April 20, 1992

MEMORANDUM FOR COMPTROLLER OF THE DEPARTMENT OF DEFENSE
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE SECURITY ASSISTANCE AGENCY


We are providing this audit report for your information and comments. Comments on a draft of this report were considered in preparing the final report.

The report addresses the operations of the Special Defense Acquisition Fund including the pricing and billing of articles delivered to foreign customers and the need for unsold articles that remain in inventory.

DoD Directive 7650.3 requires that all audit recommendations be resolved promptly. Therefore, the Comptroller of the Department of Defense and the Director, Defense Security Assistance Agency, must provide final comments on the unresolved recommendations by June 19, 1992. We ask that your comments indicate concurrence or nonconcurrence with the internal control weaknesses highlighted in Part I. DoD Directive 7650.3 also requires that you comment on the estimated monetary benefits, state the amounts you concur or nonconcur with, and give the reason for any nonconcurrence. Recommendations and potential monetary benefits are subject to resolution in the event of nonconcurrence or failure to comment. See the "Status of Recommendations" section at the end of each finding for the recommendations you must comment on and the specific requirements for your comments.
The courtesies extended to the audit staff are appreciated. If you have any questions about this audit, please contact Mr. Alvin L. Madison at (703) 614-1681 (DSN 224-1681) or Mr. Robert W. Otten at (703) 693-0651 (DSN 223-0651).

Robert J. Lieberman
Assistant Inspector General
for Auditing

cc:
Secretary of the Army
Secretary of the Navy
Secretary of the Air Force
Office of the Inspector General

AUDIT REPORT NO. 92-080  
(Project No. 0FA-0052)  

April 20, 1992

FINAL AUDIT REPORT ON  
THE SPECIAL DEFENSE ACQUISITION FUND

EXECUTIVE SUMMARY

Introduction. The Special Defense Acquisition Fund (the Fund) was authorized by Chapter 5 of the Arms Export Control Act in 1981, and was capitalized at $1.07 billion from collections on foreign military sales. The Fund is operated as a revolving fund. From its inception through August 1990, implementing agencies had procured articles and services costing $1.49 billion for the Fund, and sales revenues totaled $1.025 billion.

Objectives. The objectives of the audit were to evaluate the pricing and billing of articles delivered from the Fund and the need for articles purchased for the Fund. We also evaluated the need to continue the operation of the Fund and the adequacy of internal controls over the Fund's operation.

We also followed up on the recommendations made in our Audit Report No. 87-236, September 15, 1987, "Audit of the Special Defense Acquisition Fund."

Audit Results. Our audit resulted in three reportable conditions. The pricing of articles and services for the Fund had resulted in projected excess sales revenues of $113.3 million over costs, although the Fund was required to be operated on a cost-recovery basis. The Defense Security Assistance Agency (DSAA) charged customers the last procurement price or the current DoD price, and the cost of articles sold was not only recovered, but a profit was realized (Finding A).

- An effective inventory control system had not been established that would serve as the basis for assessing customers a surcharge on Fund sales to recover the cost of any unsalable articles (Finding B).

- Operation Desert Shield and Operation Desert Storm resulted in sales from Fund assets that seemed to validate the need for continued operation of the Fund.

Internal Controls. This report identifies material internal control weaknesses in DSAA's pricing of articles sold from the
Fund, inventory management, and the Fund's accounting system. Details are discussed in Findings A and B and "Other Matters of Interest."

Potential Benefits of Audit. This report identified monetary benefits of $98.1 million to be transferred from the Special Defense Acquisition Fund to the general fund of the Treasury of the United States, and savings of $15.2 million from avoiding the write-off of unsalable Fund materiel in a future accounting period. Benefits are summarized in Appendix C.

Summary of Recommendations. We recommended that the Comptroller of the Department of Defense revise the Foreign Military Sales Financial Management Manual to require that revenues, expenses, gains, and losses be recognized when the Fund's articles and services are delivered. We recommended that DSAA modify stabilized pricing procedures for articles sold from the Fund to ensure that the Fund recovers its costs without excessive profits. We also recommended that excess sales revenues retained by the Fund be transferred to the general fund of the Treasury of the United States after unsalable assets are written off. We further recommended that the Military Departments submit required inventory reports to DSAA for reconciling inventories of Fund assets. Finally, we recommended that DSAA assess customers a surcharge to recover the cost of any future unsalable assets.

Management Comments. The Office of the Comptroller of the Department of Defense concurred with the intent of Recommendation A.1., but disagreed with Finding A. The Director, Defense Security Assistance Agency, partially concurred with two recommendations related to that Finding and nonconcurred with three others. The Comptroller of the Department of Defense and the Director, Defense Security Assistance Agency, concurred with $10.7 of the $113.3 million of monetary benefits identified in the report and transferred those excess funds to the Treasury of the United States. The Director, Defense Security Assistance Agency, partially concurred with the savings of $15.2 million resulting from the write-off of unsalable Fund materiel against existing excess revenues to avoid charges in future accounting periods. The Director, Defense Security Assistance Agency, disagreed with Finding B. He partially concurred with two recommendations related to the Finding and nonconcurred with another. The Army, Navy and Air Force concurred with the recommendation made to them. We asked the Comptroller, DoD and the Director to reconsider their positions on the nonconcurrences and to provide us with additional comments when responding to the final report. Final comments must be provided by June 19, 1992. The complete texts of management comments are in Part IV of the report.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRANSMITTAL MEMORANDUM/EXECUTIVE SUMMARY</td>
<td>1</td>
</tr>
<tr>
<td>PART I - INTRODUCTION</td>
<td>i</td>
</tr>
<tr>
<td>Background</td>
<td>1</td>
</tr>
<tr>
<td>Objectives</td>
<td>2</td>
</tr>
<tr>
<td>Scope</td>
<td>3</td>
</tr>
<tr>
<td>Internal Controls</td>
<td>3</td>
</tr>
<tr>
<td>Prior Audits and Other Reviews</td>
<td>4</td>
</tr>
<tr>
<td>Other Matters of Interest</td>
<td>5</td>
</tr>
<tr>
<td>PART II - FINDINGS AND RECOMMENDATIONS</td>
<td>7</td>
</tr>
<tr>
<td>A. Pricing of Customer Sales</td>
<td>7</td>
</tr>
<tr>
<td>B. Inventory Management</td>
<td>17</td>
</tr>
<tr>
<td>PART III - ADDITIONAL INFORMATION</td>
<td>23</td>
</tr>
<tr>
<td>APPENDIX A - Analysis of Earnings of the Special Defense Acquisition Fund as of July 31, 1990</td>
<td>25</td>
</tr>
<tr>
<td>APPENDIX B - Under- or Over- Allocation of Costs to Fund Materiel for Spare Parts and Support Equipment</td>
<td>27</td>
</tr>
<tr>
<td>APPENDIX C - Summary of Potential Benefits Resulting from the Audit</td>
<td>29</td>
</tr>
<tr>
<td>APPENDIX D - Activities Visited or Contacted</td>
<td>31</td>
</tr>
<tr>
<td>APPENDIX E - Report Distribution</td>
<td>33</td>
</tr>
</tbody>
</table>
# TABLE OF CONTENTS (cont'd)

## PART IV - MANAGEMENT COMMENTS

<table>
<thead>
<tr>
<th>Department</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comptroller of the Department of Defense</td>
<td>37</td>
</tr>
<tr>
<td>Department of the Army</td>
<td>39</td>
</tr>
<tr>
<td>Department of the Navy</td>
<td>43</td>
</tr>
<tr>
<td>Department of the Air Force</td>
<td>47</td>
</tr>
<tr>
<td>Defense Security Assistance Agency</td>
<td>49</td>
</tr>
</tbody>
</table>

This report was prepared by the Financial Management Directorate, Office of the Assistant Inspector General for Auditing, DoD. Copies of the report can be obtained from the Information Officer, Audit Planning and Technical Support Directorate (703) 614-6303 (DSN 224-6303).
PART I - INTRODUCTION

Background

Purpose of the Fund. The Special Defense Acquisition Fund (the Fund) was authorized in 1981 by the addition of Chapter 5 to the Arms Export Control Act. The Fund was established to remedy a weakness in U.S. security assistance policy. That weakness was the need to divert large amounts of stocks from U.S. Forces to meet the emergency needs of foreign allies during the Middle East War in 1973. The Military Departments, through their implementing agencies, procure Defense articles and services with long procurement lead times for the Fund, in anticipation of selling or transferring these articles to eligible foreign military sales (FMS) customers. The Fund's objective is for contractors to deliver all procurements directly to foreign customers; it is not intended that the Fund take delivery of the items. By using the Fund, the U.S. Government can fulfill national security objectives by satisfying the urgent military requirements of allied nations, while avoiding diversions of materiel from U.S. Forces and possible degradation of military readiness.

Capitalization of the Fund. The Fund was capitalized with revenues from U.S. Government and contractors' export sales. The Fund's initial FY 1982 capitalization was incrementally increased until FY 1987, and has reached the congressionally mandated limit of $1.07 billion. The Fund is operated as a revolving fund. The Defense Security Assistance Agency (DSAA) recovers the costs of procuring articles and services when it sells them to customers. Therefore, the Fund can continually be used to procure and sell materiel without any additional financial support.

Procurements for the Fund. DSAA develops the Fund's annual procurement plan after coordination with Military Departments and the Department of State. The selection of articles for procurement by the Fund anticipates the needs of foreign governments. These are articles that have long procurement lead times, that could adversely affect combat readiness if withdrawn from stocks supporting U.S. Forces, and that can be produced from existing or expanded production lines. As of August 1990, articles and services costing $1.49 billion had been procured for resale by the Fund. Missiles accounted for 36 percent of the articles purchased. Other major categories were ordnance items (26 percent), radar sets (9 percent), and combat vehicles (8 percent). The remaining 21 percent consisted of various items of military hardware.

Sales from the Fund. The terms and conditions of sales agreements between the U.S. Government and foreign customers are
documented in Letters of Offer and Acceptance (LOAs) (DD Form 1513). As of March 1990, the U.S. Government and foreign customers had implemented sales agreements estimated at $1.025 billion. The unit selling prices of the articles and services were computed by the Military Departments or Defense agencies that implemented the sales agreements. The Security Assistance Accounting Center (SAAC) transferred money from the FMS Trust Fund to the Special Defense Acquisition Fund to meet the payment schedules in the LOAs.

Accounting for the Fund. SAAC was responsible for accounting for the Fund's resources. SAAC maintained the Fund's accounting records manually and in two microcomputer data bases. Commitments, obligations, and disbursements were recorded in one data base, and sales, collections, and deliveries were recorded in another data base.

Objectives

The objectives of this audit were to:

- evaluate the pricing and billing of articles delivered from the Fund,
- evaluate the need for articles purchased for the Fund, and
- evaluate the adequacy of internal controls related to the Fund.


Objective added. At the end of the survey phase of the audit, we added the objective of evaluating the need to continue the Fund's operation. We added this objective before Operation Desert Shield and Operation Desert Storm began, in view of the Fund's apparent weakness in acceptable cost accounting procedures and potential cutbacks in DoD operations. Since the Fund was used to provide considerable support to Desert Shield and Desert Storm, we feel that it should continue to be operated.

Objectives dropped. We dropped the objective of evaluating controls over funds appropriated to DSAA to operate the Fund. Since the Fund is operated as a revolving fund and had generated excess sales revenues, it received no direct appropriations to finance operations. We also dropped the objective of evaluating physical security over Fund assets because the Military Departments safeguarded Fund assets in the same manner as other DoD materiel. Inventory reports from the Military Departments
and the Fund were not prepared using comparable procedures, and had limited value for management and audit purposes.

Discussion of objectives. Stabilized pricing and billing of articles sold from the Fund resulted in about $113.3 million in actual and projected excess sales revenues, although the Fund was required to be operated on a no-loss, no-gain basis. The pricing of customer sales is discussed in Finding A. Not all articles purchased for the Fund were needed. Our examination of the inventory of Fund assets showed that more than $15.2 million of unsalable items had been in the Fund's inventory since 1987 or earlier. The need to recover the cost of unsalable Fund assets is discussed in Finding B.

We determined that all recommendations in Audit Report No. 87-236, "Audit of the Special Defense Acquisition Fund," September 15, 1987, had not been fully implemented. DSAA was working on its computer system to produce an accurate inventory program to recoup from customers the cost of unsalable and excess materiel in the Fund's inventory. Further, a problem existed in DSAA's implementation of automated procedures to record accumulated costs of the Fund on FMS cases. Also, the concept of stabilized pricing had not ensured that customers were billed for all costs incurred by the Fund for materiel delivered. The Fund's accounting system still did not contain effective internal controls to ensure that all costs were charged to the prices of articles and services sold from the Fund. Those deficiencies are discussed in Finding A.

Scope

Fund operations. Fund assets valued at $1.025 billion had been sold to foreign customers. We reviewed documents that supported the buying and selling of military articles and services, dating from the Fund's establishment in 1982 through October 1990.

Audit, period, locations, and standards. This program audit was made from March to December 1990. The audit was performed in accordance with the 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 D.

Internal Controls

Controls assessed. We evaluated the internal controls used by the Military Departments' pricing officials to ensure that articles sold from the Fund were accurately priced and customers were not overcharged or undercharged. We also evaluated inventory management controls to determine whether unsalable
materiel in the Fund's inventory was identified and customers were assessed a surcharge on future sales to recover the costs of unsalable materiel.

**Internal control weaknesses.** We identified material internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. DSAA and the Military Departments used a stabilized pricing policy that resulted in the accumulation of revenues in excess of costs, although DSAA was required to operate the Fund on a no-loss, no-gain basis and recover only its costs. Effective controls were needed to ensure that all relevant costs were included in the prices of articles sold from the Fund. In addition, inventory management procedures did not always identify unsalable items for which customers should have been assessed a surcharge to recover applicable costs. The internal control weaknesses are discussed in Findings A. and B., together with recommendations to correct them. Correction of the internal control weaknesses will result in potential monetary benefits of $113.3 million. Copies of the final report will be provided to the senior officials responsible for internal controls in the Military Departments and at DSAA for their use in preparing annual internal control statements.

We reviewed DSAA's implementation of the Federal Managers' Financial Integrity Act as it pertained to the audit objectives. DSAA had not identified the Fund as a separate assessable unit for preparing its vulnerability assessment on operations. DSAA identified assessable units by functional areas and performed risk assessments accordingly. DSAA included the Fund's operations in the risk assessment for the fund control area and did not identify any internal control weaknesses attributable to Fund operations. DSAA had effectively implemented the Federal Managers' Financial Integrity Act as it related to our audit objectives.

**Prior Audits and Other Reviews**

**Financial reports and cost recovery.** The Office of the Assistant Inspector General for Auditing issued Report No. 87-236, "Audit of the Special Defense Acquisition Fund," September 15, 1987. The report stated that cost accounting procedures established for the Fund did not provide adequate financial data, that costs charged to the Fund for Defense materiel did not include the costs of military labor and civilian retirement, and that procedures had not been established to recover the costs of materiel and services that could not be sold to foreign customers. DSAA had established an accounting system and related procedures in compliance with our recommendations, but the system did not accumulate all costs relevant to the pricing and billing of articles and services sold to customers from the Fund. The accounting system and procedures did not
provide adequate internal controls and accurate financial data. This issue is discussed below in "Other Matters of Interest."

No-loss, no-gain concept of operations. The Office of the Assistant Inspector General for Inspections issued Inspection Report No. 90-INS-15, "Defense Security Assistance Program," July 26, 1990. The report concluded that the no-loss, no-gain concept for each piece of equipment in each foreign military sale focuses on price rather than on the benefits gained by the U.S. Government through security assistance. The report recommended that DSAA, in coordination with the State Department, propose legislation to revise the no-loss, no-gain concept. The report proposed that FMS cases should include stable, annually revised prices and should follow the Fund's example by purchasing equipment in anticipation of sales. DSAA did not concur with the recommendations.

Other Matters of Interest

The Fund is operated as a revolving fund and will be subject to an annual audit of its financial statements under the Chief Financial Officers Act of 1990. As part of our review of internal controls, we test-checked the accuracy and completeness of the Fund's financial statements for the periods ending September 30, 1989, and September 30, 1990. The statements were not prepared from a general ledger, and some account balances could not be traced to supporting accounting records. Financial statements for both periods showed that the Fund's authorized capitalization of $1.07 billion may have been exceeded. Chapter 5 of the Arms Export Control Act states that the size of the Fund may not exceed the dollar amount prescribed in United States Code, title 10, sec. 138(g). The size of the Fund is defined as "the amounts in the Fund plus the value (in terms of acquisition cost) of the Defense articles acquired under this chapter which have not been transferred from the Fund in accordance with this chapter." The possibility exists that the Fund's equity is not in compliance with the Arms Export Control Act. For fiscal years 1989 and 1990, the Fund's financial statements showed that the computed equity appeared to exceed its authorized capitalization by $76.7 million and $237.6 million, respectively.

The Fund's financial statements for the period ending September 30, 1990, showed an inventory value of $812.6 million. However, DSAA's Remaining Assets Report valued the Fund's inventory at $248.9 million as of August 3, 1990. No subsidiary records supported the valuations of the Fund's inventory as shown by the financial statements. Due to the uncertain accuracy of the inventory valuations, we did not conclude that the Fund had actually exceeded its authorized capitalization of $1.07 billion.
This page was left out of original document
PART II - FINDINGS AND RECOMMENDATIONS

A. PRICING OF CUSTOMER SALES

Pricing officials in the Military Departments overpriced or underpriced articles and services sold from the Special Defense Acquisition Fund (the Fund). Overpricing occurred because the Defense Security Assistance Agency (DSAA) charged foreign customers the historical cost or the current DoD contract price, whichever was higher. Underpricing occurred because DSAA had not established effective controls to ensure that all relevant costs were charged to the prices of articles and services sold from the Fund. As a result, the Fund's estimated sales revenues exceeded projected costs by $113.3 million.

DISCUSSION OF DETAILS

Background


DoD Manual 7220.9-M, "Department of Defense Accounting Manual," February 1988, contains accounting standards for the recognition of revenues, expenses, gains, and losses. The manual states that the basis for recording an amount as a revenue shall be the delivery of goods or services as shown by a bill to an ordering activity. Since the objective of the FMS program is to operate on a cost-recovery basis, DoD Manual 7290.3-M did not address the accounting for gains or losses from Fund sales.

The procurement and sales of Fund assets are the responsibility of DSAA and the Military Departments. The Military Departments' implementing agencies are the major subordinate commands of the Army Materiel Command; the Naval Air Systems Command, the Naval Sea Systems Command, and the Space and Naval Warfare Systems Command; and elements of the Air Force Logistics Command.

Cost recovery. By law, the Fund is required to recover all costs associated with selling articles and services to
customers. DoD Manual 7290.3-M defines the source unit price for articles sold by the Fund as the procurement cost or the current DoD contract price, whichever is higher. DSAA calls this method "stabilized pricing." DoD Manuals 7290.3-M and 5105.38-M identify the cost elements that pricing officials must add to the procurement cost or contract price in order to obtain the adjusted unit prices (sales prices) quoted in the customer's case.

Stabilized pricing. DSAA did not document the concept of stabilized pricing in DoD Manual 5105.38-M until March 1991. DSAA management explained that the stabilized selling price of a major item was intended to be the base price at which the item was procured for the Fund, plus authorized FMS surcharges. The base price is defined in DoD Manual 7290.3-M, Section 71802.C.I., as "the higher of the SDAF procurement price or the current DoD contract price, if the item is on a contract signed subsequent to the SDAF contract at the time of preparation of an LOA for the sale."

The use of stabilized pricing to determine the prices of articles sold from the Fund did not achieve the cost-recovery objective that DSAA had established for foreign military sales. Based on cases implemented as of July 31, 1990, stabilized pricing will result in projected profits of $113.3 million (excess revenues over actual costs) for the Fund. With stabilized pricing, the Fund is assured that all costs will be recovered unless items are unsalable. The difference between the Fund's procurement price and the DoD contract price in effect when cases are implemented will normally result in a profit to the Fund. The potential to accumulate profits in the Fund would be reduced if the articles were intended to be replaced. However, articles and services acquired for sale by the Fund vary from year to year, based on anticipated requirements and changes in U.S. foreign policy. The international political environment determines the articles sold from the Fund. The use of stabilized pricing means that the Fund will continue to be operated at a profit without the use of a positive or negative surcharge to adjust prices over the long term.

Excess revenues from Fund operations. DSAA records showed a projected operating profit of $113.3 million, representing a 9.2-percent profit on Fund sales from the Fund's establishment on December 29, 1981, through July 31, 1990. The profit represented total sales adjusted for non-Fund recoupments, minus the cost of goods sold. Appendix A shows our analysis of the Fund's projected profit for sales agreements implemented as of July 31, 1990. We computed that $60.5 million of the $113.3 million in projected profits had already been earned from deliveries to foreign customers. To verify the 9.2-percent projected profit shown by our analysis, we compared it to the percentage of profit realized on 271 pending case closures for FMS programs financed
by the Fund. The profit on the 271 FMS cases showed that the Fund's revenues exceeded case costs by 11.6 percent. For those cases, the profit on sales exceeded the average operating profit by 2.4 percent.

Revenues were compared to the costs of articles sold on 42 closed cases. The Fund's revenues exceeded costs by 7.6 percent, or 1.6 percent less than the Fund's average profit of 9.2 percent. The Fund was generating revenues in excess of costs, which contradicted DSAA policy; the $60.5 million earned profit should be transferred to the miscellaneous receipts account of the U.S. Treasury.

**Pricing errors in programs.** Pricing officials at the Military Departments had not properly included costs for spare parts, support, and product engineering in FMS case prices for 40 of 49 major Defense items sold by the Fund (Appendix B). Case prices for 40 articles had been understated by $15.8 million and overstated by $5.6 million. The net effect of the inaccurate allocation of costs for spare parts, support, and engineering services was a $10.2 million underbilling of costs and a $10.2 million loss to the Fund.

For 11 of the programs reviewed, all of the equipment had been sold to customers. However, $8.4 million in costs (spare parts, support, and product engineering services) for the 11 programs had not been allocated or charged to the cost of the equipment sold. In 19 programs, all costs had not been allocated to the Defense equipment sold; this could result in an additional $7.4 million in undercharges to customers. For 10 programs, costs were overallocated by $5.6 million. Costs of the remaining nine programs had been properly allocated. The following paragraphs give examples of the pricing errors found in the 40 programs.

**TPS-70 radar system.** In program year 1982, two TPS-70 radar systems, including support services and a 2-year lot of spare parts, were acquired for the Fund. The radar systems had been sold; however, $2.1 million in costs of the two radar systems had not been charged to or collected from customers.

**TPQ-37 radar system.** In 1986, the Fund bought a TPQ-37 radar system, spares, a system test, and support services. When the system was sold, $2.1 million in costs of TPQ-37 spare parts, live-fire testing, and support services was not charged to or collected from the foreign customer. This transaction understated the costs of making the system available to the customer, and resulted in a loss to the Fund of $2.1 million in operating revenues.

**Maverick missiles.** Costs were undercharged for the 1989 Maverick missile program. In 1989, the Air Force purchased
500 Maverick missiles for the Fund, together with test missiles, training equipment, and loaders, at a total cost of $45,612,659. As of August 1990, 278 of the missiles had been sold. However, customers had not been charged $181,584 for testing, training, and loading equipment related to the 278 missiles. If the undercharges continue, customers will have been underbilled approximately $330,000 when all Maverick missiles have been sold.

The absence of procedures and controls to ensure that all costs were included in sales prices had resulted in the inconsistent application of costs for Fund sales of major Defense articles.

**Internal controls.** SAAC uses both manual and automated accounting methods to account for the costs of articles and services purchased for the Fund. In response to our Audit Report No. 87-236, "Audit of the Special Defense Acquisition Fund," September 15, 1987, DSAA modified SAAC's accounting system to accumulate costs of the pricing and billing of articles and services sold from the Fund. However, SAAC's modified system lacked controls to ensure that FMS case prices included all costs for testing, training, spare parts, support, and product engineering services.

**Summary.** DSAA established the policy that all Fund sales were to be made on a firm-fixed-price basis. Therefore, DSAA would not be obligated to refund the $113.3 million in excess sales revenues to FMS customers. The $113.3 million in excess revenues includes $60.5 million earned from deliveries to customers and $52.8 million ($113.3 million minus $60.5 million) in projected earnings when deliveries are completed. The total excess revenues includes $10.2 million in costs that were not billed to foreign customers (see Appendix B). The excess revenues should be offset by $15.2 million in excess and unsalable articles and services (see Finding B). It would be difficult to determine the refunds due to various customers from the $60.5 million earned. Therefore, DSAA should transfer the $60.5 million in excess revenues to the Treasury of the United States. DSAA intended to transfer $10.7 million to the Treasury, based on cases that had been closed. DSAA management considers revenues to be earned when cases are closed, not when articles and services are delivered. We disagree with DSAA's position that earnings result at case closure. Many years can pass between the delivery of articles and services to customers and case closure.

Generally accepted accounting principles and DoD Manual 7220.9-M, "Department of Defense Accounting Manual," both recognize revenue and profit at the time deliveries are made and title is transferred to the customer. If the remaining potential excess revenues of $52.8 million ($113.3 million minus $60.5 million) are realized, the $15.2 million in excess and unsalable articles and services should be written off against those profits. The
balance of $37.6 million should be transferred to the Treasury of the United States at the time deliveries are made to customers. In response to our Audit Report No. 87-236, DSAA took the position that amounts paid by FMS customers in excess of costs would be deposited with the Treasury of the United States. These transfers of excess revenues would be in accordance with that position.

RECOMMENDATIONS FOR CORRECTIVE ACTION


2. We recommend that the Director, Defense Security Assistance Agency:

   a. Develop and implement pricing procedures as an alternative to stabilized pricing to ensure that the Special Defense Acquisition Fund is operated on a cost-recovery basis as required by the Arms Export Control Act and DoD Manual 7290.3-M, or use a negative or positive surcharge to ensure that excess sales revenues (profits) or losses are eliminated.

   b. Develop procedures and controls to identify and allocate to the prices of articles and services sold to foreign military sales customers all costs of acquiring materiel for the Special Defense Acquisition Fund.

   c. Transfer the earned excess revenues of $60.5 million from the Special Defense Acquisition Fund to the Treasury of the United States, write off the $15.2 million in unsalable articles against the remaining $52.8 million in projected excess revenues, and transfer the balance of $37.6 million to the Treasury of the United States as deliveries are made to customers.

MANAGEMENT COMMENTS

The Deputy Comptroller for Management Systems, DoD, nonconcurred with the audit position in Finding A that excess sales revenues should be determined at the time deliveries are made. He stated that Chapter 61 of DoD Manual 7220.9-M provides for gains to be reported net of any related expenses. The management comments also stated that the earliest time when all expenses are known is at the time a case is closed. Therefore, profit can only be determined at case closure.

The Director, Defense Security Assistance Agency (DSAA), disagreed with our discussion in Finding A of stabilized pricing, the overpricing and underpricing of Fund sales, and DSAA's policy on the no-loss, no-gain concept of foreign military sales (FMS). DSAA also disagreed with our recommendation to dispose of $113.3 million in excess sales revenues by partially transferring them to the Treasury of the United States and by writing off unsalable inventory. The Director stated also that the Office of Management and Budget (OMB) had concurred with DSAA's policy of recognizing profit at case closure.

DSAA stated that sales were not overpriced and that pricing policies were not intended to preclude earnings on individual sales to offset losses on other sales. DSAA stated that Chapter 5 of the Arms Export Control Act (AECA) created the Fund as a revolving fund, and that the no-loss aspect of Fund sales can be managed at the fund level rather than by individual case. DSAA also stated that full cost recovery is the objective of stabilized pricing.

DSAA did not agree that the costs of spare parts and support items should be included as relevant costs when the related end items are sold. DSAA also disagreed with facts about the three examples of pricing errors in our draft report. DSAA acknowledged the accuracy of the $113.3 million in projected excess profits, but disagreed with us as to when revenues should be recognized.

DSAA nonconcurred with Recommendation A.2.a. We had recommended that DSAA develop and implement alternatives to stabilized pricing, to ensure that the Fund is operated on a cost-recovery basis as required by the AECA and DoD Manual 7290.3-M, and to eliminate excess profits. DSAA stated that the Fund is operated in full compliance with the AECA and DoD Manual 7290.3-M. DSAA also stated that stabilized pricing is a fair method of pricing Fund assets.

The Director, DSAA, partially concurred with Recommendation A.2.b. in the draft report to develop procedures and controls to identify and allocate to the prices of articles and services sold to foreign customers all costs of acquiring Fund materiel. He stated that the Fund is not obligated to recover the costs of $10.2 million in spare parts, support, and product engineering
that were not passed on to foreign customers when related end items were sold. The Director, DSAA, supports full allocation of costs for program support and other indirect costs; he does not support full allocation for spare parts, support and equipment that may be sold separately from related end items.

The Director, DSAA, was not fully responsive to Recommendation A.2.c. to transfer the earned excess revenues of $60.5 million from the Fund to the miscellaneous receipts account of the Treasury of the United States, to write off $15.2 million in unsalable articles against the remaining $52.8 million in projected excess revenues, and to transfer the balance of $37.6 million to the Treasury of the United States as deliveries are made to customers.

DSAA did not fully concur with the potential monetary benefits of $113.3 million. DSAA agreed to transfer excess Fund revenues to the miscellaneous receipts account of the Treasury of the United States, but stated that transfers would be made when PMS cases are closed and not as deliveries are made.

**AUDIT RESPONSE TO MANAGEMENT COMMENTS**

We disagree with the Deputy Comptroller, DoD, and the Director, DSAA, that DSAA cannot recognize the profit on Fund sales until the related PMS case is closed. When deliveries are made to the foreign customers, almost all of the actual revenues and expenses of the sale should be recorded in accounting and logistical records. DSAA's procedure of recognizing profits only at case closure does not conform to the generally accepted accounting principle of matching revenues and expenses for an accounting period.

In the Government, the fiscal year is the accounting period or transaction cycle used for budgeting and accounting purposes. DoD Manual 7220.9-M, Chapter II, requires that the head of each executive agency use accrual accounting as prescribed by United States Code, title 31, sec. 3512(e), subchapter II, "Accounting Requirements, Systems and Information." DoD Manual 7220.9-M states that accrual accounting emphasizes the significance and accountability of financial transactions as they occur. Accrual accounting can contribute materially to effective financial control over resources and costs of operations, and is essential to developing adequate financial management information. By postponing recognition of revenues or expenses until cases are closed, DSAA is following neither DoD guidance nor the United States Code.

Because the U.S. Government operates on a fiscal year basis, DSAA's delay in recognizing profits is unrealistic. During the audit, we noted that some fully delivered cases dating back to
FY 1984 were still open. We believe that DSAA must have recorded all known costs for these sales; therefore, profits should be recognized.

The Comptroller, DoD, concurred with the intent of Recommendation A.1. in the draft report. However, he did not state whether DoD Manual 7290.3-M would be revised to incorporate the requirements of Chapter 81, DoD Manual 7220.9-M, "Special Funds." This chapter covers the recognition of revenues, expenses, gains, and losses on sales. When the Comptroller, DoD, responds to the final report, we request that he state when DoD Manual 7290.3-M will be revised and give the date when the revision will be complete. We also request that the Comptroller, DoD, address our audit response to his management comments.

We disagree with DSAA's statement that stabilized pricing does not result in overpricing of Fund sales to foreign customers. The overpricing is evident in the profit of $113.3 million earned by the Fund since its existence. This represents a profit of 9.2 percent over the life of the Fund. We agree that the Fund operates as a revolving fund in accordance with the AECA. However, we do not believe that the AECA intended for the Fund to yield long-term profits. We believe the AECA's intent is that the Fund remain solvent for procuring Defense articles to sell to foreign customers on a cost-recovery basis at a fair and equitable price.

A revolving fund should break even over the long term. This has not been achieved because unlike other revolving funds, the Fund does not use a positive or negative surcharge, in conjunction with stabilized pricing, to adjust for prior-year gains and losses on sales. Until DSAA implements such a surcharge, sales will be overpriced. We do not agree with DSAA's position that customers are charged fair and reasonable prices. To satisfy the intent of Recommendation A.2.a. to develop alternatives to stabilized pricing, DSAA should implement an annual surcharge (positive or negative) to ensure that the SDAF revolving account is operated at a break-even point. We have revised Recommendation A.2.a. to include such a surcharge. We request that the Director, DSAA, comment on the revised recommendation.

We believe that stabilized pricing does not conform to the contractual terms between the U.S. Government and foreign customers. All SDAF articles and services are sold to foreign customers through FMS cases. The Letters of Offer and Acceptance (DD Forms 1513) for SDAF assets contain the same general terms as all other FMS sales. Annex A, "General Conditions," DD Form 1513, states that "the price of items to be procured shall be at the total cost to the U.S. Government." Further, it states that "the USG in procuring and furnishing the items specified in this Offer and Acceptance does so on a nonprofit basis for the benefit of the Purchaser."
On Recommendation A.2.b., we disagree with DSAA's statement that the Fund is not required to allocate all relevant costs to end items sold to foreign customers. DSAA's comments contradict its response to our report, "Audit of Pricing and Billing of Stinger Missiles Sold to Foreign Military Sales Customers," Report No. 91-055, February 27, 1991. DSAA stated, "DSAA is responsible for reviewing SDAF prices to assure full cost recovery and for changing any proposed SDAF prices to achieve that objective." We disagree with DSAA's comment on our draft report that the costs of spare parts, support, and equipment should not be allocated to the selling prices of related end items. The items were procured for the Fund to support related end items, and become almost unsalable after those end items are sold (see Finding B). We do not believe that the AECA intended that the Fund should be operated to lose revenues by failing to allocate the full costs of articles and services procured for foreign customers when the related end items are sold.

Our draft report does not contain factual errors in projected over- and undercharges (unallocated costs). We computed potential over- and undercharges from information provided by DSAA that was accurate as of August 3, 1990. The examples accurately show the projected effect of selling spares and support equipment separately from major end items. They were procured as total packages and should have been sold as such. The effect is that the spares and support equipment remain in inventory for long periods of time, or become obsolete and unsalable.

Recommendation A.2.c. concerned the transfer of excess revenues from the Fund to the miscellaneous receipts account of the Treasury. This issue must be considered both for legality and the proper accounting treatment of those revenues. The AECA requires the transfer of any funds that exceed the amount in the Fund. The AECA states that "the corpus of the Fund may not exceed such dollar amount as is prescribed in Title 10 of the United States Code." That amount is currently $1.07 billion. The AECA further states that "for purposes of this limitation, the corpus of the Fund is the amounts in the Fund plus the value (in terms of acquisition cost) of the Defense articles acquired under the AECA which have not been transferred from the Fund." Therefore, the cash plus the value of inventory in the Fund cannot exceed $1.07 billion. In the Fund's financial statement for September 30, 1990, cash was reported as $831,548,616, and inventory was valued at $812,634,119. If the financial statement was correct, the sum of the cash plus inventory as shown on the financial statement exceeded the authorized corpus of the SDAF by $574,182,735. We believe it is essential that DSAA accurately compute the value of the Fund's inventory and deposit any funds in excess of the authorized corpus to the miscellaneous receipts account of the Treasury of the United States, in compliance with the AECA.
We agree with DSAA's position that the transfer of excess revenues to the miscellaneous receipts account of the Treasury of the United States should be made in accordance with generally accepted accounting principles, DoD policies, and applicable laws. However, we disagree with DSAA's procedure of recognizing profits or losses only at case closure. Transfers of the Fund's net profits should be made to the miscellaneous receipts account of the Treasury of the United States each time the limitation on the Fund corpus is exceeded, or at least once each fiscal year. This procedure would comply with generally accepted accounting principles, DoD policies, and applicable laws. Further, the use of accrual accounting would reduce the risk that the Fund corpus could be exceeded and not be detected by DSAA.

DSAA's management stated that the delay between a "delivery complete" status on a customer's case and case closure is not more than 1 or 2 quarters for Fund cases and does not represent a material time difference. This is not true. As of September 24, 1990, DSAA had closed only 164 (11 percent) of the cases implemented during the Fund's existence. Further, as of October 10, 1990, 502 (39 percent) of 1,289 open case lines were both "delivery complete" and paid for by customers, but the cases had not been closed.

DSAA misstated the facts regarding the Office of Management and Budget's (OMB's) concurrence with DSAA's policy of recognizing profits at case closure. On February 27, 1991, OMB approved the use of a "nonexpenditure transfer via a SF 1151 to receipt account 111614" to return the Fund's surplus capital to the Treasury of the United States. OMB did not discuss when profits should be recognized.

We request that the Director, DSAA, reconsider his position based on the audit response and state his concurrence or nonconcurrence with the finding and recommendations. The recommendations, if implemented, would bring DSAA into compliance with the AECA regarding both its authorized capitalization and the requirement for revolving funds to break even over the long term. The management, comments should also address the potential benefits shown in Appendix C.

**STATUS OF RECOMMENDATION**

<table>
<thead>
<tr>
<th>Number</th>
<th>Addressee</th>
<th>Concur or Nonconcur</th>
<th>Proposed Action</th>
<th>Completion Date</th>
<th>Related Issues*</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.1</td>
<td>Comptroller, DoD</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>A.2.a</td>
<td>Director, DSAA</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>A.2.b</td>
<td>Director, DSAA</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>A.2.c</td>
<td>Director, DSAA</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>M</td>
</tr>
</tbody>
</table>

* M Monetary Benefits
B. INVENTORY MANAGEMENT

The Defense Security Assistance Agency (DSAA) had not established a surcharge to recoup from FMS customers the costs of excess and unsalable materiel purchased for the Special Defense Acquisition Fund (the Fund). DSAA's inventory records of Fund assets had different balances from the Military Departments' inventory records. This occurred because the Military Departments were not submitting the required inventory reports that DSAA needed to reconcile balances and identify unsalable materiel. Further, DSAA and the Military Departments used different criteria to compute inventories and dollar values of Fund assets. As a result, the Fund had not billed customers a surcharge to recover costs of $15.2 million for unsalable materiel and did not have effective inventory management controls over Fund assets costing $259.6 million.

DISCUSSION OF DETAILS

Background

DoD Manuals 7290.3-M and 5105.38-M furnish guidance for managing items purchased by the Fund. DoD Manual 7290.3-M requires DSAA to establish an annual surcharge to recover the costs of items that the Military Departments purchase for sale from the Fund, but that may result in losses to the Fund. Losses can be caused by pilferage, obsolescence, and sales of Fund items at reduced prices. The surcharge should be charged to FMS customers to recover potential losses.

Fund Inventory. As of August 3, 1990, DSAA valued the Fund's inventory at $248.9 million. The Military Departments valued the 3,553 inventory items that the Fund owned, but stored at the Military Departments' depots, at $259.6 million. Each valuation excluded communications equipment managed by NSA. Based on the Military Departments' reports, spare parts and support equipment accounted for 3,388 items, valued at $33.2 million. The remaining 165 items, valued at $226.4 million, consisted of major end items. The Naval Air Systems Command (NAVAIR), Washington, D.C., and the Naval Sea Systems Command (NAVSEA), Washington, D.C., could not furnish accurate counts of spare parts and support equipment that the Fund owned but stored at NAVAIR and NAVSEA depots.

Unsalable Items. We obtained reports showing demand data for the $33.2 million of spare parts and support equipment owned by the Fund and reported by the Military Departments as being in inventory. These reports listed the last transaction date for each item received in inventory and shipped from inventory. Of the 3,388 items identified as spare parts and support equipment, 1,658 items, valued at $6.3 million, had no recorded customers' demands or other transactions for 3 years. Neither foreign
customers nor the Military Departments had expressed any interest in obtaining these items. Therefore, DSAA should have classified the items as unsalable. However, DSAA had not identified these obsolete and nondemand items as unsalable and had not established a surcharge to recoup the costs of the items from foreign customers, as required by DoD Manual 7290.3-M.

Of the 165 types of major end items remaining in inventory, 20 GPU-5A gun pods, valued at $7.3 million, were purchased for the Fund in FY 1983. Spare parts, ammunition, and ammunition loaders, valued at $1.6 million, were also purchased to support the 20 GPU-5A gun pods. At the time of our audit, the 20 gun pods and support equipment had not been sold and remained in inventory. We recommended in our Audit Report No. 87-236, "Special Defense Acquisition Fund," September 15, 1987, that DSAA establish procedures to recoup the cost of the 20 GPU-5A gun pods through a surcharge on Fund sales. Although DSAA had established the recommended procedures, it had not recouped the cost of those unsalable items by developing and applying a surcharge on sales to foreign customers, as required by DoD Manual 7290.3-M.

Submission of inventory reports. The Military Departments were not submitting inventory reports, as required by DoD Manual 5105.38-M, to enable DSAA to monitor Fund inventories. Prior to January 1991, the DoD Manual required monthly inventory reports; quarterly reports are now required. Inventory reports would have given DSAA a means of identifying over $15.2 million of the Fund's assets as excess and unsalable assets. DSAA could have used the cost of the unsalable articles, which consisted of $6.3 million in spare parts and $8.9 million in gun pods and support equipment, to calculate a surcharge on sales to recover the cost of the materiel. DSAA should also establish a surcharge to recover the costs of potentially unsalable materiel in the future. The cost of unsalable assets should be charged to the Fund's projected and actual earnings of $113.3 million, as discussed in Finding A. Disposal of the unsalable materiel would also avoid storage costs that the Fund incurs to keep the items in inventory.

Discrepancies in inventory balances. DSAA's Remaining Assets Report (A-3 Report), dated August 3, 1990, was compared with inventory records obtained from the Military Departments. The comparison showed significant discrepancies for certain items. We requested the inventory reports because the Military Departments were not submitting them to DSAA as required. DSAA reported the Fund's inventory as $248.9 million, or $10.7 million less than the Military Departments' reported value of $259.6 million. Larger discrepancies existed between the Fund's reported inventory values and actual quantities of certain items. For example, inventory records at the U.S. Army Communications and Electronics Command, Fort Monmouth, New Jersey, showed that 1,291 AN-PRC-77 radio sets, valued at
$1,636,988, remained in inventory. However, DSAA's A-3 Report showed that 2,261 units, valued at $3,119,815, remained in inventory. This discrepancy of 970 units was valued at $1,482,827. At the Space and Naval Warfare Systems Command, 11 KG-40 serial communications units, valued at $197,400 remained in inventory. DSAA's A-3 Report listed 19 units, valued at $272,232, in inventory. This discrepancy of 8 units was valued at $74,832. DSAA could improve inventory controls over Fund assets if the Military Departments submitted inventory reports to DSAA as required, and DSAA periodically reconciled its inventories with the Military Departments' inventories.

**Inventory controls.** DSAA's procedures did not effectively control fund assets that were in the custody of the Military Departments. The records we obtained from the Military Departments showed that inventory quantities and values of Fund assets were based on physical inventory records. The Military Departments' inventory records valued the Fund's inventory at $259.6 million, or $10.7 million more than DSAA's own valuation of $248.9 million. DSAA used a computational method to determine inventory quantities and values. DSAA considered articles and services to be part of the Fund inventory when Military Interdepartmental Purchase Requests (MIPRs) were issued to procure the articles or services, and the implementing agency accepted the MIPRs. The Military Departments designated implementing agencies to execute FMS programs. DSAA dropped articles from inventory at the time they were allocated to an FMS case. Articles could remain physically in inventory for long periods of time, even after the materiel was allocated to a case. In some instances, FMS cases with allocated assets were never finalized. Therefore, DSAA should have recorded the allocated materiel as Fund inventory.

The intent of the regulatory requirement for the Military Departments to submit inventory reports to DSAA was to reconcile the Military Departments' inventory records with DSAA's inventory records to provide controls over Fund assets. However, the system that DSAA used to account for inventory quantities prevented any meaningful reconciliation of inventory records. For an accurate accounting of Fund assets controlled by the Military Departments, DSAA needs to establish an inventory control system for Fund assets that is reconcilable with the Military Departments' systems.

**RECOMMENDATIONS FOR CORRECTIVE ACTION**

(In this finding, we are not recommending that the Defense Security Assistance Agency write off $15.2 million of the Special Defense Acquisition Fund's unsalable assets. That recommendation is made in Finding A.)
1. We recommend that the Army Materiel Command, the Navy International Programs Office, and the Air Force Logistics Command direct their subordinate commands to submit quarterly inventory reports to the Defense Security Assistance Agency in the format prescribed by DoD Manual 5105.38-M.

2. We recommend that the Director, Defense Security Assistance Agency:

   a. Establish criteria to determine when Special Defense Acquisition Fund materiel should be classified as unsalable for the purpose of computing surcharges and should be dropped from inventory.

   b. Establish a Special Defense Acquisition Fund surcharge to be applied to foreign military sales cases to recover the costs of any future losses that may result from unsalable items, as required by DoD Manual 5105.38-M.

   c. Establish an inventory control system for the Special Defense Acquisition Fund that is reconcilable with the Military Departments' systems.

**MANAGEMENT COMMENTS**

The Army and the Air Force concurred with Recommendation B.1. in the draft report to submit quarterly inventory reports to DSAA in the format prescribed by DoD Manual 5105.38-M. The Navy nonconcurred with the recommendation, and stated that quarterly inventory reports will be submitted in accordance with the January 1991 change to DoD Manual 5105.38-M.

The Director, DSAA, nonconcurred with our statements that the Fund had failed to establish a required surcharge to recoup the costs of excess and unsalable materiel, and that the Fund did not have effective inventory management controls over assets. The Director partially concurred with Recommendation B.2.a. to establish criteria to determine when Fund materiel should be classified as unsalable for the purpose of computing surcharges and should be dropped from inventory. He stated that DoD Manual 7290.3-M includes criteria to assess surcharges for inventory losses, pilferage, and obsolescence. He also stated that DSAA will recommend that DoD Manual 7290.3-M be changed to add nonmarketability to the other criteria for surcharges.

The Director, DSAA, nonconcurred with Recommendation B.2.b. to establish a Fund surcharge to be applied to FMS cases to recover the costs of losses that may result from unsalable items, as required by DoD Manual 5105.38-M. He stated that stabilized pricing acts as a built-in surcharge that allows losses on some transactions to be absorbed by earnings on others. He also disagreed with the use of a surcharge.
The Director, DSAA, partially concurred with Recommendation B.2.c. to establish an inventory control system for the Fund that is reconcilable with the Military Departments' systems. He agreed with the principle of reconcilable systems, and he agreed that the Fund's Management Information System can accomplish the reconciliation if the Military Departments furnish quarterly inventory information in the format required by DoD Manual 5105.38-M.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

We consider the comments received from the Army, the Navy, and the Air Force to be responsive to Recommendation B.1. in the draft report.

DSAA's comments misstate the details of our finding regarding a surcharge to recover the cost of future unsalable materiel in the Fund's inventory. We stated that the Fund had not billed customers a surcharge to recover costs of $15.2 million in unsalable materiel. We did not state that DSAA was required to establish an annual surcharge. In accordance with DoD Manual 7290.3-M, a special surcharge is required to recover the costs of inventory losses, pilferage, obsolescence, and any loss of proceeds resulting from sales at reduced prices. We disagree with DSAA's comment that the excess revenue generated by stabilized pricing constituted a built-in surcharge that negated the need for a special surcharge. We concluded that stabilized pricing of customer sales resulted in overcharging most customers, but this did not negate the need for the special surcharge intended by DoD Manual 7290.3-M. We did not recommend that a special surcharge be assessed to recover $15.2 million in unsalable assets, but that those costs be offset against the projected profit of $113.3 million. In the future, DSAA should implement a special surcharge to recover the costs of unsalable assets.

We also disagree with DSAA's position that an effective inventory control system was in place. DSAA agreed that the Military Departments were not submitting inventory reports as prescribed by DoD Manual 5105.38-M, that DSAA needed to improve its ability to track physical inventory, and that DSAA maintained inventory records on a different basis than the Military Departments that had physical custody of SDAF assets. Those facts are inconsistent with DSAA's position that an effective inventory control system was in place. Because the valuation of the inventory is one factor used to determine whether or not the Fund has exceeded its corpus limitation, DSAA management should ensure that the inventory is valued accurately.

The Director, DSAA's comments on Recommendation B.2.a. in the draft report were not fully responsive. The comments did not
specifically address what criteria would be used to identify unsalable (unmarketable) assets remaining in inventory.

DSAA's nonconcurrency with Recommendation B.2.b. in the draft report contradicts the AECA, which requires that all costs be recovered on articles and services sold through FMS. All articles and services sold to foreign customers are sold through FMS cases. LOAs for the sale of articles and services of SDAF assets contain the same general terms as all other FMS sales. Under "General Conditions," the LOAs state that "the price of items to be procured shall be at the total cost to the U.S. Government." Both the AECA legislation and the terms of the sales contract require that the full costs of articles and services be recovered at the individual FMS case level. As we state in our responses to the comments on Finding A, we disagree that gains made through stabilized pricing negate the requirement to recover any losses sustained by the Fund. We do not intend for DSAA to establish a annual surcharge to recover future anticipated losses. We recommended that DSAA establish a special surcharge to recover actual losses incurred in future periods that may result from unsalable items, as required by DoD Manual 5105.38-M.

On Recommendation B.2.c. in the draft report, to establish a reconcilable inventory control system, DSAA's comments satisfy the intent of our recommendation. An accurate inventory is essential to properly evaluating DSAA's compliance with AECA limitations on the capitalization of revolving funds.

We request that DSAA's comments on the final report state whether DSAA will recommend that DoD Manual 7290.3-M be revised to include criteria for identifying unsalable Fund assets so that DSAA can assess a special surcharge to recover their cost. We also request that DSAA give us an estimated date for completion of that action. We request that the Director reconsider his position on Recommendation B.2.b. and indicate his concurrence or nonconcurrency with that recommendation.

STATUS OF RECOMMENDATION

<table>
<thead>
<tr>
<th>Number</th>
<th>Addressee</th>
<th>Response Should Cover:</th>
<th>Concur or Nonconcur</th>
<th>Proposed Action</th>
<th>Completion Date</th>
<th>Related Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.2.a</td>
<td>Director, DSAA</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>M</td>
</tr>
<tr>
<td>B.2.b</td>
<td>Director, DSAA</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

* M Monetary Benefits
This page was left out of original document

Sales $1,243,703,779.17
Add: Investments 47,851,616.74 1/
Deduct: Non-Fund recoupments transferred to the Treasury of the United States (65,844,455.36) 2/

Adjusted sales $1,225,710,940.55

Cost of Goods Sold

Beginning inventory $ .00
Add: Obligations of funds for procurements 1,630,650,908.21
Deduct: Ending inventory (518,246,115.95)

Cost of goods sold (1,112,404,792.26)

Profit (loss)/excess sales revenues $ 113,306,148.29 3/

1/ Net amount invested in the Defense Stock Fund.

2/ Amounts collected from FMS customers for recoupment of asset use charges and other nonrecurring costs.

This page was left out of original document
## APPENDIX B: UNDER- OR OVER- ALLOCATION OF COSTS TO FUND MATERIAL FOR SPARE PARTS AND SUPPORT EQUIPMENT

<table>
<thead>
<tr>
<th>Program Year</th>
<th>Defense Article (End Item)</th>
<th>Quantity Bought</th>
<th>Quantity Remaining</th>
<th>Amount Under- or Over-Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>AIM 9-M Sidewinder</td>
<td>500</td>
<td>0</td>
<td>$97,532.89</td>
</tr>
<tr>
<td>1984</td>
<td>Jeep, M151 1/4-ton</td>
<td>621</td>
<td>0</td>
<td>$44,493.00</td>
</tr>
<tr>
<td>1983</td>
<td>M198 howitzer</td>
<td>54</td>
<td>0</td>
<td>$15,682.59</td>
</tr>
<tr>
<td>1984</td>
<td>M198 howitzer</td>
<td>54</td>
<td>0</td>
<td>$942,434.91</td>
</tr>
<tr>
<td>1984</td>
<td>M60 machine gun</td>
<td>2,000</td>
<td>0</td>
<td>$516,062.63</td>
</tr>
<tr>
<td>1982</td>
<td>M60A3 tank</td>
<td>54</td>
<td>0</td>
<td>$1,285,390.92</td>
</tr>
<tr>
<td>1985</td>
<td>Radar AN/TPQ-36</td>
<td>9</td>
<td>0</td>
<td>$322,215.77</td>
</tr>
<tr>
<td>1986</td>
<td>Radar AN/TPQ-36</td>
<td>3</td>
<td>0</td>
<td>$359,519.63</td>
</tr>
<tr>
<td>1986</td>
<td>Radar AN/TPQ-37</td>
<td>1</td>
<td>0</td>
<td>$2,149,406.62</td>
</tr>
<tr>
<td>1982</td>
<td>Radar TPS-70</td>
<td>2</td>
<td>0</td>
<td>$2,079,905.85</td>
</tr>
<tr>
<td>1984</td>
<td>TOW II</td>
<td>2,130</td>
<td>0</td>
<td>$567,047.01</td>
</tr>
</tbody>
</table>

Subtotal

<table>
<thead>
<tr>
<th>Program Year</th>
<th>Defense Article (End Item)</th>
<th>Quantity Bought</th>
<th>Quantity Remaining</th>
<th>Amount Under- or Over-Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>AIM-7M Sparrow</td>
<td>250</td>
<td>60</td>
<td>$56,739.96</td>
</tr>
<tr>
<td>1985</td>
<td>AIM-9M Sidewinder</td>
<td>500</td>
<td>100</td>
<td>$34,466.22</td>
</tr>
<tr>
<td>1989</td>
<td>M60 machine gun</td>
<td>961</td>
<td>901</td>
<td>$303.14</td>
</tr>
<tr>
<td>1989</td>
<td>Maverick missile</td>
<td>500</td>
<td>222</td>
<td>$181,584.57</td>
</tr>
<tr>
<td>1987</td>
<td>Radar AN/TPQ-37</td>
<td>1,810</td>
<td>20</td>
<td>$1,072,451.00</td>
</tr>
<tr>
<td>1983</td>
<td>Radio AN/PRC-77</td>
<td>1,810</td>
<td>208</td>
<td>$322,095.47</td>
</tr>
<tr>
<td>1984</td>
<td>Radio AN/PRC-77</td>
<td>1,810</td>
<td>208</td>
<td>$403,829.52</td>
</tr>
<tr>
<td>1985</td>
<td>Radio AN/CRM-114</td>
<td>58</td>
<td>21</td>
<td>$102,229.63</td>
</tr>
<tr>
<td>1986</td>
<td>Radio AN/PRC-77</td>
<td>4,000</td>
<td>1,050</td>
<td>$168,847.19</td>
</tr>
<tr>
<td>1983</td>
<td>Radio VRC-12</td>
<td>780</td>
<td>8</td>
<td>$1,163,500.18</td>
</tr>
<tr>
<td>1984</td>
<td>Radio VRC-12</td>
<td>780</td>
<td>8</td>
<td>$782,497.35</td>
</tr>
<tr>
<td>1985</td>
<td>Radar AN/TPQ-37</td>
<td>1,975</td>
<td>1,389</td>
<td>$670,058.56</td>
</tr>
<tr>
<td>1986</td>
<td>Radar M16A2</td>
<td>10,000</td>
<td>3,003</td>
<td>$3,457.27</td>
</tr>
<tr>
<td>1984</td>
<td>Stinger missile</td>
<td>393</td>
<td>8</td>
<td>$1,426,198.37</td>
</tr>
<tr>
<td>1985</td>
<td>TOW II</td>
<td>3,200</td>
<td>297</td>
<td>$973,484.71</td>
</tr>
<tr>
<td>1987</td>
<td>TOW II-A</td>
<td>1,500</td>
<td>196</td>
<td>$30,192.29</td>
</tr>
<tr>
<td>1986</td>
<td>Truck, 2.5-ton</td>
<td>300</td>
<td>2</td>
<td>$3,416.26</td>
</tr>
<tr>
<td>1988</td>
<td>Truck, 2.5-ton</td>
<td>150</td>
<td>32</td>
<td>$7,344.04</td>
</tr>
<tr>
<td>1986</td>
<td>Truck, 5-ton</td>
<td>34</td>
<td>3</td>
<td>$36,004.90</td>
</tr>
</tbody>
</table>

Subtotal

<table>
<thead>
<tr>
<th>Program Year</th>
<th>Defense Article (End Item)</th>
<th>Quantity Bought</th>
<th>Quantity Remaining</th>
<th>Amount Under- or Over-Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>AIM-7M Sparrow</td>
<td>500</td>
<td>25</td>
<td>$(21,294.00)</td>
</tr>
<tr>
<td>1985</td>
<td>G/VLLD</td>
<td>10</td>
<td>4</td>
<td>$(6,537.32)</td>
</tr>
<tr>
<td>1987</td>
<td>G/VLLD</td>
<td>10</td>
<td>10</td>
<td>$(25,308.82)</td>
</tr>
<tr>
<td>1984</td>
<td>M113A2 APC</td>
<td>75</td>
<td>3</td>
<td>$(232,136.35)</td>
</tr>
<tr>
<td>1984</td>
<td>M2 machine gun</td>
<td>1,800</td>
<td>832</td>
<td>$(136,149.19)</td>
</tr>
<tr>
<td>1986</td>
<td>Night sight</td>
<td>10</td>
<td>4</td>
<td>$(1,916.46)</td>
</tr>
<tr>
<td>1986</td>
<td>Stinger missile</td>
<td>930</td>
<td>176</td>
<td>$(1,021,948.17)</td>
</tr>
<tr>
<td>1987</td>
<td>Stinger missile</td>
<td>400</td>
<td>150</td>
<td>$(2,472,291.35)</td>
</tr>
<tr>
<td>1988</td>
<td>Torpedo MK46</td>
<td>250</td>
<td>38</td>
<td>$(5,066.16)</td>
</tr>
<tr>
<td>1986</td>
<td>TOW II</td>
<td>1,200</td>
<td>985</td>
<td>$(1,660,806.68)</td>
</tr>
</tbody>
</table>

Subtotal

<table>
<thead>
<tr>
<th>Total</th>
<th>Amount Under- or Over-Allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$(5,583,454.50)</td>
</tr>
</tbody>
</table>

Total Amount Under- or Over-Allocated: $10,214,917.95
This page was left out of original document
<table>
<thead>
<tr>
<th>Recommendation Reference</th>
<th>Description of Benefit</th>
<th>Amount and/or Type or Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.1.</td>
<td>Internal controls. Procedures and controls applicable to the Special Defense Acquisition Fund would be clarified in accordance with DoD Manual 7220.9-M.</td>
<td>Nonmonetary.</td>
</tr>
<tr>
<td>A.2.a.</td>
<td>Program results. Alternate pricing procedures that would eliminate stabilized pricing should allow the Fund to be operated on a cost-recovery basis for FMS sales and would eliminate Fund profits.</td>
<td>Nonmonetary.</td>
</tr>
<tr>
<td>A.2.b.</td>
<td>Internal controls. These procedures and controls would ensure that DSAA recovers all costs incurred for the Fund on purchases of articles and services for foreign customers.</td>
<td>Nonmonetary.</td>
</tr>
<tr>
<td>A.2.c.</td>
<td>Program results. Excess profits from the Fund would be transferred to the Treasury of the United States for funding of other Government programs.</td>
<td>Collections used by the Treasury of the United States for Government operations. Actual earnings of $60.5 million put to better use in the current period on a one-time basis. Projected earnings of $37.6 million put to better use in future periods on a one-time basis.</td>
</tr>
</tbody>
</table>
**APPENDIX C: SUMMARY OF POTENTIAL BENEFITS RESULTING FROM AUDIT**
(cont'd)

<table>
<thead>
<tr>
<th>Recommendation Reference</th>
<th>Description of Benefit</th>
<th>Amount and/or Type or Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.2.a</td>
<td>Program results. The current profit in the Fund would be reduced by offsetting the costs of unsalable materiel against prior accumulated earnings rather than charging against future Fund revenues. The criteria would aid in computing surcharges, and all unsalable materiel could be dropped from inventory.</td>
<td>Fund operations would not be charged with the costs of unsalable materiel in a future period. $15.2 million of funds put to better use.</td>
</tr>
<tr>
<td>B.2.b</td>
<td>Compliance with regulations. Establishing a surcharge for unsalable items is a requirement of DoD Manual 7290.3-M.</td>
<td>Nonmonetary.</td>
</tr>
<tr>
<td>B.2.c</td>
<td>Compliance with regulations. Reconciliation of inventories is required by DoD Manual 5105.38-M.</td>
<td>Nonmonetary.</td>
</tr>
</tbody>
</table>
APPENDIX D: ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Joint Chiefs of Staff, Washington, DC

Department of the Army

Headquarters, U.S. Army Materiel Command, Alexandria, VA
Letterkenny Army Depot, Chambersburg, PA
U.S. Army Armaments, Munitions, and Chemical Command,
Rock Island, IL
U.S. Army Communications and Electronics Command,
Fort Monmouth, NJ
U.S. Army Missile Command, Huntsville, AL
U.S. Army Security Affairs Command, Alexandria, VA
U.S. Army Security Affairs Command, New Cumberland, PA

Department of the Navy

Navy International Programs Office, Washington, DC
Naval Air Systems Command, Washington, DC
Naval Sea Systems Command, Washington, DC
Space and Naval Warfare Systems Command, Washington, DC

Department of the Air Force

Deputy Under Secretary of the Air Force for International
Affairs, Washington, DC
Air Force Logistics Command, Wright-Patterson Air Force Base,
Dayton, OH
Eglin Air Force Base, FL

Defense Agencies

Defense Logistics Agency, Alexandria, VA
Defense Security Assistance Agency, Washington, DC
Defense Finance and Accounting Service, Denver, CO
This page was left out of original document
APPENDIX E: REPORT DISTRIBUTION

Office of the Secretary of Defense

Assistant Secretary of Defense (International Security Affairs)
Comptroller of the Department of Defense

Department of the Army

Secretary of the Army
Assistant Secretary of the Army (Financial Management)

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and
Comptroller)
Auditor General, Air Force Audit Agency

Defense Agencies

Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency
Director, Defense Security Assistance Agency
Director, Defense Finance and Accounting Service

Non-DoD Federal Organizations

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 Governmental Affairs
Ranking Minority Member, Senate Committee on Armed Services
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
Ranking Minority Member, House Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security,
Committee on Government Operations

33
This page was left out of original document
PART IV: MANAGEMENT COMMENTS

Comptroller of the Department of Defense
Department of the Army
Department of the Navy
Department of the Air Force
Defense Security Assistance Agency
This page was left out of original document
MEMORANDUM FOR DIRECTOR, FINANCIAL MANAGEMENT DIRECTORATE, DODIG

SUBJECT: Draft Report on the Audit of the Special Defense Acquisition Fund (Project No. OPA-0092)

In a memorandum dated June 5, 1991, you requested our comments on the subject draft audit report. Our comments are attached. Only one recommendation was addressed to the DoD Comptroller, and we concur in the intent of the recommendation. Our detailed comments are attached.

We appreciate the opportunity to provide comments on this report.

Alvin Tucker
Deputy Comptroller
(Management Systems)

Attachment
MANAGEMENT COMMENTS: COMPTROLLER OF THE DEPARTMENT OF DEFENSE (cont’d)

FINDING A. (Summary): DSAA should transfer excess sales revenues of $60.5 million, which was determined based on deliveries to customers, to the U.S. Treasury. DSAA intended to make a transfer to the U.S. Treasury of $10.7 million based on cases that had been closed. DSAA management considers revenues to be earned at case closure, not when articles and services are delivered.

DOD COMPTROLLER COMMENT: Nonconcurs that excess sales revenues should be determined at the time deliveries are made. Chapter 61 of DoD 7290.3-M, "DoD Accounting Manual," provides for gains to be reported net of any related expenses. The earliest time that all expenses are known is at the time a sales case is closed. Therefore, a profit can only be determined at case closure.


MEMORANDUM THRU ASSISTANT SECRETARY OF THE ARMY (INSTALLATIONS & ENVIRONMENT)

FOR INSPECTOR GENERAL, DOD (AUDITING)

SUBJECT: Draft Report on the Audit of the Special Defense Acquisition Fund (SDAF) (Project OFA-0052)

1. References:
   a. IG, DoD (Auditing) draft report, 5 June 1991, subject as above.
   b. DALO-SAA memorandum, 6 February 1990, subject: Special Defense Acquisition Fund (SDAF) Inventory Reporting (enclosed).

2. Concur with the finding in referenced audit stating that the MILDEPs direct their subordinate commands to submit monthly inventory reports to the Defense Security Assistance Agency (DSAA) in the format prescribed in DOD 5105.38-M.

3. Per reference 1b, the U.S. Army Security Assistance Command (USASAC) was requested to submit monthly reports to the DSAA. From that time forth, the USASAC has provided the DSAA with the prescribed monthly report.

4. Directorate for Security Assistance POC is Mel Weinstein (DALO-SAA), (703) 614-3762.

FOR THE DEPUTY CHIEF OF STAFF FOR LOGISTICS:

[Signature]

H. J. SERRER
Col., GS
Acting Director of Security Assistance

Encl

CP:
SAIG-PA
MEMORANDUM FOR COMMANDER, U.S. ARMY SECURITY AFFAIRS COMMAND, ATTN: AMSAC-MP-R, 5001 EISENHOWER AVENUE, ALEXANDRIA, VA 22333-0001

SUBJECT: Special Defense Acquisition Fund (SDAF) Inventory Reporting

1. References:
   a. DSAA memorandum, 30 Jan 1990, subject as above (enclosed).

2. Referenced memorandum stated that the HILEVCs and Defense Agencies are not submitting their monthly accountability reports for inventory items financed by SDAF. These reports are required by DoD 5105.38-M, Security Assistance Management Manual. DSAA needs these reports so they can effectively manage the SDAF program.

3. Accordingly, it is requested that USASAC start submitting this report to DSAA on a monthly basis in the format specified in ref 1b. The report for January 1990 will be forwarded to DSAA no later than 21 February 1990. Thereafter, these reports will be submitted by the tenth day following the end of the reporting month. It is further requested that DALO-SAA be provided with a copy of these reports.

4. Director for Security Assistance POC is Mr. Mel Weinstein (DALO-SAA), 694-3762.

5. NCOs - Leadership for Logistics.

FOR THE DEPUTY CHIEF OF STAFF FOR LOGISTICS:

T. H. HARVEY, JR.
Major General/ GS
Assistant Deputy Chief of Staff for Logistics (Security Assistance)
MEMORANDUM FOR ASSISTANT DEPUTY CHIEF OF STAFF FOR LOGISTICS
DEPARTMENT OF THE ARMY
DIRECTOR, NAVY OFFICE OF TECHNOLOGY TRANSFER
AND SECURITY ASSISTANCE (NAVOTSA)
DEPARTMENT OF THE NAVY
DIRECTOR OF INTERNATIONAL PROGRAMS/PRI
DEPARTMENT OF THE AIR FORCE
DIRECTOR, NATIONAL SECURITY AGENCY (DDC)

WASHINGTON DC 20301-2800

8 JAN 1990

SUBJECT: Special Defense Acquisition Fund (SDAF) Inventory Reporting

REFERENCE: DOD 5105.38-M, Security Assistance Management Manual (SAMM), Table 1400-2

The U.S. Military Departments (MILDEPS) and DOD Agencies are responsible to insure property accountability for all SDAF assets. Inventory control is an essential element in the program and financial management of the SDAF.

The mechanism for this control and accountability is the monthly inventory reporting which is required to be performed by reference. At the present time, SDAF inventory reporting appears to have been discontinued by the MILDEPS since DSAA has not received these reports in any regular fashion for some time.

Accordingly, it is requested the MILDEPS resume submitting SDAF inventory reports in the format specified by reference. The report for the period ending 31 January 1990 should be forwarded to DSAA not later than (NLT) 21 February 1990; thereafter, monthly reports should be submitted in accordance with the referenced requirement.

May I underscore that the resumption of SDAF inventory reporting and its continuation on a regular basis is a matter of high interest to DSAA. If you require further discussion of this matter, please contact my SDAF action officer, Gregory B. Cleve, extension 202-695-4448.

Sincerely,

[Signature]

GLENN A. RUDD
ACTING DIRECTOR
This page was left out of original document
MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: DRAFT REPORT ON THE AUDIT OF THE SPECIAL DEFENSE ACQUISITION FUND (PROJECT NO. OFA-0052) - ACTION MEMORANDUM

Ref: (a) DODIG memo of 5 Jun 91

Encl: (1) DON response to Draft Audit Report

I am responding to the draft audit report forwarded by reference (a) concerning the operation of the Defense Security Assistance Agency managed Special Defense Acquisition Fund.

The Department of the Navy response is provided at enclosure (1). Our nonconcurrence is not based on disagreeing with the findings of the audit team, but on the fact that procedures have been officially changed by DSAA, and have thus made the recommendation no longer valid.

DON is complying with the new procedure.

Gerald A. Cann

Copy to:
NAVINSGEN
NAVCOMPT (MCB-53)
RECOMMENDATION. We recommend that the Army Materiel Command, the Navy International Programs Office, and the Air Force Logistics Command direct their subordinate commands to submit monthly inventory reports to the Defense Security Assistance Agency in the format prescribed in DOD Manual 5105.38-M.

NAVY COMMENT. We agree. Refer to the section on, "Discussion of Details" in the background paragraph entitled "Submission of Inventory Reports" in reference (a). The monthly reporting requirement discussed in this paragraph has been revised to quarterly by Change 3 of the SAMM dated 1 March 1991. Table 1400-3 of DOD Manual 5105.38-M (attached) is provided for information. (At the time of the audit, monthly reports were required. However, experience showed that activity in the SDAF inventory did not support a monthly frequency and DSAA directed the change to quarterly.)

U.S. Navy activities have been directed to provide quarterly inventory reports in compliance with the requirements of enclosure (1). This current quarterly reporting satisfies the requirements of DSAA as specified in DOD Manual 5105.38-M and no change is necessary.
TABLE 1400-3
DEFENSE SECURITY ASSISTANCE AGENCY
SPECIAL DEFENSE ACQUISITION FUND
INVENTORY REPORT

By the tenth day following the end of the reporting quarter, the responsible Military Department will submit to DSAA an SDAF Inventory Report identifying items received and transferred during the quarter and the physical quarter-end inventory on hand.

Minimum data required:
1. Procurement Directive Program line and sub-line (i.e., MPR)
2. Item Description
3. NSN
4. Contract Data
5. Total Quantity Due in
6. Cumulative Quantity Received through End of Current Quarter
7. Quantity Due in Next Quarter
8. Date Last Due In
9. Quantity Shipped - By FMS LOA
10. Anticipated Shipments Next Quarter - Qty and FMS LOA
11. Quantity Allocated - By Country and LOA
12. Quantity On Hand at End of Current Quarter

Inventory Report Format

<table>
<thead>
<tr>
<th>MPR Line</th>
<th>Item Description</th>
<th>NSN</th>
<th>Contract Data</th>
<th>Total Quantity Due In</th>
<th>Cumulative Quantity Received</th>
<th>Quantity Due in Next Qtr</th>
<th>Date Last Due In</th>
<th>Quantity Shipped By LOA</th>
<th>Quantity Allocated By Country and LOA</th>
<th>Quantity On Hand at End of Current Quarter</th>
</tr>
</thead>
</table>

Change No. 1, March 1991
This page was left out of original document
MANAGEMENT COMMENTS: DEPARTMENT OF THE AIR FORCE

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C.

2 JUN 1991

SUBJECT: DoD IG Draft Report on The Audit of The Special Defense Acquisition Fund (Project No. OPA-0052) (yracco, 20 Jun 91)

SAP/FMFF

1. This letter is in reply to the request for management comments to the subject draft audit. We concur with the findings and recommendations in the draft audit report. Specifically, the submission of the Inventory Report as required by the Security Assistance Management Manual (SAMM), DoD 5105.38-M, has been reinstated. The Air Force subordinate commands will, through the International Logistics Center at Air Force Logistics Command, submit the format prescribed in the SAMM.

2. The OPR for this report and subsequent actions should be changed to SAP/IAP. This is an AF/LGR, SAP/FFM and SAP/IAP coordinated response.

[Signature]

W.D. HAWKINS, COL, USAF
Acting Director, Concepts & Integration
DCS/Logistics
This page was left out of original document
MEMORANDUM FOR THE DIRECTOR, FINANCIAL MANAGEMENT
OFFICE OF THE INSPECTOR GENERAL, DOD

SUBJECT: Draft Report on the DoD IG Audit of the Special
Defense Acquisition Fund (Project No. OPA-0052)

REFERENCE: (a) DoD IG Memorandum, June 5, 1991, Transmittal
of the Subject Report
(b) Meeting Between Ms. Nancy Butler, DoD IG,
Director of Financial Management, and Mr. Glenn Rudd, DSAA Deputy Director,
June 26, 1991, subject as above

This memorandum forwards the comments of the Defense
Security Assistance Agency (DSAA) to the subject draft
report.

Our response addresses each of the findings and
Recommendations as required by reference a. We wish to
highlight our particular concerns with the elements of the
draft report related to the interpretation of the policy of
no-loss, no-gain; to the suggested revision of Stabilized
Pricing; to the requirement to establish a prospective SDAF
surcharge; and, to the return of SDAF funds to the U.S.
Treasury based on case deliveries. Our specific dis-
agreements with these elements were also discussed during
the referenced b meeting.

We appreciate the opportunity to comment on the draft
report. The point of contact for this response is Gregory
Cleva, DSAA/Plans/SDAF, extension 695-4448.

GLENN A. RUDD
ACTING DIRECTOR

Attachment:
As stated
FINDING A. PRICING OF CUSTOMER SALES

Pricing officials in the Military Departments overpriced or underpriced articles and services sold from the Special Defense Acquisition Fund (the SDAF). Overpricing occurred because the Defense Security Assistance Agency (DSAA) charged foreign customers either the historical cost or the current DoD contract price, whichever was higher. Underpricing occurred because DSAA had not established effective controls to ensure that all relevant costs were charged to the prices of articles and services sold from the Fund. As a result, the Fund's estimated sales revenues exceeded projected costs by $113.3 million.

DSAA'S RESPONSE TO FINDING A.

Nonconcurs with this finding related to "overpricing", "underpricing", and to the subordinate conditions reported that address DSAA's policy of no-loss, no-gain on FMS and the prospective financial impact of $113.3 million.

We disagree with the assertion that "overpricing" occurred. The underlying concept of "no-loss, no-gain", referred to in the report, does not apply to the SDAD on a transaction by transaction basis as referred to in the draft report. Considering the loss and gain aspects separately, the no-loss concept has its basis in the Arms Export Control Act (AECA) for sales from stock and new procurements, Sections 21 and 22, respectively. For these sales, the no-loss concept applies to the FMS Trust Fund at individual case level. The SDAD, on the other hand, is a revolving fund, as legislated by Chapter 5 of the AECA. This distinction is in law is important. It affords the DoD the alternative to manage the no-loss aspect of SDAD sales at the corpus fund level rather than by individual case.

Similarly, a distinction must be drawn between the FMS Trust Fund and the SDAD with regard to the no-profit concept. The DoD charges prices to foreign governments that represent the actual or estimated replacement cost of the assets sold under Sections 21 and 22 of the AECA. The DoD policy implementing this law excludes the making of a profit on those sales. SDAD pricing policies, however, were never intended to preclude earnings on individual sales that could be used to offset losses on other sales.

The finding states that "the use of stabilized pricing to determine the prices of articles sold from the Fund did not achieve the no-loss, no-gain objective the DSAA had established for FMS" (p. 11). This misrepresents DSAA's position. The objective of stabilized pricing is full cost recovery. Stabilized pricing has been approved by OSD and included in DoD 7290.3-M.
Stabilized pricing charges the higher of the SDAP cost or the latest contract price. This policy contains a self-correcting mechanism that insures earnings are sufficient to cover the normal cost of operations and to recover occasional losses when unsalable assets are written off or sold at reduced prices. In a sense, stabilized pricing provides for a built-in surcharge. It is also an equitable pricing tool. The SDAP account benefits by modest earnings over normal operating costs. Foreign customers of the SDAP benefit from having a fixed price, and, usually, SDAP provides a better (lower) price than the country would see on a normal sales case. There is also a general fairness for all FMS in that stabilized pricing avoids the effects of widespread price disparities between normal FMS and SDAP.

Foreign customers pay prevailing prices at the time of sale for SDAP assets. This is not an overcharge, but represents a slight premium paid by foreign customers for receiving an item earlier than normal delivery. Since financial requirements are fixed and fully known in advance of case acceptance, the FMS customer is able to budget and plan in an orderly fashion.

We oppose changing the rules for stabilized pricing. Should we be required to charge historic prices, rather than stabilized prices, foreign governments would receive a substantive price break, which was not the intent of Congress with respect to SDAP assets. Also, charging historic prices for SDAP assets would permit some foreign purchasers to compete the SDAP against current commercial contractor prices and affect negotiations for such assets. This would be unfair to U.S. producers.

The finding states that SDAP assets were underpriced, and that "relevant costs" totalling $10.2 million were not recouped. Specifically, the audit report states that "Pricing officials at the Military Departments had not properly included costs for spare parts, support, and product engineering in FMS cases prices for 40 of 49 major defense items sold by the Fund (Appendix B)." We disagree with the finding that costs for spare parts and support items should be included as "relevant costs" when only related end items are sold. Spares and support items are almost never sold in the same proportion as when they were bought. This difference naturally occurs because foreign governments have different fielding requirements for spares and support items. The SDAP charges for assets delivered to the foreign governments, but the foreign governments choose which spares and support items they desire.

The finding also includes "engineering services" in its claim that costs were inaccurately allocated. We agree that engineering services are legitimate charges to foreign
MANAGEMENT COMMENT: DEFENSE SECURITY ASSISTANCE AGENCY (cont’d)

customers when related end items are sold. We note that the auditors review of closed cases, discussed on pages 14 and 15 of the draft report did not disclose unallocated engineering costs.

The finding provided three examples to support its "pricing errors": TPS-70 radar, TPQ-37 radar, and Maverick missiles. We found all three examples to contain material misstatements of fact.

Two TPS-70 radars were purchased by the SDAF and subsequently sold. The first was sold at full cost and included $2.9 million in spares and support items. The second radar was sold at a discounted price and included $1.4 million in spares and support items. (It should be noted that the DoD IG’s 1987 audit of the SDAF identified the second TPS-70 radar as a potentially unsaleable item.) SDAA now has roughly $600,000 in unsold spares being held for sale to other customers. The finding erroneously states that $2.1 million in costs related to the two radars had not been charged.

The next example states that a TPQ-37 radar was sold and $2.1 million in costs for spare parts, live fire testing, and support services were not charged. The one radar in question was sold at a stabilized price and we expect a profit of about $433,000. The spares in question were not sold and remain available for other FMS customers.

For the last example, the finding projects a possible underbilling of $380,000 on Maverick missile sales. We project a profit. SDAF has purchased $2.6 million in test sets, training missiles, maintenance trainers, missile loaders and launchers. Of this total, $1.4 million has been sold and another $500,000 has been approved for sale. Only $700,000 remains to be sold, and a gain greater than this amount is expected to be collected when the remaining end items are sold at stabilized prices. We cannot agree with the finding's projections of possible underbillings.

The audit finding states that “based on cases implemented as of July 31, 1990, stabilized pricing will result in projected profits of $113.3 million (excess revenues over actual costs) for the Fund” (p. 13). SDAA should transfer $60.5 in earned excess revenues to the U.S. Treasury (p. 18). The $60.5 million amount is based on the estimated value of deliveries on SDAF sales cases. The $113.3 million and $60.5 million are prospective amounts of excess revenues. All costs related to the computation of the amounts have not been finalized. SDAA accepts the fact that revenues are realized based on reported deliveries to the foreign customers; however, knowing only the amount of revenue generated is not sufficient to determine gains or losses on sales. We must also know the cost of goods sold.
MANAGEMENT COMMENT: DEFENSE SECURITY ASSISTANCE AGENCY (cont’d)

in accordance with the matching concept to bring together revenues and expenses. Unless this matching occurs, the decision to declare a profit would be premature and not in agreement with generally accepted accounting principles. We object to the amounts included in the report and the transfer of excess revenues to the U.S. Treasury before actual costs are matched against these revenues.

RECOMMENDATIONS FOR CORRECTIVE ACTION


2. Although not directed to DSAA, we partially concur with this recommendation. We accept the point that revenues are recognized based on reported deliveries to the FMS Trust Fund. This acceptance, however, does not support the following recommendations that prospective profits should be transferred to miscellaneous receipts of the U.S. Treasury. Revenues are based on reported deliveries. Related expenses are recognized when all deliveries for a particular case line are reported. Lastly, profits or losses are recognized at case closure, which is the earliest point in the life cycle of a case when revenues and expenses can be matched. For SDASF cases, this matching usually occurs one or two quarters following delivery completion for each line.

2a. We recommend that the Director, Defense Security Assistance Agency develop and implement pricing procedures as an alternative to stabilized pricing to ensure that the Special Defense Acquisition Fund is operated on a cost-recovery basis, as required by the Arms Export Control Act and DoD Manual 7290.3-M, and to ensure that excess sales revenues (profits) are eliminated.

2a. Nonconcur. The SDASF is operated in full compliance with the AECA and DoD 7290.3-M. Full cost recovery is built into the theory and procedural practices followed by the Military Departments when pricing SDASF sales cases. Excess sales revenues, should they occur, result from the conditions prevailing at the time sale. Stabilized pricing provides a fair method of pricing SDASF assets that is applied uniformly to all FMS purchasers and is accepted by them. This policy assures that the emphasis on sales from the fund addresses the equipment needs of the foreign governments and not their financial shortfalls. A major foreign objection to FMS, that final prices are never known
MANAGEMENT COMMENT: DEFENSE SECURITY ASSISTANCE AGENCY (cont’d)

for sure, is resolved with SDAP sales. SDAP prices are fixed. Also, refer to the response made for Finding A.

2b. We recommend that the Director, Defense Security Assistance Agency develop procedures and controls to identify and allocate to the prices of articles and services sold to foreign military sales customers all costs of acquiring SDAP material.

2b. Partially concur to the extent this recommendation is not addressing spare parts, support assets, and ancillary equipment that may be sold separately from the related end item. Concomitantly, we support full allocation of costs for program support and other indirect cost elements incurred to produce end products.

2c. We recommend that the Director, DSAA transfer the earned excess revenue of $60.5 million from the SDAP to the U.S. Treasury, write off the $15.2 million in unsalable articles against the remaining $52.8 million in projected excess revenues, and transfer the residual balance of $37.6 million to the U.S. Treasury as deliveries are made to foreign military sales customers.

2c. Partially concur. DSAA will transfer excess SDAP revenues to the miscellaneous receipts account of the U.S. Treasury. However, such transfers must be made in accordance with generally accepted accounting principles and DoD policies. To that end, DSAA realizes profits or losses on sales case at the time of case closure and not as deliveries are processed. The time delay between delivery complete status and the processing of case closure is normally not more than one or two quarters for SDAP cases and does not represent a material difference. DSAA obtained concurrence from the Office of Management and Budget (OMB) for its policy to recognize profits at case closure.

We partially concur with the idea of writing off unsalable assets; however, DSAA has not reached its conclusion regarding what assets are unsalable. Further, should DSAA write off the value of such assets, we believe it prudent to provide the option to retain the assets should later sales opportunities occur.

We nonconcur with the recommendation to transfer the residual $37.6 million in excess revenues based on reported deliveries. Such excess revenues will be recognized at case closure and the ultimate transfer to miscellaneous receipts will be taken in coordination with OMB.
FINDING B. INVENTORY MANAGEMENT

The Defense Security Assistance Agency (DSAA) had not established a surcharge to recoup from FMS customers the costs of excess and unsalable material purchased for the Special Defense Acquisition Fund (the Fund). DSAA's inventory records of Fund assets had different balances from the Military Departments' inventory records. This occurred because the Military Departments were not submitting the required monthly inventory reports that DSAA needed to reconcile balances and identify unsalable material. Further, DSAA and the Military Departments used different criteria to compute inventory quantities and dollar values of Fund assets. As a result, the Fund had not billed customers a surcharge to recover costs of $15.2 million for unsalable material and did not have effective inventory management controls over assets costing $259.6 million.

DSAA'S RESPONSE TO FINDING B

Nonconcur in the following elements of the Finding: the Fund retained $15.2 million of unsalable material; and, the DSAP did not have effective inventory management controls over Fund assets.

Partially concur in the following elements of the Finding: the inventory records of the Military Departments and DSAA were discrepant because different methodologies were used to compute quantities and dollar values of inventory assets; and, the Military Departments were not submitting the required monthly (quarterly) inventory reports in the format required in Chapter 14 of DoD 5105.38, the Security Assistance Management Manual (SAMM).

We disagree with the DoDIG's Finding that the DoD 7290.3-M, FMS Financial Manual, requires DSAA to establish an annual SDAP surcharge. Rather, the DoD 7290.3-M is permissive in this area. It allows DSAA to establish an annual surcharge, but does not require that such a surcharge be established. Specifically, DoD 7290.3-M, Paragraph 71807, states that, "...a special SDAP surcharge will be applied, as necessary, to recover the cost of SDAP inventory losses, pilferage, obsolescence, and any loss of SDAP proceeds resulting from sales at reduced prices."

We highlight the phrase, "as necessary," to point out that an SDAP surcharge would be employed only if certain conditions necessitated its use. The DoD 7290.3-M, Paragraph 71807, states that, "The purpose of this surcharge is to maintain the solvency of the SDAP account." Accordingly, the primary condition for establishing a
MANAGEMENT COMMENT: DEFENSE SECURITY
ASSISTANCE AGENCY (cont'd)

sucharge would be if inventory losses cause the SDAF to
suffer a net loss at the Fund level, thereby eroding its
capitalization. This condition has never existed in the
SDAF. Moreover, the successful implementation of stabilized
pricing as a built-in surcharge--a self-correcting
mechanism--that allows earnings on some transactions to be
offset against losses on others, in the aggregate, the Fund
has always operated on a solvent basis.

The finding likewise suggests that DSAA should
establish a surcharge to recover the costs of potentially
unsalable material projected for the future. It is our
intention to address this point fully in our response to
Recommendation 1.b. However, it is to be emphasized that
generally accepted pricing and accounting practices sanction
the use of a surcharge principally to recover operating
losses. This raises serious questions regarding the use of
a prospective surcharge--particularly in circumstances where
there is no net Fund loss or projected estimate of
potentially unsalable material.

The finding indicates that the Fund retained
approximately $15.2 million in unsalable material that
should now be offset against anticipated SDAF earnings.
This material was estimated to consist of 1,658 items,
valued at $6.3 million, that had no recorded customer demand
or other transaction activity for 3 years. To these items
were added 20 GPU-5A gun pods, valued at $7.3 million,
and associated support, valued at $1.5 million.

We concur we should net this amount against SDAF
earnings prior to returning funds to the U.S. Treasury.
Additionally, future SDAF accounting reports will reflect an
adjustment in equity for assets deemed unsalable.

Apart from this accounting adjustment, however, we
believe it is in the interest of the U.S. Government for the
SDAF to pursue selling these articles at cost or at a
reduced value, rather than exceeding them at minimal cost
recovery. Several factors argue for this approach. The May
1991 Code 7 (SDAF assets) reports for the U.S. Army
Commands--the source data for the DoDIG Finding--now show
approximately 1,547 items, valued at $3,466,047.68 with no
transaction activity for 3 years. This represents a
reduction of 11 items and approximately $2.8 million in
assets in the 10 months following the DoDIG review. In
large part, this reduction of remaining assets resulted from
SDAF Program Management Reviews (PMRs), conducted in the
period August 1990-May 1991, that highlighted the need for
aggressive action by the Military Departments to sell any
remaining assets procured into the Fund prior to FY 1987.
Similar actions to either place these items on FMS sales
cases or to have them procured into MILDEF inventories, with
SECDEF approval, are ongoing at all of the major Commands.
Further, the report creates the impression that inactive inventory is a problem throughout the entire SDADF--a problem generic to all commodities and commands. In fact, 1,295 or 84% of the 1,547 items listed in the May 1991 Code 7 (SDAF assets) reports are retained by the U.S. Army Communication and Electronics Command (CECOM). This equates to approximately $2.9 million of the $3.5 million total of assets with no transaction history for over 3 years. Our examination of this list indicates that the majority of these items are associated with end items such as TPQ-36 and TPQ-37 radars and PRC-77 radios that SDADF presently has on-hand or on-order. These assets are salable with the associated end item, or potentially marketable on non-SDADF FMS cases or to the Military Departments.

We acknowledge that the GPU-5A gun pods remain unsold after several years in SDADF inventory. Recent developments, however, make us reluctant to classify these systems as unsalable. In the last year, we have had inquiries from two FMS customer countries regarding the gun pods, and have actually made an informal allocation of 5 systems to one of these countries. Moreover, the GPU-5A gun pods can be carried on the F-4, F-5, and A-10 aircrafts. The A-10 aircraft performed particularly well during Desert Storm. The U.S. Air Force has announced plans to sell approximately 200 A-10s worldwide. Accordingly, the potential for sale of the GPU-5A in the FMS community at full- or near full-cost recovery is still viable.

We agree with that element of the report's findings that the Military Departments are not submitting inventory reports on a quarterly basis in the format prescribed in Chapter 14, Table 1400-3 of DoD 5105.38-H, the Security Assistance Management Manual (SAMM). We have addressed this point in correspondence with the MILDEP's, as well as part of our 1990 Vulnerability Assessments under the Federal Managers' Integrity Act (FMIA). For the most part, SDADF records are focused on asset allocation, whereas MILDEF records cite on-hand inventory data. The provision of MILDEF inventory information in the SAMM format would likely have allowed the audit team to reconcile the reported discrepancy between the $248.9 million in SDADF inventory records and the $259.6 million in MILDEF records. It would also improve our ability to track physical inventory.

The fact that we are not receiving inventory information in the SAMM format is not the same as saying we are receiving no inventory information. Both the U.S. Navy and the National Security Agency (NSA) provide DSAA regular inventory information; the U.S. Army provides a detailed allocation report on a monthly basis from which physical inventory information can be derived. Additionally, DSAA/SDAF is in daily contact with the MILDEF's and various
MANAGEMENT COMMENT: DEFENSE SECURITY ASSISTANCE AGENCY (cont’d)

Command directs their subordinate commands to submit monthly inventory reports to the Defense Security Assistance Agency in the format prescribed in DoD Manual 5105.38-M.

1. Concur. Although DSAA is receiving periodic information regarding SAIP inventory from the Military Departments and the Defense Agencies, it is not being provided in the format specified in the SAMM. The data elements in the SAMM format are necessary to track physical inventory. To facilitate SAIP inventory reporting, DSAA modified this requirement from a monthly to a quarterly report in the March 1991 revision to the SAMM.

2a. We recommend that the Director, Defense Security Assistance Agency establish criteria to determine when Special Defense Acquisition Fund material should be classified as unsalable for the purpose of computing surcharges and dropped from inventory.

2a. Partially concur. The DoD 7290.3-M currently includes criteria for unsalable assets that could be utilized in determining the need for an SDAF surcharge. Specifically, Paragraph 71807 cites SDAF inventory losses, pilferage, and technological obsolescence. Obviously, articles in any of these categories are unsalable as SDAF assets. To these, we would add the condition of non-marketability. Accordingly, an item having no current or probable future market would be considered unsalable for the purposes of dropping it from inventory. We emphasize that this condition must be viewed in relative terms. The non-marketability of assets may be correlated with the length of time items have remained inactive in inventory, but this is not an absolute correlation. For example, sales for which items were originally procured may not develop, but future markets can still be projected. Additionally, efforts such as increasing management attention to sell the item, reducing the asset's price, and, possibly, altering its configuration to make it more salable must be considered before an item is said to have no market. DSAA will recommend that the DoD 7290.3-M be changed to add the condition of non-marketability to the other criteria for unsalable assets.

2b. We recommend that the Director, Defense Security Assistance Agency establish a Special Defense Acquisition Fund surcharge to be applied to Foreign Military Sales cases to recover the costs of any future losses that may result from unsalable items, as required by DoD Manual 5105.38-M.

2b. Nonconcur. We have serious reservations in employing an SDAF surcharge as long as the Fund is operating on a solvent basis. In general, this is due to the successful implementation of stabilized pricing. As a method of insuring full cost recovery, stabilized pricing acts as a built-in surcharge—a self-correcting mechanism—that allows
project offices. From a management perspective, this provides DSAA real time status of the SDAF physical inventory.

As part of the finding, the report specifically cites the AN-PRC-77 radio sets and the KG-40 COMSEC equipment as examples of discrepant balances in MILDEF and DSAA inventory records. The audit team's first visit to CECOM coincided with the initial stages of Desert Shield—a period when PRC-77 deliveries and allocations were in a state of considerable flux. CECOM and DSAA records were substantially reconciled during their December 1990 Program Management Review. The discrepancy cited for KG-40s can only be attributed to an administrative error in the A-3 SDAF report for that time period. All KG-40 COMSEC physical inventory is carefully managed and tracked by the U.S. Navy. Both of these items have been reviewed with the respective MILDEP and fully reconciled at the present time. Their status is shown below:

<table>
<thead>
<tr>
<th>Item</th>
<th>PRC-77</th>
<th>KG-40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Procured</td>
<td>10,993</td>
<td>130/130</td>
</tr>
<tr>
<td>Total Allocated</td>
<td>1,112</td>
<td>130/130</td>
</tr>
<tr>
<td>Total Sold</td>
<td>9,821</td>
<td>123/130</td>
</tr>
<tr>
<td>Quantity Received</td>
<td>9,243</td>
<td>130/130</td>
</tr>
<tr>
<td>Quantity Due-in</td>
<td>1,750</td>
<td>0/0</td>
</tr>
<tr>
<td>Quantity Shipped</td>
<td>7,897</td>
<td>123/130</td>
</tr>
<tr>
<td>Quantity On-Hand</td>
<td>1,346</td>
<td>7/0</td>
</tr>
</tbody>
</table>

The report states that DSAA uses a computational method to determine inventory quantities and values. It is true that the DSAA MIS derives a fiscal inventory for the SDAF based on the total value of articles procured into the SDAF less the value of articles sold and allocated. DSAA does not equate this fiscal inventory of remaining assets with the physical inventory of on-hand assets in the custody of the MILDEP. We disagree, however, with the report's finding that these records cannot be meaningfully reconciled, and that DSAA should establish an inventory control system to accomplish this reconciliation. DSAA already possesses a vehicle to accomplish inventory control and reconciliation in the SDAP MIS. What is needed is MILDEF reporting in the format specified in Table 1400-3 of the SAM--a subject addressed earlier in the DoDIG finding. This quarterly data for physical inventory could be loaded to the SDAP MIS and tracked accordingly. The DSAA MIS would then possess all relevant fiscal and physical inventory information for the SDAF.

**Recommendations for Corrective Action**

1. We recommend that the Army Material Command, the Navy International Program Office, the Air Force Logistics
looses on some transactions to be absorbed by earnings on others. In the aggregate, stabilized pricing insures that the SDAP is financially sound.

We would also highlight our disagreement with the use of a surcharge that is prospective and generic in nature. Should conditions ever warrant that an SDAP surcharge be used, it would be our policy to assess a surcharge that is specific to the loss incurred. Essentially, we would seek only to recoup for the amount that has been lost, and from the business base closest to the procurement that incurred the loss.

c. We recommend that the Director, Defense Security Assistance Agency establish an inventory control system for the Special Defense Acquisition Fund that is reconcilable with the Military Departments' systems.

2c. Partially Concur. In managing the SDAP, DSAA is concerned with tracking the allocation status of the Fund's assets. Hence, its reports are focused on allocations, and, derivatively, on maintaining a fiscal inventory of the Fund. Concomitantly, the Military Departments have custodial responsibility for SDAP assets. Their reports are focused on control of on-hand assets and maintenance of a physical inventory. We agree that these records of fiscal and physical SDAP inventory should be reconciled. We disagree that an inventory control mechanism to accomplish this reconciliation has not been established. The SDAP MIS can accomplish this reconciliation, provided that the Military Departments furnish quarterly inventory information to DSAA in the format of Table 1400-3 of the SAMM. Consequently, we believe that the corrective action associated with Recommendation 1 also applies here.
The following acronyms are used in this report.

AECA........................................Arms Export Control Act
DSAA........................................Defense Security Assistance Agency
FMS........................................Foreign Military Sales
LOA...........................................Letter of Offer and Acceptance
MIPR..........................Military Interdepartmental Purchase Request
NAVAIR...............................Naval Air Systems Command
NAVSEA..................................Naval Sea Systems Command
NSA........................................National Security Agency
SAAC..........................Security Assistance Accounting Center
List of Audit Team Members

Nancy L. Hendricks, Director
David R. Stoker, Deputy Director
Alvin L. Madison, Program Director
Martin J. Torpey, Program Manager
Samuel J. Scumaci, Team Leader
Titus S. Simmons, Team Leader
Thomas Smith, Team Leader
Julius L. Hoffman, Auditor
Michael J. McKinnon, Auditor
Louise Merdinian, Auditor
James R. Slates, Auditor
INTERNET DOCUMENT INFORMATION FORM

A. Report Title: The Special Defense Acquisition Fund

B. DATE Report Downloaded From the Internet: 06/12/99

C. Report's Point of Contact: (Name, Organization, Address, Office Symbol, & Ph #):
   OAIG-AUD (ATTN: AFTS Audit Suggestions)
   Inspector General, Department of Defense
   400 Army Navy Drive (Room 801)
   Arlington, VA  22202-2884

D. Currently Applicable Classification Level: Unclassified

E. Distribution Statement A: Approved for Public Release

F. The foregoing information was compiled and provided by:
   DTIC-OCA, Initials: ___VM___ Preparation  Date 06/12/99

The foregoing information should exactly correspond to the Title, Report Number, and the Date on the accompanying report document. If there are mismatches, or other questions, contact the above OCA Representative for resolution.