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General Accounting Office
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National Security and
International Affairs Division

B-256183

February 8, 1994

The Honorable Lee Hamilton
Chairman, Committee on Foreign Affairs
House of Representatives

Dear Mr. Chairman:

In response to your request, we reviewed cash flow financing for foreign military sales, a method of financing weapons sales to allied countries with U.S. appropriated grant or loan monies. Our specific objectives were to determine (1) why the United States provides cash flow financing to certain countries, (2) what the policy implications of such financing are, and (3) whether such financing commits the United States to future military assistance.

Normally, countries using U.S. grant or loan aid for military sales are required to use "full commitment financing" and reserve the total amount of the purchase at the time of the agreement. With cash flow financing, countries set aside only the amount of money needed to meet the current fiscal year's cash requirement.

RESULTS IN BRIEF

The United States uses cash flow financing as a means to demonstrate its strong political commitment to certain allied governments. It has no impact on the administration of weapons sales, but allows a country to order more U.S. defense goods and services than it normally could. Defense Security Assistance Agency (DSAA) and State Department officials stated that only Israel and Egypt will be able to use cash flow financing in the future. Three other countries currently use cash flow financing--Greece and Portugal are expected to pay off their cash flow balances in fiscal year 1994, and Turkey expects to pay its balance by fiscal year 1996. (See encl. I for trends in the use of cash flow financing.)

WHY COUNTRIES RECEIVE CASH FLOW FINANCING

The United States allows certain allied countries to cash flow finance the purchase of defense systems and services as a means to demonstrate its strong political ties to those countries. DSAA and State Department officials stated that a cash flow financing agreement represents a "best effort" commitment to secure annual U.S. appropriations in sufficient amounts to pay for contractual costs incurred by the foreign country. DSAA permits Israel and Egypt to use their entire annual military assistance appropriations in this way. Turkey, Portugal, and Greece may use cash flow financing only to purchase specific systems such as the F-16 aircraft. Some of these other countries use such financing for only a portion of the total weapons cost and pay the remainder with national and/or coalition funds. (See encl. 2.)

IMPLICATIONS OF CASH FLOW FINANCING

Cash flow financing permits a country to order more defense goods and services than it normally could because less money must be reserved when a contract is signed. For example, with cash flow financing, a country buying a weapon system costing $1 billion could reserve $200 million of its assistance package each year for 5 years for that system and could use any remaining assistance funds to order additional defense weapons or services. However, letters of offer and acceptance state, and DSAA and State Department officials confirmed, that foreign governments are required to pay the full cost or balance of the contract if U.S. appropriations are not forthcoming in future years.

Cash flow financing is similar to a "dependable undertaking" whereby a foreign government makes a firm commitment to pay the full cost of a contract for a weapon system or defense service in such amounts and at such times as required by the contract rather than reserve the total funds needed at the beginning of the contract period. Dependable undertakings involve national funds only; no U.S. funds are used.

The Defense Finance and Accounting Service-Denver Center (DFAS-Denver) administers purchases using cash flow financing with standard Foreign Military Sales financial controls after the decision to allow cash flow financing is made. It handles transactions through the Foreign Military

Sales trust fund. Our review of trust fund and loan operations, calculations of billings, and disbursements for countries using cash flow financing indicated that these transactions appear reasonable and authorized. Funds available for termination liability currently appear to provide sufficient reserves to cover potential defaults. A DSAA official pointed out that the Secretary of Defense has waived Israel's termination liability requirements, but because of the likelihood of continued Israeli aid, the waiver represents a minimal risk.

IMPACT OF CASH FLOW FINANCING ON EXECUTIVE AND LEGISLATIVE BRANCHES IN THE FUTURE

In the early 1980s, we reported that cash flow financing represented a strong commitment to future appropriations and could limit Congress' prerogatives in authorizing the U.S. security assistance program.[1] More recent experience has shown that cash flow financing does not necessarily commit the Congress or the executive branch to continued military assistance. For example, in the late 1980s, when Congress reduced aid requests and U.S. foreign policy priorities changed, the executive branch eliminated aid to Spain and South Korea, countries which had received cash flow financing since at least fiscal year 1985. In addition, although the executive branch has adhered to commitments to request appropriations for cash flow financing, the Congress has sometimes altered these requests by appropriating funds in loan rather than grant form (as in fiscal year 1993). Nevertheless, all countries which have used cash flow financing have met their obligations and, in general, continue to buy U.S. defense equipment and services.

SCOPE AND METHODOLOGY

We conducted our work between July and November 1993 and reviewed documents and interviewed officials from DSAA, DFAS-Denver, and the State Department. We surveyed DSAA and DFAS-Denver operations to assess the reasonableness of controls but did not independently verify the dollar figures provided. All cash flow financing data were provided as of October 1, 1993. Data on Israel's specific

[1] U.S. Assistance to the State of Israel (GAO/ID-83-51, June 24, 1983).

cash flow financed purchases was provided as of October 1992.

We hope this information is helpful to you. If you have any questions about this information, please call me on (202) 512-4128. The major contributors to this review were Stewart L. Tomlinson, Assistant Director; Barbara Schmitt, Evaluator-in-Charge; and Hynek Kalkus, Evaluator.

Sincerely yours,

Joseph E. Kelley

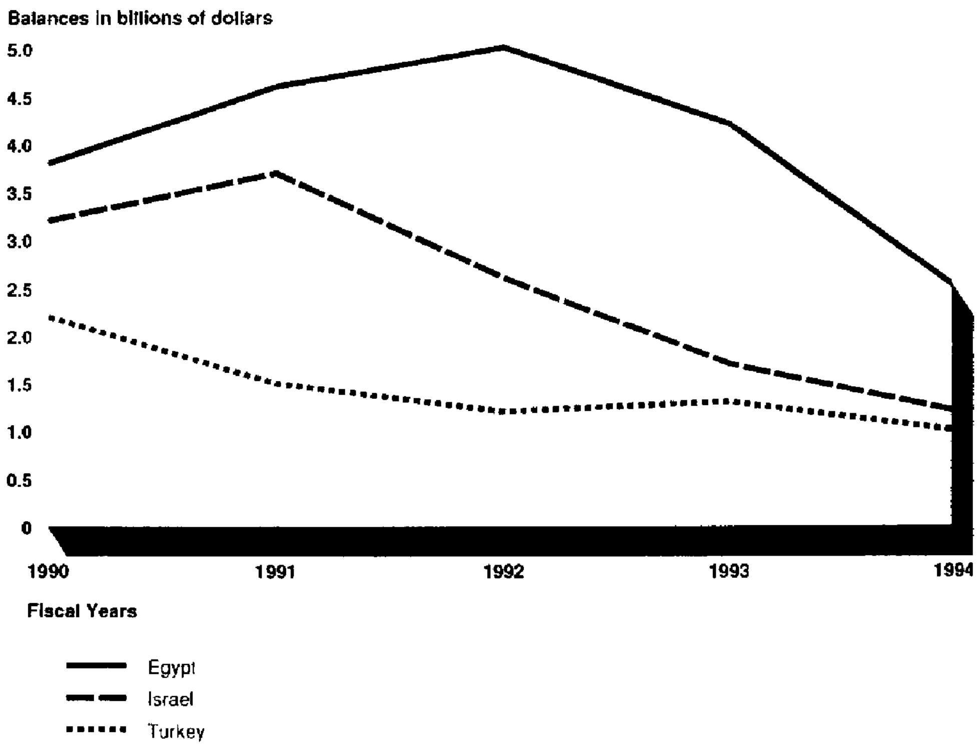
Joseph E. Kelley
Director-in-Charge
International Affairs Issues

Enclosures - 2

TRENDS IN CASH FLOW-FINANCED BALANCES OF CURRENT USERS

Figure 1.1 depicts the actual cash flow-financed balances of Egypt, Israel, and Turkey as of the beginning of each fiscal year since fiscal year 1990. Greece's and Portugal's cash flow balances are not included in the figure because they have always been relatively small, and as of the start of fiscal year 1994 were $170 million combined.

Figure 1.1: Trends in Cash Flow-Financed Balances of Egypt, Israel, and Turkey



Source: Derived from information provided by DSAA.

COUNTRIES' USE OF CASH FLOW FINANCING

ISRAEL AND EGYPT

Israel and Egypt receive their military assistance on a grant or nonrepayable loan basis. The United States allows Israel and Egypt to cash flow finance their entire military assistance packages--one of several means the United States uses to show its strong commitment to securing peace in the Middle East.

Since Israel started using cash flow financing in 1974, it has purchased more than $33 billion of defense systems and services with U.S. assistance. DSAA officials estimated that Israel's outstanding cash flow obligations were about $1.2 billion as of December 31, 1993. The most current detailed information available (as of Oct. 1, 1992) shows Israel's obligations to be only $809 million (see table 2.1). Israel is allowed to use cash flow financing for all types of defense procurements--major systems as well as fuel, training, munitions, spare parts, and support items. In addition, Israel uses cash flow financing for both commercial and government-to-government sales.

Since Egypt started using cash flow financing in 1979, it has purchased about $20 billion of defense systems and services with U.S. assistance. Its outstanding obligations are about $3 billion. Egypt is also allowed to use cash flow financing for all types of defense procurements, but its purchases are primarily government-to-government sales. (See table 2.2.)

TURKEY, PORTUGAL, AND GREECE

Turkey, Greece, and Portugal now receive all their military assistance on a loan basis. Prior to fiscal year 1993, these countries received grants and loans. In fiscal year 1993, Congress authorized concessional rate loans rather than grants, and in fiscal year 1994, Congress authorized market rate loans. Greece and Turkey are using national or other funding for portions of their current cash flow-financed purchases.

Turkey has used cash flow financing for about $4.5 billion of major weapon systems purchases. In the past, Turkey used cash flow financing to purchase M-48 tanks, F-4 aircraft, howitzers, and Track IIs. For its two current F-16 procurements, totaling $3.6 billion, it has an outstanding cash flow finance balance of $970 million, which should be paid off in fiscal year 1996. Portugal has used cash flow financing for over $1.2 billion of weapons purchases, including frigates, Chaparral missiles, antisubmarine warfare sonars and radars, and P-3 and F-16 aircraft. Greece has used cash flow financing to pay for $300 million of the total $1.3 billion cost of 40 F-16 aircraft. Both Portugal and Greece are expected to pay off their current cash flow-financed balances in fiscal year 1994. (See table 2.3.)

Table 2.1: Status of Israel's Cash Flow Financing as of October 1, 1992

Dollars in millions

System purchased (number of items)	Fiscal year obligations				Total obligation remaining
	1994	1995	1996	1997	
Government-to-government purchases					
F-15 aircraft (5)	$11.0	$4.6	0	0	$15.6
Apache helicopters (18)	56.2	.8	0	0	57.0
F-16 aircraft (60)	128.0	58.8	$25.0	$9.6	221.4
Cobra helicopter laser night attack system (40)	12.0	1.6	0	0	13.6
Other purchases[a]	18.6	23.6	20.0	8.4	70.6
Subtotal, government-to-government	$225.8	$89.4	$45.0	$18.0	$378.2
Commercial purchases					
F-100 engine upgrade program	$44.2	$31.3	0	0	$75.5
SAAR V corvettes (3)	72.6	0	0	0	72.6
Long range optical camera program	3.1	0.9	0	0	4.0
Multimode radar system program	39.0	0	0	0	39.0
F-16 engine[b]	22.8	0	0	0	22.8
Fuel	0	0	$15.2	$7.0	22.2
Other commercial purchases[a]	39.3	78.2	39.8	37.8	195.1
Subtotal, commercial	$221.0	$110.4	$55.0	$44.8	$431.2
Total, government-to-government and commercial	$446.8	$199.8	$100.0	$62.8	$809.4

[a]Examples include follow-on support, munitions, spare parts, and training.

[b]This represents an accumulation of multiple engine purchases for which the totals could not be readily discerned.

Source: Derived from information provided by DSAA.

Table 2.2: Status of Egypt's Cash Flow Financing as of October 1, 1993

Dollars in millions

System purchased (number of items)	Fiscal year obligations				Total obligation remaining
	1994	1995	1996	1997 and out	
122mm artillery (76)[a]	$49.4	$8.6	0	0	$58.0
Apache helicopters (24)	56.6	0.3	0	0	56.9
Coastal minehunter (3)	14.5	0	0	0	14.5
E-2C aircraft (6)	8.0	3.6	0	0	11.6
F-16 aircraft (93)	639.3	366.8	$200.9	$89.2	1,296.2
Communications systems (7)	12.5	9.7	1.8	0	24.0
Hawk PIP III air defense (12 batteries)	10.0	65.8	0	0	75.8
M1A1 tanks (524)	477.8	447.6	30.7	42.5	998.6
Pathfinder(12)/ sharp-shooter (12)	9.6	1.5	0	0	11.1
Patrol boats (10)	7.1	1.5	0.1	0	8.7
TOW missiles (10,184) and launchers (302)	19.0	26.2	5.4	0.4	51.0
Other items[b]	254.0	82.0	24.3	10.4	370.7
Total[c]	$1,558.0	$1,013.5	$263.1	$142.4	$2,976.9

[a]These items were purchased under a commercial contract.

[b]Examples include follow-on support, machine guns, training contracts, and vehicles.

[c]Totals may not add due to rounding.

Source: Derived from information provided by DSAA.

Table 2.3: Status of Greece's, Portugal's, and Turkey's Cash Flow Financing as of October 1, 1993

Dollars in millions

System purchased (number of items)	Fiscal year obligations				Total obligation remaining
	1994	1995	1996	1997	
Greece					
F-16 aircraft (40)	$100	0	0	0	$100
Portugal					
F-16 aircraft (20)	$70	0	0	0	$70
Turkey					
F-16 aircraft (200)	$325	$325	$320	0	$970

Source: Derived from information provided by DSAA.

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