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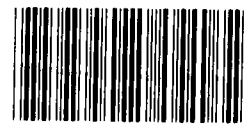
## OF THE UNITED STATES

### Better Accounting Needed For Foreign Countries' Deposits For Arms Purchases

GAO found that improvements are needed in the collection of and accounting for foreign countries' funds deposited in the United States for arms purchases. Also, definitive guidelines are needed for implementing the U.S. policy allowing foreign countries to transfer moneys not needed to meet current obligations from their trust fund accounts to interest-bearing accounts.

GAO was asked by the Chairman of the Subcommittee on Limitations of Contracted and Delegated Authority, Senate Judiciary Committee, to evaluate the impact of this policy and determine if the interests of the United States are protected in the event a foreign country cancels an arms purchase agreement.

This report discusses the problems GAO found, reiterates the need for action on problems previously identified, and recommends actions to protect the interests of the United States.



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COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON D.C. 20548

B-200227

The Honorable Max S. Baucus  
United States Senate

Dear Senator Baucus:

In your February 28, 1980, letter, as Chairman of the Subcommittee on Limitations of Contracted and Delegated Authority, Senate Judiciary Committee, you expressed concern about the policy allowing foreign countries to transfer moneys not needed to meet current obligations from their trust fund account to interest-bearing accounts. You asked that we evaluate this policy and determine whether (1) established collection procedures are being followed and (2) safeguards are being established that will keep adequate funds in this country to insure the United States against loss in the event of arms purchase agreement cancellation.

This report discusses the improvements that we feel are needed in the collection of and accounting for foreign countries' funds deposited in the United States for arms purchases. It also discusses the need for definitive guidelines to cover possible cancellation of arms purchase agreements.

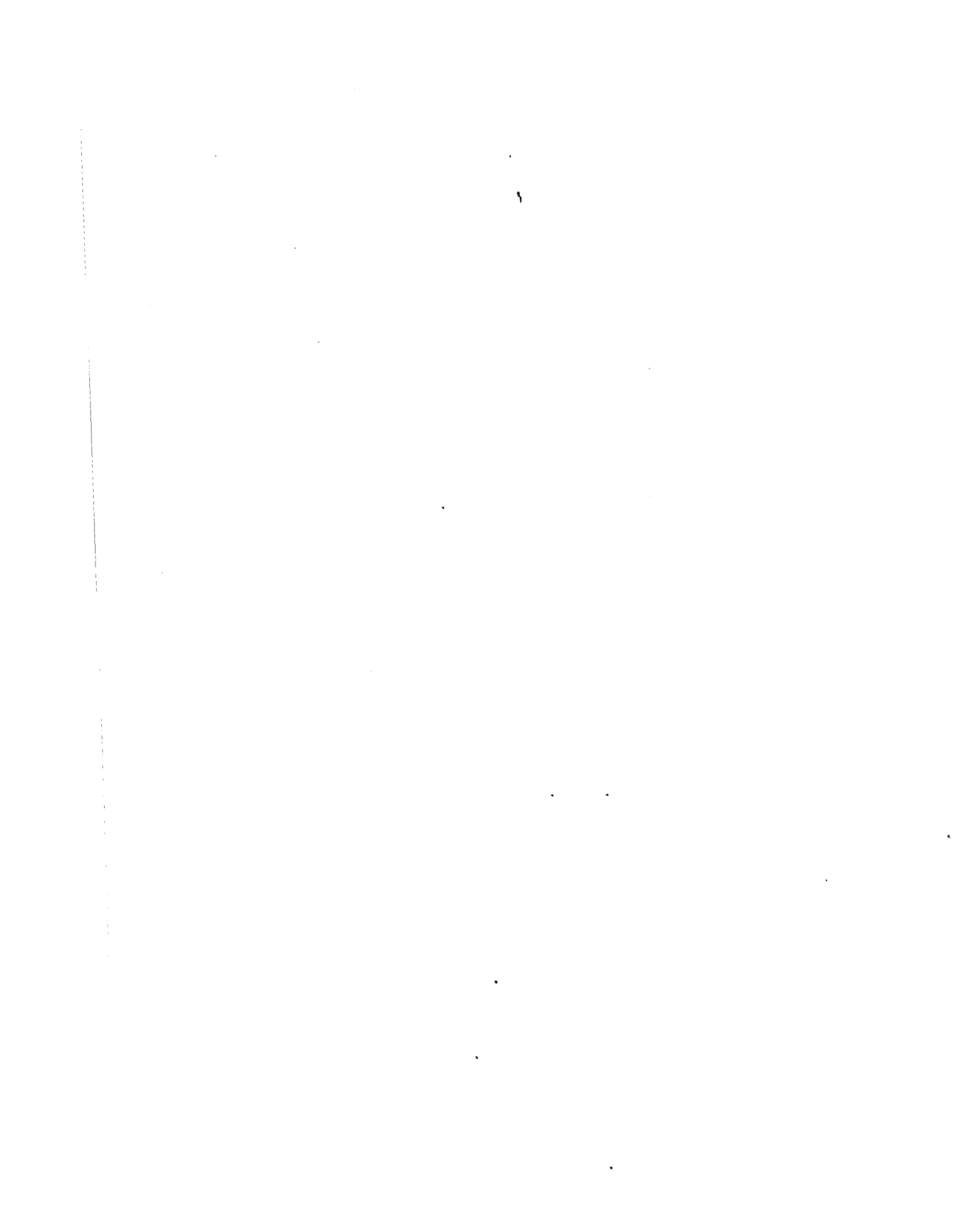
As requested by your office, we did not obtain comments from the Department of Defense on this report. The financial information in the report is based, in part, on information shown in the Defense Department's accounting records and provided by Defense officials. Because of the magnitude of the information requested in your letter, the number of accounting systems involved, and the short time provided to prepare the report, we could not always verify this information.

Also as requested by your office, unless you publicly announce its contents earlier we plan no further distribution of this report until 7 days from the date of this letter. 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 "Thomas A. Stearns".

Comptroller General  
of the United States



D I G E S T

GAO found that a more accurate Department of Defense accounting system is needed to bill, collect, and disburse advance payments from foreign countries which are held in trust fund accounts to meet obligations incurred under military sales agreements. These advance payments, which totaled about \$8.5 billion as of September 1, 1980, are collected to protect the United States against loss and thus should be sufficient to cover all costs and damages associated with the sales agreement, including potential contract termination costs.

Foreign countries have obtained Defense approval to transfer moneys not needed to meet current obligations from their trust fund accounts with the U.S. Treasury to interest-bearing accounts. As of September 30, 1980, about \$3.5 billion of the \$8.5 billion in advance deposits has been transferred to these interest-bearing accounts, some of which are with commercial banks. The following safeguards are needed to adequately protect U.S. interests:

- Established collection procedures must be enforced. Countries were not always paying the amount billed, and Defense personnel were not pursuing collection primarily because of questions about the accuracy of the amounts billed.
- The amount of funds available for transfer into interest-bearing accounts must be accurately determined. Funds available to foreign customers for transfer to interest-bearing accounts could be overstated because of processing delays encountered when the military services pay for foreign military sales charges from their appropriations accounts and then obtain reimbursement. The withdrawal of funds from the trust fund account is often delayed because billings are not made until long after the expenditures are made by the military services. Also, controls have not been established to ensure that funds collected as insurance against cancellation of the contract by the purchasing country are not used for routine contractor payments.

--Definitive guidelines must be established by Defense for processing foreign countries' requests to invest advance payments in interest-bearing accounts. Although approval of these requests is virtually automatic, adequate guidelines are not available to (1) provide criteria for determining what funds can be transferred to investment accounts, (2) limit the extent of Defense personnel involvement in selecting fund depositories, and (3) ensure that foreign customers are aware of the risks they are assuming.

Defense has recognized the importance of improving the accounting system used to collect from countries under foreign military sales agreements. It is currently testing a centralized accounting system which it expects will improve the accuracy of bills to foreign customers. Also, Defense has acted to discontinue the use of its own funds for interim financing of foreign military sales.

#### RECOMMENDATIONS

GAO recommends that the Secretary of Defense take the following actions to protect the interests of the United States:

- Establish controls to ensure that funds received for possible contract termination are not used for routine contractor payments. These controls would help ensure the availability of needed funds if a foreign customer should abruptly and unilaterally cancel its foreign military sales agreement.
- Provide guidance for administration of interest-bearing accounts to specify what funds are available for such accounts, where such accounts must be maintained, and the extent Defense personnel may be involved in selecting commercial depositories.
- Include provisions in future agreements establishing interest-bearing accounts to ensure that foreign customers are aware that any losses sustained as a result of investments made in commercial accounts are borne by the customer. Also, foreign customers with existing commercial bank accounts should be advised in writing of the risks they have assumed.

AGENCY COMMENTS

As requested by the Office of the Senator requesting this review, GAO did not obtain written comments from the Department of Defense.





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## CHAPTER 1

### INTRODUCTION

On February 28, 1980, the Chairman of the Subcommittee on Limitations of Contracted and Delegated Authority, Senate Judiciary Committee, expressed concern that the policy allowing foreign countries to transfer moneys not needed to meet current obligations from their trust fund account to an interest-bearing account could fail to protect U.S. interests. He asked that we evaluate this policy and determine whether (1) established collection procedures are being followed and (2) safeguards are being established that will keep adequate funds in this country to insure the United States against loss in the event of arms purchase agreement cancellation.

The International Security Assistance and Arms Export Control Act of 1976 gives the Department of Defense authority to sell Defense articles and services to foreign countries at no cost to the U.S. Government. Defense normally requires 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. These advance payments are held in trust to protect the interests of the United States. Defense then uses these moneys to cover disbursements for goods and services it buys for foreign customers, and for other costs.

### SIZE OF PROGRAM

In recent years, increased congressional interest has focused on the rapid growth of the foreign military sales program and on major accounting and financial management problems encountered by Defense in executing the program. The foreign military sales program has grown from about \$1 billion in goods and services ordered in fiscal 1970 to over \$15 billion ordered in fiscal 1980. The remaining value of unfilled orders was over \$53 billion as of September 1980. Foreign customers had about \$8.5 billion in advance payments on deposit in the United States in early September 1980.

Of this \$8.5 billion on deposit, about \$5 billion was deposited in an escrow-type account with the U.S. Treasury. The foreign countries had placed the other \$3.5 billion in interest-bearing accounts in the United States. These interest-bearing accounts were with the Federal Reserve System or commercial banks.

### FUNCTIONING OF TRUST FUNDS

Accounting and financial management activities of the foreign military sales program involve more than 40 Defense organizations. The Security Assistance Accounting Center (Center) in Denver, Colorado, is Defense's central foreign military sales billing and collecting organization. The Center is responsible for giving foreign customers an accounting of their deposits and the costs

incurred on their behalf, preparing bills to foreign customers, and reimbursing the military departments' appropriations for expenses incurred. The military departments are responsible for detailed obligation, expenditure, and cost accounting; for paying contractors; and for reporting these payments to the Center.

The amount of funds that should be provided by the foreign customer is based on the billing statement prepared by the Center. Customers are generally billed quarterly. The quarterly billing statement is the United States' official claim for payment from the foreign customers. It requests the money needed by the United States to continue the customer's program for the quarter following the billing payment date. For example, the money requested by the June 30, 1980, billing statement was due September 15 and was for anticipated contractor payments and costs expected to be incurred by Defense on behalf of the customer for the quarter beginning October 1, 1980, and for reserve funds.

After the money is received, it is classified by Defense into three funds. These are

- working funds, the amounts necessary to cover accrued liabilities and provide sufficient funds to make payments during the next 30 days;
- reserve funds, the amounts withheld from contractor payments until satisfactory completion of contract performance (contractor holdback) and amounts to pay Defense contractors if their services are terminated prior to completion of contract performance (termination liability); and
- excess funds, the amounts on deposit which are in excess of the requirement for working funds and reserve funds as described above. These funds generally result from payments by foreign countries in excess of amounts billed.

Payments received from the foreign customers are deposited directly into the trust fund held by the Treasury or into the interest-bearing accounts. Only excess funds may be deposited in commercial bank accounts. Defense policy requires that reserve funds be held in the trust fund account with the Treasury or in the Federal Reserve System.

#### PRIOR AUDIT REPORTS

In addition to this report, we have issued two other reports which specifically recommended improvement in the management of cash balances in the foreign military sales trust fund account. We reported on:

- The financial and legal implications of Iran's cancellation of arms purchase agreements. We recommended action to protect the financial interests of the United States (FGMSD-79-47, July 25, 1979).

--The comparison of the Saudi Arabian and Iranian trust funds and the operation of all military sales trust funds (FGMSD-80-26, Jan. 28, 1980).

These reports recommended that collections of potential termination costs be (1) deposited in advance and (2) separately identified and segregated in the trust fund so that the funds are not available for routine contractor payments.

Also, the Defense Audit Service issued two reports (No. 79-053, Feb. 28, 1979, and No. 80-129, Sept. 2, 1980), dealing with the collection and billing process. The reports stated that

--foreign customers were not paying promptly when billed by the Center and

--the bills to foreign customers were based on inaccurate forecasts of such requirements (payment schedules).

The Defense Audit Service found that payment schedules were not revised when actual financial requirements were significantly less or greater than initial estimates. Inaccurate forecasts of cash requirements were recognized as contributing to late and inaccurate payments by foreign customers.

#### OBJECTIVES, SCOPE, AND METHODOLOGY

The purposes of our review were to (1) evaluate Department of Defense policies and procedures for approving the transfer of moneys not needed to meet current foreign military sales obligations, from the trust fund into investment accounts; (2) determine whether established collection procedures are followed; and (3) determine whether safeguards were established to keep adequate funds in this country to insure the United States against loss in the event of arms purchase agreement cancellation.

Our review was conducted from April through November 1980 and included examination of accounting records, contract files, and related documents, as well as discussions with program officials. We reviewed trust fund accounting records and contract files at the Security Assistance Accounting Center in Denver, Colorado. We also discussed policies and procedures for approving foreign countries' investment accounts with senior officials at the Defense Security Assistance Agency, Washington, D.C.; the Department of the Treasury, Washington, D.C.; and the Security Assistance Accounting Center. Also, we reviewed accounting records and contract files at the Defense Contract Administration Services Region, Dallas, Texas, and the San Antonio Air Logistics Center, San Antonio, Texas.

In addition, we discussed prior audit coverage with senior management personnel at the Defense Audit Service, Arlington, Virginia. Because of their coverage of the billing and collecting process and prior GAO coverage, it was possible to limit our work in this area.

We reviewed the overall status of trust fund balances for all 12 countries which had established interest-bearing accounts as of September 1980. At September 30, 1980, these countries were very significant in the overall foreign military sales program, having \$33 billion of the \$53 billion in open foreign military sales orders. However, we did not evaluate Defense's classification of these countries' moneys on deposit into working funds, reserve funds, and excess funds. Without such evaluation, it was not possible to determine if excess funds were properly identified. Therefore, we did not make a detailed analysis of the compliance with Defense policy requiring advance deposit of reserve funds and did not verify the accuracy of Defense calculations of working funds.

The financial information in this report is based mainly on Department of Defense accounting records and information provided by Defense officials. Although we analyzed the data and made limited tests to determine its accuracy, we were not always able to verify the accuracy of the trust fund account balances as recorded at the Security Assistance Accounting Center because the accounting systems involved are highly complex and most countries have many individual sales cases. Also, because of the short time frame for preparing this report, we did not evaluate the accuracy of billings against these trust fund accounts.

## CHAPTER 2

### ACCOUNTING FOR FOREIGN CUSTOMERS'

#### DEPOSITS FOR ARMS

##### PURCHASES CAN BE IMPROVED

A more accurate Defense accounting system is needed to bill, collect, and disburse foreign military sales funds to ensure that sufficient moneys are retained in foreign countries' trust fund accounts to adequately protect the interests of the United States. Also, definitive guidelines are needed for processing and approving foreign customers' requests for establishment of investment accounts. Because some of these investment accounts involve commercial banks, it is important that foreign customers be made aware of the risks involved and be given proper notice that the United States is not liable for any losses that may result from such accounts.

##### ADVANCE PAYMENTS ARE REQUIRED TO PROTECT U.S. INTERESTS

The International Security Assistance and Arms Export Control Act of 1976 gives the Department of Defense authority to sell Defense articles and services to foreign countries at no cost to the U.S. Government. In keeping with this no-cost requirement, and to facilitate cash sales of goods and services, Defense has established the foreign military sales trust fund. This trust fund, which is on deposit with the U.S. Treasury, consists of advance payments made by the foreign countries.

Although the Arms Export Control Act does not require establishment of a trust fund to protect U.S. interests, contracts with the foreign customers normally require them to provide funds well in advance of the need to make payments. Defense has determined that it would be legally sufficient for it to receive funds from the foreign country immediately before normal contract payments or termination charges become payable to a contractor. However, Defense has determined that it would not be prudent to conduct foreign military sales without trust funds to protect the interests of the United States.

To protect U.S. interests, the contractual agreements between Defense and foreign customers provide that the Security Assistance Accounting Center will maintain sufficient funds in the trust fund account to cover accrued liabilities and meet disbursement requirements. Also, the Center will continue to request quarterly payments from the foreign countries through the normal billing process on the basis of predetermined payment schedules as cited in the original sales agreement.

As there is no legal requirement for foreign countries to retain large sums of money in the trust fund when the money is not immediately required to make payments, they have elected to place funds in investment accounts. These investment accounts, which are with the Federal Reserve System or commercial banks, are covered by three-party agreements.

The policy of allowing foreign customers to deposit reserves and excess funds in interest-bearing accounts is in keeping with the intent of the above policy and affords customers the opportunity to practice prudent cash management. However, controls are required to ensure that sufficient funds are transferred to a customer's trust fund account to offset any U.S.-appropriated funds used to pay for Defense articles or services purchased on behalf of the foreign country.

#### FINANCIAL MANAGEMENT OF TRUST FUNDS SHOULD BE IMPROVED

On February 28, 1980, the Chairman of the Subcommittee on Limitations of Contracted and Delegated Authority, Senate Judiciary Committee, expressed concern over the policy of allowing foreign countries to transfer moneys not needed to meet current obligations from their trust fund account to an interest-bearing account. He felt that this could have an adverse impact upon this country by establishing a precedent and failing to protect U.S. interests. He asked that we evaluate this policy and determine whether (1) established collection procedures are being followed and (2) safeguards are being established that will keep adequate funds in this country to insure the United States against loss in the event of arms purchase agreement cancellation.

In addition, we followed up on recommendations in a prior report (FGMSD-80-26, Jan. 28, 1980) which were designed to protect U.S. interests if foreign military sales agreements were abruptly canceled. The recommendations at that time were:

- Uniformly implement Defense's procedures for computing termination liability reserves.
- Collect such amounts promptly.
- Ensure that these amounts are unavailable for routine contractor payments.

We found that improvements are needed to ensure that established collection procedures are followed. Also, a more accurate accounting system is essential to the establishment of safeguards to ensure that adequate funds are kept in this country to protect the United States against loss in the event an arms purchase agreement is canceled. Although the Center was taking steps to improve the identification of funds reserved for contract termination, this separate identification did not preclude the use of these funds for



routine contractor payments. In addition, definitive guidelines for processing foreign customers' requests for investment accounts would more fully protect the interests of the United States. More specific details on the results of our review follow.

Collection procedures are not enforced

Our review showed that customers were not always promptly paying the amounts billed by the Center and that Center personnel were hesitant to pursue strict followup action for full payment. Personnel could not be sure the bills were accurate when countries questioned them, because payment schedules were not revised when warranted.

Our analysis of payments made by eight countries with active interest-bearing accounts as of December 1979 showed that most did not pay in full by the due date. These customers did make payments after the due date. However, the late payments were not applied against the current bill but were used to offset the estimated financial requirements for subsequent bills. The following chart shows the amounts billed by the Center in January 1980 and the amounts the eight customers paid by the due date.

<u>Country</u>	<u>Amount billed</u>	<u>Amount paid by due date</u>	<u>(Underpayment) overpayment</u>
	------(millions)-----		
Saudi Arabia	\$845.9	\$700.9	\$(145.0)
Switzerland	82.5	50.2	( 32.3)
Belgium	108.0	70.2	( 37.8)
Denmark	35.4	35.7	( .3)
Netherlands	98.2	62.9	( 35.3)
Norway	92.4	33.0	( 59.4)
Germany	39.6	.9	( 38.7)
(note a)	17.8	.7	( 17.1)
	26.5	--	( 26.5)
	41.0	71.7	30.7
United Kingdom	36.4	25.4	( 11.0)
(note b)	36.4	24.5	( 11.9)

a/Germany was billed monthly with payments due in February, March, April, and May (30 days after each billing).

b/The United Kingdom has Defense approval to pay its bill in three equal installments.

The mutual lack of confidence in the billing statements is justified. According to earlier GAO reports and recent Defense Audit Service reports, payment schedules--which are an integral part of the billing statement--were not being revised when actual financial requirements were significantly less than initial estimates. This resulted in customers depositing or being requested to deposit substantially larger sums than necessary to meet financial requirements. The Defense Audit Service report also mentioned examples of customer underbilling because payment schedules had not been revised upward when warranted and because the services were not following prescribed Defense pricing guidance.

The services mostly agreed that the reported deficiencies existed and stated that they would take action to resolve the problems. Center officials, in their comments on the reports, stated that the payment schedules should not be revised without close coordination with the foreign customers. In some instances, the customers have asked to be billed in accordance with a payment schedule even though actual financial requirements are less than initial estimates. This manner of billing avoids creating internal budgeting and funding problems for the customer.

Center officials advised us that in deciding whether or not to follow up on delinquent or partial payments, they considered the customer's past payment history, the perceived accuracy of the financial forecast, and other extenuating circumstances. Generally, if the customers have sufficient funds on hand in the trust fund and/or interest-bearing account to cover the expected issuance of expenditure authority and to cover anticipated reimbursables to the services, no followup action is taken. Also, late payments by customers did not necessarily mean that their programs were in financial difficulty. For example, an analysis by the Center indicated that by 30 days after the due date, Belgium, Denmark, and The Netherlands had overpaid cumulative billings by \$30, \$841,770, and \$66,304,150 respectively.

Amount of funds available for transfer  
to interest-bearing accounts  
is not accurately determined

The amount of funds available for transfer into interest-bearing accounts cannot be accurately determined because of long delays between the time the services make expenditures under the foreign military sales agreement and the time the customer's trust fund is billed. This delay in the withdrawal of funds from the trust fund account occurs because billings are primarily based on deliveries rather than amounts disbursed.

For instance, we found that the Air Force Logistics Centers do not always report contractor progress payments made for foreign military sales customers as they make disbursements. Instead, they wait until the goods have been shipped from the contractor before any charges are reported to a Center for reimbursement. In these

cases, the charges reported are the prices of items and not the actual payments made to the contractors as of the date the items are shipped.

As discussed in the following subparagraphs, the time lag between the actual Air Force expenditure and the subsequent reimbursement can be substantial. In addition, the amounts billed the customers are not always accurate. For example:

--In May 1978, a \$45,526 progress payment was made to a contractor for a Saudi Arabian order. Another payment of \$26,818 was made in July 1979 to bring the total disbursed to \$72,344. Records show that the items ordered were shipped in July 1979 and charges were not reported to the Center until September 1979. In October 1979, 17 months after the initial disbursement, the Center reimbursed the Air Force. However, the amount billed by the Air Force was incorrect and in a subsequent attempt to correct it, the amount billed was changed to \$198. When we brought this error to the attention of Air Force officials, they initiated the appropriate action to correct the error and obtain the correct reimbursement.

--In September 1979, a \$231,107 progress payment was made for another Saudi Arabian order. By July 1980, progress payments for this order had accumulated to \$354,783. As of October 17, 1980, no charges had been reported to the Center for reimbursement. We anticipate that the billings will be processed after the order is delivered.

The Department of Defense was aware that both the Army and Air Force had experienced delays in obtaining reimbursements from the trust fund accounts. As a result, a change was initiated in 1979 which should, when fully implemented, reduce interim financing of foreign military sales by Defense appropriations. The Army has established a system to bill for estimated progress payments and the Air Force is converting to a system which directly cites the foreign military sales trust fund. The contracts which are being financed from Air Force appropriations were awarded prior to implementation of the new procedure in October 1979.

#### Reserve funds could be improperly used

The Center considers all funds on deposit as available to meet working fund requirements. However, certain funds were collected to be held in reserve for termination liability and for contractor holdback. Defense policy states that these reserve funds should not be considered as available to meet cash needs.

During the review, we found that the Center was taking steps to improve the identification of termination liability reserve funds. However, the separate identification does not preclude the use of these funds for routine contractor payments as it is possible for the Center to use any available funds to meet working fund requirements.

## Guidelines are needed for administration of interest-bearing accounts

Defense needs to establish definitive guidelines for processing foreign countries' requests for approval to invest advance payments in interest-bearing accounts. Although approval of these requests is virtually automatic since the Administration's approval of the Saudi Arabian agreement, adequate guidelines are not available to (1) provide criteria for determining what funds can be transferred to investment accounts, (2) limit the involvement of Defense personnel in selecting fund depositories, and (3) ensure that foreign customers are aware of the risks they are assuming.

Without adequate guidance there is no assurance that the interests of the United States are protected. Both the number of interest-bearing accounts and the amounts kept in them are increasing. Because of this growth, written guidance is necessary to ensure that the Defense personnel responsible for approving the agreements are aware of all matters which should be considered.

Since the Saudi Arabian request was approved in August 1979, similar agreements authorizing interest-bearing accounts for other countries have been established or are being processed. Switzerland, Korea, Taiwan, and the United Kingdom were authorized to deposit reserve and excess foreign military sales funds with the Federal Reserve Bank of New York. Other countries were authorized to deposit excess funds in commercial bank accounts. Defense is currently considering other countries' requests for establishment of interest-bearing accounts.

The interest-bearing accounts by country as of September 1, 1980, are shown in the chart on the following page.

The agreements establishing these accounts generally require that the accounts be "blocked." This means that even though the money belongs to the foreign country, the country cannot make withdrawals without the Security Assistance Accounting Center's approval. However, the Center can unilaterally withdraw funds from the accounts. There are exceptions--the larger Venezuelan account is not blocked and the Germany and Italy accounts may not be, as the agreements between these countries and Defense do not address this requirement.

The interests of the United States are adequately protected only if all accounts are blocked. Written guidelines are needed to make sure Defense personnel responsible for approving these agreements are aware of this consideration.

Without written guidance, other important considerations also could be overlooked by Defense personnel in the approval process. For example, the Comptroller, Defense Security Assistance Agency, advised us that according to Defense policy, reserve funds cannot be invested in commercial banks but excess funds can.

<u>Country</u>	<u>Financial institution</u>	<u>Balance</u>
Belgium	Commercial Bank	\$ 36,710,859
Denmark	Commercial Bank	18,678,322
Germany	Treasury	113,490,390
Germany	Treasury	1,911,452
Italy	Treasury	363,895
Korea (note a)	Federal Reserve Bank of New York	75,400,000
Netherlands	Commercial Bank	60,000,000
Netherlands	Treasury	68,788,636
Norway	Commercial Bank	55,455,851
Saudi Arabia	Federal Reserve Bank of New York	2,802,035,599
Switzerland	Federal Reserve Bank of New York	141,800,356
Taiwan	Federal Reserve Bank of New York	70,188,946
United Kingdom	Federal Reserve Bank of New York	65,492,834
Venezuela (note b)	Commercial Bank	833,533
Venezuela (note c)	Commercial Bank	<u>3,906,330</u>
Total		<u>\$3,515,057,003</u>

a/Account balance as of September 9, 1980.

b/Account balance as of September 5, 1980.

c/Account balance as of September 3, 1980.

Also, Security Assistance Accounting Center personnel advised us that U.S. funds loaned to other countries for foreign military purchases cannot be deposited in interest-bearing accounts. In one case, the agreement for an interest-bearing account with a country which has such loans contained provisions which recognized this policy. Written guidelines would help ensure that Defense personnel do not overlook this important consideration in future agreements.

Although Defense officials did not select the banks used for the commercial accounts, they did assist foreign country representatives in their selection process. The lack of a firm policy statement and controls limiting the extent of Defense involvement in bank selection could raise serious questions concerning the appropriateness of the selection process. Although we recognize that each country has the right to deposit its excess funds as it deems appropriate, the extent of Defense involvement in the decision should be well documented and very limited.

Also, the agreements between the commercial banks, the foreign countries, and the Center contain no provision specifying the extent of U.S. liability for financial losses resulting from the

deposit of funds in commercial banks. The Defense General Counsel's office believes that the United States would not be legally responsible for any financial losses incurred if one of the commercial banks holding the foreign customer's funds becomes insolvent. Although we agree with this review, it seems prudent to advise foreign countries of this fact. Defense could accomplish this by including a provision in future agreements with foreign customers.

## CONCLUSIONS

The policy of allowing foreign customers to deposit reserve and excess funds in interest-bearing accounts represents another demand for accurate and timely information from the foreign military sales accounting systems. Adequate fund controls are needed to ensure that U.S. interests are protected.

Current controls over the billing and collection process do not provide the fullest possible protection should foreign countries abruptly cancel their foreign sales agreements. These controls can be fully effective only when amounts due are correctly determined and collected in full, and the amount of funds on deposit in the trust fund account is correctly determined.

Although Defense has acted to include appropriate termination costs in the foreign governments' payment schedules and has increased the visibility of these reserves, more needs to be done. Controls should be established to ensure that these reserves are not used for routine payments to contractors.

Also, Defense has not developed definitive guidance for processing and approving foreign customers' requests for establishment of investment accounts. Such guidance for use by Defense components is necessary to ensure that all accounts are blocked--that is, the foreign countries cannot withdraw their funds on deposit in interest-bearing accounts without the United States' approval. The guidance should specify what funds can be invested in interest-bearing accounts and limit the extent of involvement by Defense officials in the selection of commercial depositories. Without written guidance, important considerations could be overlooked and foreign customers may not have necessary information to use in evaluating their alternatives.

Although foreign customers may be aware that they are assuming all risks in the event that losses are sustained as a result of investing their funds in commercial accounts, the United States should notify the countries of this in writing. Additionally, in order to ensure that U.S. interests are protected and that foreign customers are aware of the risks involved in the commercial bank accounts, future agreements between Defense and its customers should contain a provision stating that the United States is not liable for any losses that may result from such investment accounts.

Because the need for major changes in the foreign military sales accounting system has been addressed in prior reports, and Defense is currently testing a centralized accounting system, we are not making further recommendations on actions needed to improve the accuracy of billings to foreign customers. Also, because the Air Force is discontinuing the practice of using its own funds for interim financing of foreign military sales, we are not recommending action to provide for more timely withdrawals from the trust fund account. However, Defense still needs to act on our recommendation that termination liability reserve funds be made unavailable for routine contractor payments.

#### RECOMMENDATIONS

We recommend that the Secretary of Defense take the following actions to protect the interests of the United States:

- Establish controls to ensure that funds received for possible contract termination are not used for routine contractor payments. These controls would help ensure the availability of needed funds if a foreign customer should abruptly and unilaterally cancel its foreign military sales agreement.
- Develop guidance for administration of interest-bearing accounts to specify what funds are available for such accounts, where such accounts must be maintained, and the extent Defense personnel may be involved in selecting commercial depositories.
- Include provisions in future agreements establishing interest-bearing accounts to ensure that foreign customers are aware that any losses sustained as a result of investments made in commercial accounts are borne by the customer. Also, foreign customers with existing commercial bank accounts should be advised in writing of the risks they have assumed.

#### AGENCY COMMENTS

As requested by the Office of the Senator requesting this review, we did not obtain written comments from the Department of Defense.

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STEPHEN BREYER, CHIEF COUNSEL

SUBCOMMITTEE ON  
 LIMITATIONS OF CONTRACTED AND DELEGATED AUTHORITY  
 MAX BAUCUS, CHAIRMAN  
 HOWELL HEPFLIN THOMAS COCHRAN  
 FRANKLIN B. DILLEY, STAFF DIRECTOR

## United States Senate

COMMITTEE ON THE JUDICIARY

WASHINGTON, D.C. 20510

February 28, 1980

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

Dear Mr. Comptroller General:

The Department of Defense recently approved a Saudi Arabian request that the U.S. transfer monies not needed to meet its current obligations from its trust fund account into an interest-bearing account. This action is expected to cost the U.S. Government about \$200 million annually.

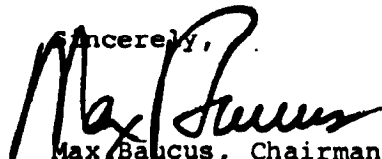
I am concerned because this action can have an adverse impact upon this country in two ways. It will undoubtedly establish a costly precedent. Also, U.S. interests may not be adequately protected.

I would like you to evaluate this policy, determine whether established collection procedures are being complied with, and determine if safeguards are being established to assure that adequate funds are being kept in this country to ensure the U.S. against loss in the event of arms sales agreement cancellation. I would like a report on this matter by the end of the calendar year.

It is my hope that Darby Smith and Roy Taylor will receive the assignment delineated in this letter. Not only are they masters of the subject matter beyond any others I can think of, but the work that they and their colleagues have done has spotlighted a serious deficiency in government activities and will probably save the public significant sums of money. They have shown in the finest possible light what competent workers can accomplish. I cannot praise them too highly, and I know you will recognize their accomplishments accordingly.

With best personal regards, I am

Sincerely,



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

(903008)





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