contractors in the Defense supply system in the United States or were stored in a warehouse at McGuire Air Force Base. However, commercially procured items such as helicopter repair parts continued to be shipped to Iran.

In August 1979, Defense resumed shipments to Iran of unclassified items, primarily spare and repair parts. As of September 30, 1979, Defense had approved for release to Iran about \$300 million of Defense equipment--about \$250 million of equipment contracted before February 1979 and about \$50 million of equipment that was being stored. According to Defense officials, most of this equipment has already been paid for out of the Iranian trust fund. The other equipment will be paid for by the Iranian trust fund when production is completed.

Recent events in Iran during November 1979, however, have resulted in the suspension of both military and commercial shipments. The last known shipment of items to Iran was on November 4, 1979, from the warehouse at McGuire Air Force Base. The shipment was valued at approximately \$2.2 million and consisted of helicopter parts, copper mining equipment, communication cables, and jeeps. As of November 16, 1979, the remaining items in storage at McGuire were valued at over \$5 million.

Before these developments, representatives of the Iranian Air Force had contacted Defense officials and requested that they be shipped approximately \$5 million of spare and repair parts for aircraft systems previously sold to them. Defense officials approved the request on a "cash only" basis and the deposit was made to the Iranian trust fund in late October 1979. As of November 16, 1979, however, Defense had not received requisitions from Iran for the items previously requested and stated that until the current situation is resolved, no requisitions will be accepted.

Additionally, in conjunction with the Iranian Air Force request, the Defense Security Assistance Agency directed the military services to estimate the cost of articles and services Iran needs to support and maintain its existing military program. The services estimated that cost at between \$200 million and \$400 million annually. This effort has also been suspended because of the recent developments in Iran.

CONCLUSIONS AND RECOMMENDATIONS

The financial interest of the United States should be protected to the fullest extent possible should other foreign countries cancel their foreign sales agreements as Iran has done. In this regard, we believe that the Congress should consider legislation as recommended in our July 25, 1979, report (FGMSD-79-47), to amend the Arms Export Control Act. The amendment would require foreign customers to provide the United States with sufficient funds to cover current costs as well as termination costs.

Since January 1970, the Department of Defense, as a matter of policy, has required foreign customers to pay such amounts. However, as in the case of Iran, this policy has not always been followed. Defense recently reaffirmed this policy by requiring the military departments to determine and include appropriate termination costs in the foreign government's payment schedules. Defense should ensure that the policy is uniformly implemented by the military departments and that the estimated termination liability reserves are promptly billed to foreign governments. This should help ensure that liability does not fall on the United States should foreign sales agreements be cancelled in the future.

In addition, we believe that segregating such amounts in the trust fund would improve visibility and financial management. This segregation would also improve controls by making termination liability reserves unavailable for routine payments to contractors.

Finally, in the event that foreign sales agreements are cancelled, the established procedures for pricing Iranian items

diverted to second buyers should be followed. Because Defense has not always followed these procedures, there is no certainty that the transfer of funds into the Iranian account is valid.

We recommend that the Secretary of Defense ensure that:

- The military departments uniformly implement Defense procedures for computing termination liability reserves.
- Payment schedules include adequate termination liability reserves and foreign governments are promptly billed.
- Collections for possible contract termination costs be segregated in the trust fund and not used for routine contractor payments.

Further, we recommend that the Secretary of Defense ensure that established procedures for pricing items diverted to second buyers are followed before funds are transferred to the Iranian trust fund.

EDWARD M. KENNEDY, MASS. CHAIRMAN
 BIRCH BAYNE, IND.
 ROBERT C. BYRD, W. VA.
 JOSEPH R. BIDEN, JR., DEL.
 JOHN C. EDWARDS, IOWA
 HOWARD M. METZENBERG, OHIO
 DENNIS DECONCINI, ARIZ.
 PATRICK J. LEAHY, VT.
 MAX BAUKUS, MONT.
 HOWELL HEFLIN, ALA.

STROM THURMOND, S.C.
 CHARLES McC. MATHIAS, JR., MD.
 PAUL LAXALT, NEV.
 ROBERT D. BYRD, W. VA.
 THOMAS S. CLAY, MISS.
 A. CLAYTON ANDERSON, W. VA.

United States Senate

COMMITTEE ON THE JUDICIARY

WASHINGTON, D.C. 20510

DAVID BOIES
 CHIEF COUNSEL AND STAFF DIRECTOR

April 30, 1979

Honorable Elmer B. Staats
 Comptroller General
 General Accounting Office
 Washington, D. C. 20548

Dear Mr. Staats:

Because of my request for an evaluation of certain aspects of the Iranian Trust Fund, a number of questions regarding other such funds have arisen, especially regarding that one dealing with Saudi Arabia. Therefore, please answer the following questions:

1. How large is the Saudi Trust Fund?
2. Does it differ in any substantive manner from the Iranian Trust Fund? This includes terms of payment and the like.
3. How exactly does it function?
4. What would happen if a similar situation developed regarding this trust fund as took place with the one set up between the U.S. and Iran?
5. Could the fund be drained by arms contractors at will, given a unilateral abrogation of contracts like that which occurred in the case of Iran?
6. Would the U.S. Treasury be the ultimate guarantor of the fund because of the way in which the fund is set up or the contracts are drawn?
7. How much is in the fund at any one time?
8. Do the individual U.S. military services do the disbursing or is there a central clearinghouse controlling such disbursements from the fund?

Honorable Elmer B. Staats
April 30, 1979
Page Two

Because of the disconcerting events surrounding the unilateral Iranian cancellation, I feel the Saudi Trust Fund needs the same kind of evaluation as you are now conducting at my request. I also feel such an evaluation should be done as quickly as possible.

Sincerely,

A handwritten signature in black ink that reads "Max Baucus". The signature is written in a cursive style with a long, sweeping underline.

Max Baucus, Chairman
Subcommittee on Limitations of
Contracted and Delegated Authority

EDWARD M. KENNEDY, MASS., CHAIRMAN

BIRCH BAYNE, IND.	BYRON THURMOND, S.C.
ROBERT L. BYRD, W. VA.	CHARLES McC. MATHEW, JR., MD.
JOSEPH R. BIDEN, JR., DEL.	PAUL LARLEY, NEV.
JOHN C. CALYER, IOWA	ROBERT G. HATCH, UTAH
HOWARD M. METZENBAUM, OHIO	ROBERT J. RANKS
DENNIS DE CONCIINI, ARIZ.	THOMAS COCHRAN, MISS.
PATRICK J. LEAHY, VT.	ALAN K. SIMPSON, WYO.
MAX BAUCUS, MONT.	
HOWELL HEFLIN, ALA.	

United States Senate

COMMITTEE ON THE JUDICIARY
WASHINGTON, D.C. 20510

DAVID BOIES
CHIEF COUNSEL AND STAFF DIRECTOR

May 7, 1979

Honorable Elmer B. Staats
Comptroller General
General Accounting Office
Washington, D. C. 20548

Dear Mr. Comptroller General:

The subject of this letter is trust funds maintained at the Pentagon to pay for American weapons and military services contracts ordered by foreign governments.

On March 29 of this year I wrote the General Accounting Office asking that certain questions be answered specifically regarding the Iranian Trust Fund. Such a report is now underway. Senator Riegle has asked for a more limited report from GAO, dealing solely with the Spruance Class Destroyer aspect of the Iranian Trust Fund. I have blocked out in discussions with your personnel a more comprehensive, institutional report, seeking to delineate how these contracts are entered into, what their limitations are, what our public financial liability is, what the abuses have been, if any, and how we can avoid repetitions, if necessary, through contractual changes. After discussions with GAO and seeking data from a variety of sources, it is obvious that our government's financial liability could be great, that little seems to be known about the status of the fund, and that there seems to be no central control over its disbursements. Therefore, I wish GAO's report to me on the Iranian Trust Fund to contain specific institutional recommendations to guarantee that the public financial interest is better protected in any future situation of this sort.

I have also requested, in a letter dated April 30, 1979, that GAO evaluate and answer certain specific questions regarding the Saudi Arabian Trust Fund. I seek a comparison between the Saudi and Iranian Funds in the report GAO does on the former country's fund, as well as specific GAO recommendations in that report as well. If there are common threads of weakness running through operations of both funds, I hope your findings will deal with them.

Finally, I feel it is critical for GAO to report on what, if any, accounting improvements are needed in all existing military trust funds, which handle some \$9 billion annually, and allegedly contain an annual balance of \$6 billion. One of the most critical aspects deals with whether or not the Pentagon maintains accurate verification records of receipts, disbursements and balances. A second essential element to be ascertained is whether the individual U.S. military services do disbursing from these funds, and the need for a central clearing house controlling disbursements from these trust funds. If no such central disbursing clearing house exists in the Iranian, Saudi or any other fund, then there should be a specific addressing of that problem in your reports.

The Iranian situation shows how serious these problems have become. I believe that in addition to the already requested Iranian and Saudi reports, there should be a third GAO report dealing with the remainder of these trust funds, summing up all findings. Congress is absolutely devoid of even minimal information on this subject. Yet we are being asked to vote immense sums and delegate substantial authority in the name of the American people. It is my hope that you are assigning a substantial priority to this work.

Sincerely



Max Baucus, Chairman
Subcommittee on Limitations of
Contracted and Delegated Authority

SCHEDULE OF SAUDI ARABIAN TRUST FUNDACTIVITY FOR THE 24-MONTH PERIODENDED SEPTEMBER 30, 1979 (note a)

	<u>Deposits</u>	<u>Disbursements</u>	<u>Balance</u> (note b)
Balance as of Sept. 30, 1977			\$ 658,174,625
Oct. 1977	\$ 61,542,983	\$ 50,499,745	669,217,863
Nov. 1977	461,318,683	160,318,926	970,217,620
Dec. 1977	37,680,216	81,882,390	926,015,446
Jan. 1978	220,774,810	104,428,736	1,042,361,520
Feb. 1978	766,862,836	74,449,980	1,734,774,376
Mar. 1978	245,518,535	246,815,200	1,733,477,711
Apr. 1978	103,657,355	252,617,118	1,584,517,948
May 1978	426,449,947	(17,230,342)	2,028,198,237
June 1978	23,096,936	274,750,849	1,776,544,324
July 1978	415,339,216	207,504,834	1,984,378,706
Aug. 1978	47,085,175	275,327,446	1,756,136,435
Sept. 1978	220,654,713	148,096,560	1,828,694,588
Oct. 1978	124,363,674	202,604,839	1,750,453,423
Nov. 1978	665,744,214	188,316,356	2,227,881,281
Dec. 1978	137,255,824	201,431,773	2,163,705,332
Jan. 1979	257,786,650	215,468,439	2,206,023,543
Feb. 1979	195,640,392	195,363,370	2,206,300,565
Mar. 1979	141,091,111	258,782,523	2,088,609,153
Apr. 1979	250,914,810	214,920,380	2,124,603,583
May 1979	c/(42,662,106)	226,870,506	1,855,070,971
June 1979	283,791,167	245,343,948	1,893,518,190
July 1979	397,279,140	223,759,582	2,067,037,748
Aug. 1979	280,912,634	227,425,131	2,120,525,251
Sept. 1979	22,505,980	237,687,703	1,905,343,528

a/Figures represent amount on Defense Department records.

b/Defense derived this figure based on Defense and Treasury records.

c/Funds transferred to Jordan trust fund account.

**SCHEDULE OF IRANIAN TRUST FUND ACTIVITY FOR THE
30-MONTH PERIOD ENDED SEPTEMBER 30, 1979 (note a)**

	<u>Deposits</u>	<u>Disbursements</u>	<u>Balance</u> <u>(note b)</u>
Balance as of Mar. 31, 1977			\$661,622,161
Apr. 1977	\$ 63,816,945	\$198,114,564	527,324,542
May 1977	15,449,968	189,827,809	352,946,701
June 1977	384,602,905	215,946,606	521,603,000
July 1977	174,246,850	159,912,056	535,937,794
Aug. 1977	18,656,312	112,590,916	442,003,190
Sept. 1977	478,473,111	250,029,514	670,446,787
Oct. 1977	117,031,385	64,571,213	722,906,959
Nov. 1977	1,986,432	190,289,959	534,603,432
Dec. 1977	260,299,321	128,288,201	666,614,552
Jan. 1978	218,914,000	75,004,902	810,523,650
Feb. 1978	31,059,300	83,263,134	758,319,816
Mar. 1978	350,326,912	363,057,295	745,589,433
Apr. 1978	185,777,907	174,096,137	757,271,203
May 1978	6,063,794	106,542,454	656,792,543
June 1978	86,305,808	232,270,569	510,827,782
July 1978	226,728,617	135,219,160	602,337,239
Aug. 1978	30,737,367	165,214,734	467,859,872
Sept. 1978	17,020,846	63,138,438	421,742,280
Oct. 1978	218,324,625	111,472,627	528,594,278
Nov. 1978	175,487,262	102,774,067	601,307,473
Dec. 1978	120,031,876	174,394,209	546,945,140
Jan. 1979	227,528,582	126,072,736	648,400,986
Feb. 1979	128	120,957,669	527,443,445
Mar. 1979	146	169,305,191	358,138,400
Apr. 1979	8,347,017	<u>c/</u> 21,973,350	<u>c/</u> 344,512,067
May 1979	219,776	61,979,247	282,752,596
June 1979	632,051	138,192,537	145,192,110
July 1979	2,932	<u>d/</u> (421,021,289)	566,216,331
Aug. 1979	-	47,359,905	518,856,426
Sept. 1979	<u>e/</u> (1,963,814)	31,602,236	<u>f/</u> 485,290,376

a/Figures represent amount on Defense Department records.

b/Defense derived this figure based on Defense and Treasury records.

c/Refunds from the Air Force and Army of \$34 million and \$19 million, respectively, have been credited against disbursements. Also, the account was credited for \$37.6 million for the diversion of the F-16 aircraft to a second buyer.

d/A refund from the Navy of \$490.5 million was credited against disbursements for the purchase of the Spruance-class destroyers.

e/Adjustment resulting from erroneous posting of Saudi Arabian deposits to Iranian trust fund for April 1979.

f/Defense officials estimate the trust fund balance will be approximately \$80 million at program completion.

SCOPE OF REVIEW

We reviewed information from the Department of Defense and analyzed and summarized the data and made limited tests to determine its accuracy. Most of the information developed was based on Defense estimates and records.

We made our review at the following military departments and organizations:

- Headquarters, Departments of the Army, Navy, and Air Force; Washington, D.C.
- Defense Security Assistance Agency; Washington, D.C.
- Security Assistance Accounting Center; Denver, Colorado.
- Naval Material Command; Washington, D.C.
- Naval Sea Systems Command; Washington, D.C.
- Naval Air Systems Command; Washington, D.C.
- Navy International Logistics Control Office; Philadelphia, Pennsylvania.
- U.S. Army Materiel Development and Readiness Command; Washington, D.C.
- U.S. Army Tank-Automotive Readiness Command; Warren, Michigan.
- U.S. Army Missile Readiness Command; Huntsville, Alabama.
- U.S. Army Corps of Engineers; Washington, D.C.
- Air Force Logistics Command; Wright-Patterson Air Force Base, Dayton, Ohio.
- Aeronautical Systems Division; Wright-Patterson Air Force Base, Dayton, Ohio.
- Air Force Systems Command; Andrews Air Force Base, Maryland.



Single copies of GAO reports are available free of charge. Requests (except by Members of Congress) for additional quantities should be accompanied by payment of \$1.00 per copy.

Requests for single copies (without charge) should be sent to:

U.S. General Accounting Office
Distribution Section, Room 1518
441 G Street, NW.
Washington, DC 20548

Requests for multiple copies should be sent with checks or money orders to:

U.S. General Accounting Office
Distribution Section
P.O. Box 1020
Washington, DC 20013

Checks or money orders should be made payable to the U.S. General Accounting Office. NOTE: Stamps or Superintendent of Documents coupons will not be accepted.

PLEASE DO NOT SEND CASH

To expedite filling your order, use the report number and date in the lower right corner of the front cover.

GAO reports are now available on microfiche. If such copies will meet your needs, be sure to specify that you want microfiche copies.

AN EQUAL OPPORTUNITY EMPLOYER

**UNITED STATES
GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548**

**OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, \$300**

**POSTAGE AND FEES PAID
U. S. GENERAL ACCOUNTING OFFICE**



THIRD CLASS