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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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INTERNATIONAL DIVISION

JUL 14 1971

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Dear Mr. Secretary:

The General Accounting Office has made a review of selected activities relating to the liquidation of the Foreign Military Sales Fund. Our review was performed principally at the Office of the Assistant Secretary of Defense for International Security Affairs and, to a limited extent, at the Treasury Department and the Export-Import Bank of the United States.

The Foreign Military Sales Fund was authorized as a revolving loan fund by the 1965 amendment to the Foreign Assistance Act of 1961 which had the effect of expanding the loan activities authorized by prior foreign assistance legislation. Initial capitalization of the fund on July 1, 1965, was $153,252,001 which had increased to $381,175,080 as of June 30, 1968, when the fund was terminated. During this period, direct loans and guarantees of private and Export-Import loans with a 25 percent reserve were authorized under the Foreign Assistance Act. Principal and interest proceeds from loan repayments were authorized to be used to make additional loans and guarantees on a revolving basis. Pursuant to this and prior authorizations extending back to 1955, DOD had, by June 30, 1968, financed direct loans and guaranteed loans totaling about $1.5 billion.

Authority for the revolving fund to make new loans was terminated as of June 30, 1968, by the 1967 amendment to the Foreign Assistance Act of 1961. At that point the fund entered an estimated 10-year liquidation period.

Unnecessary Retention of Money Excess to Fund Needs

Our review showed that money, which could otherwise have been returned to the general fund of the Treasury during the period of fund liquidation, was being retained because of a questionable anticipation of defaults on repayments by foreign countries. As of June 30, 1970, about $181.6 million of funds was being held in reserve to cover contingency defaults on outstanding loans and commitments amounting to about $526.2 million, even though DOD has never experienced a default on

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its credit sales. This amounted to approximately a 35 percent reserve at June 30, 1970. Additional funds were being unnecessarily retained to cover commitments to make loans directly from the fund, even though a cash flow analysis indicates that funds necessary to cover these direct commitments will be available from repayments received from other loans outstanding.

The Foreign Assistance Act of 1967 terminated DOD's authority to make loans from the fund as of June 30, 1968, and required that all assets of the fund be transferred to a special account of the Treasury. The assets of the special account are to be available to discharge outstanding liabilities and obligations incurred by the fund prior to June 30, 1968, and any monies in excess of the aggregate United States dollar amount of the liabilities and obligations are to be withdrawn from the special account and deposited to the general fund of the Treasury.

DOD Interpretation

This legislation has been interpreted by DOD to mean that they should retain money required for the reserve for guarantee of private and Export-Import Bank loans in the amount established at June 30, 1968, and they should also retain money necessary to satisfy direct commitments. In this regard, it is DOD's view that only money above these requirements should be returned to the general fund of the Treasury. Accordingly, the DOD transferred only about $2.3 million to the Treasury at June 30, 1968, and approximately $5.6 million at June 30, 1970.

DOD officials informed us that their preference for this interpretation as opposed to returning any money not needed currently or in the foreseeable future, was influenced by the concern of officials of the Export-Import Bank of the United States that sufficient reserves might not be retained and, in that event, defaults could create the necessity of requesting a supplemental appropriation to repay the Export-Import Bank.

With regard to the above, Export-Import Bank officials informed us that former Export-Import Bank officials had expressed such concern when the fund was terminated and, in their opinion, the DOD interpretation seems quite reasonable. They expressed uncertainty about availability of funds in the event defaults were higher than the reserve.

GAO Analysis

As of June 30, 1968, at the beginning of the liquidation period, funds of about $181.6 million had been reserved to guarantee a contingent liability of about $724.2 million to the Export-Import Bank and private lending institutions. The $181.6 million was approximately 25 percent of the contingent liabilities to be guaranteed at that date. This was in accordance with the Foreign Assistance Act of 1961, as amended, which required a minimum 25 percent reserve. The FAA states:

> "Obligations shall be recorded against the funds available for credit sales under this part in an amount not less than 25 per centum of the contractual liability related to any guaranty, insurance, coinsurance, and reinsurance issued pursuant to this part and the funds so obligated together with fees and premiums shall constitute a single reserve for the payment of claims under such contracts."

The FAA also specifies that the guarantees are backed by the full faith and credit of the United States.

By June 30, 1970, the contingent liability to the Export-Import Bank and private lending institutions had been reduced to about $526.2 million.

Based on the Department of Defense interpretation, however, the reserve was maintained at $181.6 million rather than being proportionately reduced. While the 1967 amendment to the Foreign Assistance Act may permit the interpretation given it by DOD, it appears to us that prudent management of Government funds requires that any money excess to actual needs be returned to the general fund of the Treasury where it can be made available for other purposes.

It is our opinion that the reserve should be based on historical experience and managerial analysis rather than on arbitrary 100 percent reserve. Historical experience by itself would indicate that no reserve is necessary because no defaults have ever occurred.

It seems to us that the fund should be maintained at the minimum 25 percent required by the Foreign Assistance Act until such time as a managerial analysis indicates a reserve above 25 percent is necessary.

On the basis of a minimum 25 percent, the reserve could have been reduced by about $24.3 million by June 30, 1969, and could have been further reduced by about $50.1 million by June 30, 1970. Similarly, as of June 30, 1969, funds amounting to $83.7 million were also being retained in the fund to cover direct commitments of the fund. By the following year, June 30, 1970, funds being retained for this purpose had increased to $104.8 million. These funds were being retained even though a cash flow analysis of the fund prepared by DOD officials indicates that they were excess to fund needs as of these dates.

It is our opinion that retention of these excess funds is unnecessary since sufficient money will be available for this purpose from repayment of other loans outstanding.

On a combined basis of need plus a cash reserve for guarantees limited to 25 percent, approximately $107.9 million was excess to needs at June 30, 1969, and approximately $154.9 million was excess at June 30, 1970.

We were informed by Treasury Department officials that if excess money were transferred to the general fund of the Treasury, it would be available for other purposes. As long as the money remains in the special fund account it must be reserved for possible fund expenditure.

We believe that prudent management requires retention of only those amounts reasonably necessary as opposed to the current practice of retaining the maximum allowable by law. Furthermore, we believe that the DOD should evaluate this reserve requirement and establish the level of the reserve, using historical experience and analysis of loans outstanding as the appropriate basis. It is our opinion that, in view of the Foreign Assistance Act requiring a minimum 25 percent reserve, the reserve should be limited to 25 percent of guaranteed liabilities, at least until an analysis of loans or amounts of loans outstanding indicate a real possibility of default in excess of 25 percent. We believe that the amount of money retained in the fund to discharge outstanding liabilities and obligations should be limited to amounts needed to discharge current direct obligations, taking into consideration normal fluxuations in fund balances, as opposed to the present practice of retaining 100 percent of aggregate direct liabilities and obligations. All funds in excess of the 25 percent reserve and funds retained to discharge current liabilities and obligations should be promptly returned to the general fund of the Treasury.

B-165731

Need for Internal Audit
of Fund Accounting System

We were informed that no internal audit of the fund's activities has been made since its establishment on July 1, 1965.

The internal audit function uniquely supplements routine management checks through its independent approach and methods of review. The internal audit function is one of the essential tasks of management that complements all other elements of management control. It assists management in attaining its goals by furnishing information, analysis, appraisals, and recommendations pertinent to the adequacy on individual performances, policies and procedures established and other elements of control.

We believe that periodic internal audits are essential to establish an orderly method of winding up fund affairs in anticipation of final liquidation in 1978.

We request that our Office be informed of the actions taken in regard to this matter and that we be furnished with the results of any internal audits undertaken, including copies of the internal audit reports.

Copies of this letter are being furnished to the Senate Committee on Foreign Relations, the Senate Committee on Appropriations, the House Committee on Foreign Affairs, the House Committee on Government Operations, the House Committee on Appropriations, the Director, Office of Management and Budget, and the Chairman and President of the Board of the Export-Import Bank.

Sincerely yours,

Oye V. Stovall

Oye V. Stovall
Director

The Honorable
The Secretary of Defense