PERSPECTIVES IN SECURITY ASSISTANCE MANAGEMENT

a focus on special topics of interest

FINANCIAL MANAGEMENT OF SECURITY ASSISTANCE IN THE 1980's*

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MILITARY ASSISTANCE PROGRAM

A primary issue now before us, the outcome of which will affect financial management of security assistance programs throughout the 1980s, is how to cope with the demise of the Military Assistance Program (MAP) after FY 1981. As things stand today we can look forward to going into FY 1982 with a security assistance program comprised of guaranteed Foreign Military Sales (FMS) credit, a grant International Military Education and Training (IMET) program, probably continued debt forgiveness for a portion of the Israeli program, and cash sales/FMS. The question being asked in Washington today, for which an answer must be established by the time the FY 1982 budget is submitted, is whether these financial tools are sufficient to carry forward a Security Assistance program which will fulfill the national interest.

GUARANTEED FMS CREDIT

There is an uneasy feeling that the guaranteed FMS credit program may not be the sole solution for continuing a military assistance program dedicated to continuing access to important bases, to enhancing the military capability of certain of our treaty allies, and to accomplishing various other politico-military objectives. The question is whether the receipt of loans of funds at from ten to 13% interest rates, even with extended repayment

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terms, is the sole support required by the friends and allies whose cooperation we seek for a variety of reasons. For example, the effects of credit on these terms can be illustrated by the fact that the Egyptians will repay approximately $4.5 billion over a 30-year period for the $1.5 billion loan they received in FY 1979. The long term guaranteed credit approach may not be the sole answer for economically depressed allies like Turkey, base access situations like Portugal or Oman, or for certain smaller countries with foreign policy importance but little or no economic means. We have to ask ourselves whether the problems which might arise from difficulties in repaying such loans, such as loan defaults which could disrupt our relations with the countries involved, might not override the collective security benefits which can be gained by providing military equipment on such terms. In some instances the diversion of funds from economic development purposes in order to repay the loans could actually result in a situation where the country would be less secure or stable than if the credit had not been issued.

FINANCING ALTERNATIVES

The only alternatives for changing this status quo, should it be the decision to do so, will involve either obtaining additional appropriations from the Congress or reducing the cost of items and services provided under Security Assistance. Appropriations would be necessary either to provide for low or no interest loans over longer periods of time, with lengthy repayment periods, or to provide for a continuation of the MAP program even though it might be known by such other names as debt forgiveness, FMS gift certificates or cost sharing. You may recall that in the early 1970s, the FMS credit program was primarily a direct credit program which required a dollar for dollar appropriation for the credit being extended. This direct appropriation provided the means, if deemed necessary, to reduce or eliminate the amount of interest charged on credit loans. Rightly or wrongly, as the 1970s progressed, the program was converted almost entirely to guaranty credit. The advantage of this conversion was to reduce the requirement for appropriations to 10% of that required for direct credits; the disadvantage -- if it is viewed as such -- is that interest charges must approximate the cost of money to the United States. The Senate Foreign Relations Committee, apparently knowing a good thing when it sees one, has now introduced legislation to do away even with the 10% guaranty reserve -- that is to eliminate the requirement for any appropriations in order to provide guaranteed FMS credit. I point this out because it is illustrative of one of the major difficulties which will be encountered if the decision is made to try to introduce flexibility into the terms of our security assistance. The Congress clearly is proceeding toward the objective of reducing the need for Security Assistance appropriations as much as possible, at the same time that we are looking at Security Assistance alternatives that realistically must involve appropriation increases.

If the decision is made to try to resurrect MAP, in whatever form, an axiom which we will follow will be to handle it within the FMS administrative system. We long have recognized the disadvantages to implementing agencies of operating the two parallel financial and reporting systems that we use for FMS and MAP. We do not believe that it would be worthwhile to convert the FY 1981 MAP materiel program into the FMS system, since as plans stand today this will be its final year, but if it continues we will do so starting in FY 1982. Any legislative proposal involving grant aid that emanates from the current study of the matter would, I would hope, request such authority under the Arms Export Control Act rather than the Foreign Assistance Act. I would like to emphasize that this is hypothetical, since the decision just as likely could be to continue the status quo or to limit additional flexibility to lower cost, direct loans. The recent action taken by the House, to cut FY 1981 Security Assistance authorizations by 10%, indicates that <u>any</u> increased appropriation requests face a rocky road in future years. The 10% cut could, however, be mitigated by conference action.

In any event, we have taken the first tentative steps toward providing a mechanism for merging the FMS and MAP programs by requesting, and receiving in FY 1981 legislation, the authority to merge MAP funds into the FMS trust fund of the recipient. This would allow the FMS recipient country to pay FMS bills with its MAP money, in a manner similar to the use of credit. You can see why we call it the "FMS Gift Certificate Program." We may find the occasion to use this authority in implementation of the Portugal A7P program -- but the program has not yet progressed far enough for us to decide to do so. Also, regardless of potential future legislative initiatives, we intend to continue to request MAP funds to cover packing, crating, handling and transportation (PCH&T) and similar close-out costs for MAP programs approved in FY 1981 and prior.

As I mentioned earlier, the other possibility that is being mentioned to provide flexibility is to find the means to reduce the cost of certain items or services provided under our existing authority. DSAA considers this to be a basic non-starter for wide application not only because it would require additional statutory authority but also because it would have such an impact on the DOD budget that we would not want to request such authority on a generalized basis. However, this approach has been used on limited occasions in the past such as for the NATO AWACS, and it is being considered by the Congress in the form of charging only incremental costs for training granted under IMET and training sold to NATO. I believe that the Military Departments and OSD are unanimous in backing these training proposals -- DOD as you know introduced the one for NATO -- even though it is evident that a portion of DOD's fixed training costs previously paid by the Security Assistance recipients now would have to be paid from the DOD budget.

CONTRACT ACCOUNTING TEST

Turning to more current and less esoteric financial management issues, I would first like to discuss the contract accounting test now being conducted by SAAC. As far as I know, the overwhelming majority of people in the Military Departments and OSD believe in retrospect that the centralization of trust fund accounting and billing in SAAC was a good idea. We will be faced through the 1980s with questions as to whether additional centralization makes sense from a point of view of program management, financial management, and economy of operation. The first of these questions was raised by the General Accounting Office (GAO), which persuaded the House Appropriations Committee to call for centralization of all contract accounting and contract disbursements at SAAC. As you know, we agreed to test this approach during 1980 and the test was initiated on the first of March. I would like to emphasize that this test was not initiated with any preconceived notion as to its success or failure. There is no person that I know of in a responsible management position in OSD who has made up his mind that we should adopt the GAO suggestion. We merely want an unbiased, objective, meaningful test and we need the test results in order to make up our minds. The test has encountered a certain amount of difficulty in the form of delays in obtaining necessary contract modifications by the Military Departments, in selecting cases and contracts for transfer to SAAC and in the transfer of related fiscal authorities. I believe that these delays are more symptomatic of misunderstandings associated with the test start than they are of an unwillingness of the Military Departments to participate. I hope so because I think that only an unbiased test can provide the means to say "no" to the House Appropriations Committee if we conclude the idea is not worthwhile, as well as the means to say "yes" if the concept shows significant potential. In any event the test will continue for as long as is necessary to reach one of these conclusions and we anticipate an expansion in the near future from 16 contracts valued at $240 million to about 60 contracts valued in excess of $8 billion.

FMS BILLING

Another issue that has arisen recently, partly as a result of our disastrous experience in implementing the asset use charge, and particularly because of decisions associated with the FMS administrative budget, is the development of methodologies for charging additional costs directly to cases rather than as surcharges. The precedent in this respect was our recent action to increase the price of stock fund items by 14.5%, and to do so by increasing the unit and extended price of the item being sold, even though stock fund catalogs were not updated to reflect the higher price. As you are aware, SAAC took approximately three months to reprogram the Defense Integrated Financial System - FMS (DIFS) system to establish the capability to incorporate the surcharge as a part of the unit price. This effort was worthwhile, since the result of the first quarter billing was an increase of $16 million to cover what was a legitimate price change. We have not yet had complaints from FMS purchasers as to this price increase. This may be due to the fact that the billings were sent only recently, but it also may be because, unlike our handling of the asset use charge, we notified the purchasers in advance and we included the price increase within the item price rather than as a separate surcharge.

We currently are planning to expand the concept used with respect to the stock fund price increase so as to charge all DOD contract services directly to the price of FMS items involved. You may recall that GAO has beat us severely about the head and shoulders for not recovering all the quality assurance costs in the manner prescribed in DOD Instruction 2140.1. Notwithstanding our serious objections to the shortcomings and overstatements in the GAO findings, the House Appropriations Committee went ahead and reduced the Services' FY 1980 O&M budgets by the amounts that GAO alleged were lost. To prevent any further damage to DOD budgets and to correct any shortcomings which we do have in our abilities to bill for all contract admin costs, we propose to assess a 1½% surcharge against all cases for procurement items offered after 1 October 1980. We still are working out the details of the methodology to be used to reimburse the Services for such costs, but generally speaking we intend to include the 1½% within the billed unit price of the items, transfer the funds received against the billing to a clearing account maintained at SAAC, and reimburse the Military Departments for their costs based on documented quarterly billings submitted to SAAC.

DSAA recently has placed emphasis on charging extraordinary administrative expenses directly to cases as a separate line item in the Letter of Offer, i.e.: against a case management line established for that purpose. We have published fairly detailed guidelines for doing this, but recognize fully that sometimes there is a very fine line in defining the difference between a normal FMS admin cost and an extraordinary admin cost solely due to management requirements of a single FMS program. The guidelines issued received full Military Department coordination, but the success of their application depends on mature management judgment. I won't go into the details of the MASM change which provides for specific case management lines, but I do commend the change to your attention. You can find it in Appendix 1 to Chapter D of the MASM.

FINANCIAL CONTROLS

Another aspect of financial management which requires our attention in the early 1980s is to question how much we will benefit from continuing to exercise such finite financial control over the FMS system. As you know, the DD-2060/2061 system was designed primarily to control the effects of foreign military sales on DOD reimbursable appropriations. As it currently is implemented it is extremely cumbersome, labor intensive, and its cost effectiveness is debatable. Some 1250 Comptroller personnel now are engaged in administering the FMS program DOD-wide. A significant number of them, probably $10 million a year worth, are managing and controlling this allotment control system. At the same time, we are progressing in several areas from a reimbursably financed program to one which emphasizes a direct cite of FMS funds on contracts. While we recognize that the current system has added substantial controls that were necessary, based on where we were before 1977, we are not at all sure that all of these controls are required in all of their particulars. We therefore are investigating what types of procedural modifications might be made not only to minimize the financial impact of the allocation control procedure, but also to simplify the system of releasing obligational authority from SAAC. We intend to consult with the Military Departments on lessons learned over the last couple of years and to solicit your input for any proposals that we may make to OSD (Comptroller) to simplify the procedures.

PRICING OF FMS CASES

I now would like to turn to the general subject of pricing of FMS cases. A problem that we have had in the past and one which will continue in the future is the need for a continuing improvement of our capabilities to interrelate between functional staff areas in the process of pricing and reporting FMS charges, with the objective of assuring that the DOD recovers all costs of FMS cases. The definition of what constitutes all such costs is one which has plagued us in the past and in all likelihood will continue to do so in the future. To look backwards for a moment, the systems of controls, pricing guidelines and reporting systems of FMS evolved from MAP. During the 1960s and early 1970s there was minimal emphasis placed on what now is called full cost recovery, since management emphasis tended to be placed on the Security Assistance aspect of the program, rather than on the sales aspect per se. The first assessment of the administrative charge on FMS cases did not occur until 1967. To my knowledge the first charge to recover military salaries for military personnel effort expended directly in support of FMS cases did not occur until the dispatch of a USAF F-4 TAFT team to Iran in 1968. The concept of charging replacement prices for items sold from stock which require replacement was not implemented until after the 1973 Arab-Israeli War. Pro rata R&D waivers were more the rule than the exception before around 1975. It would be incorrect to say that the FMS program during this period was so small that these charges would have been a drop in the bucket. The U.S. sold $20 billion worth of items and services under FMS before 1974. With few exceptions, these charges were made, or not made as the case may be, within the same general statutory framework that we have today. I point this out not because I think we should not assess charges for any of the items I mentioned -- I believe that they are all valid and proper charges -- but rather to illustrate the evolution that has occurred in pricing concepts that has got us to where we are today. Our current emphasis is on full cost recovery to include many millions of dollars of fixed costs that DOD will incur anyway or, as in the case of pro rata R&D, to recover costs it already has incurred for its own programs. Examples of major recoveries of our fixed costs include the indirect costs portions of training tuition rates, asset use charges, in many instances the charges for personnel salaries, and pro rata R&D. At the same time that we are recovering such fixed costs, we also are deriving benefits from the program as a result of economies of scale in production. To give just one example of this, we recently calculated that DOD saved somewhere on the order of four billion dollars due to production economies of scale during the 1973 to 1979 time frame. I raise this topic not because I advocate any changes in our current policies with respect to pricing but only to illustrate that our pricing system always has been in a state of flux and probably will continue to be so during the 1980s. I think that the key question that we have to ask ourselves -- since I can anticipate that there will be continued GAO emphasis on the subject and that such emphasis may result in recommendations for assessment of additional fixed costs to FMS -- is whether we should generally be disposed to resist such efforts or not only to accept them but possibly to encourage them. Or, conversely, should we press for statutory release which will give us increased flexibility to reduce certain charges if we believe that the national security, foreign policy, and economic benefit deriving from particular sales would warrant it? For example, should we seek broad authority which would enable us to do what we did under specific statutory authority allowing for reduced charges for the NATO AWACS program?

The question of concessionary pricing ties back to the problem of the abolishment of the MAP program -- the new legislation which will reduce IMET costs indicates that in certain instances the Congress believes that concessionary pricing for poor countries makes sense from a security standpoint. The problem is in accountability for resources. We cannot expect Congress to keep appropriating funds for one purpose if we spend them for another. Depending sometimes on the perspective of the viewer, we find that this runs both ways; U.S. appropriations funding costs for which FMS purchases should pay, and FMS purchasers paying for fixed costs that U.S. appropriations should fund. There is a fairly widespread point of view that some of the present pricing rules work against our security interests and our ability to support our poorer friends and allies by making us charge them more than perhaps we should.

GAO REPORTS

I mentioned GAO reports a little earlier. It has been a long time -- in fact it defies memory -- since GAO has issued a report congratulating us on the good job that we are doing. This probably is to be expected, but unfavorable GAO reports seem to have produced new consequences recently. The House Appropriations Committee has developed an unfortunate habit of taking GAO findings which allege DOD losses due to undercharging FMS purchasers -- and some of these findings are really "off the wall" -- and reducing DOD appropriation requests by the amount alleged to be lost. There is a school of thought that the appropriation cuts would have had to be made anyway to reach budget targets, and that the reports provide a reason for making them look less arbitrary, but this is certainly a dubious conclusion. Anyway, this tendency must be borne in mind both during the progress of GAO audits and in commenting on GAO reports. It is incumbent on us as managers to assure that the auditors are informed as to what we are doing and why we are doing it so that they can start drawing informed conclusions in their reports. It also is incumbent on us all to treat GAO reports as important documents, not only so that we can implement any recommendations that may be helpful, but also so that we can explain in detail the reasons that we consider some recommendations to be off base.

FINANCIAL MANAGEMENT AT THE CASE LEVEL

The final topic that I would like to discuss is financial management at the case level. Regardless of what pricing policies are published, it is one of the most important functions of the financial manager to insure recovery of the full cost of implementing the case under those policies. Under our current system, this involves a very complex set of personnel interrelationships, which cut across functional staff lines, in order to implement a mixed automated/manual system designed to prepare, price, record performance against, and close each FMS case. In a sense all persons involved in the system, meaning just about anybody who touches the FMS program, are financial managers. The individual who aggregates the data and actually prepares and identifies the line items on the DD Form 1513 sets the stage for all financial management which follows. This person seldom if ever is a Comptroller person and probably does not regard himself as a financial manager. And yet he or she is the key one. Unless we can lay out the various cost elements of the program, either in the 1513 itself, or sometimes more preferably in supporting documentation which can be provided to implementing activities, the system may lose the trail in its ability to recover all costs of the case. This was emphasized in a sense in the 1977 memorandum published by Fred Wacker, ASD (Comptroller), which called for the preparation of the DD Form 2061, which is entitled "The FMS Planning Document." I personally think that this form is not the precise mechanism for establishing a financial management game plan which is designed to assure the recovery of full costs in implementing each case. Not only does it provide incomplete information for the purpose, it also is too complicated to be totally useful. Nevertheless, we do need some form of financial management plan, for all but the most routine cases which can be handled completely within our existing automated stock list pricing and requisition processing systems, so as to establish a plan of attack and crosschecks necessary to maximize economic returns consistent with existing pricing policies. I am not prepared to recommend what this improved form or approach should be, since I believe that an attempt to impose a standard approach to case financial management, which involves an almost infinite variety of individual situations, would just result in paperwork problems similar to those we now have in the 2060/2061 system. Nevertheless, I think that the idea of developing a better understanding and means of formal communication among people in different functional areas, designed to assure a consistent approach as to how a given case should be managed financially, is important and I commend it to your attention.

CLOSING

I know that I rambled through a lot of diverse topics during this presentation, but the diversity of problems and situations involved with this program help to make FMS financial management both unique and interesting.

THE AUTHOR

Mr. Glenn A. Rudd is the Director of the Operations Directorate at the Defense Security Assistance Agency (DSAA). Prior to assuming his present position, he served as Comptroller, DSAA, and as Deputy Director of the Operations Directorate, DSAA.