# Audit Report

OFFICE OF THE INSPECTOR GENERAL

## COMMERCIAL SALES FINANCED UNDER THE FOREIGN MILITARY SALES FINANCING PROGRAM

Report Number 91-081

May 21, 1991

**Department of Defense**

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

May 21, 1991

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (INTERNATIONAL SECURITY AFFAIRS)

SUBJECT: Report on the Audit of Commercial Sales Financed Under the Foreign Military Sales Financing Program (Report No. 91-081)

This is our final report on the Audit of Commercial Sales Financed Under the Foreign Military Sales Financing Program, provided for your information and use. Comments on a draft of this report were considered in preparing the final report. We made the audit from August 1989 through May 1990. The primary objective of the audit was to determine whether contract administration controls existed over direct commercial sales financed under the Foreign Military Sales Financing Program (the FMS Financing Program). In addition, we evaluated internal controls over direct commercial sales contracts financed under the FMS Financing Program. We also followed up on prior audit reports covering the subject area and on recommendations made in a 1985 special study by the DoD Inspector General. During FY 1989, $1.9 billion was approved for direct commercial sales financing.

The audit showed that a number of improvements have been made in recent years in internal controls over direct commercial sales contracts, but not enough to prevent fraud, waste, and abuse and adequately protect U.S. interests. The results of the audit are summarized in the following paragraphs, and the details and audit recommendations are in Part II of this report.

Internal controls over the administration of direct commercial sales contracts were ineffective. Consequently, there was no assurance that the maximum benefit was received from loans used to finance direct commercial sales contracts. Because management's response to the draft report did not indicate that the Defense Security Assistance Agency was willing to develop alternative methods of oversight for direct commercial sales, we now recommend that the Assistant Secretary of Defense (International Security Affairs) improve internal controls by requiring that direct commercial sales contracts financed through the FMS Financing Program be placed under the controls and procedures of the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS). We also recommend amending the procedures in DoD Manual 5105.38-M, "Security Assistance Management Manual," October 1, 1988, to reflect this change in policy.

The audit identified internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. Controls did not ensure that U.S. interests were protected and that maximum benefits were received from credit loans used for direct commercial sales contracts. Recommendation 1. in this report, if implemented, will correct the weaknesses. Copies of this final report will be provided to the senior official responsible for internal controls within the Office of the Secretary of Defense.

We have determined that quantifiable monetary benefits will not be realized by implementing these recommendations (see Appendix H).

We provided a draft of this report to the addressee on October 18, 1990, and requested comments by December 17, 1990. We received comments from the Office of the Director, Defense Security Assistance Agency (DSAA) on January 9, 1991. The comments are summarized in Part II of this report, and the complete text of the management response is in Appendix G.

The Director, DSAA concurred with Recommendations 1.b., 1.d., 3., and 7. in the draft report. However, the Director nonconcurred with the finding and Recommendations 1.a., 1.c. 2., 4., 5., and 6. in the draft report. Those recommendations were to develop an alternative system for managing direct commercial sales that protects U.S. interests and further strengthens existing internal controls over commercial sales financed under the FMS Financing Program. The Director, DSAA did not agree that direct commercial sales between foreign countries and U.S. contractors that are financed by foreign military financing credits are DoD procurements and should follow FAR and DFARS requirements for acquisition and contract administration. The Director explained that commercial sales contracts are executed between the foreign country and the U.S. contractor and are submitted to DSAA for foreign military financing. He added that DSAA is not a party to the contract, is not involved in disputes, and does not administer the contract except for payments. The Director pointed out that the foreign country uses its own procurement system to solicit, contract for, and administer the foreign military financing contract.

The Director's comments did not address the deficiencies identified by the audit and proposed no alternative solutions to improve oversight over U.S.-financed direct commercial sales. As we noted in our report, during FY 1989, $1.9 billion was approved for direct commercial sales financing. Recent news articles have identified $12 million in contractor kickbacks in Israeli direct sales programs. This has raised questions about the way military aid and contracts between the United States and Israel are executed. One of the problems with the Israeli program was the

lack of supervision over FMS loans for direct commercial sales. We believe that direct commercial sales contracts should be subjected to the same review and oversight required for FMS government-to-government contracts governed by FAR and DFARS procedures. Requiring FMS-funded direct commercial sales contracts to go through FMS channels would minimize similar occurrences in the future.

Because of DSAA's failure to identify an alternative solution that would increase oversight of U.S. Government funds used for direct sales, the final report has been modified. The seven recommendations made in the draft report have been withdrawn and replaced with two new recommendations. Those new recommendations, if implemented, will correct the deficient conditions. We request that the Assistant Secretary of Defense (International Security Affairs) comment on the new recommendations when responding to the final report.

The cooperation and courtesies provided to the audit staff are appreciated. Please contact Mr. Alvin L. Madison, Program Director, at (202) 614-1681 (DSN 224-1681) or Mr. F. Jay Lane, Project Manager, at (202) 693-0651 (DSN 223-0651) if you have any questions concerning this report. A list of audit team members is in Appendix J, and copies of this report are being provided to the activities listed in Appendix K.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosure

cc:
Director, Defense Logistics Agency
Director, Defense Security Assistance Agency
Comptroller of the Department of Defense

REPORT ON THE AUDIT OF COMMERCIAL SALES FINANCED UNDER THE FOREIGN MILITARY SALES FINANCING PROGRAM

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Prepared by:
Financial Management Directorate
Project No. 9FA-0059

# REPORT ON THE AUDIT OF COMMERCIAL SALES FINANCED UNDER THE FOREIGN MILITARY SALES FINANCING PROGRAM

## PART I - INTRODUCTION

### Background

The purchase of Defense articles and services by foreign governments may be made through direct commercial contracts with U.S. contractors. For certain countries, commercial sales are eligible for U.S. Government financing under the Arms Export Control Act. Within the Department of Defense, the Under Secretary of Defense for Policy is the principal for security assistance matters and provides staff supervision and direction to the Defense Security Assistance Agency (DSAA) through the Assistant Secretary of Defense (International Security Affairs). DSAA's responsibilities include approving requests for the financing of direct commercial Foreign Military Sales (FMS) contracts, issuing procedures and guidelines regarding such approvals, and overseeing these contracts. During FY 1989, $1.9 billion was approved for direct commercial sales financing.

Direct commercial sales contracts financed under the FMS Financing Program have a history of impropriety, including fraudulent pricing schemes involving kickbacks and unreasonably high prices. Congress has expressed concern over these practices. Since 1984, DSAA has issued a series of procedural changes to improve controls and practices for financing approval and disbursement of funds for direct commercial sales contracts. On June 14, 1985, the DoD Inspector General and DSAA issued a study, "Commercial Purchases Financed Under the Foreign Military Sales Financing Program." The study made nine recommendations for improved management controls over these contracts. Comments on the implementation of these recommendations are in Part II of this report.

DoD Manual 5105.38-M, "Security Assistance Management Manual," October 1, 1988, gives policy, procedures, and guidelines for security assistance, including the approval of financing for direct commercial sales contracts.

### Objective and Scope

The overall objective of the audit was to determine whether adequate contract administration controls existed over direct commercial purchases funded under the FMS Financing Program. To meet the objective, we reviewed procedures and internal controls at the DSAA, the Military Departments, and the Defense Logistics Agency as they related to contract administration and support for direct commercial sales contracts.

We reviewed DSAA approvals for funding such contracts, contract pricing, collection of nonrecurring costs and asset use charges, controls of contract deliveries, approvals of progress payments to contractors, procurement quality assurance, and compliance with the Buy American Act. To review internal controls at each U.S. Government activity we visited, we obtained the most recent Annual Statement of Assurance required by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987.

We tested DSAA's procedures for oversight of contract administration by taking a statistical sample of direct commercial sales contracts. To accomplish this, we identified a universe of 354 non-Israeli contract actions valued at over $1 billion, covering all of FY 1988 and the first 10 months of FY 1989. From this universe, we randomly selected a sample of 20 contract actions valued at $132.9 million. These actions had a dollar range from $85,000 to $95 million, represented 530 contract line items, and were applicable to 4 countries. We made statistical projections where applicable and feasible.

We also tested the adequacy of support for selected contract line item prices. To accomplish this, we took a judgmental sample of 26 contract line items valued at $52.5 million from the above statistical sample of 20 contract actions. The 26 line items were applicable to 8 contract actions, 8 contractors, and 4 countries. We visited the 8 contractor plant locations and reviewed the adequacy of contractor support for the 26 selected contract line items. This included, where applicable, comparison of contract pricing rates and factors used in similar U.S. Government contracts.

To determine the propriety of contract line item prices, we took a judgmental sample of line items and compared the contract prices for these items to prices shown in DoD data bases.

To identify prior audit reports and the status of recommendations made in those reports, we took the following actions:

- We examined the data base of the DoD Inspector General's Automated Reports Tracking System to identify reports issued by the DoD Inspector General and the General Accounting Office;

- We asked the Defense Logistics Studies Information Exchange to examine its data base to identify audit reports issued by the Army Audit Agency, Naval Audit Service, and Air Force Audit Agency; and

- We contacted the Defense Criminal Investigative Service to determine the status of recommendations made in its report, "Fraud Prevention Survey of Foreign Military Sales Credit Loan for Direct Commercial Contracts - Country of Turkey," October 29, 1985.

Additionally, we followed up on the implementation of nine recommendations made to the Deputy Secretary of Defense for management improvements in direct commercial sales under the security assistance program. The recommendations were made in 1985 in a special study by the DoD Inspector General.

Our audit did not cover:

- A review of the DSAA computerized systems that produced our audit sample or contractors' products that we used to verify certain contract data;

- Israeli direct commercial sales, which were being reviewed by the U.S. General Accounting Office at the time of our audit;

- A detailed review of the loan process incidental to awarding the direct commercial sales contracts;

- Contract administration practices at contractor facilities, except for the pricing support aspects of the selected contracts and associated line items;

- A detailed review of contractor rates and factors used to support sampled line item amounts, such as: overhead, general and administrative expenses, labor, warranties, and the cost of money;

- An in-depth review of procurement quality assurance.

This performance audit was made from August 1989 through May 1990 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, and accordingly included such tests of internal controls as were considered necessary. Activities visited or contacted during the audit are listed in Appendix I.

Internal Controls

We obtained the most recent Annual Statements of Assurance required by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. We concentrated on prescribed control procedures and actual practices as they related to the adequacy of contract administration controls over direct commercial sales contracts. Material internal control weaknesses are cited in Part II of this report.

## Prior Audit Coverage

From 1984 to 1990, the DoD Inspector General issued eight reports and the U.S. General Accounting Office issued two reports that addressed the administration of direct commercial sales contracts under the FMS Financing Program. Problems were found with nonrecurring cost charges and reporting, asset use charges and requirements for recoupment, identification of commercial sales to DoD, the auditing of contractors and subcontractors, the establishment of policies and procedures for direct commercial sales, pricing and billing for materials and services, and the management of contract administration sales cases.

DoD Inspector General Audit Report No. 84-105, "Financial Reports and Credit Program Division, Defense Security Assistance Agency," June 28, 1984, made 11 recommendations that were either implemented or addressed by DSAA. Recommendation 1. in the report was that a policy be established to specify the types of materials and services for which FMS credit funds can be used to finance commercial purchases. DSAA nonconcurred with the recommendation and stated that the same guidelines apply to commercial sales and government-to-government sales. The DoD Inspector General agreed and eliminated the recommendation from further consideration. Implementation of Recommendation 1. in this report will correct the conditions described in the prior report.

Two reports had recommendations that had not been implemented: DoD Inspector General Report No. 89-087, "Contractor Rental of Government Property and Payment of Nonrecurring Costs," June 30, 1989, and Report No. 89-060, "The Reimbursable Billing System at Defense Logistics Agency," March 20, 1989. Report No. 89-087 contained 17 recommendations that pertained to rental and nonrecurring costs applicable to foreign commercial sales. The report recommended changing regulations to clarify policy and procedures on contractor use and rental of DoD real property, negotiating sound commercial rental rates for facility/lease contracts, and clarifying policies for recoupment of nonrecurring costs. From Report No. 89-060, two recommendations on direct commercial sales contracts had not been implemented. Our followup on these recommendations showed that they were still being implemented and are considered open.

DoD Inspector General Inspection Report No. 90-INS-15, "Defense Security Assistance Program," made one recommendation that DSAA expand oversight over direct commercial sales to promote interoperability, standardization, and a more fully coordinated overall sales program. DSAA partially concurred with the recommendation stating that in those circumstances where the U.S. is financing procurements with security assistance funds, it may be able to further structure customer purchases to support standardization and interoperability objectives. See Appendix A for a list of the 10 reports.

## PART II - FINDING AND RECOMMENDATIONS

Controls Over Direct Commercial Sales

### FINDING

The Defense Security Assistance Agency (DSAA) had ineffective internal controls over the review, processing, and monitoring of direct commercial sales contracts. Office of Management and Budget Circular A-123 requires that a system of internal controls be established to provide reasonable assurance that Government resources are protected against fraud, waste, and mismanagement. DSAA's procedures for administering contracts under the Foreign Military Sales Financing Program (the FMS Financing Program) did not properly protect U.S. interests. Consequently, there was no assurance that the maximum benefit was received from credit loan funds used to finance direct commercial sales contracts.

### DISCUSSION OF DETAILS

Background. FMS loans may be used, when approved by DSAA on a case-by-case basis, to purchase Defense articles and services through direct commercial contracts with U.S. contractors. The purchasing country must make a formal request to DSAA, accompanied by a copy of the contract to be financed. These loans are generally approved on the same basis as government-to-government transactions under the FMS Financing Program. Purchasing countries can use either government-to-government contracts or direct commercial sales contracts to meet their defense needs.

Office of Management and Budget (OMB) Circular A-123, "Internal Control Systems," August 4, 1986, requires that a system of internal controls be established to provide reasonable assurance that Government resources are protected against fraud, waste, and abuse. DoD Directive 5010.38 implements OMB Circular A-123 and requires that all DoD activities report significant internal control deficiencies annually.

To implement FMS policy, DSAA issued DoD Manual 5105.38-M, "Security Assistance Management Manual," October 1, 1988. The manual provides policies, procedures, and guidelines for FMS to manage security assistance in accordance with public law. Included in the manual are guidelines for the processing and approval of FMS loans for direct commercial sales contracts. The guidelines require DSAA to review these contracts and supporting documentation to provide assurances covering the Buy American Act, the contractor's capability, competition, the propriety of the contract, and approval of payments to the contractor. DSAA may, after reviewing loan information and associated contract data, request assistance from the administrative contracting

officer and the Defense Contract Audit Agency office responsible for the contract. This assistance may be necessary to verify contractors' statements or determine their capability to perform under a contract. DSAA is responsible for contract acquisition management and oversight of contract administration. The guidelines in DoD Manual 5105.38-M are similar to those in the Federal Acquisition Regulation (FAR).

During FY 1989, $1.9 billion was approved for direct commercial sales financing. These funds may be committed, obligated, and disbursed in subsequent fiscal years.

DSAA Contract Administration Support and Oversight. We statistically selected 20 direct commercial sales contract actions, valued at $132.9 million, from DSAA's data base (see Appendix B). We reviewed DSAA's contract and loan files for the sampled actions to ascertain whether contract administration procedures were adequate and were being followed. We found deficiencies and weaknesses that are noted in the following paragraphs.

Competition. Five of the 20 sampled actions were contract amendments; therefore, we did not test these actions for competition. Our test of the remaining 15 actions showed the following results.

Acquisition Plans. For 12 actions valued at $26.7 million, purchasing countries did not submit the required acquisition plans to DSAA. We projected that 212 contract actions valued at $216.4 million did not have required acquisition plans (see Appendix C, Part I). DoD Manual 5105.38-M requires that purchasing countries submit acquisition plans identifying direct commercial purchases to be made with FMS funding. Acquisition plans should identify items or services to be purchased, quantities, estimated purchase value, firms that will receive bid requests, and information on the competitive acquisition process. For the three sampled actions that had plans, two of the plans did not justify sole source procurements; DSAA personnel could not locate the third plan, although correspondence referred to it.

The Federal Acquisition Regulation/Defense Federal Acquisition Regulation Supplement (FAR/DFARS) provides for acquisition planning, which includes provisions for identifying needs, required contractor capabilities, delivery requirements, and prospective sources of supply. Acquisition plans provide for effective competition to the greatest extent practicable and integrate the significant aspects of the acquisition. The purpose of acquisition planning is to ensure that the buying entity meets its needs in the most effective, economical, and timely manner.

Acquisition Letters. DoD Manual 5105.38-M requires that when a purchasing country has selected a contractor and submitted a contract to DSAA for FMS financing review, the purchasing country should identify, by separate letter, the various contractors solicited and the basis for contractor selection. The manual also requires that in the case of sole source selection, the letter should state the reasons for the contract award. Letters were not found for 11 of the 15 actions; the 11 actions were valued at $120.7 million. We projected that 195 contract actions, valued at $733.4 million, did not have the required acquisition letters (see Appendix C, Part I). In three of the four actions that had letters, justification was inadequate to show that proper competition had taken place; these actions were all competitive and had a total value of $950,595. One letter stated, "The lowest price and the shortest delivery time considered the main factors in evaluating." This letter did not contain the names of the contractors or information on how the individual contractors competed with each other, such as dollar amounts or technical capabilities.

The FAR/DFARS has a detailed system for documenting both advertised and negotiated procurements. Such documents become part of the contract file and support the propriety of competitive action taken to award contracts in accordance with specified legal requirements.

Price Comparisons. DoD Manual 5105.38-M requires that DSAA perform price comparisons on a selective basis as part of the contract review process. This includes comparison to current DoD procurement prices or other domestic sources. The purpose of the comparison is to ensure that FMS credit funds do not finance excessive prices. Our audit tests showed that none of the 20 sampled contract actions had received a price comparison.

To assure fair and reasonable prices, the FAR/DFARS requires that a price analysis be done for each procurement. With certain exceptions, a cost analysis is required for procurements over $100,000. The cost analysis may include a technical analysis and an audit of the contractor's proposal to assure contractor price integrity.

We judgmentally selected 25 contract line items or subitems for price comparisons applicable to 9 of the 20 sampled contract actions. We compared the contract unit prices for these amounts to amounts shown in three data bases 1/ researched for us by the Defense Logistics Agency. These data bases showed prices for

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1/ The three data bases were: the Defense Reutilization and Marketing Service Integrated Disposal Management System; Haystack; and the Defense Logistics Service Center Total Item Record.

currently stocked items maintained in the DoD inventory. The data bases also provided both current and historical prices for stocked items. Eight items could not be located in the DoD data bases. For the remaining 17 items (various spare parts with a total contract unit price value of $6,652), significant price differences occurred. Except for three contract line items, customers paid more than the DoD inventory price (see Appendix D):

- The overall unit price difference for the 17 items was $1,917 ($6,651 total contract unit price minus $4,734 total amount paid by the U.S. Government) where the U.S. inventory price was 40 percent lower.

- Fourteen items were priced higher than the U.S. inventory price. Dollar differences ranged from $625.83 to $0.42 with a total dollar difference of $2,275.64.

- Two items had contract prices lower than the U.S. inventory price. The dollar differences were $358.00 and $0.55, respectively, for a total dollar difference of $358.55.

- The contract price for one item was found to be the same as the U.S. inventory price.

Propriety of Purchases. We made internal control tests to determine whether the sampled procurements were financed in accordance with legal and regulatory requirements. Our tests showed that DSAA should not have approved financing for 7 of the 20 sampled contract actions.

Waivers for Spare Parts Actions. Five of the sampled actions pertained to procurement of spare parts by one country for various weapon systems (Appendix B, Items 16 through 20). DoD Manual 5105.38-M provides that except in special circumstances, financing is not approved for purchases of spare parts, including replacements for worn, damaged, or lost equipment. Exceptions may be granted in special circumstances, such as an adverse military development in the borrowing country or an unprogrammed overhaul of major equipment that would prevent or delay the purchase of new end items.

DSAA records contained no waivers for any of the five actions. Much of the equipment in purchasing countries' inventories is outmoded by U.S. standards, and many countries may not be able to afford the newer, more sophisticated equipment in the U.S. weapons inventory. DoD should comply with its policy requirements or consider changing its policy on financing of spare parts for credit sales. However, we believe that implementation of Recommendation 1. in this report will correct this condition.

Contractor's Capabilities. DoD Manual 5105.38-M requires that a prime contractor must demonstrate to the DSAA, by preaward survey or other means, its capability to perform under the financed contract, including expertise, experience, facilities, and financial soundness. Audit tests showed that two contractors accepted by DSAA were not the most suitable to perform under their respective contracts.

One contractor was to have furnished aviation spare parts; the contract amount was for $105,655 (Appendix B, Item 16). The contractor, who had a history of successful performance with DSAA on direct commercial sales contracts, did not complete deliveries under the contract. DSAA procedures do not require performance of an additional preaward survey after completion of the initial survey. An additional preaward survey may be necessary for small or medium-sized contractors where negative fluctuations in the business climate can have a detrimental effect on a contractor's ability to perform in accordance with contract terms.

According to DSAA records, the contractor received progress payments based on actual delivery. The purchasing country did not lose any money, but a new contract, which would mean additional costs for the U.S. Government and the purchasing country, may be needed to complete deliveries.

The second contractor was selected to furnish chemicals for a contract amount of $125,000 (Appendix B, Item 1); however, a Dun & Bradstreet financial report showed that the contractor specialized in steel products and was not associated with the chemical industry. To satisfy the contract requirements, the contractor would have had to subcontract out and charge a higher-than-normal price. DSAA records do not indicate that this contractor's capabilities were reviewed before the loan was approved. Failure to properly review a contractor's capabilities can lead to unjustifiably high prices.

DSAA patterned its procurement and contract administration procedures after the FAR/DFARS. However, the FAR/DFARS procedures governing contractors' qualifications are more extensive than DSAA's. The FAR/DFARS includes responsibilities and standards for contractors and subcontractors. It also includes procedures for debarment, suspension, ineligibility, and conflicts of interest. The FAR/DFARS requires greater assurance that contractors are technically and financially qualified to perform, particularly prior to contract award.

Deliveries. The 20 sampled actions had a total of 530 line items, of which 517 line items, valued at $27.6 million, were scheduled for delivery during the audit period. Results of our audit tests showed that 144 line items, valued at $2.9 million and applicable to 4 countries and 10 contract actions, were delivered after the required delivery date. The deliveries ranged from 1 to 587 days late.

For 9 of the 10 late actions, there was no evidence that applicable contract penalty clauses were invoked and proceeds forwarded to the U.S. Government as required. DoD Manual 5105.38-M requires contractors to forward contract penalties or liquidated damages to DSAA for credit to the purchasing country's trust fund account, where they are available to the country for other financing. For the remaining action, valued at $314,367, we computed a total penalty of $25,276. The country invoked the contract penalty clause and assessed the contractor $14,517, which was not forwarded to the U.S. Government as required; the purchasing country deducted this amount from five of the contractor's invoices. The remaining $10,759 is due the U.S. Government.

We computed that a total of $91,117 may be owed the U.S. Government due to late deliveries for the nine actions (see Appendix E for computations). Statistically projecting the $91,117, we estimated that a total of $737,900 may be owed the U.S. Government (see Appendix C, Part II). Based on the 10 contract actions and 144 associated line items delivered after the required delivery date, we estimated that a total of 99 contract actions with 2,533 line items, valued at $23.6 million, were delivered late. We further estimated that no penalty clauses were invoked on a total of 89 contract actions valued at $23.2 million (see Appendix C, Part II).

Also, 2 of the 20 contract actions (Appendix B, Items 6 and 13), valued at $273,200, did not have penalty clauses included in the contracts. We projected that a total of 35 contract actions, valued at $2.2 million, did not have penalty clauses included in their contracts (see Appendix C, Part II).

DSAA is not required to monitor contractor performance, and DSAA procedures do not require that direct commercial sales contracts contain penalty clauses for late delivery. The FAR/DFARS provides for penalty clauses for late deliveries and requires that delivery dates be included in contracts. The FAR/DFARS also requires that contracting officers monitor contractor performance and implement liquidated damage provisions for contracts when contractors fail to meet delivery dates.

Recommendations from DoD Inspector General's Special Study. In 1985, the DoD Inspector General conducted a special study of direct commercial sales contracts funded through the FMS

Financing Program. The purpose of the study was to reduce fraud, waste, and abuse in these contracts, which had a history of overpricing and product substitution. The study was coordinated with the Under Secretary of Defense for Policy and the Director, DSAA. The study made nine recommendations to improve controls over direct commercial sales contracts.

On June 14, 1985, these recommendations were forwarded to the Under Secretary of Defense for Policy for implementation. Followup showed that two of the nine recommendations had not been implemented as of Janurary 1990 (see Appendix F). The two recommendations were:

> Place standard items purchased by foreign governments into the Foreign Military Sales Program. Certain waivers may be granted where it can be shown that exceptional circumstances exist; and
>
> The Defense Security Assistance Agency will selectively review and audit initial payments and follow-on payments for compliance with DoD 5105.38-M.

Based on the results of the current audit, we believe that both recommendations still have merit and should be implemented. The first recommendation would require that purchasing countries order standard items in the U.S. inventory through government-to-government FMS channels, i.e., from depot stocks or an existing contract. This would give both the United States and the purchasing governments the benefit of economy of buy. The second recommendation would give greater assurance that goods or services ordered were actually received and that prices paid were in accordance with the contract terms. The implementation of Recommendation 1. in this report will correct the deficiencies discussed in the special study.

Contractors' Pricing Support for Selected Line Item Prices. We took a judgmental sample of 26 line items, valued at $52.5 million, from the previously sampled 20 contract actions covering 530 line items. The 26 line items were applicable to 8 contract actions, 8 contractors, and 4 countries (see Appendix B). Our purpose was to determine whether the contractors had adequate pricing support for the selected line items. Our test of contractor records showed the following results.

Supporting Documentation. Five of the 8 contractors could not provide adequate documentation for $38.2 million, covering 22 line items. Documentation would include copies of original contract cost proposals and allied cost breakdowns. The DSAA does not require contractors to retain specific records of contracts under the FMS Financing Program. However, the FAR/DFARS requires that contractors maintain books, records, and

other supporting evidence to satisfy contract negotiation, administration, and audit requirements.

Subcontract Line Item Support. For 6 contractors, we reviewed 190 subcontract items applicable to 10 line items, valued at $51.2 million; 96 subcontract items, valued at $37.7 million, did not receive adequate cost or price analysis. For example:

- For one contractor, there were two competitive procurements where we found no evidence of history searches for prices of items used in the manufacture of a system that had been produced for many years. A standard practice for price analyses is to maintain a record of prices of frequently purchased items and compare them to current solicited prices to ensure that current prices are reasonable, considering the last purchase price, escalation factors, and product improvement. We found no such evidence in these cases.

- For sole source procurements of 15 items at the same contractor, justification was inadequate to support selection of the vendors awarded the subcontract. DSAA procedures require that purchasers submit lists of prime contractors' subcontractors to DSAA with their loan request packages. DoD Manual 5105.38-M further states, "It is assumed that the purchasing government will be aware of the extent of additional cost or markup by the prime contractor and this data can be provided upon request." DSAA procedures do not set forth any rules governing competition and relationships between prime contractors and subcontractors in direct commercial sales. However, the FAR/DFARS has specific guidelines on the use of subcontractors by contractors, including reviews of purchasing systems and attendant competition. Reviews are conducted by administrative contracting officers who have a thorough knowledge of the contractor's operation. Under the FAR/DFARS, purchasing activities have greater protection in price reasonableness and competition.

Profit. Profits charged to the eight sampled contracts ranged from zero percent to 25 percent. Two of the eight contractors charged the zero-percent profit rate. The reason given by these manufacturers for charging such a rate was "to enter the market." Two contracts had profit rates of 20 percent and 25 percent. Contracting officials stated that they charged these higher rates because they incurred risks by signing offset agreements with foreign governments. Offset agreements, which are not normally financed by the U.S. Government, may require contractors to make investments or procurements in a country other than the United States.

The profit range shown in the Armed Services Pricing Manual for firm-fixed-price manufacturing contracts was from 6 percent to

8 percent. The Armed Services Pricing Manual also states that the risk factor is critical in reducing costs. Unlike contractors under offset agreements, the Armed Services Pricing Manual considers assigned responsibility for costs and the risk of cost overrun. With the use of the weighted guidelines method shown in the FAR/DFARS, the profit might go as high as 16 percent. The weighted guidelines method uses factors such as risk, facilities, production capability, and the use of skilled personnel to arrive at a profit rate.

We did not compute the rate using the weighted guidelines method, but we believe that the profit rates for both of these contracts would be lower if the foreign governments had used government-to-government FMS contracts. Review of a U.S. Government contract related to one of the sampled contracts showed the profit rate to be 16 percent, versus 20 percent on the sampled contract.

Criminal Aspects. During the audit, we held discussions with the Defense Criminal Investigative Service (DCIS) concerning the administration of direct commercial sales contracts financed with FMS credits. We were informed by DCIS representatives that as of June 19, 1990, DCIS had over 30 active criminal cases involving direct commercial sales contracts; all were product substitution cases. We made a cursory review of DSAA and selected contractor records of procurement quality assurance for our sampled contract actions, and our audit results did not disclose any problems. However, the numerous criminal cases at DCIS were another indicator of risk in direct commercial sales contracts.

When Defense articles are purchased under the government-to-government FMS program, articles in the U.S. inventory or purchased as part of a U.S. Defense contract receive procurement quality assurance. Foreign governments would normally pay a surcharge for this service. Under a direct commercial sales contract, varying amounts of procurement quality assurance are received. For example, the contracts for our 20 sampled contract actions showed that procurement quality assurance varied from a contractor's certificate of inspection to assurance provided by the U.S. Government. In most cases where the U.S. Government provides this service, the Arms Export Control Act requires the purchaser to pay for the service. We believe that DSAA should develop a standard for procurement quality assurance. The standard should protect U.S. interests by ensuring that the purchaser receives the goods or services financed.

Conclusion. Internal controls over direct commercial sales contracts are ineffective to prevent fraud, waste, and abuse and should be reported as material internal control weaknesses in accordance with DoD Directive 5010.38. Improvements during the past 6 years have not prevented these internal control weaknesses. DSAA managers stated that they did not have enough

personnel to perform many acquisition and contract administration tasks. Some of these tasks have been incorporated into DoD Manual 5105.38-M. Our audit showed that procedures were not being followed and that further improvements were needed to protect U.S. interests. Management has two alternatives for improving procurement and contract administration in the FMS Financing Program.

One alternative would be to add contract specialists to the DSAA staff. Contract specialists, who have extensive training and experience in procurement operations and contract administration, would review contracts and loan information for propriety. Employment of contract specialists would benefit the FMS Financing Program because many of the loan approval criteria are based on FAR/DFARS requirements. We estimate less than 10 contract specialists would be required.

The second alternative would be to eliminate direct commercial sales under the FMS Financing Program and offer only government-to-government credit sales to purchasers. This would force all credit sales purchasers to use DoD contracts, which are covered by the FAR/DFARS and receive protection similar to U.S. Government contracts.

## RECOMMENDATIONS FOR CORRECTIVE ACTION

We recommend that the Assistant Secretary of Defense (International Security Affairs) improve internal controls over direct commercial sales contracts financed under the Foreign Military Sales Financing Program. Specifically, the Assistant Secretary should:

1. Require that direct commercial sales contracts financed through the Foreign Military Sales Financing Program be placed under the controls and procedures required for Foreign Military Sales government-to-government contracts, and subject them to the provisions of the Federal Acquisition Regulation and the Defense Federal Acquisition Regulation Supplement.

2. Amend the current procedures in DoD Manual 5105.38-M, "Security Assistance Management Manual," dated October 1, 1988, applicable to direct commercial sales contracts financed under the Foreign Military Sales Financing Program, in order to implement Recommendation 1.

## MANAGEMENT COMMENTS

The Director, Defense Security Assistance Agency concurred with Recommendations 1.b., 1.d., 3., and 7. in the draft report. DSAA agreed to ensure that only qualified contractors are used to satisfy approved loan requirements; ensure that contracts contain adequate provisions for procurement quality assurance; comply

with the requirements of the Arms Export Control Act and DoD Manual 5105.38-M, "Security Assistance Management Manual," by providing credit loans only for coproduction contracts; and report and track the internal control deficiencies cited in the report. The Director nonconcurred with the finding and Recommendations 1.a., 1.c., 2., 4., 5., and 6. in the draft report. Those recommendations were to develop an alternative system for managing direct commercial sales that protects U.S. interests and further strengthens existing internal controls over commercial sales under the FMS Financing Program. The Director did not agree that since direct commercial sales between foreign countries and U.S. contractors that are financed by foreign military financing credits are DoD procurements, these sales should follow FAR and DFARS requirements in the acquisition process and contract administration.

The Director stated that commercial sales contracts are executed between the foreign country and the U.S. contractor and subsequently submitted to DSAA for foreign military financing. DSAA is not a party to the contract, is not involved in the dispute process, and does not administer the contract except for payments. The foreign country uses its own procurement system to solicit, contract for, and administer foreign military financing contracts. The Director also pointed out that the foreign country's use of its own procurement system is supported by Comptroller General Decision B-222483, April 16, 1986. The full text of management comments is at Appendix G.

## AUDIT RESPONSE TO MANAGEMENT COMMENTS

We consider DSAA's comments to be nonresponsive. The comments did not address the deficiencies identified in the draft report, and proposed no alternative solutions to improve oversight over U.S. Government-financed direct commercial sales between U.S. contractors and foreign customers. DSAA responded that it had no oversight responsibility for contract administration of commercial contracts, beyond verifying conformance with DSAA guidelines for funding eligibility and requiring acceptance-billing documentation before making payments. We believe that DSAA did not adequately respond to the draft report's finding and recommendations.

The DSAA comments did not identify an alternative system to improve internal controls that would:

- ensure that proper procurement and contract administration procedures are followed (Recommendation 1.a.);

- ensure that both DSAA and contractors maintain documentation to support contract prices (Recommendation 1.c.);

- develop specific standards for procurement quality assurance to be included in contracts before supporting loans are approved (Recommendation 2.);

- comply with U.S. policy by stopping the procurement of spare parts with credit loan funds, or changing the policy to accommodate current loan practices (Recommendation 4.);

- implement a recommendation from a 1985 DoD Inspector General special study to place standard items purchased by foreign governments into the FMS Financing program.

- implement recommendation A.1. from DoD Inspector General Audit Report No. 84-105, "Financial Reports and Credit Program Division, Defense Security Assistance Agency," June 28, 1984, which required the establishment of a policy for materials and services for which FMS credit funds could be used to finance commercial purchases (Recommendation 6.).

Regarding the Comptroller General's decision cited by DSAA, the General Accounting Office noted that it had no authority to make bid protest decisions on contracts involving a foreign country and a U.S. contractor, even if financed through a loan made by a Federal agency. We believe that under DoD Manual 5105.38-M, "Security Assistance Management Manual," October 1, 1988, DSAA has authority over FMS loans for direct commercial sales contracts between U.S. contractors and foreign countries. In addition, we believe that DSAA has a fiduciary responsibility to safeguard funds loaned by the U.S. Government to foreign customers for direct commercial sales.

DSAA proposed no alternative solutions to address the deficiencies identified in this report. Management had two alternatives for improving procurement and contract administration in the FMS Financing Program. One Alternative was to add contract specialists to the DSAA staff. The second alternative was to eliminate direct commercial sales under the FMS Financing Program and offer only government-to-government credit sales to purchasers. As stated earlier, during FY 1989, $1.9 billion was approved for direct commercial sales financing. Recent news articles have identified $12 million in contractor kickbacks involving the Israeli direct sales programs. This has raised questions about the way military aid and direct sales contracts between the United States and Israel are executed. One of the problems with the Israeli program was the lack of close supervision over FMS loans for direct commercial sales. We believe that direct commercial sales contracts should be subjected to the same review and oversight required for FMS government-to-government contracts governed by the FAR and DFARS procedures. Requiring FMS-funded direct commercial sales contracts to go through FMS channels would minimize similar occurrences in the future. Because of DSAA's

failure to identify an alternative solution that would increase oversight of U.S. Government funds used for direct sales, we have revised this final report. The seven recommendations made in the draft report have been withdrawn and replaced with two new recommendations. These new recommendations, if implemented, will correct the conditions described in the draft report.

## LIST OF REPORTS RELATED TO DIRECT COMMERCIAL SALES CONTRACTS ISSUED BY THE GENERAL ACCOUNTING OFFICE AND THE OFFICE OF THE INSPECTOR GENERAL

| Agency | Report No. | Date | Title |
|---|---|---|---|
| DoDIG [1/] | 84-105 | June 28, 1984 | Financial Reports and Credit Programs Division, Defense Security Assistance Agency |
| DoDIG | 85-006 | October 19, 1984 | Pricing of Technical Assistance Sold to Foreign Military Sales Customers |
| DCIS [2/] | S850104L | October 29, 1985 | Fraud Prevention Survey of Foreign Military Sales Credit Loan for Direct Commercial Contracts - Country of Turkey |
| DoDIG | 86-033 | November 4, 1985 | Nonrecurring Cost Recoupment Charges to Foreign Military Sales |
| GAO [3/] | NSIAD-86-44 (OSD [4/], Case No. 6546) | February 28, 1986 | Cost Recovery - Collecting Research and Development Costs on Commercial Sales |
| DoDIG | 86-080 | March 7, 1986 | DoD Policies and Procedures for Assessing Asset Use Charges to Foreign Military Sales Customers |
| GAO | NSIAD-86-95 (OSD Case No. 6998) | April 18, 1986 | Nonrecurring Costs: Improvements Needed in DoD Cost Recovery Efforts |
| DoDIG | 89-060 | March 20, 1989 | The Reimbursable Billing System at Defense Logistics Agency |
| DoDIG | 89-087 | June 30, 1989 | Contractor Rental of Government Real Property and Payment of Nonrecurring Costs |
| DoDIG | 90-INS-15 | July 26, 1990 | Defense Security Assistance Program |

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1/ Department of Defense Inspector General
2/ Defense Criminal Investigative Service
3/ General Accounting Office
4/ Office of the Secretary of Defense

## LIST OF CONTRACTS COVERED BY THE AUDIT

| | Contract No. | Country/Case No. | Contract Amount | Contractor | Items Contracted For |
|---|---|---|---|---|---|
| 1. | POW/JF/Ali Bann/88/10 | Egypt/EG-S-AOF | $ 125,000.00 | Ali Bann Enterprise | Calcium hypochlorite |
| 2. | Cairo/KE/P&H/87/5, Amendment No. 3 | Egypt/EG-S-ANU | 53,872.00 | Harnischteger Corp. | Crane, rough terrain and spare parts |
| 3. | Cairo/BX/PA* | Egypt/EG-S-ANI | 488,500.00 | Para-Flite, Inc. | Aerial delivery systems |
| 4. | Cairo/AM/AY* | Egypt/EG-S-ANL | 500,000.00 | Aydin Corp. | Radios and spare parts |
| 5. | Cairo/AD/AM | Egypt/EG-S-ANA | 4,457,840.00 | Eico Corp. | Communications cable |
| 6. | 7/86 Amendment No. 1* | Greece/GR-S-ACK | 152,200.00 | General Electric Co. | Engine health tracking system |
| 7. | 230.201/7/87 Amendment No. 1* | Greece/GR-S-ADE | 336,450.00 | Magnavox Overseas Limited | AN/ARC-164 radio system |
| 8. | 0572/87* | Greece/GR-S-ACZ | 887,602.00 | Optic-Electronic Corp. | Aerial sights, optical test sets, and machine gun mounts |
| 9. | 0625H/88* | Greece/GR-S-ADC | 15,428,034.00 | BMY Corp. | M-109 self-propelled howitzers and spare parts |
| 10. | 0150A/88 | Greece/GR-S-ADJ | 3,460,925.00 | Gentex International Incorporated | Ballistic helmets |
| 11. | 1366/1/ME749/ Up-Gradation/ DGDP/PC-3, Amendment No. 1 | Pakistan/PK-S-AAH | 85,000.00 | Hughes Aircraft Systems International | Simulated optical range targets |
| 12. | DPD-5302/87-88 Magnovox/14006 | Pakistan/PK-S-AAN | 185,735.00 | Magnavox Overseas Limited | AN/ARC-164 radio system |
| 13. | 1616-001/PC-3 DPD/5292/MGO/ Rockwell/12934 | Pakistan/PK-S-AAK | 121,000.74 | Rockwell International Corp. | Radio receivers/transceivers |

*See footnote on page 1, Appendix B.

## LIST OF CONTRACTS COVERED BY THE AUDIT (Continued)

| | Contract No. | Country/Case No. | Contract Amount | Contractor | Items Contracted For |
|---|---|---|---|---|---|
| 14. | 1342/28/LAADS/ 0415-0018/AM/ DCDP/PC-3 | Pakistan/PK-S-AAJ | $ 645,000.00 | AM General Corp. | Trucks and trailers |
| 15. | 101/V&EE/88-89* | Pakistan/PK-S-AAL | 95,000,000.00 | FMC Corp. | Coproduction of M113 armored personnel carriers |
| 16. | 87 HCVL 3/3 | Turkey/TK-S-AYS | 105,654.65 | Government Supply Corp. | Aviation spare parts |
| 17. | 88/T-10B | Turkey/TK-S-BBI | 147,728.50 | RDB Industries, Inc. | Aviation spare parts |
| 18. | 87-3/2 | Turkey/TK-S-AWY | 314,366.50 | Mott Haven Truck Parts, Inc. | Ordnance spare parts |
| 19. | 87-HVCL-3/6* | Turkey/TK-S-AZH | 319,484.98 | Relli Technologies, Inc. | Aviation spare parts |
| 20. | TAF/GE-1983-1, Amendment No. 4 | Turkey/TK-S-AHN | 10,000,000.00 | General Electric Co. | Aircraft engine spare parts, repair, and support |
| | Total | | $132,914,393.37 | | |

*Contractor records were reviewed for these contracts to determine the adequacy of support for selected contract line item dollar amounts.

## STATISTICAL PROJECTIONS

| Projections | Point Estimate | Margin of Error With 90 Percent Confidence |
|---|---|---|
| (Part I, Competition) | | |
| Projected number of contract actions with no acquisition plans. | 212 | ± 62 contract actions. |
| Projected dollar value of contract actions with no acquisition plans. | $216.4 million | ± $31.2 million. |
| Projected number of contract actions with no acquisition letters. | 195 | ± 63 contract actions. |
| Projected dollar value of contract actions with no acquisition letters. | $733.4 million | ± $101.2 million. |
| (Part II, Late Deliveries) | | |
| Projected number of contract actions with late deliveries. | 99 | ± 57 contract actions. |
| Projected dollar value of late deliveries. | $23.5 million | ± $12.9 million. |

## STATISTICAL PROJECTIONS (Continued)

| Projections | Point Estimate | Margin of Error With 90 Percent Confidence |
|---|---|---|
| (Part II, Late Deliveries-continued) | | |
| Projected number of contract actions with no penalty clauses invoked. | 89 | ± 11 contract actions. |
| Projected dollar amount of contract actions with no penalty clauses invoked. | $23.2 million | ± $1.0 million. |
| Projection of monies that may be due the U.S. Government because of late deliveries. | $737,900 | ± $47,000. |
| Projected number of contract actions with no penalty clauses. | 35 | ± 32 contract actions. |
| Projected dollar value of contract actions with no penalty clauses. | $2.2 million | ± $.032 million. |

## COMPARISON OF CONTRACT PRICES TO PRICES SHOWN IN DOD DATA BASES

| Item No. | NSN/PN [1/] Nomenclature | Contract Amount | DoD Data Base Amount | Difference (Col. 3 - Col. 4) | Percentage Variance | Type of Items Contracted |
|---|---|---|---|---|---|---|
| 1. | 6625-01-265-6000 Ammeter | $ 422.94 | $ 116.00 | $ 306.94 | 264.60 | M109A2SPH [2/] Spare parts |
| 2. | 4933-00-712-2378 Pump kit, hydraulic | 981.83 | 356.00 | 625.83 | 175.79 | " " |
| 3. | 5180-00-448-2362 Threading kit, screw | 389.22 | 234.72 | 154.50 | 65.82 | " " |
| 4. | 5120-00-316-9217 Wrench, socket | 147.02 | 16.24 | 130.78 | 805.30 | " " |
| 5. | 5210-00-221-1990 Gage, thickness | 13.65 | 2.32 | 11.33 | 488.36 | " " |
| 6. | 5325-00-998-3305 Stud | 1.00 | .58 | .42 | 72.41 | Aviation spare parts |
| 7. | 5340-00-254-5025 Clamp | 4.56 | .97 | 3.59 | 370.10 | " " |
| 8. | 5305-00-089-3105 Screw | 1.80 | 2.35 | -.55 | -23.40 | " " |
| 9. | 8030-00-685-0915 Seal | 27.70 | 12.87 | 14.83 | 115.23 | " " |
| 10. | 5120-00-812-4133 Wrench, torque | 283.00 | 85.00 | 198.00 | 232.94 | " " |

(See footnotes on page 2, Appendix D.)

## COMPARISON OF CONTRACT PRICES TO PRICES SHOWN IN DOD DATA BASES (Continued)

| Item No. | NSN/PN [1/] Nomenclature | Contract Amount | DoD Data Base Amount | Difference (Col. 3 - Col. 4) | Percentage Variance | Type of Items Contracted |
|---|---|---|---|---|---|---|
| 11. | 3120-00-690-7504<br>Bushing, sleeve | $ 14.00 | $ 1.34 | $ 12.66 | 944.78 | " " |
| 12. | 2520-01-026-0614<br>Clutch | 700.00 | 1,058.00 | -358.00 | -33.84 | Ordnance spare parts |
| 13. | 2540-00-318-1136<br>Shock | 220.00 | 115.00 | 105.00 | 91.30 | " " |
| 14. | 2040-01-174-8123<br>Plug | 107.91 | 32.58 | 75.33 | 231.22 | Aviation spare parts |
| 15. | 4730-00-773-2622<br>Coupling | 300.28 | 254.10 | 46.18 | 18.17 | " " |
| 16. | 5821-01-062-0961<br>622-4291-001<br>CM-482 comparator | 1,337.00 | 746.75 | 590.25 | 79.04 | Radio receiver |
| 17. | 5305-01-246-1400<br>111-22-48<br>Shaft assembly | 1,700.00 | 1,700.00 | 0 | 0 | Aviation spare parts |
| | | $6,651.91 | $4,734.82 | $1,917.09 | 40.49 | |

1/ NSN/PN = National Stock Number/Part Number
2/ SPH = Self-propelled howitzer

# SCHEDULE OF PENALTY AMOUNTS FOR LATE DELIVERIES

ITEM 1

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA 1/ |
|---|---|---|---|---|---|---|
| EG-S-ANI | $488,500.00 | 6 | 5 | $473,836.00 | $3,715.61 | $3,715.61 |

| Penalty Percentage | No. of Weeks Late | Value of Line Items Delivered Late |
|---|---|---|
| 1 | .1428 | $393,527.99 = $ 561.96 |
| 1 | 3.7142 | 20,529.60 = 762.51 |
| 4 | | 59,778.41 = 2,391.14 |
| | | Total Penalty $3,715.61 |

Note: For the first two items, penalty amounts equal penalty percentages multiplied by the number of weeks delayed times the value of the items delivered late.

For the third item, the penalty amount was calculated by multiplying the value of items delivered late by 4 percent (maximum penalty).

ITEM 2

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA |
|---|---|---|---|---|---|---|
| EG-S-ANL | $500,000.00 | 7 | 5 | $102,841.00 | $4,113.64 | $4,113.64 |

| Penalty Percentage | Value of Line Items Delivered Late |
|---|---|
| 4 | $ 882.00 = $ 35.28 |
| 4 | 3,548.00 = 141.92 |
| 4 | 7,540.00 = 301.60 |
| 4 | 793.00 = 31.72 |
| 4 | 50,000.00 = 2,000.00 |
| 4 | 20,000.00 = 800.00 |
| 4 | 20,000.00 = 800.00 |
| 4 | 78.00 = 3.12 |
| | Total Penalty $4,113.64 |

Note: Penalty amounts equal maximum penalty percentages multiplied by the value of the items delivered late.

1/ Defense Security Assistance Agency

## SCHEDULE OF PENALTY AMOUNTS FOR LATE DELIVERIES (Continued)

ITEM 3

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA |
|---|---|---|---|---|---|---|
| EG-S-ANA | $4,457,840.00 | 10 | 2 | $4,560.00 | $171.00 | $171.00 |

| Penalty Percentage | No. of Weeks Late | Value of Line Items Delivered Late |
|---|---|---|
| 4 | | $1,900.00 =$ 76.00 |
| 1 | 3.5714 | 2,660.00 = 95.00 |
| | | Total Penalty $171.00 |

Note: For the first item, the penalty amount equals the maximum penalty percentage multiplied by the value of the items delivered late.

For the second item, the penalty amount equals penalty percentages multiplied by the number of months or parts of months times the value of the items delivered late.

ITEM 4

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA |
|---|---|---|---|---|---|---|
| GR-S-ACZ | $887,602.00 | 14 | 14 | $887,602.00 | $44,380.09 | $44,380.09 |

| Penalty Percentage | Value of Line Items Delivered Late | |
|---|---|---|
| 5 | $824,084.25 = | $41,204.20 |
| 5 | 5,105.10 = | 255.26 |
| 5 | 27,500.00 = | 1,375.00 |
| 5 | 3,995.49 = | 199.77 |
| 5 | 21,644.74 = | 1,082.23 |
| 5 | 5,272.42 = | 263.63 |
| | Total Penalty | $44,380.09 |

Note: Penalty amounts equal penalty percentages multiplied by the value of the items delivered late.

## SCHEDULE OF PENALTY AMOUNTS FOR LATE DELIVERIES (Continued)

ITEM 5

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA |
|---|---|---|---|---|---|---|
| GR-S-ADO | $15,428,034.00 | 13 | 12 | $993,097.68 | $23,118.42 | $23,118.42 |

| Contract Item No. | Total Contract Price | Days Late | Total Penalty | Maximum Amount | Total Penalty Due | |
|---|---|---|---|---|---|---|
| 1 | $13,740,000 | 119 | $884,856.00 | $343,500.00 | $343,500.00 | (Cancelled) |
| | | 88 | 983,784.00 | 343,500.00 | 343,500.00 | (Cancelled) |
| 2 | 445,951 | 88 | 24,060.13 | 9,340.11 | 9,340.11 | |
| 3 | 855,273 | 27 | 8,971.51 | 26,232.50 | 8,971.51 | |
| 4 | 23,540 | 27 | 402.54 | 1,177.00 | 402.54 | |
| 5 | 181,618 | 27 | 1,411.78 | 4,126.06 | 1,411.78 | |
| 6 | 39,538 | 27 | 562.34 | 1,673.52 | 562.34 | |
| 7 | 2,438 | 27 | 41.69 | 121.90 | 41.69 | |
| 8 | 42,672 | 27 | 729.69 | 2,133.60 | 729.69 | |
| 9 | 1,938 | 27 | 33.14 | 96.90 | 33.14 | |
| 10 | 88,888 | 27 | 1,519.98 | 4,444.40 | 1,519.98 | |
| 11 | 6,178 | 27 | 105.64 | 308.90 | 105.64 | |
| | | | | Total | $710,118.42 | |

| | |
|---|---|
| Total penalty calculated | $710,118.42 |
| Less penalty cancelled | 687,000.00 |
| Total penalty | $ 23,118.42 |

Penalty Criteria: Delay of 1-20 days: penalty of .10 percent for the first day and .03 percent for each of the following 19 days.
Delay of 21-40 days: penalty of .80 percent for 21 days and .04 percent for each of the following 19 days.
Delay of 41-60 days: penalty of 1.70 percent for 41 days and .05 percent for each of the following 19 days.
Delay of 61-80 days: penalty of 2.80 percent for 61 days and .05 percent for each of the following 19 days.
Delay of 81-100 days: penalty of 3.90 percent for 81 days and .05 percent for each of the following 19 days.
After the 100th day: the penalty will be .06 percent of value of delayed items for each additional day of delay.

If any deliveries are delayed, no penalties will be imposed for the first 60 days of delay. The maximum penalty to be imposed will not exceed 5 percent of the contractual value of the delayed item. Due to partial on-time shipments, the maximum penalty amount may not be 5 percent of the total contract line item.

A portion of the penalty was cancelled due to late delivery of U.S. Government-furnished material.

# SCHEDULE OF PENALTY AMOUNTS FOR LATE DELIVERIES (Continued)

ITEM 6

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA |
|---|---|---|---|---|---|---|
| PK-S-AAN | $185,735.00 | 3 | 2 | $ 81,050.00 | $2,315.60 | $2,315.60 |

| Penalty Percentage | No. of Months Late | Value of Line Items Delivered Late |
|---|---|---|
| 2 | 1.4285 | $80,250 = $2,292.74 |
| 2 | 1.4285 | $ 800 = 22.86 |
| | | Total Penalty $2,315.60 |

Note: Penalty amounts equal penalty percentages multiplied by the number of months or parts of months times the value of the items delivered late.

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ITEM 7

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA |
|---|---|---|---|---|---|---|
| TK-S-AYS | $105,654.65 | 176 | 53 | $9,245.26 | $924.53 | $924.53 |

| Penalty Percentage | Value of Line Items Delivered Late |
|---|---|
| 10 | $9,245.26 = $924.53 |

Note: Penalty amounts equal penalty percentages multiplied by the value of the items delivered late.

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ITEM 8

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA |
|---|---|---|---|---|---|---|
| TK-S-AWY | $314,366.50 | 26 | 19 | $252,759.37 | $10,759.23 | $10,759.23 |

| Penalty Percentage | Value of Line Items Delivered Late | |
|---|---|---|
| 10 | $252,759.37 = | $25,275.93 |
| | Total Paid to Date | 14,516.70 |
| | Total Penalty Still Owed | $10,759.23 |

Note: Penalty amounts equal penalty percentages multiplied by the value of the items delivered late.

## SCHEDULE OF PENALTY AMOUNTS FOR LATE DELIVERIES (Continued)

ITEM 9

| Country/ Case No. | Dollar Value of Line Items | No. of Line Items | No. of Line Items Delivered Late | Dollar Value Delivered Late | Penalty Clause Calculation | Dollar Value of Penalty Due DSAA |
|---|---|---|---|---|---|---|
| TK-S-AZH | $319,484.98 | 222 | 17 | $20,091.01 | $1,619.19 | $1,619.19 |

| Penalty Percentage | No. of Days Late | Value of Line Items Delivered Late | | |
|---|---|---|---|---|
| .001 | 42 | $1,201.20 = | $ 50.45 | (Contract Line Item No. 5) |
| .001 | 62 | 700.00 = | 43.40 | (Contract Line Item No. 95) |
| .001 | 62 | 1,124.10 = | 69.69 | (Contract Line Item No. 98) |
| .001 | 7 | 70.00 = | .49 | (Contract Line Item No. 104) |
| .001 | 62 | 201.30 = | 12.48 | (Contract Line Item No. 172) |
| 10 | N/A | 409.50 = | 40.95 | (Contract Line Item No. 4) |
| 10 | N/A | 163.80 = | 16.38 | (Contract Line Item No. 5) |
| 10 | N/A | 738.00 = | 73.80 | (Contract Line Item No. 25) |
| .001 | 75 | 8,678.56 = | 650.89 | (Contract Line Item No. 29) |
| 10 | N/A | 62.40 = | 6.24 | (Contract Line Item No. 43) |
| 10 | N/A | 479.00 = | 47.90 | (Contract Line Item No. 70) |
| 10 | N/A | 1,630.00 = | 163.00 | (Contract Line Item No. 75) |
| 10 | N/A | 309.30 = | 30.93 | (Contract Line Item No. 76) |
| 10 | N/A | 2,388.80 = | 238.88 | (Contract Line Item No. 117) |
| 10 | N/A | 1,386.00 = | 138.60 | (Contract Line Item No. 206) |
| 10 | N/A | 135.30 = | 13.53 | (Contract Line Item No. 207) |
| 10 | N/A | 215.75 = | 21.58 | (Contract Line Item No. 220) |
| | | Total Penalty | $1,619.19 | |

Note: Late deliveries per the contract are normally calculated based on a factor of .001 percent times the value of the items times the number of days late. The contract limits the penalty to a maximum of 10 percent of the value of the goods considered late. Our calculations were made up to the cutoff date of April 1, 1990. Contract Line Item No. 5 involved a split shipment; one shipment arrived 84 days late and was calculating using the .001 factor, while the other shipment had not arrived as of April 1, 1990. Because of the cost limitation, the 10 percent factor was used.

## SCHEDULE OF PENALTY AMOUNTS FOR LATE DELIVERIES (Continued)

Estimated Total Penalty

| Item No. | Penalty |
|---|---|
| 1 | $ 3,715.60 |
| 2 | 4,113.64 |
| 3 | 171.00 |
| 4 | 44,380.09 |
| 5 | 23,118.42 |
| 6 | 2,315.60 |
| 7 | 924.53 |
| 8 | 10,759.23 |
| 9 | 1,619.19 |
| Grand Total | $91,117.30 |

## IMPLEMENTATION OF NINE RECOMMENDATIONS FROM INSPECTOR GENERAL'S 1985 STUDY

1. Ensure that preaward surveys are performed for contractors that have not done business with DoD or have not sold similar items to DoD. COMMENT: Implemented in DoD Manual 5105.38-M.

2. Place standard items purchased by foreign governments into the Foreign Military Sales program. Certain waivers may be granted where it can be shown that exceptional circumstances exist. COMMENT: Not implemented as of January 1990.

3. a. Require the foreign government to use competition to the maximum extent possible. In those cases where a sole source must be used, the foreign government should document the reasons and state the basis for acceptance of the price. COMMENT: Implemented in DoD Manual 5105.38-M, but not followed.

b. To the extent necessary, and within available resources, the Defense Security Assistance Agency will compare prices with Government and commercial purchases of similar items, perform market checks, independent estimates, and analysis. COMMENT: Implemented in DoD Manual 5105.38-M, but not followed.

4. Recognize that different countries have different capabilities to administer purchases. Evaluate and administer the proposed purchases in view of this capability. COMMENT: Implemented in DoD Manual 5105.38-M.

5. Provide for audit access to prime contractors and flow down to lower-tier subcontractors. COMMENT: Implemented in DoD 5105.38-M to the extent that procedures provide for access to prime contractors and first-tier subcontractors.

6. a. The Defense Security Assistance Agency will review its procedures on when to request quality assurance from DoD to assure that the quality of materials shipped is in accordance with contract terms. Where marginal contractors are involved, and based upon results of preaward surveys, DoD quality assurance will be required, providing the Defense Logistics Agency has the capability to perform the quality assurance. COMMENT: Implemented in DoD Manual 5105.38-M.

b. The Defense Security Assistance Agency will explore the use of guarantee provisions as to quality and performance bonds in order to assure meeting of contract specifications. COMMENT: Implemented in DoD Manual 5105.38-M.

7. An initial payment may not exceed the amount of cost incurred at the time of contract signature (plus termination of payments) as certified by the contractor. Follow-on payments will be based

upon the accomplishment of specific milestones detailed in the contract. Milestone payments will be in consonance with contractor's cost to be incurred prior to the next milestone payment. COMMENT: Implemented in DoD Manual 5105.38-M.

8. Defense Security Assistance Agency will selectively review and audit initial payments and follow-on payments for compliance with paragraph 7. COMMENT: Not implemented as of January 1990.

9. Establish procedures for obtaining proof of shipment before credit payments are made for shipments or final payments are made. COMMENT: Implemented in DoD Manual 5105.38-M.

DEFENSE SECURITY ASSISTANCE AGENCY

WASHINGTON, DC 20301-2800

0 9 JAN 1991

In reply refer to:
I-058059/90

MEMORANDUM FOR THE DIRECTOR, FINANCIAL MANAGEMENT DIRECTORATE, OFFICE OF THE INSPECTOR GENERAL

SUBJECT: Draft Report on the Audit of Commercial Sales Financed Under the Foreign Military Sales Financing Program (Project No. 9FA-0059)

This is in response to your memorandum, dated 18 October 1990, which requested comments on the subject audit report.

DSAA has carefully considered the findings and recommendations of subject report and is providing the attached comments which are keyed to the major headings and subheadings to include DSAA's position on the seven recommendations. The overriding theme of the report is that direct commercial sales between foreign countries and U.S. contractors which are financed by foreign military financing (FMF) credits are DoD procurements and as such, should follow FAR and DFARS requirements in the acquisition process and contract administration.

DSAA disagrees with the contention that direct commercial sales should be treated as DoD procurements. The commercial contracts are executed between the foreign country and the U.S. contractor and subsequently submitted to DSAA for FMF. DSAA is not a party to the contract, is not involved in the disputes process, and does not administer the contract except for payments. The foreign country utilizes its own procurement system to solicit, contract for, and administer the FMF contract. This position is supported by the attached Comptroller General Decision, File B-222483, dated 16 April 1986. DSAA's positions on the recommendations are based on the above understanding of DSAA's role in the direct commercial sales program.

If you have any questions concerning this matter, please contact Major Ben Pierce at (703) 695-5733.

Teddy G. Allen
Lieutenant General, USA
Director

Attachments
As stated

DECISION

THE COMPTROLLER GENERAL
OF THE UNITED STATES
WASHINGTON, D C 20548

FILE: B-222483 DATE: April 16, 1986

MATTER OF: Environmental Tectonics Corp.

DIGEST:

General Accounting Office has no authority to consider a protest of the award of a contract by the Government of Egypt to be financed under the Foreign Military Sales program because the solicitation was issued and the award made by other than a federal agency.

Environmental Tectonics Corp. protests the award of a contract for aeromedical equipment to Technology, Inc. by the Government of Egypt. The contract is to be financed by the Defense Security Assistance Agency under the Foreign Military Sales program.

Under the Competition in Contracting Act of 1984 (CICA), 31 U.S.C.A. §§ 3551-3556 (West Supp. 1985) and our implementing Bid Protest Regulations, 4 C.F.R. § 21.1(a) (1985), an interested party may protest to this Office a solicitation issued by or for a federal agency for the procurement of property or services, or the proposed award or award of such a contract. A "federal agency" is defined to mean any executive department or independent establishment in the executive branch, including any wholly owned government corporation, and any establishment in the legislative or judicial branch, except the Senate, the House of Representatives, and the Architect of the Capitol and any activities under his direction. See 4 C.F.R. § 21.0(b).

Here, although it appears that the contract may be financed through a loan made by a "federal agency," the solicitation was issued and the award was made by the Government of Egypt, which clearly is not a "federal agency." Since the protest does not concern a solicitation issued by or for a federal agency, it does not fit within our bid protest authority under CICA. See Chas. G. Stott & Co., Inc., B-220302, Sept. 24, 1985, 85-2 CPD ¶ 333.

PUBLISHED DECISI
65 Comp. Gen. __

¶ :

The protest is dismissed.

Ronald Berger
Deputy Associate
General Counsel

¶ 377

DRAFT REPORT ON THE AUDIT OF COMMERCIAL SALES FINANCED UNDER THE FOREIGN MILITARY SALES FINANCING PROGRAM

## PART 1 - INTRODUCTION

### Background

The current policy and procedures for direct commercial contracts are established by DSAA in the Guidelines for FMS Financing of Direct Commercial Contracts, dated 28 February 1989. A copy of the guidelines was provided to the DoDIG at the commencement of the audit. Since initially published in 1984, the guidelines have made a clear distinction between the use of foreign military financing (FMF) to make purchases pursuant to government-to-government agreements called Letters of Offer and Acceptance (LOA) and the use of FMF to finance direct commercial contracts between the foreign government and U.S. suppliers. Contracts written by the USG in implementation of FMF LOA's are subject to the U.S. Federal Acquisition Regulation. Direct commercial contracts are subject to the DSAA guidelines.

Direct commercial contracts are executed between the eligible country and a U.S. contractor for defense articles, defense services, and design and construction services. DSAA is not a party to the contract, nor does DSAA dictate the foreign customer's acquisition policy and procedures. It is only when the foreign customer seeks FMF that the contract and contracting procedures become subject to review pursuant to DSAA's guidelines for financing eligibility. Any dispute or arbitration is between the contracting parties, not between DSAA and the contracting parties. Penalty clauses, performance bonds, letters of guarantee, etc., are agreed to between the contracting parties and implemented in accordance with the contract terms and through other agreements between the parties.

DSAA is concerned that the scope of the audit exaggerates this agency's accountability for contracts between private parties. DSAA has no oversight for contract administration of commercial contracts beyond verifying conformance with the DSAA guidelines for funding eligibility and requiring acceptable billing documentation prior to making payments in accordance with the guidelines. Notably, the 1989 revision to our guidelines informs the contractor and foreign customer that any FMF commercial contract may be subject to DCAA audit and that questionable activity will be reported to DCIS for further investigation. We emphasize that DSAA does not have a dedicated contract audit function and accordingly, have established in our guidelines our reliance

on both DCAA and DCIS for support (Paragraph 20. of the Guidelines).

Our responsibility for commercial contracts is more limited than stated in the draft report. Accordingly, the scope of DSAA's responsibility for Internal Management Control of those contracts is limited to the oversight and internal control of financing direct commercial contracts in accordance with guidance in the Guidelines.

The Draft Report describes procedures to validate compliance with DoDD 5010.38, "Internal Management Control Program." The DoDIG considered control procedures to include "*DSAA approvals for funding such contracts*, contract pricing, collection of nonrecurring costs and asset use charges, controls of contract deliveries, procurement quality assurance, *approval of progress payments to contractors*, compliance with the Buy American Act, and ...*adequacy of support for selected contract line item prices.*" Only two of the seven criteria are specifically applicable to DSAA's financing role for direct commercial contracts (They have been highlighted). A third, adequacy of support for selected contract line item prices, relies on available price comparisons on similar items purchased by DoD. The determination of a fair and reasonable price is subject to the foreign customer's convenience, speed in delivery, and other non-monetary considerations the foreign customer makes with input from DSAA as appropriate. This determination is independent of the pricing criteria for contracts with the USG as required by the U.S. Federal Acquisition Regulation.

Since the direct commercial contract is a contract between two parties outside DoD, administration of the contract falls upon the contracting parties. Specifically, the country administers the contract to ensure compliance with its terms and conditions to include timely deliveries and enforcement of penalty clauses.

As the "banker," DSAA ensures that the contracting parties comply with policies and procedures which have been established to protect the Security Assistance recipient's interest and that of the USG by ensuring that the FMF is utilized for its intended purpose. This is accomplished through monitoring of country programs by DSAA Country Directors, establishing requirements for advance payments to cover costs incurred prior to contract implementation plus termination liability, less profit, requiring milestones for progress payments, requiring verification of invoices and shipping documents prior to payment, requiring the execution of a contractor's certification and agreement with DSAA (the 1989 version was coordinated with the Justice Department), requesting audits through DCAA of FMF contracts, and reporting questionable activity to DCIS for investigation.

DSAA Position on Recommendations.

PART II - FINDINGS AND RECOMMENDATIONS

Controls Over Direct Commercial Sales

Background. DoD 5105.38-M was issued in the 1960's as the Military Assistance and Sales Manual and superceded by the SAMM in 1984. A complete revision was done in 1988 and Change No. 1 was issued 20 October 1989. Although the updated DSAA Guidelines for FMS Financing of Direct Commercial Contracts, dated 28 February 1989, were incorporated in Change No. 1, editorial changes were made which changed the meaning of some policies as stated in the guidelines. Corrections will be made in the next change to the SAMM.

The Draft Report states "Purchasing countries can use either government-to-government contracts or direct commercial sales contracts to meet their defense needs." This may be a misleading assumption. The customer's decision to purchase FMS or commercial is not an either-or decision. Rather it should be influenced by the decision criteria carefully worked out by DSAA to assist the customer with this choice. Requirements with unique specifications, no follow-on support requirements, and non-availability in the DoD system are better suited for commercial contracting. Standard items or complex defense systems with significant follow-on support requirements are better suited for purchase through DoD. Moreover, many FMF recipients are legally ineligible for FMF of direct commercial contracts.

The Buy American Act does not apply to direct commercial contracts, because it only applies to USG purchases of items for use in the United States. The applicable statutory provision is found instead in Section 42(c) of the Arms Export Control Act (AECA), and the DSAA procedures are found in the SAMM, Sec. 90210. The policies implemented through the guidelines, however, do rely on the implementation of the Buy American Act by DoD procurement activities for the purchase of similar items. Although DSAA has responsibility for "contractor capability, competition, propriety of the contract, and payments to the contractor (approval of payments is the responsibility of the country)," one cannot infer that DSAA has responsibility for "contract acquisition management and oversight of contract administration." The responsibility of DSAA is to ensure that the contract meets the guideline requirements for FMF; contract administration is the responsibility of country.

DSAA Contract Administration Support and Oversight.

Competition.

Acquisition Plans. Paragraph 19. of the Guidelines states the importance of prior notification to DSAA of acquisition plans. Although countries often fail to provide acquisition plans when commercial contracts are received for review and FMF approval, the contracts are provided to the DSAA Country Directors for review and for comparison to the country's overall acquisition program.

Acquisition Letters. In March 1990 DSAA implemented a more stringent approach to the preparation and submission of acquisition letters. Letters are not required for amendments to existing contracts or basic ordering agreements.

Price Comparisons. Price comparisons have been performed since 1987 on a selective basis and are available for review. The price comparisons specifically targeted the procurement of spare parts. The reviews showed a wide disparity in pricing of parts but that overall, pricing was comparable to DoD prices. Because of concerns in this area, in April 1990 the Government of Turkey, the major buyer of spare parts, was directed to seek to obtain spare parts through the FMS system prior to obtaining spare parts from commercial sources. This policy was effective for spare parts contracts signed after 31 May 1990.

Propriety of Purchases.

Coproduction Waiver. The SAMM, Sec. 140104 D.2. states that "DSAA Operations will not approve release of an FMS LOA, or funding of a direct commercial sale contract for coproduction/licensed production which is covered under a government-to-government MOU, to be financed with FMS credit funds until the Department of State has been advised of the pending program, and the Department of State has advised Congress as required by AECA, Section 42(b)." The contract for coproduction of M113 Armored Personnel Carriers between the Government of Pakistan and FMC Corporation was not covered by an associated LOA or an MOU and thus, was not required to be notified to the State Department. DSAA's policy meets the intent of the AECA in that Congress' intent was to be notified of any coproduction effort which was initiated by the DoD. A direct commercial sale voluntarily entered into by a U.S. contractor was not intended to be covered by the AECA.

Waivers for Spare Parts Actions. The requirement for a waiver to be submitted by the country allowing the procurement of spare parts is applicable to government-to-government sales (SAMM, Section 90102). The guidelines do not have a similar requirement. The exclusion on spare parts procurement is in the process of being deleted from

DoD 5105.38-M and will be effective upon implementation of Change 3.

Purchases of Questionable Material. The FMF of a commercial contract for calcium hypochlorite, a type of bleach, is consistent with the AECA. The chemical is used as a decontaminant and was used by DoD prior to the development of the decontaminant DS2. The item is not used as a material for chemical warfare, but is used as the result of chemical warfare. The recommendation that a definitized policy be established with respect to the types of material and services for which foreign military sales credit funds can be used to finance commercial purchases was not implemented from the 1984 DoDIG audit report as DSAA nonconcurred with the recommendation.

Contractor's Capability. The report states that "Audit tests showed that two contractors accepted by DSAA were not the most suitable to perform under their respective contracts". The contracts were approved for FMF based on a preaward survey and prior contract performance. A preaward survey only provides information on the contractor's capability but cannot provide guarantees that the contractor will perform. As noted, no money was lost by the contractor's nonperformance due to payment procedures established by the DSAA guidelines.

The contract for chemicals with a contractor who specializes in steel products was with All Bann. All Bann has produced decontamination equipment for DoD since 1967 to include providing decontamination chemicals. All Bann currently provides the decontamination chemical DS2 to DoD from its subsidiary in Texas. The subsidiary is capable of producing calcium hypochlorite, but All Bann decided it was less expensive to procure the chemical from a subcontractor since their own subsidiary was operating at capacity and All Bann would have had to do some conversion to produce the chemical. This contract was awarded to All Bann on a competitive basis by the Government of Egypt.

Deliveries. Deliveries are a contractual requirement to be administered by the contracting parties (DSAA is not a party to the contract). Accordingly, the country must monitor timely delivery as agreed to by the parties. Any penalties incurred by late delivery are payable to the U.S. Treasury for credit to the FMF trust fund account of the country. Late delivery does not have to generate a monetary penalty as the contracting parties can agree to other administrative remedies. In the example provided, the country chose to decrease the payment of the invoice amount. The effect of decreasing the invoice was the same as had the country approved payment of the entire amount and then made the contractor pay back the penalty for late delivery.

Although DSAA does not require that countries include penalty clauses for late delivery, FMF is protected through guideline payment procedures since payments are only made after costs are incurred or deliveries are made. Additionally, most contracts approved have dispute and arbitration clauses. Any payments awarded to the countries under arbitration or resolution of disputes would be credited to the FMF trust fund account of the country.

Recommendations from DoD Inspector General's Special Study. The following recommendations were not implemented from the 14 June 1985 report:

Place standard items purchased by foreign governments into the Foreign Military Sales Program. Certain waivers may be granted where it can be shown that exceptional circumstances exist.

DSAA Position: DSAA memorandum I-003964/85, dated 25 June 1985, subject: Commercial Purchases Financed Under the Foreign Military Sales Credit Program -- DECISION MEMORANDUM, resolved this issue as the USDP concurred with not implementing the recommendation.

DSAA will selectively review and audit initial payments and follow-on payments for compliance with paragraph 7. (Paragraph 7 of the Special Report was implemented in the guidelines establishing new payment procedures.)

DSAA Position: Recommendation was implemented in March 1990. DSAA coordinated with DCAA which agreed to perform audits in accordance with audit criteria provided by DSAA. The contracts to be audited will be randomly selected by DCAA and the results provided to DSAA.

Contractor's Pricing Support for Selected Line Item Prices.

Supporting Documentation. DSAA guidelines require Contractors, who otherwise contract with DoD, to comply with approved cost accounting procedures. Other contractors are not required to abide by DoD pricing policies and they utilize commercial practices to support and cost material and services.

Subcontract Line Item Support. The referenced DSAA procedures requiring contractors to identify subcontractors are applicable to those contractors that are a procurement agent, broker, import-export firm or other intermediary: not to a prime manufacturer. The guidelines have been misquoted in that "the purchasing government will be aware of the extent of additional cost or markup by the intermediary" (not the prime contractor). DSAA's policy

concerning competition is that "it is highly recommended that whenever possible, several U.S. manufacturers be contacted by the purchaser for solicitation of bids to meet their specific needs." The countries are required to identify the various contractors solicited and the basis for selection.

Profit. As these contracts are not DoD procurements, DoD profit policy is not applicable. Even though items may be less expensive if procured through government-to-government FMS contracts, countries make decisions to purchase directly with private firms often based on reasons unrelated to price, e.g., delivery or control over the procurement process. If the DoD price is compared to the commercial price without taking into account the accessorial costs associated with government-to-government FMS sales, then the DoD price is not a true reflection of the price the country pays for the item. As such, the overall cost to the country may be less expensive through a commercial source than from FMS.

Criminal Aspects. DSAA is fully aware of the on going DCIS investigations and relies heavily on DCIS to help ensure the integrity of the direct commercial sales program. The investigations do not deal so much with the quality of the product being supplied as the fact that some contractors are substituting non-U.S. content for items that are supposed to be manufactured in the U.S. The countries have the option to request Defense Contract Management Command (DCMC) quality assurance support through the initiation of an FMS case. Otherwise, the country is responsible for quality assurance.

Conclusion. The Draft Report's conclusion that DSAA's internal controls over commercial contracts are ineffective is drawn from the DoDIG's position that DSAA is a party to the contract and has contract administration responsibilities. DSAA's position has been described above - DSAA is not a party to the contract and the country has responsibility for contract administration. DSAA has taken significant steps to ensure the funds expended in support of the foreign military financing program (FMFP) are utilized for the purpose intended by Congress through continual revision to the guidelines and the contractor's certification and agreement with DSAA. Revised payment procedures ensure contract delivery/performance prior to disbursement of FMF and the revised certification requires that the U.S. Government has access to contractor financial and bank account records. Our policies and procedures provide the cornerstone for a program that actively deters fraud, waste, and abuse, and for those contractors that intentionally circumvent our policies and procedures, action is taken quickly to maintain the integrity of the program as evidenced by the fact that DCIS has approximately 30

contractors under investigation with many cases having been referred by DSAA.

The Draft Report identifies two alternatives for improvement of procurement and contract administration in the FMFP. Those alternatives are addressed below:

Alternative one is to add contract specialists to the DSAA staff. Although adding staff would make it easier for DSAA to perform its responsibilities related to FMF approval for direct commercial contracts, the budgetary climate would make this alternative difficult to implement. The perceived purpose of adding contract specialists is so DSAA can become a contract administration activity similar to a Defense Contract Management Area Operation and administer direct commercial contracts accordingly. As DSAA is not responsible for contract administration, this alternative would not enhance DSAA's performance in relation to the costs involved in adding increased staffing.

The second alternative is to eliminate direct commercial sales under the FMFP. Implementation of this alternative would be intensely opposed by U.S. industry which already complains that DSAA's oversight into the commercial market place is making them non-competitive in a shrinking world arms market. The foreign countries which are currently authorized by Congress to procure defense items and services through direct commercial sales would likely complain that the U.S. Government is unduly interfering with their acquisition process and limiting their choices. It could be argued that implementation of this alternative is contrary to DoD's stated policy of neutrality as to whether countries acquire defense items under the FMFP or from commercial sources.

## RECOMMENDATIONS FOR CORRECTIVE ACTION

1. Selecting a solution that protects U.S. interests and includes sufficient internal controls to assure that:

a. Proper procurement and contract administration procedures are followed to provide reasonable contract prices;

DSAA Position: Nonconcur. DSAA is not involved in the procurement process and only sees the commercial contract when submitted by the foreign country for financing. Pricing is reviewed on a selective basis in accordance with our guidelines. DSAA does not dictate commercial prices as prices for direct commercial contracts are established in the commercial marketplace. DSAA does not administer direct commercial contracts; this is the responsibility of the foreign country.

b. Only qualified contractors are used to satisfy approved loan contract requirements;

DSAA Position: Concur. DSAA screens all commercial contractors against the GSA "List of Parties Excluded from Federal Procurement or Nonprocurement Programs." Contractors are also screened against the list of DoD contractors which have received contract awards with a net value over $25,000. Contractors which have not received prior DoD contracts or are a prior contractor with DSAA are referred to the appropriate DCMC activity for a preaward survey.

c. Documentation is maintained by both the Defense Security Assistance Agency and contractors to support contract prices; and

DSAA Position: Nonconcur. The financing of direct commercial contracts is not a DoD procurement covered by the FAR and DFARS. As such, cost and pricing data is not required. Contractors who have had prior contracts with DoD must comply with approved cost accounting standards in accordance with our guidelines. In addition, records of any company whose contract is FMF must be made available to an authorized representative of DoD for three years following receipt of the final payment by DSAA.

d. Contracts contain adequate provisions for procurement quality assurance to assure that purchasers receive goods and services contracted for.

DSAA Position: Concur. The guidelines provide for the option of the foreign country to obtain DCMC support of quality assurance. However, in numerous cases, the foreign country utilizes its internal quality assurance program and provides for access to the contractor's facilities through specific clauses in the commercial contract. As DSAA is not a party to the contract, it is normally the foreign country's responsibility to decide the type and depth of quality assurance desired.

2. Developing specific standards for procurement quality assurance to be included in contracts before supporting loans are approved.

DSAA Position: Nonconcur. In a commercial contract, the foreign country decides the level of quality assurance that the contractor must meet. Countries commonly require DoD contractors to maintain quality assurance systems which have been approved by DoD, i.e., MIL-Q-9858A or MIL-I-45208A. However, many contractors which provide items to the foreign countries are not DoD contractors and no DoD system exists. In this case, countries utilize best commercial practice. DSAA retains the right to require

foreign countries to utilize DCMC quality assurance support in order to obtain FMF of any particular contract.

3. Complying with the requirements of the Arms Export Control Act and DoD 5105.38-M by providing credit loan funds only for coproduction contracts that:

a. Have a proper waiver; and

b. Will not adversely affect the economy or the industrial mobilization base of the United States.

DSAA Position: Concur. However, it is unclear what waiver authority is under reference. DSAA is not required to notify State Department, which in turns notifies Congress, unless the direct commercial contract for coproduction/ licensed production is covered under an associated LOA or a government-to-government MOU (DoD 5105.38-M, Sec. 140104 D.2.).

4. Complying with U.S. policy by stopping the procurement of spare parts with credit loan funds, or changing the policy to accommodate current credit loan practices.

DSAA Position: Nonconcur. Direct commercial contracts are approved for FMF under the policies and procedures laid out in DSAA's Guidelines for FMS Financing of Direct Commercial Contracts. No prohibition exists in the guidelines against the FMF of spare parts. However, DSAA is deleting the prohibition from the SAMM for government-to-government sales through Change 3 which will be issued in mid 1991.

5. Implementing the two unimplemented recommendations from the 1985 DoDIG Special Study in conjunction with Recommendation 1.

DSAA Position: Nonconcur.

Recommendation 2. Place standard items purchased by foreign governments into the foreign military sales program. Certain waivers may be granted where it can be shown that exceptional circumstances exist.

DSAA Position: DSAA memorandum I-003964/85, dated 25 June 1985, subject: Commercial Purchases Financed under the Foreign Military Sales Credit Program -- DECISION MEMORANDUM, resolved this recommendation.

Recommendation 8. DSAA will selectively review and audit initial payments and follow-on payments for compliance with paragraph 7.

DSAA Position: Recommendation was implemented in March 1990. DSAA coordinated with DCAA which agreed to perform audits in accordance with audit criteria provided by DSAA. The contracts to be audited will be randomly selected by DCAA and the results provided to DSAA. In addition, DSAA retains the option to request audits on an as requested basis.

6. Implementing Recommendation A.1., DoDIG Audit Report No. 84-105, which requires that a policy be established with respect to the types of materials and services for which foreign military sales credit funds can be used to finance commercial purchases.

DSAA Position: Nonconcur. DSAA's position has not changed since we nonconcurred with the above referenced audit in our memorandum I-015849/83, dated 18 January 1984, Subject: Draft Report on the Audit of the Financial Reports and Credit Program Division, DSAA (Project 3FA-050).

7. Reporting and tracking the internal control deficiencies cited in this report as required by DoD Directive 5010.38.

DSAA Position: Concur. DSAA will report and track any applicable internal control deficiencies.

## SUMMARY OF POTENTIAL MONETARY AND OTHER BENEFITS RESULTING FROM AUDIT

| Final Report Recommendation Reference | Description of Benefits | Amount and Type of Benefit | Draft Report Recommendation Reference |
|---|---|---|---|
| A.1., A.2. | Protects U.S. interests by providing reasonable contract prices and support for such prices. | Nonmonetary. Reduce potential for fraud, waste, and abuse. | A.1. |
| | Provides specific standards on the types of quality assurance to be included in commercial sales contracts. | Nonmonetary. Provide assurance that what was contracted for was actually purchased and received by the purchasing country. | A.2. |
| | Ensures compliance with U.S. policy by requiring approval of credit loans for the purchase of spare parts. | Nonmonetary. Ensure that credit loans are approved in accordance with U.S. policy. | A.3. |
| | Ensures compliance with the Arms Export Control Act by requiring approval of loans for coproduction contracts unless specific waivers are granted as permitted in the Act. | Nonmonetary. Require compliance with the law, which will ensure that such contracts do not hinder the U.S. economy. | A.4. |
| | Implements prior Inspector General recommendations requiring that standard items purchased by foreign governments be placed into the government-to-government Foreign Military Sales program, and that the Defense Security Assistance Agency selectively review and audit initial payments and follow-on payments for compliance with the directive's requirements. | Nonmonetary. These recommendations have the potential to provide cost benefits to both the U.S. and purchasing countries by ensuring that quantity buys are taken advantage of and that contract payments are made in accordance with contract terms. | A.5. |

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

| Final Report Recommendation Reference | Description of Benefits | Amount and Type of Benefit | Draft Report Recommendation Reference |
|---|---|---|---|
| A.1, A.2. | Establishes policy with respect to the types of materials and services for which Foreign Military Sales credit funds can be used to finance commercial purchases. | Nonmonetary. Benefits will ensure that only materials and services will be purchased that are of mutual benefit to the U.S. and foreign governments and that such purchases meet the intent of the Arms Export Control Act. | A.6. |
| | Report and track internal control deficiencies as required by DoD Directive 5010.38. | Nonmonetary. Ensure that internal control reporting and tracking requirements are complied with. | A.7. |

## ACTIVITIES VISITED OR CONTACTED

### Office of the Secretary of Defense

Comptroller of the Department of Defense, Washington, DC
Defense Criminal Investigative Service, Washington, DC
  Defense Criminal Investigative Service Field Office, New York, NY
  Defense Criminal Investigative Service Field Office, Philadelphia, PA

### Department of the Army

Deputy Chief of Staff for Logistics, Washington, DC
U.S. Army Security Assistance Affairs Command, Washington, DC
Defense Logistics Studies Information Exchange, Fort Lee, VA

### Department of the Navy

Assistant Secretary of the Navy (Research, Development and Acquisition), Washington, DC
Naval Office of Technology Transfer and Security Assistance, Washington, DC

### Department of the Air Force

Deputy Assistant Secretary of the Air Force (Budget), Washington, DC
Deputy Assistant Secretary of the Air Force (Accounting and Finance), Washington, DC
Air Force Plant Representative Office, General Electric, Cincinnati, OH
  General Electric Company, Cincinnati, OH

### Defense Contract Audit Agency

Headquarters, Defense Contract Audit Agency, Cameron Station, Alexandria, VA
  Defense Contract Audit Agency, York Branch Office, York, PA
  Defense Contract Audit Agency, Southern New Jersey Branch Office, Marlton, NJ
  Defense Contract Audit Agency, Nassau Branch Office, Garden City, NY
  Defense Contract Audit Agency, General Electric Company Resident Office, Cincinnati, OH
  Defense Contract Audit Agency, Magnavox Electronics Company Suboffice, Fort Wayne, IN
  Defense Contract Audit Agency, Dallas Branch Office, Dallas, TX
  Defense Contract Audit Agency, East Bay Branch Office, Union City, CA
  Defense Contract Audit Agency, Silicon Valley Branch, Santa Clara, CA

## ACTIVITIES VISITED OR CONTACTED (Continued)

Defense Logistics Agency

Headquarters, Defense Logistics Agency, Cameron Station, Alexandria, VA
- Defense Contract Administration Services Region, Philadelphia, PA
  - Defense Contract Administration Services Management Area, Reading, PA
    - BMY Corporation, York, PA
  - Defense Contract Administration Services Management Area, Philadelphia, PA
    - Para-Flite Incorporated, Pennsauken, NJ
- Defense Contract Administration Services Region, New York, NY
  - Defense Contract Administration Services Management Area, Garden City, NY
    - Relli Technologies, Incorporated, Valley Stream, NY
- Defense Contract Administration Services Region, Chicago, IL
  - Defense Contract Administration Services Plant Representative Office, Magnavox, Fort Wayne, IN
    - Magnavox Overseas, Limited, Fort Wayne, IN
- Defense Contract Administration Services Region, Dallas, TX
  - Defense Contract Administration Services Management Area, Dallas, TX
    - Optic-Electronic Corporation, Dallas TX
- Defense Contract Administration Services Region, Los Angeles, CA
  - Defense Contract Administration Services Management Area, San Francisco, CA
    - Aydin Corporation, San Jose, CA
    - FMC Corporation, Santa Clara, CA

Other Defense Activities

Defense Security Assistance Agency, Washington, DC

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Other Defense Activities

Director, Defense Logistics Agency
Director, Defense Security Assistance Agency
Director, Defense Acqusition Regulatory Council

Non-DoD Activities

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

Congressional Committees:

Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Government Affairs
Senate Ranking Minority Member, Committee on Armed Services
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
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