

September 2010

IRAQI-U.S. COST-SHARING

Iraq Has a Cumulative Budget Surplus, Offering the Potential for Further Cost-Sharing



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Why GAO Did This Study

Since 2003, the United States has reported obligating \$642 billion for U.S. military operations in Iraq and provided about \$24 billion for training, equipment, and other services for Iraqi security forces. To assist Congress in overseeing efforts to encourage the Iraqi government to contribute more toward the cost of securing and stabilizing Iraq, this report provides information on (1) the amount and availability of Iraq's budget surplus or deficit, (2) the amount of Iraq's financial deposit balances, and (3) the extent to which Iraq has spent its financial resources on security costs. To conduct this audit, GAO analyzed Iraqi financial data, reviewed U.S. and Iraqi documents, and interviewed U.S. and Iraqi officials.

What GAO Recommends

GAO believes that Congress should consider Iraq's available financial resources when reviewing the administration's fiscal year 2011 budget request and any future funding requests for securing and stabilizing Iraq. Also, GAO recommends that the Departments of State and the Treasury work with the Iraqi government to further identify available resources. This includes assisting Iraq in completing IMF-required reviews of outstanding advances and central government accounts. State and Treasury agreed with the recommendation, although State, Treasury, and DOD had different perspectives on how much money would be available for cost-sharing.

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IRAQI-U.S. COST-SHARING

Iraq Has a Cumulative Budget Surplus, Offering the Potential for Further Cost-Sharing

What GAO Found

GAO analysis of Iraqi government data showed that Iraq generated an estimated cumulative budget surplus of \$52.1 billion through the end of 2009. This estimate is consistent with the method that Iraq uses to calculate its fiscal position. Adjusting for \$40.3 billion in estimated outstanding advances as of September 2009 reduces the amount of available surplus funds to \$11.8 billion. In April 2010, a senior Ministry of Finance official stated that advances should be deducted from the budget surplus because they are committed for future expenditures or have been paid out. According to this official and Board of Supreme Audit reports on Iraq's financial statements, advances include funds for letters of credit, advance payments on domestic contracts, and other advances. However, Iraq's Board of Supreme Audit has raised concerns that weaknesses in accounting for advances could result in the misappropriation of government funds and inaccurate reporting of expenditures. Furthermore, the composition of some of these advances is unclear; about 40 percent of the outstanding advances through 2008 are defined as "other temporary advances." Under the terms of a February 2010 International Monetary Fund (IMF) arrangement, Iraq agreed to prepare a report on its outstanding advances, which will identify those advances that are recoverable and could be used for future spending, and set a time schedule for their recovery. This Iraqi report is to be completed by September 30, 2010.

Another means of assessing Iraq's fiscal position is to examine its financial deposit balances. Iraqi government data and an independent audit report show that, through the end of 2009, Iraq had accumulated between \$15.3 billion and \$32.2 billion in financial deposit balances held at the Central Bank of Iraq, the Development Fund for Iraq in New York, and state-owned banks in Iraq. This range reflects a discrepancy between the amount of government-sector deposits reported by the Central Bank of Iraq to the IMF and the amount that the Ministry of Finance asserts is available for government spending. In November 2009, the Ministry of Finance reclassified \$16.9 billion in state-owned banks as belonging to state-owned enterprises and trusts, leaving \$15.3 billion of \$32.2 billion available to the Iraqi government for other spending. The IMF is seeking clarification on the amount of financial deposits that is available for government spending. Under the terms of Iraq's 2010 arrangement with the IMF, the Ministry of Finance is required to complete a review of all central government accounts and return any idle balances received from the budget to the central Iraqi Treasury by March 31, 2010. As of August 2010, according to the IMF, this review was still under way.

Iraqi government data show that Iraq's security ministries—the Ministries of Defense and Interior—increased their spending from 2005 through 2009 and set aside about \$5.5 billion for purchases through the U.S. Foreign Military Sales program. However, over this 5-year period, these ministries did not use between \$2.5 billion and \$5.2 billion of their budgeted funds that could have been used to address security needs. The administration is requesting \$2 billion in additional U.S. funding in its fiscal year 2011 budget request to support the training and equipping of Iraq's military and police.

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Abbreviations

CERP	Commander's Emergency Response Program
DOD	Department of Defense
DSCA	Defense Security Cooperation Agency
FMS	Foreign Military Sales
I-CERP	Iraq-Commander's Emergency Response Program
IMF	International Monetary Fund
MNF-I	Multinational Forces-Iraq
USAID	U.S. Agency for International Development
USF-I	U.S. Forces-Iraq

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Congressional Committees

Since 2003, the United States has reported obligating about \$642 billion for U.S. military operations in Iraq and provided about \$24 billion for training, equipment, supplies, facility construction, and other services for Iraqi security forces.¹ The fiscal year 2009 National Defense Authorization Act instructed the U.S. government to take actions to ensure that Iraqi funds are used to pay the costs of training, equipping, and sustaining Iraqi security forces.² Under current plans, the United States will withdraw all U.S. forces from Iraq by the end of 2011. However, the U.S.-Iraq Strategic Framework Agreement affirms the desires of the two countries to establish a long-term relationship of cooperation in the economic, diplomatic, cultural, and security fields, among others.³ Iraq's large oil reserves offer the government the potential to contribute to the country's current and future security and stabilization requirements. Oil revenues account for over 50 percent of the country's gross domestic product and about 90 percent of the government's revenues. Prior GAO reports have shown that Iraq reported substantial budget surpluses from 2005 through 2008.⁴

To assist Congress in overseeing U.S. efforts to better leverage U.S. funding and encourage the Iraqi government to contribute more toward the costs of securing and stabilizing Iraq, this report provides information on (1) the amount and availability of Iraq's budget surplus or deficit, (2) the amount of Iraq's financial deposit balances, and (3) the extent to which Iraq has spent its financial resources on security costs. In addition,

¹Iraqi security forces include the Iraqi army, navy, and air force under the Ministry of Defense and the Iraqi police, federal police, and border enforcement under the Ministry of Interior.

²Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, Pub. L. No. 110-417 (Oct. 14, 2008).

³*Strategic Framework Agreement for a Relationship of Friendship and Cooperation between the United States of America and the Republic of Iraq* (Nov. 17, 2008), effective January 1, 2009.

⁴GAO, *Stabilizing and Rebuilding Iraq: Iraq Revenues, Expenditures, and Surplus*, [GAO-08-1031](#) (Washington, D.C.: Aug. 5, 2008); and *Iraq: Key Issues for Congressional Oversight*, [GAO-09-294SP](#) (Washington, D.C.: Mar. 24, 2009).

this report identifies examples of other governments' contributions to the cost of U.S. security support in their countries, which could inform future Iraqi-U.S. cost-sharing arrangements. Due to broad congressional interest in issues related to Iraq, we completed this report under the Comptroller General's authority to conduct evaluations on his own initiative.

To conduct this audit, we analyzed relevant data, reviewed documents, and interviewed Iraqi officials in Baghdad, Iraq, including the Ministers of Finance, Defense, and Interior; the Governor of the Central Bank of Iraq; the President of the Trade Bank of Iraq; and the Deputies General of Accounting at the Rafidain and Rasheed banks, which are Iraq's two largest state-owned commercial banks. We analyzed data on Iraq's reported revenues and expenditures from the Minister of Finance for 2005 through 2009, including reports on Iraq's financial statements prepared by Iraq's Board of Supreme Audit⁵ for 2005 through 2007. We also analyzed similar data on Iraq's advances⁶ through September 2009. We obtained data on Iraq's cash deposits from the Ministry of Finance, Central Bank of Iraq, and Rafidain and Rasheed banks, and reviewed audit reports of the International Advisory and Monitoring Board on Iraq's deposits in the Development Fund for Iraq. We did not independently verify the reliability of information provided to us. We also interviewed U.S. and other officials in Washington, D.C., and Baghdad, Iraq, including officials from the Departments of Defense (DOD), State (State), and the Treasury (Treasury); the World Bank; the International Monetary Fund (IMF); and the Federal Reserve Bank of New York. We completed an initial draft of this report in January 2010. On the basis of preliminary comments on the draft that we received from DOD and Treasury, we traveled to Baghdad, Iraq, in April 2010 to interview Iraqi officials and obtain additional information on Iraq's fiscal position. This report reflects the additional data collection and analysis that we conducted subsequent to our initial draft report. The level of cooperation and coordination between GAO and State, Treasury, and DOD was unprecedented and afforded U.S. government officials the ability to obtain Iraqi financial data that previously had not been available to the U.S. government. Appendix I contains a more detailed description of our scope and methodology.

⁵The Board of Supreme Audit is the supreme audit institution of Iraq, as GAO is the supreme audit institution of the United States.

⁶The Iraqi Ministry of Finance considers advances to be funds that are encumbered or have been paid out, but which have not been recorded as an expenditure.

We conducted this performance audit from October 2008 through September 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings based on our audit objectives.

Results in Brief

GAO analysis of Iraqi revenue and expenditure data showed that Iraq generated an estimated cumulative budget surplus of \$52.1 billion through the end of 2009. This estimate is consistent with the method that Iraq uses to calculate its fiscal position. Adjusting for \$40.3 billion in estimated outstanding advances reduces the amount of available surplus funds to \$11.8 billion. In April 2010, a senior Ministry of Finance official indicated that these advances should be deducted from the \$52 billion cumulative budget surplus because they are committed for future expenditures or have been paid out.⁷ According to this official and Board of Supreme Audit reports on Iraq's financial statements,⁸ these advances include funding for letters of credit,⁹ advance payments on domestic contracts, and other advances. However, Iraq's Board of Supreme Audit has noted concerns about Iraq's accounting for these advances. In 2009, the board concluded that weaknesses in accounting for advances could result in the misappropriation of government funds, the means by which ministries exceed their annual budgets, and the inaccurate reporting of expenditures.¹⁰ The composition of some of these advances also is unclear. For example, 40 percent of total outstanding advances through 2008 are classified by the Ministry of Finance as "other temporary advances," which are not otherwise defined. Under the terms of a February 2010 IMF arrangement, Iraq agreed to develop new procedures for approving, monitoring, and controlling advances; set a time schedule for collecting

⁷No data that GAO received from the Ministry of Finance through Treasury prior to February 2010 included information on advances.

⁸Hereafter referred to as Board of Supreme Audit reports.

⁹The Trade Bank of Iraq issues letters of credit to confirm that funds have been set aside for Iraqi government purchases from foreign companies.

¹⁰Republic of Iraq, Board of Supreme Audit, *Financial Statement for the Republic of Iraq through 12/31/06* (Sept. 30, 2009).

recoverable amounts; and write off those that were not recoverable. This Iraqi report is to be completed by September 30, 2010.

A second method of evaluating Iraq's available resources is to examine its financial deposit balances. Iraqi government data and an independent audit report show that, as of December 2009, Iraq had accumulated between \$15.3 billion and \$32.2 billion in financial deposit balances held at the Central Bank of Iraq, the Development Fund for Iraq in New York, and state-owned banks in Iraq.¹¹ This range reflects a discrepancy between the amount of government-sector deposits reported by the Central Bank of Iraq to the IMF and the amount that the Ministry of Finance asserts is available for government spending. In November 2009, the Ministry of Finance reclassified \$16.9 billion held in state-owned banks as unavailable for government spending, stating that these funds belong to state-owned enterprises and trusts established for orphans and government pensions, among other things. Therefore, according to the Ministry of Finance, only \$15.3 billion of the \$32.2 billion in deposits reported by the Central Bank of Iraq was unencumbered and available to the government of Iraq for spending. The IMF is seeking clarification on the amount of Iraq's financial deposits that is available for government spending. Under the terms of a February 2010 arrangement with the IMF, the Iraqi Ministry of Finance is required to complete a review of all central government accounts, reconcile them with Iraqi Treasury records, and return any idle balances received from the budget to the central Iraqi Treasury. This review was due to be completed by March 31, 2010; however, according to the IMF, it was still under way as of August 2010.

Iraqi government data indicate that security spending under the Ministries of Defense and Interior increased from \$2.0 billion in 2005 to an estimated \$8.6 billion in 2009. In addition, these ministries set aside about \$5.5 billion over this period for the purchase of equipment, training, and services under the U.S. Foreign Military Sales (FMS) program. In certain instances, the United States has provided an incentive for these ministries to increase their security spending by leveraging U.S. funds to supplement Iraq's FMS purchases. The Iraqi government also funded the Iraq-Commander's Emergency Response Program and assumed responsibility for the salaries

¹¹These financial deposit balances exclude about \$10 billion held at JP Morgan Chase and Citibank for fully funded letters of credit and about \$3.2 billion held at the Federal Reserve Bank of New York for U.S. Foreign Military Sales purchases.

of almost 90,000 Sons of Iraq.¹² While security spending has increased, our analysis of data from the Iraqi government, DOD, and the Trade Bank of Iraq showed that the ministries did not spend or set aside between \$2.5 billion and \$5.2 billion of their 2005 through 2009 budgeted funds—funds that could have been used to address security needs.¹³ State and DOD officials cited overly centralized decision making and weak procurement capacity as reasons for the ministries' inability to spend these funds. In April 2010, Ministry of Defense officials received Ministry of Finance approval to use \$143 million of their unspent 2009 funds for FMS purchases. Ministry of Interior officials planned to use more than \$300 million of their unspent 2009 funds for similar purposes. The administration is requesting \$2 billion in additional U.S. funding in its fiscal year 2011 budget request to support the training and equipping of forces under Iraq's security ministries.

GAO believes that Congress should consider Iraq's available financial resources when it reviews the administration's fiscal year 2011 budget request and other potential future budget requests for additional funds to train and equip Iraqi security forces. Iraq generated an estimated cumulative budget surplus of \$52.1 billion through December 2009. Adjusting for outstanding advances, at least \$11.8 billion of this surplus was available for future spending. Iraqi data indicate that this surplus has enabled Iraq to accumulate at least \$15.3 billion in available financial deposit balances, another means by which to assess Iraq's fiscal position. Additional clarity is needed on Iraq's outstanding advances and financial deposits to determine whether Iraq may have additional resources that are available for future spending. To this end, GAO recommends that State and Treasury work with the Iraqi government to further identify available resources, including by assisting Iraq in completing IMF-required reviews of outstanding advances and deposits in central government accounts.

We provided State, Treasury, DOD, and the IMF with a draft of this report. The three agencies' comments are contained in appendixes V, VI, and VII, respectively. All three agencies and the IMF provided technical comments, which we incorporated in the report as appropriate. State and Treasury

¹²The Sons of Iraq are local, nongovernmental security contractors hired by U.S. and Coalition forces to help maintain security in their communities.

¹³The range that we estimate reflects uncertainty regarding what portion of the funds set aside for FMS purchases and paid as letters of credit has been recorded as expenditures by the Ministry of Finance and is therefore included in expenditure totals.

concluded with our recommendation and agreed to work with their Iraqi counterparts to identify available financial resources. Treasury also agreed in principle that, while Iraq's fiscal accounts are not well ordered, Iraq potentially will have financial resources to engage in greater cost-sharing in the future. State, Treasury, and DOD stated that the Iraqi government's available funds are closer to the low end of GAO's range, and that Iraq needs to maintain a fiscal reserve. We believe that it is premature to determine that Iraq's available resources fall at the low end of the range until Iraq has completed IMF-required reviews of outstanding advances and central government accounts, particularly in light of the substantial shortcomings associated with Iraq's accounting for advances and financial deposits. These reviews will clarify the total resources available for government spending in 2010 and beyond. We agree that it may be prudent for Iraq to maintain a fiscal reserve. As part of its arrangement with the IMF, Iraq agreed to maintain \$2.6 billion in the Development Fund for Iraq to pay for 2 to 3 months of employee wages. Iraq maintained this level with the at least \$15.3 billion it had at the end of 2009. Furthermore, through June 2010, Iraq generated almost \$2 billion more in revenue than it had predicted in its budget. If this trend continues, Iraq may have about \$4 billion in additional oil export revenues by the end of 2010.

DOD also commented that it believes the overall message of the draft report—that the Iraqi government currently has significant cash reserves that would allow it to pay more of its security costs now and in 2011—is inaccurate. We disagree. As our report states, Iraq ended 2009 with at least \$15.3 billion in financial deposits. Moreover, when completed, IMF-required reviews of Iraq's outstanding advances and central government accounts will clarify the total funds that are available to the government for spending in 2010 and beyond. While we do not predict Iraq's fiscal position through 2011, we note that Iraq had predicted deficit spending in each of the past 5 years, but ended each of these years with a cash surplus.

Background

In August 2008, GAO reported on the challenges that the Iraqi government faced in spending resources to finance key reconstruction and stabilization efforts, including those to develop Iraq's security forces.¹⁴ We also reported that from January 2005 through April 2008, Iraq's Ministries of Defense and Interior reported spending \$2.9 billion of the \$12.3 billion they were budgeted for investment expenditures in support of the Iraqi

¹⁴[GAO-08-1031](#).

security forces. Iraq and other countries use the DOD-administered FMS program to purchase defense articles, services, and training from the U.S. government. In fiscal year 2009, more than 100 foreign governments spent \$38.1 billion through the FMS program.¹⁵

According to State and DOD officials, the United States and Iraq have not yet defined their longer-term security relationship. However, the United States and Iraq signed two bilateral agreements in November 2008 that set the stage for Iraq to assume a greater role in providing for its own security and for cooperation between the two countries. The U.S.-Iraq Security Agreement¹⁶ requires the withdrawal of U.S. forces in Iraq by December 31, 2011, and governs their presence in the interim. Within the security agreement, the Iraqi government requests the temporary assistance of U.S. forces to support its efforts to maintain security and stability in Iraq.¹⁷ According to DOD and State officials, the U.S. and Iraqi governments may amend the security agreement by mutual agreement. Such amendments could include an extension of the withdrawal timetable or an authorization of a residual U.S. force to continue training the Iraqi security forces after 2011.

Historically, Congress and U.S. agencies have sought to encourage host nation contributions for U.S. security support¹⁸ activities worldwide. (See app. IV for more information on cost-sharing with other countries for security support activities.) For example, Congress authorized the Secretary of Defense, in consultation with the Secretary of State, to accept

¹⁵This total includes some FMS purchases made with U.S. government funds. For example, some foreign governments, such as Egypt and Israel, made purchases with U.S. funding through the Foreign Military Financing program. In addition, DOD made FMS purchases for Iraq and Afghanistan with U.S. government funds.

¹⁶*Agreement Between the United States of America and the Republic of Iraq on the Withdrawal of United States Forces from Iraq and the Organization of Their Activities during Their Temporary Presence in Iraq* (Nov. 17, 2008), effective January 1, 2009.

¹⁷For more information on the U.S.-Iraq Security Agreement and the timetable for the drawdown of U.S. forces, see [GAO-09-294SP](#) and *Securing and Stabilizing Iraq: U.S. Drawdown Plans Should Include Contingency Plans for Use If Key Assumptions about Security Conditions and Iraqi Capabilities Prove Wrong*, GAO-09-939C (Washington, D.C.: Sept. 30, 2009).

¹⁸For the purposes of this report, we use the term security support to describe a range of activities, including security cooperation activities, which are intended to shape the operational environment in peacetime, and security force assistance, which is used to improve the capability and capacity of foreign security forces in security conditions ranging from stable peace to general war.

contributions from host countries to share in the cost of DOD construction, supplies, and services in the country.¹⁹ Moreover, it is DOD policy to offset the administrative and operating expenses of security support activities to the maximum extent feasible through host country contributions.²⁰ The Secretary of Defense also provided an annual report to Congress through 2004—under legislative provisions dating back to the Defense Authorization Act of 1981 and in more recent defense authorizations—that compared the defense costs borne by the United States, allies, and partner nations. In these reports, DOD officials stated that they would urge allied and partner nations to increase their cost-sharing contributions.

Iraq's Estimated Actual and Available Cumulative Budget Surplus through the End of 2009

Iraq generated an estimated cumulative budget surplus of \$52.1 billion through 2009, according to GAO's analysis of data provided by the Iraqi government. Adjusting for \$40.3 billion in advances that were outstanding as of September 2009 reduces the amount of available surplus to \$11.8 billion. Iraq's Board of Supreme Audit has highlighted weaknesses in Iraq's accounting for a large and growing amount of advances. Under an arrangement with the IMF, Iraq is conducting a review of its outstanding advances to identify funds that may be available for government spending.

Iraq Generated an Estimated \$52.1 Billion Cumulative Budget Surplus through 2009

A key indicator of a government's fiscal condition is its annual budget surplus or deficit, measured primarily on a cash basis. According to Iraq's Board of Supreme Audit, the tracking of revenues and expenditures using Iraq's amended cash accounting is an important tool for fiscal planning and oversight of budget execution.²¹ GAO's analysis of Iraqi data indicated that Iraq's revenues exceeded expenditures through the end of 2009, resulting in an estimated cumulative budget surplus of \$52.1 billion (see table 1). We calculated this estimate by adding (1) Iraq's cumulative budget surpluses through the end of 2004, as reported by the Board of Supreme Audit; (2) Iraq's reported annual surpluses from 2005 through 2008; and (3) an estimated \$2.2 billion Iraqi budget surplus through

¹⁹10 U.S.C. § 2350j.

²⁰DOD Instruction 2110.31, 5.1 (Apr. 10, 1967).

²¹Republic of Iraq, Board of Supreme Audit, *Financial Statement for the Republic of Iraq through 12/31/05* (Mar. 30, 2009).

December 2009.²² The cumulative budget surplus in table 1 differs from the sum of all annual surpluses due to the appreciation of the Iraqi dinar (see table 1 note). Table 1 shows that Iraq's reported revenues and expenditures increased through 2008, particularly during the rapid increase in oil prices in 2008. (See app. II for more information on Iraq's oil revenues.)

Table 1: Iraq's Estimated Annual Surpluses and Cumulative Budget Surplus, through 2009

U.S. dollars in billions

	Estimated budget surplus, by year						Cumulative through 2009
	Cumulative through 2004	2005	2006	2007 ^a	2008	2009	
Total revenues	^b	\$27.0	\$32.7	\$43.6	\$67.2	\$46.8	\$217.3 ^c
Total expenditures	^b	20.6	25.0	31.2	56.1	44.5	177.4 ^c
Cash surpluses^c	\$5.8^b	\$6.4	\$7.7	\$12.4	\$11.1	\$2.2	\$52.1^c

Source: GAO analysis of Iraqi Ministry of Finance data on government revenues and expenditures.

Note: Annual cash surpluses may not equal the difference between total revenues and total expenditures due to rounding.

^aThe 2007 Board of Supreme Audit report provides inconsistent information on expenditures. The narrative section of the report lists total expenditures as 39.3 trillion dinar (\$31.2 billion), whereas the report's financial statements list expenditures as 32.7 trillion dinar (\$26.0 billion). The 2007 report states that this difference is due to a new accounting guide implemented by the Ministry of Finance, which requires the Board of Supreme Audit to report operating and investment spending separately. We used the 39.3 trillion dinar figure as an estimate of 2007 expenditures because we believe it includes both operating and investment expenditures. See Republic of Iraq, Board of Supreme Audit, *Financial Statement for the Republic of Iraq through 12/31/07* (Apr. 14, 2010).

^bThe cumulative cash surplus through 2004 is based on information from the 2005 Board of Supreme Audit report. The 2005 report does not contain data on cumulative revenues and expenditures before 2005. See Republic of Iraq, Board of Supreme Audit, *Financial Statement for the Republic of Iraq through 12/31/05* (Mar. 30, 2009).

^cTo calculate the net cumulative surplus, we estimated the net cumulative surplus through the end 2009 in Iraqi dinars and then used the 2009 budget exchange rate (1,180 Iraqi dinar per U.S. dollar) to express it in U.S. dollars. Thus, the cumulative cash surplus is different from the sum of all annual surpluses due to the appreciation of the Iraqi dinar. To calculate cumulative revenues and expenditures, we converted each year's revenues and expenditures from Iraqi dinars to U.S. dollars at that year's exchange rate and summed the resulting dollar-denominated, annual revenues and expenditures through 2009. As a result, the cumulative cash surplus does not equal the difference between cumulative revenues and cumulative expenditures due to the appreciation of the Iraqi dinar.

²²This estimate (\$2.2 billion) is based on Ministry of Finance revenue and expenditure data through December 2009. It is not clear whether these data reflect final, end-of-year adjustments.

We estimated Iraq's budget surpluses through the end of 2009²³ on the basis of revenue and expenditure data obtained from the Ministry of Finance.²⁴ For 2005 through 2007, we based our analysis of Iraq's revenues and expenditures on the Board of Supreme Audit's reports on the annual financial statements of the Iraqi government, which the Ministry of Finance provided to us. For 2008, we based our analysis of revenues and expenditures on the final accounts for the Iraqi government, which the Ministry of Finance submitted to the Board of Supreme Audit for review and subsequently provided to us. For 2009, we based our analysis on monthly revenue and expenditure data obtained from the Ministry of Finance through Treasury. We based budget surpluses accumulated before 2005 on data included in the Board of Supreme Audit's report on the government's 2005 financial statements.

According to the Ministry of Finance, Outstanding Advances Reduce Iraq's Available Surplus

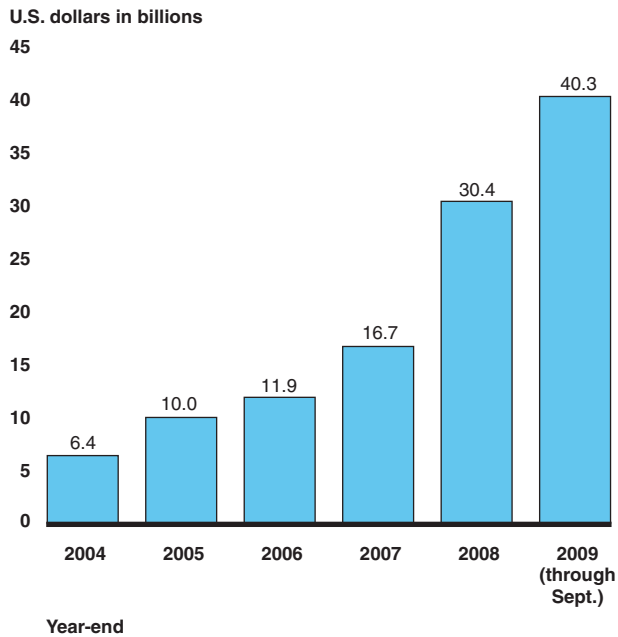
During April 2010, a senior Ministry of Finance official stated that funds the ministry categorizes as "advances" are encumbered or have been paid out. This official stated that we should therefore deduct these funds from the cash surplus to more accurately represent funds available to the government for future uses. He stated that advances include funds set aside for FMS purchases and letters of credit as well as advance payments to contractors. Our analysis of data provided by the Ministry of Finance showed that the Iraqi government recorded about \$40.3 billion in outstanding advances as of September 2009. Deducting these funds reduces Iraq's available surplus to about \$11.8 billion. Prior to February 2010, data provided to us by the Ministry of Finance through Treasury had not included any information on advances.

Our analysis of Ministry of Finance data indicated that outstanding advances have grown considerably over time (see fig. 1).

²³Iraq's fiscal year is the calendar year.

²⁴With the possible exception of 2009 data, these expenditure data reflect final, end-of-year adjustments made when the Ministry of Finance reconciled its accounts with individual ministries. Similar analyses presented in past GAO reports used monthly expenditure data provided by the Ministry of Finance through Treasury, which did not include these final, end-of-year adjustments. This analysis also reflects final, adjusted revenue data provided by the Ministry of Finance.

Figure 1: Estimate of Cumulative Outstanding Advances Recorded by the Iraqi Government, 2004-September 2009



Source: GAO analysis of data provided by the Iraqi Ministry of Finance.

According to the Board of Supreme Audit report on Iraq's 2005 financial accounts, Iraq had about \$6.4 billion in outstanding advances through the end of 2004. By September 2009, the amount of outstanding advances had grown to more than \$40.0 billion, according to Iraqi government data. The largest increase in the amount of outstanding advances occurred between the end of 2007 and September 2009. Outstanding advances more than doubled over this period from \$16.7 billion to \$40.3 billion.

Questions Remain about the Accounting for and Composition of Advances

The Board of Supreme Audit has noted weaknesses in Iraq's accounting for advances. In a March 2009 report on Iraq's 2005 financial accounts, the board stated that a failure to settle advances at the end of the fiscal year had resulted in inaccurate expenditure data and created difficulty in settling these increasingly large advances over time. The report also stated that the Iraqi government had failed to comply with legal requirements and regulations in executing advances. In a September 2009 report on Iraq's 2006 financial accounts, the board again expressed concern about the increase in the government's use of advances. This 2009 report explained that the increase in advances could indicate weaknesses in the government's follow-up procedures used to close out advances as

expenditures, which could lead to inaccuracies in individual ministries' expenditure reports. It also noted that advances could provide cover for ministries or other entities to exceed their budget allocations or to hide the misappropriation of government funds.

The composition of advances is unclear. A senior Ministry of Finance official stated that advances include funds set aside for FMS purchases and letters of credit as well as advance payments to contractors. In addition, the Board of Supreme Audit identifies 26 categories of advances. However, 40 percent of total outstanding advances through 2008 was categorized as "other temporary advances," which are not fully defined (see app. III). Furthermore, the board does not include a category of advances that clearly identifies funds transferred for FMS purchases. We did not collect data on which ministries or other entities had received the advances, whether advances were intended for operating or investment activities, and the amount of advances that are recorded as expenditures annually. The senior Ministry of Finance official said that this type of information is housed at more than 250 government spending units in Iraq.

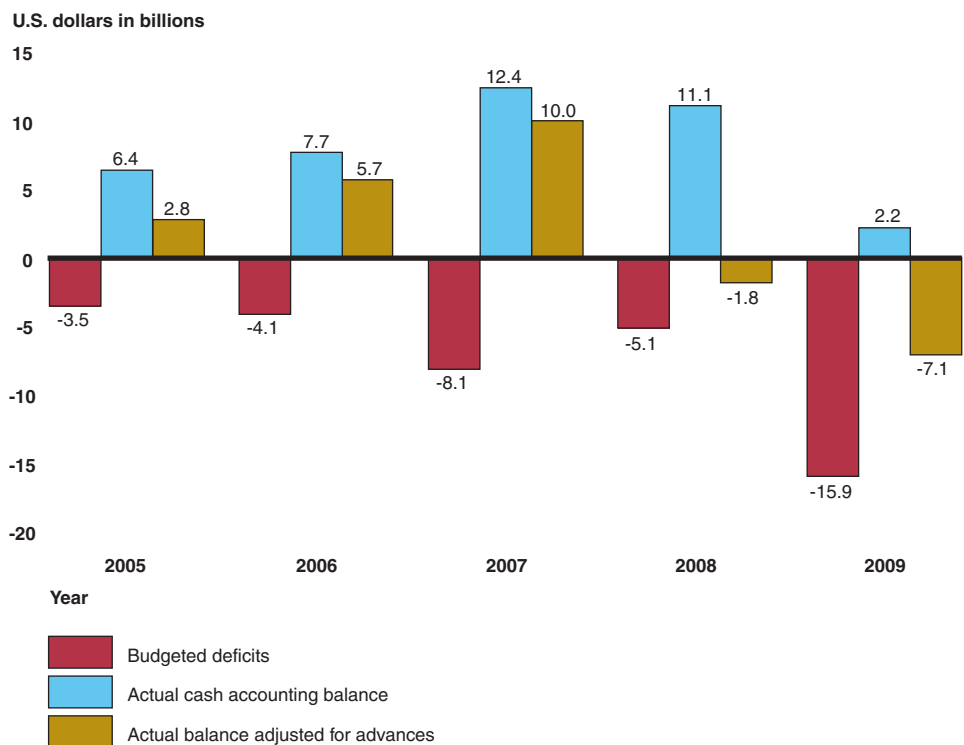
Moreover, as part of a \$3.6 billion IMF arrangement approved in February 2010, Iraq agreed to reform various aspects of its public finance management system, including strengthening its accounting for advances. For example, Iraq agreed to strengthen reporting and cash management by requiring spending units to submit reports on all spending, including advances, no later than 2 months after the end of each month, and to reconcile these amounts with the cash balances at the beginning and end of the reporting period. Iraq also agreed to follow procedures for approving the release of cash to spending units as a way of reducing idle balances in spending units' accounts to the minimum required for the continuity of government operations. Furthermore, Iraq agreed to prepare a report on its outstanding advances, identify advances that are recoverable, set a schedule for their recovery, and eventually write off advances that are deemed irrecoverable. Under the terms of the IMF arrangement, Iraq has committed to completing this report by September 30, 2010.

Iraq's Budgets Have Been Unreliable Indicators of Iraq's Year-end Fiscal Balances

GAO's analysis of Iraqi financial data indicated that Iraqi budgets are unreliable indicators of the country's fiscal balance at the end of each year. As depicted in figure 2, from 2005 through 2009 Iraq began each year with budgets that projected government spending would exceed government revenue by \$3.5 billion (2005) to \$15.9 billion (2009). If the government had spent funds in accordance with its budgets, and its

revenue projections had proved accurate, the government would have generated more than \$35 billion in cumulative deficits through the end of 2009. However, our analysis of Iraqi data showed that actual expenditures for the past 5 years have consistently fallen short of budget projections, while actual revenues, in general, have met or exceeded projections. On a cash accounting basis, Iraq generated budget surpluses in each year from 2005 through 2009, rather than the deficits projected by its budget. Finally, after adjusting for advances, Iraq generated budget surpluses from 2005 through 2007. In 2008 and 2009, Iraq produced adjusted deficits after deducting advances, but these deficits were less than one-half of the amounts that it projected in its budget.

Figure 2: Iraq’s Annual Budgeted Deficits, Actual Cash Accounting Balance and Actual Balance Adjusted for Advances, 2005-2009



Source: GAO analysis of Iraqi Ministry of Finance data on government revenues, expenditures, and advances; and Iraqi budget law.

In commenting on a draft of this report, DOD acknowledged that Iraq’s budgets serve as imperfect predictors of the country’s year-end fiscal balance. DOD noted that experience from 2008 and 2009 showed that actual deficits were about one-half of what was projected by the budget. Accordingly, DOD concluded that although Iraq budgeted for a \$20 billion

to \$25 billion deficit in 2010, it is more likely that Iraq will generate a \$8 billion to \$10 billion deficit.

Iraq's Financial Deposit Balances

Iraqi government data and an independent audit report show that, through the end of 2009, Iraq had accumulated between \$15.3 billion and \$32.2 billion in financial deposit balances held at the Central Bank of Iraq, the Development Fund for Iraq in New York, and state-owned banks in Iraq. This range does not include approximately \$10 billion in JP Morgan Chase and Citibank accounts to cover Iraq's letters of credit and about \$3.2 billion in a Federal Reserve Bank of New York account for Iraq's FMS purchases. The range reflects a discrepancy between the amount of government-sector deposits reported by the Central Bank of Iraq to the IMF and the amount that the Ministry of Finance asserts is available for government spending. In November 2009, the Ministry of Finance reclassified \$16.9 billion held in state-owned banks as unavailable for government spending, stating that these funds belong to state-owned enterprises and government trusts, such as those that were established for orphans and pensioners. Therefore, according to the Ministry of Finance, only \$15.3 billion of the \$32.2 billion is unencumbered and available for spending. The IMF is seeking additional clarity on the amount of financial deposits that may be available for government spending.

Ministry of Finance Reclassified \$16.9 Billion of \$32.2 Billion in Deposits as Encumbered and Not Available to the Iraqi Government

Data from the Central Bank of Iraq and the International Advisory and Monitoring Board show that Iraq began 2010 with \$32.2 billion in financial deposits held at state-owned banks in Iraq,²⁵ the Central Bank of Iraq, and the U.S. Federal Reserve Bank's Development Fund for Iraq account (see table 2).²⁶ We obtained data on Iraq's deposit balances in state-owned banks from the Central Bank of Iraq during an April 2010 trip to Baghdad, Iraq. These data separate central ministry accounts from state-owned enterprises' accounts. However, the Central Bank of Iraq consolidates

²⁵Iraq has seven state-owned banks. The two largest, Rafidain and Rasheed, are commercial banks. The remaining five banks are specialized state-owned banks, including the Trade Bank of Iraq; the Agricultural Cooperative bank; and the Industrial, Real Estate, and Iraq banks.

²⁶The Development Fund for Iraq holds the proceeds of oil export sales from Iraq, as well as remaining balances from the United National Oil-For-Food Program and other frozen Iraqi funds. The International Advisory and Monitoring Board provides oversight for the Development Fund for Iraq and helps to ensure that its funds are used in a transparent manner for the benefit of the Iraqi people.

these categories in its reporting to the IMF. In turn, the IMF publishes the consolidated accounts in its *International Financial Statistics*.

Table 2: Comparison of Financial Deposit Balances and Financial Deposits Available, through the end of 2009

U.S. dollars in billions			
	Financial deposit balances reported by the Central Bank of Iraq	Amount reclassified by the Ministry of Finance	Available financial deposit balances
State-owned banks			
Central ministry accounts ^a	\$12.2	\$7.6	\$4.5 ^b
State-owned enterprises' accounts ^c	9.3	9.3	0.0
Subtotal	\$21.4	\$16.9	\$4.5
Central Bank of Iraq	\$0.8	\$0.0	\$0.8
Federal Reserve Bank of New York—Development Fund for Iraq	10.0	0.0	10.0
Total	\$32.2	\$16.9	\$15.3

Sources: Data from the Central Bank of Iraq, Iraqi Ministry of Finance, and KPMG audit report of the International Advisory and Monitoring Board; and interviews with officials from the Central Bank of Iraq and the Iraqi Ministry of Finance.

Note: Sums may differ from totals due to rounding. This analysis does not include about \$400 million in government “financial sector deposits” reported by the Central Bank of Iraq (about 2.0 percent of total deposits in commercial banks). The analysis also excludes about \$100 million of government-sector deposits reported by the Central Bank of Iraq to be held in private, commercial banks (about 0.4 percent of total deposits in commercial banks). Including these additional deposits would increase the deposit balances reported by the Central Bank of Iraq from \$32.2 billion to \$32.7 billion.

^aThe direct translation from Arabic to English for this category is “Government sector deposits (Centrally funded).”

^bData from the Ministry of Finance did not indicate whether these deposits are held exclusively in state-owned banks. However, data from the Central Bank of Iraq show that about 99.6 percent of government-sector deposits in Iraqi banks (excluding the Central Bank of Iraq) is held in state-owned banks and 0.4 percent is held in private, commercial banks.

^cThe direct translation from Arabic to English for this category is “Government sector deposits (Self funded).”

In April 2010, Iraq’s Minister of Finance and a senior Ministry of Finance official stated that not all of the \$21.4 billion in financial deposits in state-owned banks was available to the Iraqi government for future expenditures for two reasons. First, according to Ministry of Finance data, only \$4.5 billion of the \$12.2 billion in central ministries’ accounts at state-owned banks is available to the government (see table 2). Ministry of Finance officials said that the remaining deposits—about \$7.6 billion—are

set aside as government trust funds for the Iraqi people, such as worker pensions and court funds to support orphaned infants.²⁷ Second, the senior Ministry official explained that none of the funds in state-owned enterprises' accounts—which the Iraqi government refers to as self-funded or self-financing entities—belongs to the government, primarily because these enterprises receive few funds, if any, from Iraq's public Treasury. The Ministry of Finance officials agreed with the Central Bank of Iraq data on the amount of financial deposits in the Central Bank of Iraq and the Federal Reserve Bank's Development Fund for Iraq. Accordingly, the Ministry of Finance data show that the Iraqi government had about \$15.3 billion in financial deposits available for future expenditures through the end of 2009.²⁸

We sought a more in-depth explanation regarding why the Ministry of Finance excluded \$16.9 billion in government-sector deposits as available for governmental spending. According to a Ministry of Finance document, in November 2009, representatives of the Ministry of Finance and Iraq's two largest state-owned banks—Rafidain and Rasheed—reviewed the government's deposits at the two banks. To do so, the Ministry of Finance formed a committee that consisted of three officials from its accounting department, one of whom served as the head of the committee; an official from the ministry's inspector general department; and one official from each of the two banks. During the review process, the Ministry of Finance's accounting department developed a list of cash balances in accounts that were available to the government for future spending. It then asked the two banks to prepare similar lists for reconciliation purposes. When the committee met in late November 2009, according to the meeting minutes, the balances of the Ministry of Finance and the two banks did not reconcile. The banks' lists included accounts for state-owned enterprises²⁹

²⁷Ministry of Finance officials used the phrase “the people’s funds” to describe funds set aside for pensions and the care of orphans. In this report, we use the term “trust funds.”

²⁸In June 2010, the IMF reported in the *International Financial Statistics*—on the basis of data provided from the Central Bank of Iraq—that Iraq had about \$21.4 billion in financial deposits at the Central Bank of Iraq and other banks in Iraq. Together, these figures total about \$800 million less than the Central Bank reported to us and about \$16 billion more than the Ministry of Finance data indicated is available to the Iraqi government. According to the IMF, these data show a discrepancy between Central Bank of Iraq and Ministry of Finance reporting on government deposits in the banking sector, and IMF officials are following up with Iraqi authorities to clarify the nature and composition of these funds.

²⁹The meeting minutes referred to state-owned enterprises' accounts as “self-financing accounts.”

and others that, according to the committee minutes, were not financed by Iraq's public Treasury; the Ministry of Finance list did not include those accounts. After the committee agreed to eliminate those accounts from Rafidain's and Rasheed's lists of available funds, the Ministry of Finance's and banks' balances reconciled. This review process effectively reclassified \$16.9 billion in Iraq's deposit balances as unavailable for government spending.

We could not corroborate the Ministry of Finance's information on the availability of financial deposits or the Central Bank of Iraq's data on financial deposits in state-owned banks.³⁰ According to U.S. officials, the government's accounts in the two largest state-owned banks have not been audited by an independent organization since November 2009, when the Ministry of Finance and the two banks reclassified the deposits. Thus, we did not have an independent audit to corroborate the status of the reported financial deposits in the two banks. We note that an earlier independent audit report on Iraq's largest state-owned bank—Rafidain bank—found significant deficiencies in the bank's internal controls.³¹ Due to the significance of these problems, the auditors could not validate the existence or value of many of the bank's account balances, nor could they express an opinion on the bank's financial statements.³² Moreover, Ernst and Young independent audits of the Central Bank of Iraq could not confirm or reconcile over \$11 billion in the account balances of the Ministry of Finance and other governmental entities as of the end of 2008 and about \$800 million as of the end of 2009.³³

Furthermore, we requested other information that might help to clarify the status of funds set aside for trust funds, but a senior Ministry of Finance

³⁰The Governor of the Central Bank of Iraq stated that he is confident about the amount of these deposits because the banks are required to hold a certain share of their deposits in reserves.

³¹This undated audit report covered Rafidain Bank's 2006 financial statements. We obtained this report in April 2010. We have not been able to identify a more recent audit report for the bank. See Ernst and Young, *Special Purpose Auditors' Report to the Ministry of Finance, Government of Iraq* (undated).

³²According to U.S. officials, a separate audit report found similar problems with the 2006 financial statements of Iraq's second-largest, state-owned bank.

³³Ernst and Young, *Central Bank of Iraq Financial Statements, December 31, 2008: Independent Auditor's Report to the Ministry of Finance, Government of Iraq* (Feb. 9, 2010); and *Central Bank of Iraq Financial Statements, December 31, 2009: Independent Auditor's Report to the Ministry of Finance, Government of Iraq* (June 20, 2010).

official did not provide us with any additional information. In addition, we could not corroborate the committee minutes' statement that state-owned enterprises do not receive funds from Iraq's public treasury, and, therefore, the funds in their accounts are not available to the Iraqi government.

The IMF is seeking greater clarity on the amount of Iraq's financial deposits that is unencumbered and available for government spending. Under the terms of Iraq's February 2010 arrangement with the IMF, the Ministry of Finance is required to complete a review of all central government accounts in the banking system, reconcile them with Iraqi Treasury records, and return any idle balances received from the budget to the central Iraqi Treasury. This review was due to be completed by March 31, 2010. However, according to the IMF, the review was still under way as of August 2010.

Iraq's Financial Deposits Decreased from \$41.1 Billion in 2008 to \$32.2 Billion in 2009

Overall, Iraq's financial deposits increased by \$11.7 billion from 2007 to 2008 and then decreased by \$8.9 billion from 2008 to 2009, with most of the fluctuation occurring in deposits in banks in Iraq (see table 3).

Table 3: Iraq's Financial Deposits, through the end of 2007, 2008, and 2009

U.S. dollars in billions			
Bank and location	Financial deposits, by year		
	2007	2008	2009
State-owned banks in Iraq ^a	\$13.8	\$19.7	\$21.4
Central Bank of Iraq	5.7	11.1	0.8
Subtotal^b	\$19.5	\$30.8	\$22.2
Federal Reserve Bank of New York – Development Fund for Iraq	\$9.9	\$10.3	\$10.0
Total	\$29.4	\$41.1	\$32.2

Sources: IMF's *International Financial Statistics* and Ernst and Young and KPMG audit reports of the International Advisory and Monitoring Board (2007 and 2008 data); and the Central Bank of Iraq and the International Advisory and Monitoring Board (2009 data).

^aIn prior GAO reports, we used the terms "banking sector" and "commercial banks" to describe state-owned and private banks in Iraq. We now use the term "state-owned banks" because by the end of 2009, almost all of Iraq's deposits in commercial banks were held at Iraq's state-owned banks (about 83 percent at the two state-owned commercial banks and about 17 percent at the five specialized state-owned banks).

^bIraq also has about \$100 million in private banks (about 0.4 percent of Iraq's financial deposits) and about \$400 million in government "financial sector deposits" (about 2.0 percent of total deposits in commercial banks).

According to Central Bank of Iraq officials and data, Iraq's financial deposits at the Central Bank declined by \$10.3 billion during 2009 due to the Ministry of Finance transferring funds from the Central Bank to Iraq's two largest state-owned banks, Rafidain and Rasheed. The Central Bank of Iraq's data show no corresponding increase in government deposits at state-owned banks. According to these data, government deposits at state-owned banks increased by \$1.7 billion from 2008 to 2009, a difference of \$8.6 billion.

In commenting on a draft of this report, DOD stated that the adjusted deficit in 2009 may explain at least \$8 billion of the drawdown in deposits from 2008 to 2009. However, we do not find a consistent relationship between Iraq's adjusted fiscal balance and fluctuations in Iraq's financial deposits, as could have been the case for 2009. For example, our analysis of Ministry of Finance data showed that in 2008 Iraq generated a \$1.8 billion adjusted deficit, after deducting advances. However, over the same period, Iraq's financial deposits increased by \$11.7 billion, from \$29.4 billion to \$41.1 billion.

These problems are further amplified in independent audits of the Central Bank of Iraq conducted by Ernst and Young. The auditors could not confirm or reconcile over \$11 billion in the account balances of the Ministry of Finance and other governmental entities as of the end of 2008 and about \$800 million as of the end of 2009. Because the Central Bank of Iraq did not receive statements for these accounts, the auditors could not ensure the completeness, valuation, and accuracy of the balances. As we have previously noted, an Ernst and Young audit report of the 2006 financial statements of Iraq's largest state-owned bank—Rafidain—found significant deficiencies in the bank's internal controls. Due to the significance of these problems, the auditors could not validate the existence or value of many of the bank's account balances, nor could they express an opinion on the bank's financial statements.

Iraq Has Increased Its Spending on Security but Did Not Use All of Its Available Funds

Iraqi government data show that the Iraqi security ministries have increased their spending from 2005 through 2009 and set aside about \$5.5 billion to purchase equipment, training, and services under the FMS program. The Iraqi government has also funded the Iraq-Commander's Emergency Response Program (I-CERP) and assumed responsibility for contracts to pay the salaries of the Sons of Iraq. However, we estimate that, during this same period, the Ministries of Defense and Interior did not spend or set aside for FMS and other purchases between \$2.5 billion and \$5.2 billion of their budgeted funds that could have been used to address

security needs. Moreover, the Iraqi government did not provide any additional funding for I-CERP, as originally expected. The administration is seeking \$2 billion in additional U.S. funding in its fiscal year 2011 budget request to provide training and equipment to the Iraqi security forces.³⁴

Iraq's Security Ministries Have Increased Spending Since 2005

Data from the Ministries of Finance, Defense, and Interior show that Iraq has increased its security spending under the Ministries of Defense and Interior from \$2.0 billion in 2005 to \$8.6 billion in 2009 (see table 4). Spending by these ministries reflects the actual value of equipment that has been delivered, buildings constructed, training provided, or salaries paid. The Ministry of Defense, which is responsible for training and equipping Iraq's army, navy, and air force, increased its spending an average of about 28 percent each year from 2005 through 2009. The Ministry of Interior, which performs similar activities in support of Iraq's federal police, local police, and border enforcement,³⁵ increased its spending by 45 percent annually, on average.

Table 4: Estimated Iraqi Security Expenditures by Ministry, 2005-2009

U.S. dollars in billions						
	Estimated Iraqi security expenditures, by year					Average annual growth rate (2005-2009)
	2005	2006	2007	2008	2009 ^a	
Ministry of Defense	\$1.1	\$1.3	\$2.3	\$3.4	\$3.7	27.9%
Ministry of Interior	0.9	1.6	3.1	4.2	5.0	44.7
Total	\$2.0	\$2.9	\$5.3	\$7.6	\$8.6	35.9%

Source: GAO analysis of data from Iraq's Board of Supreme Audit (2005-2007), the Iraqi Ministry of Finance (2008), and the Iraqi Ministries of Defense and Interior (2009).

Note: Sums may differ from totals due to rounding. Although expenditures are expressed in U.S. dollars in this table, we calculated the average annual growth rate on the basis of expenditures in Iraqi dinars. Doing so eliminates any potential exchange rate effects on the growth rate in expenditures.

³⁴In addition to the approximately \$23 billion that Congress has provided to train and equip the Iraqi security forces since 2003, Congress recently approved \$1 billion in fiscal year 2010 supplemental funding to address these needs. This funding was approved on July 29, 2010, and is available for use until September 30, 2011. See Supplemental Appropriations Act, 2010, Pub. L. No. 111-212 (July 29, 2010).

³⁵The Ministry of Interior also is responsible for Iraq's oil police and point-of-entry enforcement.

^aWe did not receive 2009 data on expenditures by the Ministry of Interior for projects and reconstruction. We therefore assume that all of the \$216 million budgeted to the Ministry of Interior for projects and reconstruction in 2009 (about 4 percent of its total budget) was expended.

Iraqi government data also indicate that the Ministries of Defense and Interior have increased their spending as a percentage of budgeted funds from 2005 through 2009 (see table 5). Although the percentages of their budgets that the two ministries were able to spend has fluctuated from year to year, both spent more than 90 percent of the funds made available to them in 2009. By comparison, the Ministry of Defense spent about 64 percent of its budgeted funds from 2005 through 2009, on average; the Ministry of Interior spent about 85 percent of its budgeted funds over the same period.

Table 5: Estimated Amounts Budgeted and Spent by the Iraqi Ministries of Defense and Interior, 2005-2009

U.S. dollars in billions					
	Estimated amounts budgeted and spent, by year				
	2005	2006	2007	2008	2009 ^a
Ministry of Defense					
Budgeted	\$1.3	\$3.4	\$4.1	\$5.3	\$3.9
Spent	1.1	1.3	2.3	3.4	3.7
Percentage spent	83.2%	38.7%	55.3%	64.4%	92.5%
Ministry of Interior					
Budgeted	\$1.1	\$2.0	\$3.2	\$5.7	\$5.5
Spent	0.9	1.6	3.1	4.2	5.0
Percentage spent	86.5%	79.8%	95.7%	73.1%	91.0%

Source: GAO analysis of data from Iraq's Board of Supreme Audit (2005-2007), the Iraqi Ministry of Finance (2008), and the Iraqi Ministries of Defense and Interior (2009).

Note: Budget execution rates may differ from averages due to rounding. Amounts spent do not reflect funds set aside for FMS purchases, letters of credit, or other advances. These set-asides are not included in expenditure totals until the purchased items have been delivered and recorded by the Ministry of Finance. Later in this section of the report, we factor in these set-asides as part of a separate analysis of unused funds by the security ministries.

^aWe did not receive 2009 data on expenditures by the Ministry of Interior for projects and reconstruction. We therefore assume that all of the \$216 million budgeted to the Ministry of Interior for projects and reconstruction in 2009 (about 4 percent of its total budget) was expended.

Iraq’s Security Ministries Have Used the FMS Program to Purchase Equipment, Training, and Services

From January 2006 through December 2009, Iraq set aside about \$5.5 billion to purchase equipment, training, and services through the FMS program (see table 6). The FMS program provides an established procurement mechanism through which the Ministries of Defense and Interior can spend available Iraqi funds to address security needs. Moreover, according to the Defense Security Cooperation Agency (DSCA); the United States Forces-Iraq (USF-I);³⁶ and the Iraqi Ministers of Finance, Defense, and Interior, the program provides a way for the security ministries to spend their money without risking the loss of funds to the corruption and mismanagement that hamper Iraqi government contracting.³⁷ Under FMS, the Ministries of Defense and Interior must identify their equipment or training needs, transfer funds to an account at the Federal Reserve Bank of New York, and sign a purchase agreement.³⁸ DOD then oversees contracting with suppliers, billing, and delivery of Iraq’s purchases.

Table 6: Funds Set Aside for FMS Purchases by the Iraqi Ministries of Defense and Interior, 2006-2009

U.S. dollars in millions

	Funds set aside for FMS purchases, by year				
	2006	2007	2008	2009	Total
Ministry of Defense	\$1,638	\$1,100	\$1,551	\$0	\$4,290
Ministry of Interior	169	0	671	404	1,244
Total	\$1,807	\$1,100	\$2,223	\$404	\$5,534

Source: GAO analysis of data provided by the Defense Security Cooperation Agency.

Note: Sums may differ from totals due to rounding. The years in this table indicate when funds were deposited in Iraq’s FMS account, rather than the year during which these funds were budgeted to the Ministries of Defense and Interior.

³⁶USF-I is currently responsible for U.S. programs to train, equip, and support Iraq’s military and police. The U.S. military command in Iraq was referred to as Multinational Forces-Iraq (MNF-I) from May 15, 2004, through December 31, 2009. The command restructured and changed its name to United States Force-Iraq, effective January 1, 2010. Although many of our interviews took place when the command was still designated as MNF-I, we refer to it as USF-I throughout this report for clarity.

³⁷GAO, *Stabilizing Iraq: Preliminary Observations on Budget and Management Challenges of Iraq’s Security Ministries*, GAO-07-637T (Washington, D.C.: Mar. 22, 2007).

³⁸DSCA requires that Iraq pay the full cost of its FMS purchases up front, a term of sale known as cash with acceptance, by transferring funds to an account at the Federal Reserve Bank of New York.

From January 2006 through December 31, 2009, Iraq signed purchase agreements³⁹ with the United States to buy an estimated \$5.1 billion in equipment, training, and services through the FMS program.⁴⁰ This includes purchase agreements with the Ministry of Defense valued at about \$4.3 billion and purchase agreements with the Ministry of Interior valued at about \$840 million. Through these FMS agreements, Iraq has purchased tanks, helicopters, naval patrol boats, training aircraft, and other equipment to improve the capabilities of its army, navy, and air force. To operate and maintain this equipment, Iraq also has used FMS to purchase training, support equipment, spare parts, and maintenance and repair packages. In addition, Iraq has purchased technical services for the planning, designing, and constructing of security infrastructure, such as buildings to house its General Directorate of Counterterrorism and a pier and seawall for a naval base at Umm Qasr.

According to U.S. and Iraqi officials, the security ministries have used FMS transfers as a means of setting aside funds that remained unspent at the end of the fiscal year. For example, in April 2010, officials at the Ministry of Defense said that they had received Ministry of Finance approval to transfer \$143 million of their unspent 2009 funds into the FMS account. Similarly, officials from the Ministry of Interior said that they planned to transfer \$300 million to \$350 million of their unspent 2009 funds into the FMS account, and they noted that, if approved, this would be the 4th consecutive year in which they executed a transfer after the end of the calendar year.

The United States is also using U.S. funds to supplement Iraq's FMS purchases. Under seven arrangements, the United States contributed about \$550 million and Iraq contributed more than \$880 million to provide Iraq with more than \$1.4 billion in equipment and services (see table 7). For example, in June 2009, Iraq's Ministry of Defense signed and funded a \$110 million agreement with the United States to purchase eight T-6A training aircraft for the Iraqi air force. In July 2009, the United States supplemented this purchase by signing an agreement to provide almost

³⁹These purchase agreements between the United States and a foreign purchaser—in this case, Iraq—are called Letters of Offer and Acceptance.

⁴⁰From January 2006 through December 2009, Iraq transferred about \$5.5 billion to an account at the Federal Reserve Bank of New York in anticipation of making FMS purchases. However, over the same period, Iraq had only signed agreements to purchase about \$5.1 billion of equipment, training, and services.

\$100 million in funding for seven additional training aircraft, spare parts, training, and maintenance. According to officials from USF-I and U.S. Central Command, these arrangements provide an incentive for Iraq to purchase U.S. equipment, rather than equipment from foreign vendors, thereby enhancing military interoperability and reinforcing the strategic partnership between the two countries.⁴¹ Moreover, FMS purchases include training, sustainment, spare parts, and logistics support to help increase the likelihood that equipment will remain functional over time.

Table 7: FMS Purchases Using U.S. and Iraqi Funding

U.S. dollars in millions					
FMS purchase	Implementation date ^a	Iraqi ministry	Iraqi funding	U.S. funding	Total cost
Armed scout helicopters	Oct. 2008 (Iraq) Jan./Aug. 2009 (U.S.)	Defense	\$402.2	\$43.0	\$445.2
Umm Qasr seawall	Feb. 2008 (Iraq) Sept. 2008 (U.S.)	Defense	45.0	7.7	52.7
Mi-17 CT helicopters	Dec. 2007 (Iraq) Dec. 2007 (U.S.)	Defense	189.4	155.6	345.0
35m patrol boats	June 2009 (Iraq) July 2009 (U.S.)	Defense	95.8	154.0	249.8
T-6A training aircraft	June 2009 (Iraq) July 2009 (U.S.)	Defense	110.0	99.8	209.8
General directorate of counterterrorism buildings	June 2009 (Iraq) ^b	Interior	14.3	7.0	21.3
Offshore support vessels	Sept. 2009 (Iraq) Mar. 2010 (U.S.)	Defense	27.0	82.8	109.8
Total			\$883.7	\$549.9	\$1,433.6

Source: GAO analysis of data provided by United States Forces-Iraq and U.S. Foreign Military Sales purchase agreements provided by United States Forces-Iraq and the Defense Finance and Accounting Service.

^aThis category refers to the date that DSCA began implementation of the Iraqi-funded and U.S.-funded FMS cases that make up each cost-sharing arrangement. The first date refers to the Iraqi-funded case, and the second date refers to the U.S.-funded case.

^bThere is no implementation date for the U.S. portion of this cost-sharing arrangement because, according to USF-I, it funded its share through a direct contract, rather than through an FMS case.

⁴¹Under certain circumstances, DOD will also procure equipment from foreign countries through the FMS program. For example, as noted in table 7, Iraq signed an agreement with the United States to purchase Russian-made Mi-17 CT helicopters. DSCA must approve an exception for such purchases from a foreign country.

Iraq Has Funded I-CERP and Assumed Responsibility for the Sons of Iraq and Other Security Contracts

In addition to spending by the Ministries of Defense and Interior, the Iraqi government also has funded I-CERP and assumed responsibility for paying the salaries of the Sons of Iraq and other security-related support contracts previously paid by the United States.⁴² In April 2008, Iraq provided \$270 million to fund I-CERP, an Iraqi-funded variation of the Commander's Emergency Response Program (CERP). CERP is a U.S.-funded and-managed program that enables local commanders to respond to urgent humanitarian relief and reconstruction requirements by carrying out programs that will immediately assist the local population.⁴³ Although neither I-CERP nor CERP directly supports the Iraqi military or police, these programs contribute to a sustainable security situation and help provincial governments win the support of the local population, according to USF-I. Through I-CERP, Iraq provides funding for projects, which USF-I subsequently carries out using the same procurement, disbursement, and accountability mechanisms that it uses to implement CERP projects. As of September 1, 2009, USF-I had obligated about \$229 million of Iraqi funding for I-CERP projects, ranging from road and school improvements to small business grants.

Iraq has also assumed responsibility for some security contracts formerly paid by USF-I, most notably, the contracts to pay the salaries of the Sons of Iraq. In June 2007, USF-I incrementally began hiring Sons of Iraq as security contractors to assist the Coalition and Iraqi forces in maintaining security in their local communities. Iraq started to take responsibility for some of the Sons of Iraq contracts in October 2008 and, according to an official from USF-I responsible for monitoring these contracts, assumed full control of almost 90,000 contracts in May 2009. From February 2009 through December 2009, Iraq paid more than \$255 million for the salaries of the Sons of Iraq.⁴⁴ Before turning the Sons of Iraq contracts over to Iraq,

⁴²Unlike FMS purchases, which are funded out of the budgets of the Ministries of Interior and Defense, according to USF-I, the original funding for I-CERP came from an unobligated balance in a subaccount of the Development Fund for Iraq. Consequently, Iraq's contributions to I-CERP are not reflected in the expenditures reported in table 4.

⁴³GAO has conducted a prior review of CERP in Iraq. See GAO, *Military Operations: Actions Needed to Better Guide Project Selection for Commander's Emergency Response Program and Improve Oversight in Iraq*, [GAO-08-736R](#) (Washington, D.C.: June 23, 2008).

⁴⁴Through the end of 2009, the Iraqi government is paying the Sons of Iraq salaries out of funds budgeted to the Ministry of Interior. Eventually, the Iraqi government plans to transition 80 percent of the Sons of Iraq into employment with various Iraqi ministries and 20 percent into the Iraqi security forces. When this transition occurs, the entities that absorb the Sons of Iraq will be responsible for paying their salaries.

USF-I spent approximately \$413 million of CERP funding to pay their salaries.

Additionally, Iraq has begun to pay for security-related support contracts previously paid by the United States, and USF-I plans to transfer additional contracts as the United States reduces its presence in Iraq. According to USF-I, the command transferred almost \$132 million in security-related contracts to Iraq between September 2008 and October 2009, including a contract to manage the Bayji National Ammunition Depot and a contract to provide maintenance for armored personnel carriers. From November 2009 through April 2010, USF-I planned to transfer another seven contracts valued at about \$10 million. These include a contract to provide training for air traffic controllers in the Iraqi air force and a contract to provide maintenance for flight simulators.

Iraq's Security Ministries Have Not Fully Used Available Resources, and Funding for I-CERP Has Fallen Short of Expectations

Our analysis of data from the Iraqi Ministries of Finance, Defense, and Interior; DSCA; and the Trade Bank of Iraq indicated that—despite increases in spending by the security ministries since 2005—the Ministries of Defense and Interior did not spend or set aside between \$2.5 billion and \$5.2 billion that could have been applied to Iraq's security needs (see table 8). U.S. officials have cited several reasons that the security ministries have been unable to fully use their budgeted funds, including overly centralized decision making and weak procurement capacity. As displayed in table 8, Iraqi government data show that the Ministries of Defense and Interior spent \$28.3 billion of the \$38.4 billion they were budgeted from 2005 through 2009, resulting in about \$10 billion of unspent funds. These ministries also set aside about \$7.5 billion for advances, including FMS purchases and letters of credit. This includes approximately \$5.5 billion transferred to an account at the Federal Reserve Bank of New York for FMS purchases and about \$1.8 billion in letters of credit for purchases through foreign contracts. It also includes more than \$100 million in advances on domestic contracts made by the Ministry of Defense through the end of 2009. With the exception of this Ministry of Defense data on advances for domestic contracts, our analysis does not reflect any additional funding that the security ministries may have set aside to pay advances. We requested this information from the Ministries of Defense and Interior through the USF-I advisors to these ministries, but the ministries did not provide us with any additional data.

Table 8: Estimated Unused Funds by the Iraqi Ministries of Defense and Interior, 2005-2009

U.S. dollars in billions

	Estimated unused funds		
	Ministry of Interior	Ministry of Defense	Total (2005-2009)
Total budgeted	\$18.6	\$19.8	\$38.4
Total expenditures	(15.7)	(12.6)	(28.3)
Subtotal unspent funds	\$2.9	\$7.1	\$10.0
Outstanding advances	(1.1-1.6)	(3.7-5.9)	(4.9-7.5)
Unused funds	\$1.3-\$1.7	\$1.2-\$3.4	\$2.5-\$5.2

Source: GAO analysis of data from Iraq's Board of Supreme Audit; the Iraqi Ministries of Finance, Defense, and Interior; Trade Bank of Iraq; and the Defense Security Cooperation Agency.

Note: To calculate the unspent funds for 2005 through 2009, we found the cumulative unspent funds through 2009 in Iraqi dinars and then used the 2009 budget exchange rate to express it in U.S. dollars. Estimates of unused funds may not equal the difference between total unspent funds and outstanding advances, and sums may differ from totals due to rounding.

We report a range for outstanding advances and unused funds to reflect uncertainty regarding what portion of the advances for FMS purchases and letters of credit has been recorded as an expenditure by the Ministry of Finance and is therefore already reflected in total expenditures. Our low estimate for outstanding advances (\$4.9 billion) assumes that about \$2.6 billion of the \$7.5 billion set aside for FMS purchases, letters of credit, or Ministry of Defense advances on domestic contracts is already reflected in total expenditures. Our high estimate for outstanding advances (\$7.5 billion) assumes that none of the \$7.5 billion set aside for FMS purchases, letters of credit, or other advances has resulted in an expenditure. To determine the portion of funds set aside for FMS purchases that may have resulted in the delivery of equipment or services, and that therefore may have already been recorded as an expenditure by the Ministries of Defense and Interior, we reviewed a report from the Defense Finance and Accounting Service showing the value of FMS deliveries to the security ministries, as of December 31, 2009. Similarly, to determine the value of letters of credit that may have resulted in expenditures, we reviewed data from the Trade Bank of Iraq on letters of credit that were closed as of December 31, 2009. Finally, to determine the portion of other advances that may have been expended, we reviewed data on advances for domestic contracts provided by the Ministry of Defense. We determined that the data used in this analysis were sufficiently reliable and made the assumptions described in this section to generate estimates of unused funds.

We also found that the Iraqi government had not provided additional funding for I-CERP, as originally intended. The Memorandum of Understanding between the United States and Iraq, establishing I-CERP, stated that funding for I-CERP would eventually seek to match U.S. funding for the CERP program—more than \$1 billion in 2008. However, as of September 1, 2009, USF-I had obligated \$229 million of the \$270 million in funding provided by Iraq for I-CERP, and Iraq had not provided any additional resources to support the program. By comparison, from fiscal years 2004 through September 2009, USF-I obligated more than \$3.6 billion for CERP projects in Iraq and had forecast \$300 million in additional CERP needs for Iraq in fiscal year 2010. According to an official from USF-I who is familiar with the negotiations over additional funding for I-CERP, Iraq did not provide additional funding for I-CERP due to limited capital budgets and competing spending priorities.

The Administration Is Requesting \$2 Billion in Additional Funds for the Iraqi Military and Police Forces

In February 2010, the administration submitted a budget request for \$3 billion in additional U.S. funding to provide training, equipment, and other services to the Iraqi military and police forces. This includes a \$1 billion request for fiscal year 2010 supplemental funding, which has already been approved by Congress,⁴⁵ and a \$2 billion request as part of the administration's fiscal year 2011 budget proposal,⁴⁶ which is currently under consideration. According to USF-I, the Iraqi security forces will need additional equipment, training, and sustainment to bolster their capabilities as the United States begins to reduce its troop presence. USF-I plans to meet these needs by transferring U.S. defense articles valued at \$600 million to the Iraqi government⁴⁷ and using \$3 billion in additional U.S. government funds to purchase equipment, training, and services for the Iraqi security forces. Under the administration's proposal, about \$2.4 billion would be used to support Iraqi forces under the Ministry of Defense, and almost \$600 million would help to train and equip Ministry of

⁴⁵See Supplemental Appropriation Act, 2010, Pub. L. No. 111-212 (July 29, 2010).

⁴⁶The administration proposed that the \$1 billion requested as part of a fiscal year 2010 supplemental budget remain available through September 2011, and that the \$2 billion requested as part of a fiscal year 2011 budget remain available through September 2012.

⁴⁷According to USF-I, these transfers are authorized under section 1234 of the National Defense Authorization Act for Fiscal Year 2010. Before exercising this authority, the Secretary of Defense, with the concurrence of the Secretary of State, must provide the appropriate congressional committees with notice of the proposed transfer and a report on the plan for the disposition of equipment and other DOD property in Iraq or Kuwait. See the National Defense Authorization Act for Fiscal Year 2010, Pub. L. No. 111-84 (Oct. 28, 2009).

Interior forces. USF-I asserts that these equipment transfers and additional funding will

- bolster Iraq's internal security and stability with police training,
- provide the Ministry of Defense with a foundational capability for external defense, and
- provide the Ministries of Defense and Interior with an institutional and logistic sustainment capability.

Specifically, USF-I has stated that the \$600 million in U.S. equipment transfers would allow it to modernize one mechanized division and fully equip three infantry divisions of the Iraqi army; provide additional air surveillance capabilities; improve protection for naval infrastructure, such as ports and oil platforms; and provide training and other support for existing equipment. Additional funding would cover the costs of refurbishing and shipping some of the equipment to be transferred to the Iraqi security forces. It would also provide funding for the sustainment of equipment previously purchased by Iraq, including tanks and rotary wing aircraft; pilot training; long-range air defense radars; ammunition; and contracts for advisors to the Ministries of Defense and Interior, among other things.

In commenting on a draft of this report, State asserted that U.S. government security assistance is necessary to help the Iraqi security forces meet the minimum essential capability requirements associated with the responsible drawdown of U.S. forces. Furthermore, in the budget justification documentation accompanying its fiscal year 2011 budget request, DOD stated that the United States faces the choice of making additional investments to fill essential gaps in the capabilities of the Iraqi security forces or accept the risk that they will fall short of being able to fully secure Iraq from internal and external threats by the time U.S. forces depart in accordance with the Security Agreement. However, USF-I acknowledges that some equipment necessary for providing Iraq with a set of minimum essential capabilities would not arrive in Iraq before December 31, 2011, the final withdrawal date for U.S. forces. According to USF-I, all purchases made using U.S. funding will be conducted through the FMS process. Depending on the equipment or services being provided, it could take from 6 months to 36 months after an FMS agreement has been implemented for the items to be delivered. Consequently, some equipment and services purchased using fiscal year 2011 funding may not arrive in Iraq until 2013, well after the withdrawal of U.S. forces—with

some items, such as tank ammunition, potentially taking even longer to arrive.

Conclusions

Congress has instructed the U.S. government to take actions to ensure that Iraqi funds are used to pay for the costs of training, equipping, and sustaining the Iraqi military and police. DOD has encouraged greater Iraqi spending of its own funds, particularly through the FMS program, and Iraq has consistently increased spending on its own security over the past 5 years. However, billions of dollars that Iraq has budgeted for security have gone unused. As U.S. troops withdraw, the Iraqi government must take a larger role in providing security throughout the country. Congress recently provided the administration with \$1 billion in new funding to support Iraq's military and police through its passage of a fiscal year 2010 supplemental appropriation. The administration is currently requesting an additional \$2 billion in fiscal year 2011 funding for similar uses. However, our analysis of Iraqi government data showed cumulative budget surpluses of \$52.1 billion through December 2009, of which at least \$11.8 billion is available for future spending. These surpluses have enabled Iraq to accumulate at least \$15.3 billion in financial deposit balances. Moreover, IMF-required reviews of Iraq's outstanding advances and its balances in government bank accounts will clarify the total resources available for future spending. In light of these resources, Iraq has the potential to further contribute toward its security needs, even as it addresses other competing priorities.

Matter for Congressional Consideration

To ensure that Iraq continues to spend its own resources on security costs, Congress should consider Iraq's available financial resources when reviewing (1) a fiscal year 2011 budget request and (2) potential future funding requests to support the Iraqi security forces.

Recommendation for Executive Action

We recommend that the Departments of State and the Treasury work with the Iraqi government to further identify Iraqi resources available for future spending. This should include assisting Iraq in completing two reviews required under Iraq's arrangement with the IMF. First, State and Treasury should assist Iraq in completing a review of its outstanding advances to determine whether some of these advances may be recoverable and available for future spending. Second, State and Treasury should help Iraq complete a review of its central government accounts so that it can return any idle balances to the central Iraqi Treasury.

Agency Comments and Our Evaluation

We provided a draft of this report to the Departments of Defense, State, and the Treasury and the U.S. Agency for International Development (USAID). We also provided a draft of this report to the International Monetary Fund through Treasury. We received written comments from State, Treasury, and DOD, which we have reprinted in appendixes V, VI, and VII, respectively. USAID did not provide comments. State, Treasury, and DOD also have provided technical comments, which we incorporated throughout the report as appropriate. In addition, the IMF provided technical comments, which we incorporated in the report as appropriate.

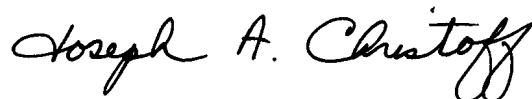
State and Treasury concurred with our recommendation. State agreed to work closely with its Iraqi counterparts to identify available financial resources, complete reviews of outstanding advances and central government accounts, and secure Iraqi cost-sharing across a variety of sectors. Treasury agreed, in principle that, while Iraq's fiscal accounts are not well ordered, Iraq potentially will have financial resources to engage in greater cost-sharing in the future. Furthermore, Treasury asserted that it continues to work with the Ministry of Finance and other Iraqi agencies to obtain more accurate estimates of available fiscal balances and enhance public financial management. However, State, Treasury, and DOD stated that they believe that the Iraqi government's available funds are closer to the low end of GAO's range. Given the substantial shortcomings associated with Iraq's accounting for advances and financial deposits, we report a range for Iraq's available surplus and financial deposits. We believe that it would be premature to suggest that Iraq's available resources fall at the low end of this range until Iraq has completed reviews of outstanding advances and central government accounts, as it agreed to in its arrangement with the IMF. These reviews will clarify the total resources available for government spending.

State, Treasury, and DOD also stated that Iraq needs to maintain a fiscal reserve, given its dependence on oil revenues and the volatility of oil prices. In its comments, DOD stated that the Iraqi government believes it needs to keep about \$10 billion to \$12 billion, or about 2 to 3 months of spending, in government accounts as a reserve. Under its arrangement with the IMF, Iraq agreed to maintain \$2.6 billion in the Development Fund for Iraq to pay for 2 to 3 months of employee wages. Iraq was capable of maintaining this amount with at least \$15.3 billion in financial deposits that it had at the end of 2009. Furthermore, through June 2010, Iraq generated almost \$2 billion more in revenue than it had predicted in its budget. If this trend continues, Iraq may have about \$4 billion in additional oil export revenues by the end of the year.

DOD agreed that there is room for improvement in the Iraqi government's financial accounting and reporting, and noted that the growing amount of outstanding advances presents a challenge to Iraq's public financial management. However, DOD also commented that it believes the overall message of our draft report—that the Iraqi government currently has significant cash reserves that would allow it to pay more of its security costs now and in 2011—is inaccurate. We disagree. As our report states, Iraq ended 2009 with at least \$15.3 billion in financial deposits. When completed, IMF-required reviews of Iraq's outstanding advances and central government accounts will clarify total resources available to the government for spending in 2010 and beyond. The review of deposits in central government accounts was due to be completed by March 31, 2010, but, according to the IMF, it was still under way as of August 2010. The review of Iraq's outstanding advances is to be completed by September 30, 2010. We cannot yet project Iraq's fiscal position through the end of 2010 or 2011. However, as we note in this report and as DOD acknowledged in its comments to our draft, past data indicate that Iraq's deficit in 2010 will be far less than is projected in its 2010 budget.

We are sending copies of this report to the appropriate congressional committees, the Secretary of State, the Secretary of the Treasury, the Secretary of Defense, the Administrator of the U.S. Agency for International Development, and other interested parties. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staffs have any questions about this report, please contact me at (202) 512-8979 or christoffj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix VIII.



Joseph A. Christoff
Director, International Affairs and Trade

List of Committees

The Honorable Carl Levin
Chairman
The Honorable John McCain
Ranking Member
Committee on Armed Services
United States Senate

The Honorable Kent Conrad
Chairman
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The Honorable Daniel K. Inouye
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and Foreign Affairs
Committee on Oversight and
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House of Representatives

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The Honorable C.W. Bill Young
Ranking Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives

The Honorable Nita M. Lowey
Chairwoman
The Honorable Kay Granger
Ranking Member
Subcommittee on State, Foreign Operations,
and Related Programs
Committee on Appropriations
House of Representatives

Appendix I: Objectives, Scope, and Methodology

In this report, we provide information on (1) the amount and availability of Iraq's budget surplus or deficit, (2) the amount of Iraq's financial deposit balances, and (3) the extent to which Iraq has spent its financial resources on security costs. In addition, this report identifies examples of other governments' contributions to the cost of U.S. security support in their countries, which could inform future Iraqi-U.S. cost-sharing arrangements. This report builds on GAO's extensive body of work on Iraq, including our August 2008 report on Iraq's fiscal balances from 2005 through 2007 and our March 2009 report in which we updated those figures through the end of 2008.¹

Iraq's Estimated Actual and Available Cumulative Budget Surplus or Deficit

To complete our analysis of the Iraqi government's estimated actual and available cumulative budget surplus, we analyzed financial data and other information that we obtained from the Iraqi Ministry of Finance, including reports by Iraq's Board of Supreme Audit on Iraq's financial accounts for 2005, 2006, and 2007.² During a trip to Baghdad in April 2010, we interviewed the Minister of Finance and a senior Ministry of Finance official to clarify data that we received on Iraq's revenues, expenditures, and advances. We also interviewed the President of the Trade Bank of Iraq and obtained data on letters of credit issued and closed by the Iraqi government. We analyzed data from the U.S. Defense Security Cooperation Agency (DSCA)³ on funds set aside by the Iraqi government for U.S. Foreign Military Sales (FMS) purchases. For this analysis, we also reviewed U.S. agency and International Monetary Fund (IMF) documents and interviewed officials from the Departments of State (State), Defense (DOD), and the Treasury (Treasury); the World Bank; and the IMF.

To determine Iraq's revenues and expenditures for 2005 through 2007, we obtained translated copies of reports on Iraq's audited accounts for each of these years. These reports were prepared by Iraq's Board of Supreme Audit and provided to GAO by the Iraqi Ministry of Finance. The reports

¹GAO, *Stabilizing and Rebuilding Iraq: Iraqi Revenues, Expenditures, and Surplus*, [GAO-08-1031](#) (Washington, D.C.: Aug. 5, 2008); and *Iraq: Key Issues for Congressional Oversight*, [GAO-09-294SP](#) (Washington, D.C.: Mar. 24, 2009).

²Republic of Iraq, Board of Supreme Audit, *Financial Statement for the Republic of Iraq through 12/31/05* (Mar. 30, 2009); *Financial Statement for the Republic of Iraq through 12/31/06* (Sept. 30, 2009); and *Financial Statement for the Republic of Iraq through 12/31/07* (Apr. 14, 2010).

³DSCA is responsible for the administration of the U.S. Foreign Military Sales program.

include final revenue and expenditure data for each year, including adjustments made by the Ministry of Finance during its end-of-year reconciliation process. To determine Iraq's revenues and expenditures for 2008, we obtained translations of the final Ministry of Finance accounts that it submitted to the Board of Supreme Audit for review. The data on total revenues and expenditures contained in Iraq's final accounts for 2008 also include adjustments made by the Ministry of Finance during its end-of-year reconciliation process. To determine Iraq's revenues for 2009, we obtained data on Iraq's monthly revenues and expenditures through December 2009 from the Ministry of Finance through Treasury. It is unclear whether these data include adjustments made by the Ministry of Finance during its end-of-year reconciliation process. We found that the revenue and expenditure data from the 2005 through 2007 Board of Supreme Audit reports were sufficiently reliable to determine Iraq's cash-based budget surplus. To corroborate Iraqi oil revenue, we compared the oil revenues data for 2008 and 2009 provided by the Ministry of Finance with Central Bank of Iraq export oil revenue receipts.

To determine Iraq's annual budget surpluses from 2005 through 2009 and cumulative surplus through the end of 2009, we used revenues and expenditures data denominated in Iraqi dinars. For each year, we subtracted total expenditures from total revenues to determine the annual cash surplus. To determine the annual cash surpluses in dollars, we used the annual Iraqi dinar-dollar budget exchange rates to convert each year's dinar-denominated annual surplus into dollars. To compute the dinar-denominated cumulative cash surplus through the end of 2009, we added the cash surplus accumulated before 2005, as reported by Iraq's Board of Supreme Audit, to the annual surpluses we calculated for each of the years from 2005 through 2008 and the estimated surplus we calculated for 2009. To calculate Iraq's dollar-denominated cumulative cash surplus through the end of 2009, we converted the dinar-denominated cumulative cash surplus into dollars using the 2009 dinar-dollar budget exchange rate. This dollar-denominated cumulative cash surplus differs from the sum of annual dollar-denominated cash surpluses due to the appreciation of the Iraqi dinar.

To estimate the amount of outstanding advances at the end of September 2009, we first determined the amount of outstanding advances through the end of 2007 on the basis of data from the 2007 Board of Supreme Audit report. Using this amount as a starting balance, we added the net annual change in outstanding advances (total advances issued minus total advances closed, regardless of the year in which they were issued) on the basis of data from (1) the 2008 final accounts that were submitted by the

Ministry of Finance to the Board of Supreme Audit and (2) Ministry of Finance data through September 2009. We interviewed officials from the Iraqi Ministry of Finance and Trade Bank of Iraq to try and clarify the composition and disposition of these advances. Finally, to better understand concerns about the way in which the Ministry of Finance accounts for advances, we reviewed reports issued by Iraq's Board of Supreme Audit and an IMF report on its arrangement with Iraq.

Iraq's Financial Deposit Balances

To assess the amount of the Iraqi government's financial deposit balances, we interviewed and obtained documentation from the Iraqi Minister of Finance, a senior Ministry of Finance official, the Governor of the Central Bank of Iraq, and staff from the two largest state-owned banks, Rafidain and Rasheed. The Iraqi government's financial deposits are held in Iraq's state-owned banks⁴ as well as in the Central Bank of Iraq and the U.S. Federal Reserve Bank in New York's Development Fund for Iraq. We also reviewed independent audit reports for the Central Bank of Iraq⁵ and Iraq's largest state-owned bank, Rafidain.⁶

The Central Bank of Iraq and the Ministry of Finance provided different sets of data on Iraq's financial deposits at state-owned banks in Iraq. The Central Bank of Iraq provided data on the account balances of government-sector accounts in Iraq's state-owned banks that were disaggregated by account ownership—that is, the central government; the self-funded government entities, also known as state-owned enterprises; and the financial sector. The Central Bank of Iraq based its data on information about required reserves that commercial banks are required to maintain with the Central Bank as a fraction of all deposits held in commercial banks. In contrast, the Ministry of Finance provided data on the available account balances to the central government for implementing the operating and investment budgets as of the end of November 2009. The Ministry of Finance data show that only a small fraction of the amount

⁴According to Central Bank of Iraq data, a small amount of government-sector deposits are also held in private commercial banks. These deposit balances total about \$100 million (approximately 0.4 percent of government-sector deposits in commercial banks).

⁵Ernst and Young, *Central Bank of Iraq Financial Statements, December 31, 2008: Independent Auditor's Report to the Ministry of Finance, Government of Iraq* (Feb. 9, 2010); and *Central Bank of Iraq Financial Statements, December 31, 2009: Independent Auditor's Report to the Ministry of Finance, Government of Iraq* (June 20, 2010).

⁶Ernst and Young, *Special Purpose Auditors' Report to the Ministry of Finance, Government of Iraq* (undated).

held in central government deposits in domestic banks is available for operating and investment purposes. The Ministry of Finance based its claim on a reclassification of accounts done in late November 2009 by representatives from the ministry's accounting and inspector general departments and the two largest state-owned banks. We were unable to independently verify the statements by the Central Bank of Iraq and the Ministry of Finance; thus, we report a range using both sets of data.

The Ministry of Finance and the Central Bank of Iraq agree on the amount of cash balances available to the central government for operating and investment budgets in the Central Bank of Iraq and the Development Fund for Iraq. The Governor of the Central Bank provided data on the Ministry of Finance's account balance as of December 2009. For the account balance of the Development Fund for Iraq, we report data through the end of 2009, which are based on the preliminary estimates published by the International Advisory and Monitoring Board in April 2010. We determined that these data were sufficiently reliable to determine the cash balance of central government deposits at the Development Fund for Iraq.

Iraq's Estimated Spending on Security

To determine the extent to which Iraq has spent its financial resources on security, we analyzed data on amounts budgeted for and spent by the Ministries of Defense and Interior. We determined expenditures by the Ministries of Defense and Interior from 2005 through 2009 on the basis of data from the 2005 through 2007 Board of Supreme Audit reports,⁷ 2008 Ministry of Finance accounts submitted to the board, and 2009 data provided by the Ministries of Defense and Interior. Amounts budgeted to the ministries are based on the 2005 through 2007 Board of Supreme Audit reports, Iraq's 2008 budget law and supplemental budget, and 2009 data from the Ministries of Defense and Interior—the same three sources. We did not receive 2009 data on expenditures by the Ministry of Interior for projects and reconstruction. We therefore assume that all of the \$216 million budgeted to the Ministry of Interior for projects and reconstruction in 2009 was spent. We used Iraqi dinar-dollar exchange rates to convert dinar expenditure figures to dollars. However, we calculated average annual growth rates in expenditures for the Ministries of Defense and

⁷Iraq's Board of Supreme Audit presents operating and investment spending separately in its 2007 report but does not disaggregate investment expenditures by ministry. Our analysis in 2007 therefore is based on operating expenditures alone. Data we obtained from the two ministries indicate that their investment spending was very small in 2007 and therefore would have a limited impact on the analysis.

Interior in Iraqi dinars to eliminate exchange rate effects on the growth rate in expenditures. We determined that these data were sufficiently reliable to describe expenditures and spending rates by the Ministries of Defense and Interior.

To determine the value of FMS agreements signed by the Ministries of Defense and Interior, we reviewed information provided by DSCA detailing the value of Iraq's FMS purchases that had been fully or partially implemented as of December 31, 2009. We corroborated this information by reviewing copies of the Letters of Offer and Acceptance⁸ for each of Iraq's FMS purchases, which we obtained from the Defense Finance and Accounting Service in Indianapolis, Indiana, as of June 22, 2009, and October 1, 2009. To determine the value of deposits made by the Ministries of Defense and Interior into Iraq's FMS account from 2006 through 2009, we also reviewed information provided by DSCA. We interviewed the Country Program Director and Country Finance Director for FMS in Iraq at DSCA and the Iraq Country Manager at the Defense Finance and Accounting Service to learn about the FMS program and clarify aspects of the information provided to us. We determined that these data were sufficiently reliable for the purposes of this analysis.

To determine the value of Iraq's FMS purchases in which the United States and Iraq shared the cost, we interviewed officials from DOD's United States Forces-Iraq (USF-I) during audit trips to Baghdad, Iraq, from September 18 to 25, 2009, and from April 12 to 16, 2010, and reviewed additional documentation provided subsequent to these trips. We interviewed the Country Program Director for FMS in Iraq at DSCA and reviewed the Letters of Offer and Acceptance for Iraq's FMS purchases to corroborate the accuracy of this information. We determined that these data were sufficiently reliable to determine the value of Iraq's FMS purchases in which the United States and Iraq shared the cost. To determine the extent to which Iraq has spent its resources through the Iraq-Commander's Emergency Response Program, Sons of Iraq contracts, and other security contracts, we interviewed officials from and reviewed information provided by USF-I and its subordinate commands.

To determine the amounts that the Ministries of Defense and Interior did not spend or set aside for FMS and other purchases from 2005 through

⁸A Letter of Offer and Acceptance serves as the official purchasing agreement for an FMS sale.

2009, we reviewed data on budgeted expenditures and expenditures from the Board of Supreme Audit and Ministries of Finance, Defense, and Interior, as previously described in this section of the report. We subtracted dinar-denominated expenditures from the amounts budgeted to these ministries in dinars from 2005 through 2009 to determine their annual unspent funds during this period. We then calculated the sum of these annual unspent funds to determine their cumulative unspent resources. Finally, we used the 2009 Iraqi dinar-dollar exchange rates to convert the cumulative total to dollars. To determine the additional amounts set aside by these ministries for FMS purchases, we reviewed a report provided by DSCA detailing the amounts deposited by the Ministries of Defense and Interior in Iraq's FMS account as of December 31, 2009. To determine amounts that the Ministries of Defense and Interior have set aside to finance purchases from foreign vendors through letters of credit, we obtained data from the Trade Bank of Iraq on letters of credit issued that remained outstanding as of December 31, 2009. Finally, we also received documentation from the Ministry of Defense indicating that it set aside about \$100 million for advances on domestic contracts through the end of December 2009. With the exception of these Ministry of Defense data on advances for domestic contracts, our analysis did not reflect any additional funding that the security ministries may have set aside to pay for advances. We requested this information from the Ministries of Defense and Interior through the USF-I advisors to these ministries, but the ministries did not provide us with any additional data. In our analysis, we therefore assumed that other advances for the Ministry of Interior total zero.

To calculate the amount of cumulative unused funds by these ministries from 2005 through 2009, we subtracted the cumulative unexpended funds set aside for FMS purchases, letters of credit, and other advances from the total unspent funds over the same period. We calculated a range of unused funds to reflect uncertainty regarding the portion of funds set aside for FMS purchases, letters of credit, and other advances that had been recorded as an expenditure. To determine the portion of funds set aside for FMS purchases that may have resulted in the delivery of equipment or services, and that therefore may have already been recorded as an expenditure by the Ministries of Defense and Interior, we reviewed a report from the Defense Finance and Accounting Service showing the value of FMS deliveries to the security ministries, as of December 31, 2009. Similarly, to determine the value of letters of credit that may have resulted in expenditures, we reviewed data from the Trade Bank of Iraq on letters of credit that were closed as of December 31, 2009. Finally, to determine the portion of other advances that may have been expended, we reviewed

data on advances for domestic contracts provided by the Ministry of Defense. Again, we did not receive any additional data on other advances from the Ministries of Defense or Interior. Our low estimate of unused funds assumes that none of the funds set aside for FMS purchases, letters of credit, or Ministry of Defense advances on domestic contracts have resulted in expenditures. Our high estimate assumes that \$1.7 billion in FMS deliveries, \$0.9 billion in closed letters of credit, and about \$0.1 billion in Ministry of Defense advances on domestic contracts are already reflected in Ministry of Finance expenditures.⁹

Examples of Other Countries' Contributions to the Cost of U.S. Security Support

To identify examples of other countries' contributions to the cost of U.S. security support (see app. IV), we reviewed relevant documents and data, including Letters of Offer and Acceptance for FMS purchases; military assistance; cost-sharing and other implementing agreements that document host country contributions to U.S. security costs; World Bank country economic income classifications; and DOD security assistance organization and security assistance program data. We also interviewed officials from various DOD offices—including the Office of the Under Secretary of Defense for Policy, DSCA, Central Command, European Command, and Pacific Command. In addition, we interviewed officials from State, including officials in the Bureaus of East Asian and Pacific Affairs, Near Eastern Affairs, and Political and Military Affairs and at U.S. embassies in Manila, Seoul, and Tokyo. Furthermore, we interviewed other knowledgeable military and academic experts, such as experts at the Defense Institute for Security Assistance Management. We traveled to Baghdad, Iraq, in September 2009 and April 2010 and interviewed officials from USF-I and the U.S. Embassy Baghdad Office of Political-Military Affairs.

In selecting countries as illustrative examples of cost-sharing for U.S. security support from the number of U.S. cost-sharing arrangements we reviewed, we considered several factors, including geographic location,

⁹We did not receive data on individual ministries' cash balances as of the end of 2009, and we were unable to determine if any of the estimated unspent funds were rolled over from previous years with the permission of the Ministry of Finance or were returned to the public Iraqi Treasury. Moreover, our analysis of unspent funds did not provide information on the source of the unspent funds (i.e., from the ministries' operating or capital budgets). Thus, it is unclear whether any potentially rolled over unspent funds could be reallocated across the two main categories of expenditures.

economic income classification,¹⁰ whether the U.S. organization that manages security support is under Chief of Mission or military command, and the presence of a major U.S. military force. Although our review is not a comprehensive review of all cost-sharing agreements that the United States has negotiated to share in the cost of U.S. security support activities, we provide a range of examples of the type of host country contributions that the United States has received to support security support activities overseas.

¹⁰We used the World Bank's economic income classification as a proxy for a host country's ability to pay.

Appendix II: Iraq's Oil Revenues

This appendix provides information on Iraq's oil revenues. Oil exports are the Iraqi government's primary source of revenue. Since 2005, oil exports constituted about 83 to 92 percent of the government's annual revenues (see table 9).

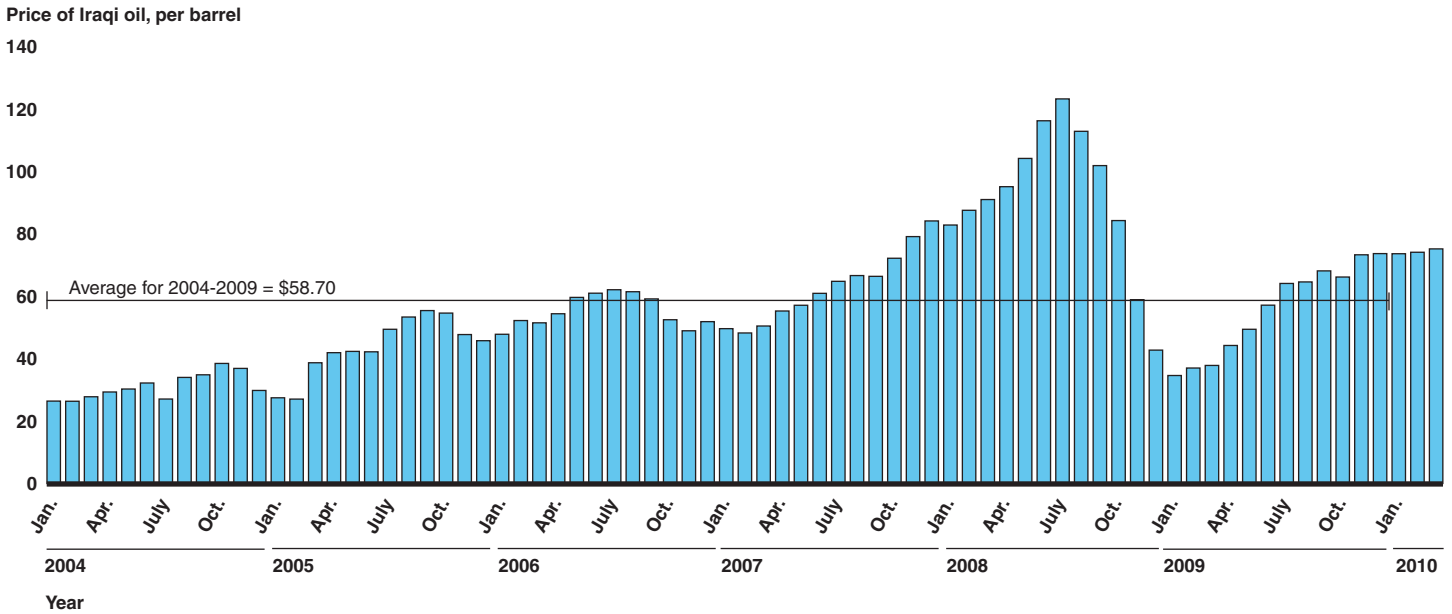
Table 9: Oil Export Revenues, 2005-2009

U.S. dollars in billions					
	Oil export revenues, by year				
	2005	2006	2007	2008	2009
Oil export revenues	\$23.0	\$29.8	\$37.8	\$61.9	\$39.0
All other revenue	4.0	2.9	5.8	5.3	8.0
Total	\$27.0	\$32.7	\$43.6	\$67.2	\$47.0
Oil export revenue as a percentage of total	85.3%	91.1%	86.7%	92.1%	83.0%

Source: GAO analysis of Central Bank of Iraq oil receipts, International Monetary Fund projections of non-oil export revenue, and Iraqi Ministry of Finance revenue data.

The price of Iraqi oil spiked during the summer of 2008 before dropping precipitously at the end of 2008 and the beginning of 2009. Prices have since rebounded, averaging \$74.36 per barrel through the first 3 months of 2010 (see fig. 3). This exceeds the average price for Iraqi oil in 2009 (\$56.54 per barrel) as well as the average for 2004 through 2009 (\$58.70 per barrel). According to DOD and the IMF, Iraq's 2010 budget assumes an average oil price of \$62.50 per barrel.

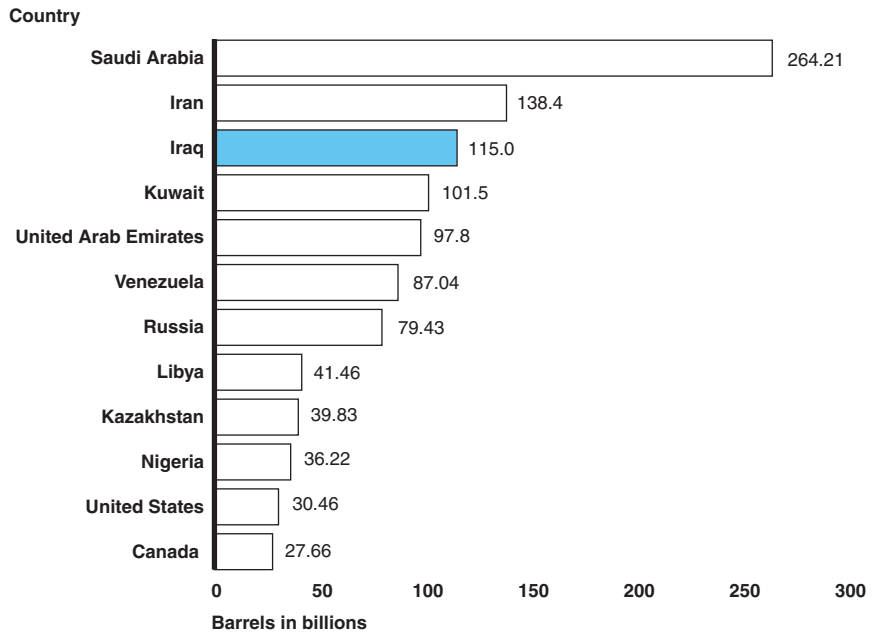
Figure 3: Average Price for Iraqi Crude Oil, January 2004-March 2010



Source: GAO analysis of Central Bank of Iraq data.

Iraq possesses an estimated 115 billion barrels of proved crude oil reserves, the world's third-largest stock (see fig. 4). Iraq's capacity to further exploit its oil resources underlies the government's ability to generate additional revenue.

Figure 4: Estimates of the World's Largest Oil Reserves by Country, as of December 2007



Source: Energy Information Administration data.

According to DOD, since June 2009, the Iraqi cabinet has approved 10 foreign investment contracts to develop or rehabilitate Iraqi oil fields that account for 65 percent of Iraq's estimated oil reserves. While U.S. officials acknowledge that it will take some time for Iraq to begin exporting oil extracted from these reserves, the contracts offer the Iraqi government the opportunity to significantly increase its exports and generate greater government revenue.

Appendix III: Amount and Categories of Iraq's Outstanding Advances through 2008

This appendix provides information on the amount and categories of Iraq's outstanding advances through the end of 2008. The amounts listed in table 10 represent the net annual change in outstanding advances (total advances issued minus total advances closed, regardless of the year in which they were issued) for 2005 through 2008 and outstanding advances through the end of 2004 and 2008. As shown in table 10, the Board of Supreme Audit identifies 26 categories of advances, but the composition of advances is unclear. For example, 40 percent of all outstanding advances through the end of 2008 are categorized as "other temporary advances," which are not fully defined. The "contractors advances" category, which was cited by a senior Ministry of Finance official as an example of an advance, accounted for 3 percent of all outstanding advances. This same official also stated that funds transferred for FMS purchases are treated as advances. However, the Board of Supreme audit does not include a category of advances that clearly identifies these transfers.

Table 10: Iraq's Outstanding Advances by Category, through 2008

U.S. dollars in millions

Type of advance	Outstanding advances paid by the Iraqi government, by year					Cumulative through 2008 ^a	
	Cumulative through 2004	2005	2006	2007	2008	Amount	Percentage of total
Temporary							
Work and services implementation	\$1,441.1	\$1,798.4	(\$892.2)	\$718.1	\$2,274.1	\$5,962.1	20.0%
Work/Business committees	26.4	18.4	28.8	13.5	101.0	207.3	1.0
Return travel (for recovering travel fees)	1.6	0.0	0.0	(1.9)	0.0	0.0	0.0
Advertising	0.1	0.0	0.0	0.1	0.9	1.1	0.0
Other	3,579.5	227.5	1,671.5	1,018.2	4,337.6	12,255.0	40.0
Subtotal	\$5,048.7	\$2,044.4	\$808.1	\$1,748.0	\$6,713.6	\$18,425.4	61.0%
Employee							
Travel	\$0.3	\$2.9	(\$0.6)	\$0.2	(\$1.8)	\$1.7	0.0%
Mission/Dispatching/Delegation	1.4	87.5	5.3	0.6	1.3	119.7	0.0
Transfer	0.0	0.0	0.0	0.0	0.3	0.3	0.0
Salaries	14.7	66.7	(0.9)	27.1	468.6	597.6	2.0
Hajj/Pilgrimage	0.0	0.0	0.0	0.1	0.0	0.1	0.0
Subtotal	\$16.5	\$157.1	\$3.9	\$27.9	\$468.4	\$719.5	2.0%

**Appendix III: Amount and Categories of
Iraq's Outstanding Advances through 2008**

U.S. dollars in millions

Type of advance	Outstanding advances paid by the Iraqi government, by year					Cumulative through 2008 ^a	
	Cumulative through 2004	2005	2006	2007	2008	Amount	Percentage of total
Permanent/Sustainable							
Cash disbursement (petty cash)	\$2.0	\$6.5	\$4.0	(\$2.2)	\$23.8	\$37.0	0.0%
Cash payments/treasuries	0.0	0.2	145.4	0.3	440.8	623.1	2.0
Fuel	0.2	0.0	0.1	0.3	0.1	0.7	0.0
Maintenance	1.3	0.1	0.0	0.1	0.2	2.0	0.0
Committee purposes (procurements)	0.0	0.0	0.0	0.0	6.2	6.2	0.0
Other	17.0	0.3	0.9	(2.5)	0.0	20.2	0.0
Subtotal	\$20.4	\$7.2	\$150.4	(\$4.0)	\$471.1	\$689.4	2.0%
Credit							
Credit	\$0.0	\$0.0	\$179.6	\$0.0	\$0.0	\$224.5	1.0%
Letters of credit (document)	1,109.7	1,134.2	705.4	485.5	4,499.5	8,696.0	29.0
Simple (small) letters of credit	0.0	0.0	(1.3)	(50.5)	9.7	(45.0)	0.0
Foreign transfers	0.0	211.6	109.1	245.7	116.6	775.5	3.0
Subtotal	\$1,109.7	\$1,345.8	\$992.8	\$680.7	\$4,625.8	\$9,650.9	32.0%
Contractors							
Initial (advance) payment	\$153.7	\$41.5	\$10.6	(\$8.9)	\$461.2	\$709.2	2.0%
Equipment and machinery	1.5	6.0	(0.1)	(0.3)	(0.2)	8.6	0.0
Contractors	0.3	0.0	0.0	4.3	73.5	78.3	0.0
Subtotal	\$155.5	\$47.5	\$10.5	(\$4.9)	\$534.4	\$796.2	3.0%
Other							
Claims	\$0.1	\$0.0	\$0.8	(\$0.4)	(\$0.5)	\$0.3	0.0%
Projects financed by others	0.0	0.0	0.0	28.5	108.4	138.3	0.0
Temporary advances for external agreements	0.0	0.0	1.6	(0.3)	0.0	1.7	0.0
Subtotal	\$0.1	\$0.0	\$2.4	\$27.9	\$108.0	\$140.4	0.0%
Total	\$6,351.0	\$3,601.9	\$1,968.1	\$2,475.6	\$12,921.2	\$30,421.9	100%

Sources: Iraq's Board of Supreme Audit reports (2005-2007); and Iraq's financial accounts submitted to the Board of Supreme Audit for review (2008).

Note: The categories of advances are based on English translations of Arabic-language Board of Supreme Audit reports and Arabic-language Ministry of Finance accounts submitted to the Board of Supreme Audit. Consequently, the names of the categories varied slightly from year to year.

^aThe amount of cumulative outstanding advances through 2008 does not equal the sum of the annual net change in outstanding advances due the appreciation of the Iraqi dinar.

Appendix IV: Cost-Sharing Arrangements for U.S. Security Support Activities in Other Countries

This appendix describes cost-sharing arrangements for U.S. security support activities¹ in selected partner nations. The United States provides a range of security support under State and DOD authorities to many countries representing a variety of income levels. To subsidize U.S. activities, several countries share in their costs under bilateral security and cost-sharing agreements with the United States.

The United States Undertakes a Variety of Security Support Activities in Other Countries

The United States provides a variety of security support under State and DOD authorities to many countries.² In more than 100 countries, U.S. personnel provide security assistance under the direction and supervision of State's Chief of Mission.³ Security assistance activities include such programs as FMS, Foreign Military Financing, and International Military Education and Training. The Foreign Military Financing program consists of congressionally appropriated grants and loans to eligible governments and international organizations to purchase U.S. defense articles, services, and training through FMS or Direct Commercial Sales channels. The International Military Education and Training program consists of training for foreign military personnel in the United States, overseas U.S. facilities, and participating countries on a grant basis.

In addition, organizations under DOD authority, such as U.S. Forces-Korea in South Korea and U.S. Forces-Japan, conduct a variety of security support activities, such as

- training foreign forces, including joint combined exchange training of U.S. special operations forces along with friendly foreign forces;

¹For the purposes of this report, we use the term security support to describe a range of activities, including security cooperation activities, which are intended to shape the operational environment in peacetime, and security force assistance, which is used to improve the capability and capacity of foreign security forces in security conditions ranging from stable peace to general war.

²Security assistance activities are generally codified in Title 22 of the *United States Code*. These activities are often referred to as Title 22 activities. Security cooperation activities are generally codified in Title 10 of the *United States Code*. These activities are often referred to as Title 10 activities.

³State's Chief of Mission is the principal officer appointed by the President to be in charge of a diplomatic mission of the United States or of a U.S. office abroad that is designated by the Secretary of State as diplomatic in nature.

- logistics support for foreign militaries, including agreements with eligible countries and regional or international organizations for the reciprocal provision of logistic support, supplies, and services; and
- military contact and cooperation, including bilateral and multilateral contacts with foreign militaries and payment of selected incremental costs for certain training partners.

The United States may have organizations under both State and DOD authorities within countries where the security relationship or other factors necessitate the type of activities traditionally undertaken by each. For example, in Saudi Arabia, two separate U.S. organizations operate under State—the U.S. Military Training Mission and the newly established Office of Program Management-Ministry of Interior. In addition, one organization operates under DOD authority—the Office of the Program Manager-Saudi Arabia National Guard. The three organizations provide training, advisory, and technical assistance to the government of Saudi Arabia. The type of security support the United States provides to Iraq and other countries depends on several factors, including host countries' security-related goals, prior experience in purchases of U.S. equipment or training, and ability to pay.

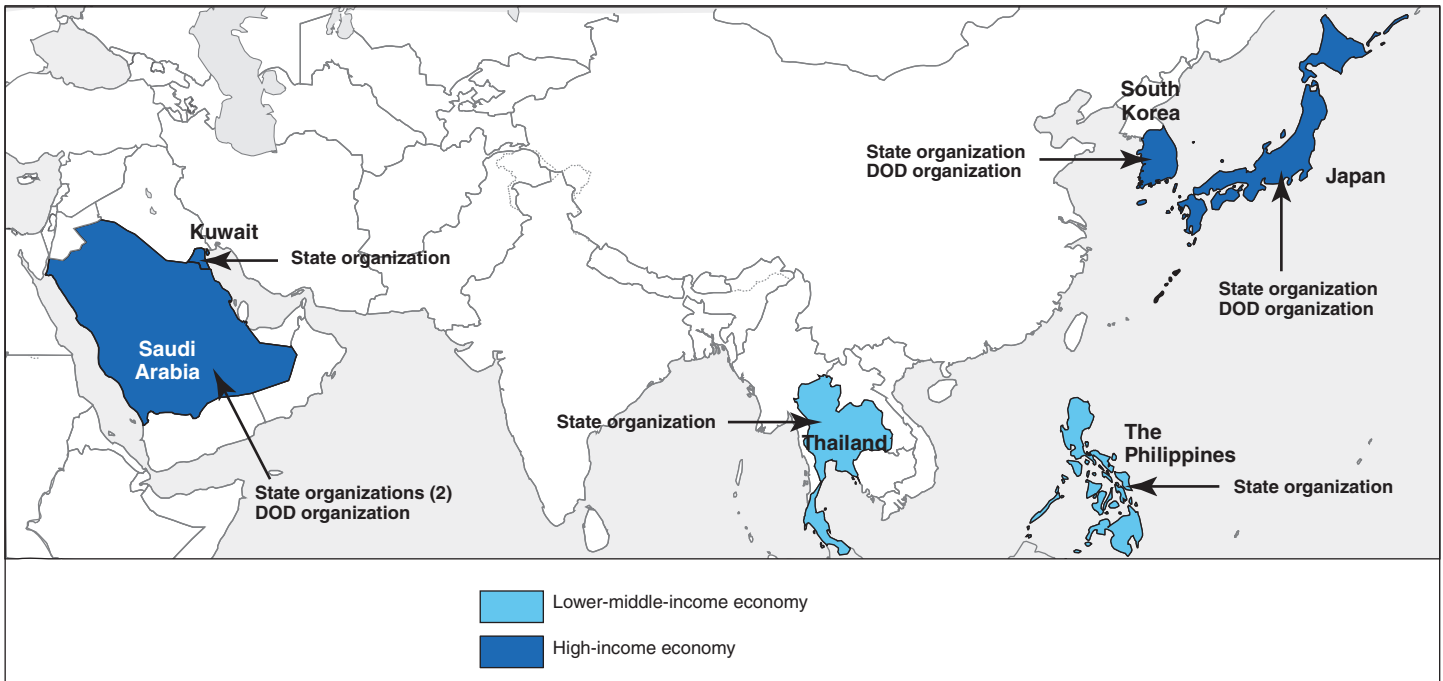
Countries at Varying Income Levels Contribute to the Cost of U.S. Security Support Activities

Several countries, representing a variety of income levels,⁴ provide cash and assistance-in-kind to share in the cost of U.S. security support activities. According to State and DOD officials, the extent and type of host government contributions for U.S. security support activities depend on the U.S. and host country security relationship as well as the country's ability and willingness to contribute to U.S. security support costs. The United States and host countries also may renegotiate these cost-sharing arrangements to reflect changes in a host nation's economic income or the nature of the bilateral security relationship. U.S. cost-sharing arrangements with Kuwait, Saudi Arabia, Japan, The Philippines, South Korea, and Thailand represent a range of geographic locations, income

⁴The World Bank classifies countries as high-, upper-middle-, lower-middle-, or lower-income economies. Under this classification, Iraq is a lower-middle-income economy.

levels, U.S. troop levels, and U.S. security support organizations (see fig. 5).⁵

Figure 5: Selected U.S. Organizations That Manage U.S. Security Support in Other Countries



Sources: Departments of State and Defense documents and interviews; World Bank data; Map Resources (map).

Despite varying income levels, security support needs, and cost-sharing arrangements, all six countries provide cash and assistance-in-kind to the United States for administrative costs, such as office facilities, supplies and equipment, or utilities. In addition, the high-income countries share labor or construction costs. Moreover, even the lower-middle-income countries provide personnel to support U.S. activities as well as grounds

⁵Because the U.S. government does not centrally collect information on cost-sharing arrangements between the United States and other countries, we could not conduct a comprehensive assessment of the various ways in which other countries subsidize the cost of U.S. security support. These cost-sharing arrangements may be included in U.S. defense assistance, cost-sharing, and implementing agreements or in FMS purchase agreements. DOD last reported to Congress on contributions for defense costs from allied host nations in 2004. See Department of Defense, *2004 Statistical Compendium on Allied Contributions to the Common Defense* (2004), which covers allied contributions in 2003.

Appendix IV: Cost-Sharing Arrangements for U.S. Security Support Activities in Other Countries

for U.S. military exercises. See table 11 for selected contributions by these six countries.

Table 11: Selected Contributions That Six Selected Countries Provide to Share U.S. Security Support Costs

Country	Economic income level	Selected cash or assistance-in-kind contributions
Middle East		
Kuwait	High	<ul style="list-style-type: none"> Office facilities and equipment Salary, retirement, dependent, and other indirect personnel costs Housing Transportation Gas
Saudi Arabia	High	<ul style="list-style-type: none"> Rents Office facilities, equipment, and supplies Housing and furnishings Facility construction and renovation Relocation and transportation Dependent education Contractual services
Asia		
Japan	High	<ul style="list-style-type: none"> Office facilities Salaries and benefits for 5 Japanese foreign service support personnel Labor (not to exceed 23,055 civilian support personnel) Utilities, including fuel, electricity, sewage, and water Drivers and vehicles Facility construction and renovation
South Korea	High	<ul style="list-style-type: none"> Housing Labor Logistics Construction
Thailand	Lower-middle	<ul style="list-style-type: none"> Office facilities and compound Utilities Vehicles and drivers Military grounds for live-fire exercises and training Military airfield

Appendix IV: Cost-Sharing Arrangements for U.S. Security Support Activities in Other Countries

Country	Economic income level	Selected cash or assistance-in-kind contributions
The Philippines	Lower-middle	<ul style="list-style-type: none"> • Office facilities within a military compound • Salaries and benefits (no less than 15 civilian support personnel) • Operational costs, including utilities • Drivers • Military grounds for exercises and training

Sources: Departments of Defense and State documents and interviews; and World Bank data.

Note: The World Bank classifies country economic income level according to 2008 gross national income per capita. The classifications are low income, \$975 or less; lower-middle income, \$976 to \$3,855; upper-middle income, \$3,856 to \$11,905; and high income, \$11,906 or more.

Kuwait

Under a 2009 agreement, Kuwait, a high-income economy, provides nearly \$28 million and assistance-in-kind for administrative costs over 2 years to support the U.S. Office of Military Cooperation. State’s security assistance office administers Kuwait’s FMS program, which totaled nearly \$315 million in sales in fiscal year 2009. Kuwait also provided the United States with a cash transfer of approximately \$94 million in fiscal year 2009, which DOD reported was used for base operations and sustainment of U.S. Army and Air Force installations in support of the U.S.–Kuwait Defense Cooperation Agreement. Cooperation under this agreement includes joint military exercises, U.S. training of Kuwaiti forces, and U.S. access to Kuwaiti facilities.⁶

Saudi Arabia

Saudi Arabia, a high-income economy, provided approximately \$35 million in cash and assistance-in-kind in 2009 to support the two U.S. security support organizations operating under State’s authority—the U.S. Military Training Mission and Office of Program Management-Ministry of Interior. The training mission oversees the FMS program in Saudi Arabia, valued at \$3.3 billion in sales in fiscal year 2009, and provides training instruction and advisory services for Saudi Arabian Armed Forces personnel. The United States established the Office of Program Management-Ministry of Interior in 2009 to provide articles and services, including technical assistance, to develop the capacity of the Saudi Arabia Ministry of Interior’s Facilities Security Force in the areas of critical infrastructure

⁶The exact nature of U.S. security support provided under the U.S.-Kuwait Defense Cooperation Agreement is classified.

protection and public security.⁷ In addition, Saudi Arabia will provide the United States approximately \$285 million from 2009 to 2013 to pay for security support activities managed by DOD's Office of the Program Manager-Saudi Arabia National Guard. The DOD office provides training and services to assist Saudi Arabia in modernizing its National Guard.

Japan

Japan, a high-income economy, financially supports two U.S. organizations—State's Mutual Defense Assistance Office, a security assistance organization that oversees the FMS program, and DOD's U.S. Forces-Japan, which administers bilateral defense activities. According to a PACOM official, Japan provides the Mutual Defense Assistance Office with five Japanese foreign service employees and several vehicles and drivers under a long-standing agreement to share in the cost of U.S. security support. The office managed FMS cases valued at about \$460 million in fiscal year 2009. Japan also provided nearly \$6.2 billion in cash and assistance-in-kind to support U.S. Forces-Japan activities in 2009.⁸ For example, under a cost-sharing agreement, renewed in 2008, Japan provided the United States with approximately \$1.4 billion for labor and utility costs in 2009.

South Korea

South Korea, a high-income economy, contributes cash and assistance-in-kind to support two U.S. organizations—State's Joint U.S. Military Affairs Group, a security assistance organization, and DOD's U.S. Forces-Korea, which has thousands of U.S. military personnel on the ground to pursue bilateral defense goals. According to State and DOD officials, South Korea contributes limited assistance-in-kind for housing to support the Joint U.S. Military Affairs Group. The organization manages Korea's FMS program, valued at nearly \$720 million in sales in fiscal year 2009. Under a cost-sharing agreement renewed in 2009, South Korea committed to provide approximately \$690 million in cash and assistance-in-kind per year from 2009 to 2013 for labor, logistics, and construction costs for U.S. Forces-Korea.⁹ According to a State official familiar with the negotiation, this

⁷The areas of critical infrastructure protection and public security include border protection, civil defense capabilities, and coast guard and maritime capabilities.

⁸This figure (\$6.2 billion) includes Japan's support for costs related to the stationing of U.S. Forces-Japan, the Special Action Committee on Okinawa, and realignment of U.S. Forces-Japan.

⁹The 2010 to 2013 contributions will be determined by increasing the contribution of the previous year by an agreed-upon inflation rate.

contribution represents about 40 percent of nonpersonnel stationing costs.¹⁰

Thailand

Thailand, a lower-middle income economy, contributes annual assistance-in-kind and cash payments to support the Joint U.S. Military Advisory Group under a long-standing military assistance agreement with the United States. The security assistance organization's activities in fiscal year 2009 included managing Thailand's Foreign Military Financing grants, FMS cases, and International Military Education and Training program, which were valued at \$1.6 million, almost \$53.0 million, and almost \$1.5 million, respectively. Thailand provided cash payments of \$285,000 for support such as drivers, vehicles, and utilities for the organization in 2009. DOD and State officials reported that Thailand also provides the United States with the use of military grounds for the U.S. military to conduct live-fire exercises and training and the use of a Thai airfield. According to State and DOD officials, Thailand is the only country that provides the United States with live-fire training grounds—a substantial benefit to the United States.

The Philippines

The Philippines, a lower-middle income economy, contributes cash payments and assistance-in-kind to the Joint U.S. Military Assistance Group. The security assistance organization administers U.S. security support programs, such as the \$28.0 million Foreign Military Financing and the \$1.7 million International Military Education and Training programs in fiscal year 2009. To financially support this organization, The Philippines provided cash transfers of approximately \$217,000 and assistance-in-kind through office facilities and support personnel in 2009. Although The Philippines provides smaller financial contributions to the United States than other countries, State and DOD officials reported that certain assistance-in-kind, such as training grounds, provide significant additional benefits to the United States.

¹⁰Nonpersonnel stationing costs are the cost of stationing U.S. forces in a host country, not including military personnel pay and allowances.

Appendix V: Comments from the Department of State

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



United States Department of State

Chief Financial Officer

Washington, D.C. 20520

APR 04 2010

Ms. Jacquelyn Williams-Bridgers
Managing Director
International Affairs and Trade
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548-0001

Dear Ms. Williams-Bridgers:

We appreciate the opportunity to review your draft report, "IRAQI-U.S. COST-SHARING: Iraqi Data Show Continued Budget Surpluses, Offering the Potential for Greater Cost-Sharing," GAO Job Code 320638.

The enclosed Department of State comments are provided for incorporation with this letter as an appendix to the final report.

If you have any questions concerning this response, please contact Kyle Peterson, Desk Officer, Bureau of Near Eastern Affairs at (202) 647-9837.

Sincerely,

A handwritten signature in black ink, appearing to read "James L. Millette".

James L. Millette

cc: GAO – Judith McCloskey
NEA – Jeffrey D. Feltman
State/OIG – Tracy Burnett

DEPARTMENT OF STATE COMMENTS ON GAO DRAFT REPORT

**IRAQ-U.S. COST-SHARING: Iraq Has a Cumulative Budget Surplus,
Offering the Potential for Greater Cost-Sharing**
(GAO-10-304, GAO Code 320638)

Thank you for the opportunity to review and comment on the July 2010 draft of the GAO's report, *Iraq-U.S. Cost Sharing: Iraq Has a Cumulative Budget Surplus, Offering the Potential for Greater Cost-Sharing*. We appreciate the close coordination between the GAO, the Administration, and Iraqi government officials during the development of this report. We agree with GAO's stated goal for this report, i.e., to "ensure that Iraq shares in its security costs." We also agree with the GAO's recommendation. In conjunction with the Treasury Department, we will continue to work closely with our Iraqi counterparts to identify available financial resources; complete reviews of outstanding advances and central government accounts; and secure Iraqi cost-sharing across a variety of sectors.

The Department of State believes that Iraq's Ministry of Finance has made progress in government spending, financial accounting, and reporting over the past few years, a particularly impressive accomplishment given that Iraq is recovering from years of civil strife. The Ministry itself was severely damaged by bombs twice in the past year, hampering its operational capabilities. Nevertheless, we agree with the GAO and others that there is room for improvement in the Iraqi government's financial accounting and reporting. The Embassy, in coordination with the International Monetary Fund (IMF) and World Bank, will continue to focus much of its capacity-development efforts toward increasing budget execution and improving accounting standards for federal and provincial government entities in Iraq. Additionally, the Embassy will continue to provide assistance to both the Ministry of Finance and the Central Bank of Iraq as they work to restructure Iraq's state-owned banks, as called for under the Iraqi government's IMF program.

The Department of State believes that the Iraqi government's available funds are closer to the low end of the draft report's range of available balances – almost \$12 billion. Given Iraq's dependence on oil revenues and the volatility of oil prices, maintaining a fiscal reserve would be sensible. Indeed, the most recent IMF staff report on Iraq notes that financing large, but declining, projected fiscal deficits over the next two years "could exhaust the government's remaining financial balances and result in the accumulation in arrears."¹

¹ International Monetary Fund, *Iraq: Staff Report for Article IV Consultation and Request for Stand-By Arrangement* (IMF Country Report No. 10/72), 12.

See comment 1.
See comment 2.

Iraq's recent financial decisions reflect its concern about its fiscal position. In 2009 and 2010, Iraq sought approximately \$5 billion in loans from the International Monetary Fund (IMF) and the World Bank to finance projected budget deficits, and borrowed almost \$5 billion for electrical infrastructure investment. And although Iraq sits on the third-largest proven conventional oil reserves in the world, the government faces a variety of constraints that could inhibit efforts to quickly increase oil output and revenue.

The draft report correctly notes that the Government of Iraq (GOI) has continually allocated and spent increasing amounts on security over the past few years. As the draft report states, "both [security ministries] spent more than 90 percent of the funds made available to them in 2009."² Furthermore, the Iraqi government budgeted a combined \$11 billion for the Ministries of Defense and Interior in the 2010 budget, which translates to almost 14 percent of Gross Domestic Product (GDP). The Department of State believes this clearly indicates the seriousness with which the Iraqi government treats its responsibility to cover its own costs for internal and external security.

As our relationship with Iraq evolves in the near term with the continued drawdown of U.S. forces from Iraq, our strategy hinges on assisting the Iraqis in developing security forces that are capable of defending Iraqi citizens against internal and external threats. Although the Iraqi government provides the bulk of its own security funding, U.S. government security assistance is necessary to help the Iraqi Security Forces meet the minimum essential capability requirements associated with our responsible drawdown of U.S. forces. The Department of State expects that security assistance of this magnitude will be short-term in nature; future requests for security assistance will be made only after a careful assessment of what we believe Iraq will need to maintain internal and external security.

Iraq remains a key strategic partner for the United States in a critical region of the world. It is important that we use civilian and military assistance effectively to support a long-term, productive bilateral relationship with Iraq. At the same time, it is important for the Administration to pursue good stewardship of taxpayer resources. As Iraq's wealth grows, we will certainly expect the Iraqi government to cover an increasing share of the cost of Iraq's security and reconstruction.

² United States Government Accountability Office, [Iraqi-U.S. Cost Sharing: Iraqi Data Show Continued Budget Surpluses, Offering the Potential for Greater Cost-Sharing \(DRAFT, June 2010\)](#), 28.

Following are GAO's comments on the Department of State's letter dated August 4, 2010.

GAO Comments

1. We believe that it is premature to assert that the Iraqi government's available funds are closer to the low end of the ranges of surplus funds and financial deposits noted in this report. Two reviews required under Iraq's arrangement with the IMF will clarify the total resources available to the Iraqi government. First, Iraq has agreed to prepare a report on its outstanding advances, identify those that are recoverable, and set a schedule for their recovery. Iraq has committed to completing this report by September 30, 2010. Second, the Ministry of Finance must review all central government accounts in the banking system, reconcile them with Iraqi Treasury records, and return any idle balances received from the budget to the central Iraqi Treasury. This review was due to be completed by March 31, 2010, but, according to the IMF, it was still under way as of August 2010.
2. We agree that it would be sensible for Iraq to maintain a fiscal reserve, and it has agreed to do so under the terms of its February 2010 arrangement with the IMF. Iraq agreed to maintain \$2.6 billion in the Development Fund for Iraq to provide sufficient funds to cover 2 to 3 months in employee wages for government workers. Iraq was capable of maintaining this amount with at least \$15.3 billion in financial deposits it had at the end of 2009. In addition, through June 2010, Iraq generated almost \$2 billion more in revenue than had been predicted in its budget. If this trend continues, Iraq may have about \$4 billion in additional oil export revenues by the end of the year. Consequently, Iraq should have sufficient resources at the end of 2010 to provide for the fiscal reserve required by the IMF.

Appendix VI: Comments from the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 4, 2010

Mr. Joseph A. Christoff
Director, International Affairs and Trade
Government Accountability Office

Dear Mr. Christoff:

Thank you for the opportunity to review and comment on the July draft of the GAO's report, *Iraq-U.S. Cost-Sharing: Iraqi Data Show Continued Budget Surpluses, Offering the Potential for Greater Cost-Sharing*. Treasury has been closely engaged with the Iraqi government to improve its procurement capacity and budget execution. We appreciate the GAO's attention to the issue of strengthening Iraq's financial management, which is crucial for Iraq to achieve adequate capability for providing internal security before the withdrawal of U.S. forces by December 31, 2011, as foreseen by the U.S.-Iraq Security Agreement. We also appreciate the close coordination between the GAO, the Administration, and Iraqi officials during the development of the report.

We agree in principle with the GAO that, while Iraq's fiscal accounts are not well ordered, Iraq potentially will have financial resources to engage in greater cost-sharing in the future. Indeed, Iraq has significantly boosted its spending on security and reconstruction in the past few years. However, we believe that the resources available to the Iraqi government are likely at the low end of GAO's range and that Iraq needs a fiscal cushion to deal with considerable variability in its fiscal revenues.

The GAO report appropriately subtracts outstanding advances to get an estimate of cumulative surpluses of almost \$12 billion. This estimate is broadly consistent with IMF figures, based on preliminary analysis, that also suggest that the cumulative budget surplus over this period was relatively small.

The GAO estimates that the Government of Iraq had between \$15 billion and \$32 billion in usable financial balances held at the Central Bank, the Development Fund for Iraq, and state owned banks as of December 2009. Data shortcomings are significant, but the actual figure is likely at the low end of this range.

- The low end of the range for available balances is consistent with estimates for Iraqi cumulative cash surpluses minus advances.

See comment 1.
See comment 2.

- The upper end of the range includes significant deposits at state owned banks that the Finance Ministry indicates are unavailable for central government fiscal purposes as they are owned by other state entities, such as pension funds or state enterprises. The IMF is working with Iraqi officials to identify whether any significant sums could be recovered by the central government.

In any event, the adequacy of Iraq's available fiscal balances should be assessed in the context of the uncertainties and variability of Iraq's fiscal position. Iraq would need some fiscal cushion as Iraq receives about 85 percent of its revenue from oil exports, and is therefore highly vulnerable to oil price fluctuations. IMF and Iraqi figures suggest that Iraq is likely to run a budget deficit this year based on current oil prices and exports. And, if oil prices fall from current levels or oil export volumes falter, the Government of Iraq may need to use most or all of its available fiscal balances to fund budget deficits in 2010 or 2011. (A \$10/barrel drop in oil prices would increase Iraq's annual deficit by about \$7 billion.) Iraq will benefit in the future from investments in the oil sector, but these benefits will not materialize for a number of years. Moreover, Iraq's still sizable external debt and unsettled political environment largely inhibits it from borrowing significant sums from the private sector before oil revenues begin to increase.

In light of its vulnerable fiscal position, Iraq has sought budget support from the international community. The IMF disbursed about \$455 million to Iraq earlier this year, as part of a program that could provide about \$3.6 billion for fiscal support during 2010-2011. The World Bank also provided \$250 million in budget support for Iraq this year. Further disbursements by the IMF and World Bank are conditional on improvements in Iraq's public financial management.

We are committed to providing policymakers with an accurate representation of Iraq's fiscal situation and recognize that data limitations pose challenges. To this end, we support GAO's recommendations to work with the Iraqi government to further identify resources available to the Iraqi government, including by assisting Iraq to complete reviews of outstanding advances and central government accounts, as agreed in Iraq's IMF program. Treasury continues to engage with the Ministry of Finance and other Iraqi agencies to obtain more accurate estimates of available fiscal balances and government advances. Through our Attaché's office in Baghdad, Treasury is working with the Iraqis to enhance public financial management more broadly, including fiscal reporting and transparency. We will continue to give strong support to the work of the IMF and Iraq to strengthen financial management at the Finance Ministry and Central Bank.



Andy Baukol
Deputy Assistant Secretary, Middle East & Africa
U.S. Department of the Treasury

See comment 3.

Following are GAO's comments on the Department of the Treasury's letter dated August 4, 2010.

GAO Comments

1. We report a range of available resources to reflect the uncertainty regarding Iraq's outstanding advances and government deposits. Furthermore, we believe it is premature to assert that the Iraqi government's available funds are closer to the low end of our ranges until Iraq has completed its IMF-required reviews of advances and government deposits. These reviews will clarify the total resources that are available to the Iraqi government.
2. We agree that Iraq may need a fiscal cushion to address potential variability in its fiscal revenues. As part of its arrangement with the IMF, Iraq agreed to maintain \$2.6 billion in the Development Fund for Iraq to cover 2 to 3 months in employee wages for government workers. Iraq was capable of maintaining this amount with at least \$15.3 billion in financial deposits it had at the end of 2009. In addition, through June 2010, Iraq generated \$2 billion more in revenue than it had predicted in its budget. If this trend continues, Iraq may have about \$4 billion in additional oil export revenues by the end of the year. Consequently, Iraq should have sufficient resources at the end of 2010 to provide for the fiscal reserve required by the IMF.
3. Past data indicate that Iraq's deficit in 2010 will be far less than projected in its 2010 budget. From 2005 through 2009, Iraq began each year with budgets that projected deficits from \$3.5 billion to \$15.9 billion, but ended each year with surpluses, measured on a cash basis. Even after adjusting for advances, Iraq generated surpluses from 2005 through 2007 and in 2008 and 2009 produced deficits that were less than one-half of the amounts projected in its budgets for those years.

Appendix VII: Comments from the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



INTERNATIONAL
SECURITY AFFAIRS

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON D.C. 20301 2400

10 NOV 2010

Mr. Joseph A. Christoff
Director, International Affairs and Trade
U.S. Government Accountability Office
441 G Street, NW
Washington, D.C. 20548

Dear Mr. Christoff:

Thank you for the opportunity to review and comment on the July 2010 draft of the GAO's report, *Iraq-U.S. Cost Sharing: Iraq Has a Cumulative Budget Surplus Offering the Potential for Greater Cost-Sharing*. We appreciate the close coordination between the GAO, the Administration, and Iraqi officials during the development of the report. It has been a positive catalyst for engagement between the United States and Iraq. We agree with GAO's stated goal for this report: to "ensure that Iraq shares in its security costs." U.S. government agencies continue to work closely with their Iraqi counterparts to secure Iraqi cost-sharing across a variety of sectors. While there is much to agree with in the draft report, the report fails to put the data in context. This could leave the readers to draw inaccurate conclusions about Iraq's current fiscal strength.

While GAO has recently changed its estimates of cumulative adjusted surplus over the past several months—from \$41.1B down to \$11.8B—the overall message of the report has not been similarly revised. We believe the overall GAO message—that Iraq currently has significant cash reserves that would allow them to pay more of their security costs now and in 2011—is inaccurate and not supported by the financial data. The current draft report also estimates between \$15 billion and \$32 billion on deposit. We believe the available deposits are closer to \$15 billion, which is consistent with the estimate of cumulative surpluses. The report also fails to mention the prudent fiscal requirement for Iraq to maintain a cash reserve to finance its expected 2010 budget deficit.

In addition, the draft report correctly notes that the Iraqi government has continually allocated and spent increasing amounts on security over the past few years. As the draft report states, "both [security ministries] spent more than 90 percent of the funds made available to them in 2009." However, this underestimates the total funds disbursed for security in 2009 since it does not include advances on domestic and foreign contracts made in 2009 by the security ministries. The Iraqi government budgeted a combined \$11B for the Ministries of Defense and Interior in the 2010 budget, which translates to almost 14 percent of Gross Domestic Product (GDP). This clearly indicates the

See comment 1.

See comment 2.

See comment 3.

See comment 4.

See comment 5.

seriousness with which the Iraqi government takes its responsibility to provide internal and external security.

We also agree there is room for improvement in the Iraqi government's financial accounting and reporting. U.S. government agencies in Iraq, in coordination with the International Monetary Fund (IMF) and World Bank, have focused much of their capacity development efforts toward increasing budget execution and improving accounting standards for federal and provincial government entities in Iraq. Specifically, we agree that the growing amount of outstanding advances totaling \$40 billion at the end of 2009 presents a challenge to Iraq's public financial management. Iraq's Ministry of Finance has made progress in this area over the past few years, despite the fact that Ministry employees were killed and injured, and Ministry facilities were severely damaged several times in the last two years. Similarly, international agencies have encouraged Iraq to continue its review of central government accounts and reconcile treasury records with bank accounts.

Iraq remains a key strategic partner for the United States in a critical region of the world. It is important that we use civilian and military assistance effectively to support a long-term, productive bilateral relationship with Iraq in a number of areas. With some significant changes, this report could play an important role in advocating continuing improvement in Iraq's public finance management processes, especially in the areas of advances and bank deposits. At the same time, it is important for the Administration to continue to pursue good stewardship of taxpayer resources. As Iraq's wealth grows, we will expect the Iraqi government to cover an increasing share of the costs for security and reconstruction.

Sincerely,



Colin Kahl
Deputy Assistant Secretary of Defense
for the Middle East

Additional Comments on the July 2010 Draft Report

- 1) We recommend changing the title to "IRAQI-U.S. COST SHARING: From 2005-2009, Iraq had a Cumulative Adjusted Budget Surplus of \$11.8B." This title is supported by the data in the report and avoids the subjective and debatable assertion that GOI's ~\$12B surplus offers the potential for greater cost sharing.
- 2) The draft report, from the title to the conclusions, fails to place Iraq's fiscal status as of December 2009 in the context of the need for a strategic cash reserve to finance budget deficits in 2010 and 2011 and to act as a shock absorber for oil price fluctuations. This reserve is particularly important at the period of transition in Iraq. GOI has budgeted for a \$20-25B deficit in 2010. However, past experience in 2008 and 2009 shows that actual deficits are about half of what is projected. Given that GOI has about \$12-15B in available funds entering 2010, it may have the resources needed to cover the likely deficit for 2010. However, discussions with Iraqi officials indicate that GOI believes it is prudent to keep about \$10-12 billion in government accounts (about 2-3 months worth of spending) for two main reasons: first, over 90% of Iraq's revenues come from oil exports and export prices are highly volatile while export quantities are smaller than projected in the 2010 budget; second, Iraq cannot easily borrow internationally, has unsettled foreign debt obligations and Iraq's domestic T-bill market is at an nascent stage of its development. Iraq's fiscal behavior is consistent with these constraints: the government does not act as if it has a large fiscal balance, and has drawn upon its SBA with IMF. Indeed, the most recent International Monetary Fund (IMF) staff report on Iraq notes that financing large, but declining projected fiscal deficits over the next two years "could exhaust the government's remaining financial balances and result in the accumulation in arrears."
- 3) MoF reports only \$4.5B of \$21.4B in government deposits in state-owned banks is available for future spending and the rest is encumbered in various ways. However, the GAO draft report tacitly asserts that the remaining \$16.9B in government deposits in state-owned banks is available for budget support. The CBI has disaggregated government accounts into central government accounts and accounts of the self-funded government entities. Out of the total amount of \$16.9 billion reclassified by MoF in 2009 as unavailable for central government spending, CBI has already recognized that \$9.3 billion does not belong to the central government. The continued review of the remaining \$7.6B should clarify how these funds are encumbered with respect to advances and long term government liabilities.
- 4) The draft report should clearly state that, according to the Ministry of Finance, as of the end of 2009 \$40B in cumulative outstanding advances and ~\$16.9B in government deposits is not available to the GOI for budget support. Whether some of this money would be available in the future is another matter and should be pursued by State and Treasury in coordination with the MoF and the IMF.

See comment 6.

See comment 7.

See comment 8.

See comment 9.

See comment 10.

5) We recommend removing the text and table on pp. 19-20 referencing a decrease in deposits and questioning the status of \$11B because GAO auditors could not corroborate MoF's data. This entire section seems to be based on tacit assertion and suspicion, rather than objective evidence. In addition, the adjusted deficit in 2009 seems to explain at least ~\$8B of the drawdown in deposits from 2008-2009, currently questioned by the draft report on pp. 19-20.

Response to the Revised Highlights Page and Tables 1 and 2 (provided to USF-I on 30 Jul 10)

See comment 11.

- 1) We agree with the proposed revision for Table 1: the cumulative cash surplus should be \$52.1B.
- 2) We agree with the proposed revision to Table 2: the cumulative adjusted surplus should be \$11.8B, not \$16.7 or \$41.1B as the draft report asserts. Further, we believe the report should remove the references that disaggregate the \$40.3B in advances into a corroborated \$15B and an uncorroborated \$25B. The entire 40.3B in advances should be treated as a whole since it was derived from the same sources: MoF and BSA reports.

Based on our analysis of the data and understanding of the situation on the ground, we offer the following narrative as an alternative optic:

Iraq has ~\$15B in the bank entering 2010 which will finance a possible 2010 deficit of \$8-10B and allow a small strategic reserve to hedge against oil price/production volatility. Iraq continues to shoulder an increasing share of its own security costs, budgeting \$11B in 2010, almost 14% of its GDP. While Iraq's ability to spend and obligate funds for capital improvement is improving, Iraq must ensure almost \$40B in outstanding advances results in greatly needed goods and services for the people of Iraq in a timely manner. Similarly, Iraq's Ministry of Finance and Central Bank of Iraq should take positive measures to improve oversight and transparency of government deposits in commercial banks. With a critical need for investment in infrastructure and services, Iraq faces challenging fiscal circumstances in 2011 and early 2012 as they partner with International Oil Companies to pursue increased oil revenue.

See comment 12.

Based on the draft highlights page we received on July 30, 2010, we understand the report could be significantly revised. We would like the opportunity to review the revision and provide final comments. We understand this is not GAO standard procedure, but we would greatly appreciate the opportunity.

Following are GAO's comments on the Department of Defense's letter dated August 10, 2010.

GAO Comments

1. We have not changed our estimates of Iraq's cumulative adjusted surplus from \$41.1 billion to \$11.8 billion. In fact, we have consistently reported a range for Iraq's available surplus on the basis of Iraq's cumulative cash-based surplus (high estimate) and Iraq's budget surplus adjusted for advances (low estimate). In a draft of this report, we stated that we were able to independently corroborate about \$15.6 billion of the \$40.3 billion in advances that were set aside for FMS purchases and letters of credit, but we were unable to corroborate the remaining \$24.7 billion. However, in comments on our draft report, DOD noted that data on all advances are from the Board of Supreme Audit and the Ministry of Finance and should therefore be treated consistently. The Board of Supreme Audit raised concerns about all advances, despite our attempt to independently corroborate a portion of these advances. We therefore modified our report by deducting the full \$40.3 billion to estimate the low end of our range, but we also noted that the composition of all the advances was unclear, and the Board of Supreme Audit highlighted weaknesses in Iraq's accounting for them. Under its arrangement with the IMF, Iraq agreed to conduct a review of all outstanding advances, which should further clarify what portion of them is available for government spending.
2. We disagree with DOD's assertion that the message of our report is inaccurate and not supported by the financial data. As this report states, Iraq ended 2009 with at least \$15.3 billion in financial deposits. Moreover, IMF-required reviews of Iraq's outstanding advances and central government accounts will clarify the total funds available to the government for spending in 2010 and beyond. The review of deposits in central government accounts was due to be completed by March 31, 2010, but, according to the IMF, it was still under way as of August 2010. The review of Iraq's outstanding advances is to be completed by September 30, 2010. Furthermore, as we note in this report and as DOD acknowledged in its comments on a draft of this report, past data indicate that Iraq's deficit in 2010 will be far less than projected in its 2010 budget. From 2005 through 2009, Iraq began each year with budgets that projected deficits from \$3.5 billion to \$15.9 billion, but ended each year with surpluses, measured on a cash basis. Even after adjusting for advances, Iraq generated surpluses from 2005 through 2007 and in 2008 and 2009 produced deficits that were less than one-half of the amounts projected in its budgets for those years.

3. We report a range for Iraq's available financial deposits on the basis of a discrepancy between the amount of government-sector deposits reported by the Central Bank of Iraq to the IMF and the amount that the Ministry of Finance asserted is available for government spending. Under the terms of Iraq's February 2010 arrangement with the IMF, the Ministry of Finance is required to complete a review of all central government accounts in the banking system, reconcile them with Iraqi Treasury records, and return any idle balances received from the budget to the central Iraqi Treasury. This review was to be completed by March 31, 2010, but was still under way as of August 2010. We believe that it is premature to suggest that Iraq's available resources fall at the low end of this range until the Ministry of Finance has completed its review, as it will clarify the total resources available for government spending.
4. We agree that it may be prudent for Iraq to maintain a fiscal reserve to hedge against volatility in oil prices, its primary source of government revenues. Under the terms of Iraq's February 2010 arrangement with the IMF, Iraq agreed to maintain \$2.6 billion in the Development Fund for Iraq to provide sufficient funds to cover 2 to 3 months in employee wages for government workers. As we note in this report, Iraq ended 2009 with at least \$15.3 billion in available financial deposits. This amount should be sufficient to provide for a fiscal reserve and cover an \$8 billion to \$10 billion deficit DOD predicts Iraq will generate in 2010.
5. We note in this report that the security ministries spent more than 90 percent of the funds made available to them in 2009. This reflects the actual value of equipment that has been delivered and training provided to the security ministries. Data we obtained from the U.S. and Iraqi governments do not allow us to determine amounts disbursed for advances from these ministries' budgets on an annual basis, including in 2009. Rather, we accounted for advances on a cumulative basis by estimating the total amount of funding spent or otherwise set aside for FMS and other foreign and domestic contracts from 2005 through 2009.
6. As we previously noted, Iraq's arrangement with the IMF requires that Iraq maintain \$2.6 billion in reserve to cover 2 to 3 months of employee wages for government workers. Our analysis of Iraqi financial data indicated that Iraq ended 2009 with at least \$15.3 billion in available financial deposits. Furthermore, as DOD acknowledged in its comments, past experience suggests that any potential deficit in 2010 is likely to be far less than predicted by Iraq's 2010 budget. This is particularly likely given that—based on current oil prices and export

volume—Iraq may generate more revenue in 2010 than predicted by its budget. Iraq’s 2010 budget was based on oil selling for \$62.50 per barrel. From January through June 2010, oil exported by Iraq averaged almost \$75 per barrel, generating revenues almost \$2 billion in excess of that which was predicted by its budget. If this trend continues, Iraq may have about \$4 billion in additional oil export revenues by the end of the year, even if export volume remains lower than expected. Thus, even if Iraq generates an \$8 billion to \$10 billion deficit in 2010, as expected by DOD, Iraq should have sufficient resources to provide for a small fiscal reserve. DOD provided no documentation to substantiate Iraqi officials’ statements that a \$10 billion to \$12 billion reserve is now needed. The IMF does not require this reserve level, nor did any Iraqi official indicate to GAO that such a reserve level was needed.

7. Iraq has some unsettled foreign debt obligations to neighboring countries. However, according to Treasury data, creditors have forgiven more than one-half of Iraq’s prewar debt since 2003, and continued diplomatic efforts may reduce these obligations further. DOD also stated that Iraq does not act like a country with a large fiscal balance, since it has drawn upon external financing provided through a Stand-by Arrangement with the IMF. However, as Treasury noted in its comments on this draft, the IMF has only disbursed about \$455 million of the \$3.6 billion available to Iraq for budget support. It is unclear whether Iraq will need to use the entire IMF financing arrangement in 2010-2011.
8. We disagree that our report asserts that funds reclassified by the Ministry of Finance are available for budget support. Rather, as we point out in comment 3, we report a range for Iraq’s available financial deposits on the basis of a discrepancy between the amount of government-sector deposits reported by the Central Bank of Iraq to the IMF and the amount that the Ministry of Finance asserted is available for government spending. In our report, we note that in November 2009, the Ministry of Finance reclassified \$16.9 billion as unavailable for government spending, including \$7.6 billion held in central ministry accounts and \$9.3 billion held in state-owned enterprises’ accounts.

We also disagree with DOD’s assertion that the Central Bank of Iraq has already recognized that the \$9.3 billion held in central ministries’ accounts at state-owned banks does not belong to the central government. The Central Bank of Iraq consolidates these categories in its reporting to the IMF, which the IMF in turn reports in its *International Financial Statistics*. The Ministry of Finance is currently undertaking a review of all central government accounts in

the banking system to reconcile them with Iraqi Treasury records and ensure that any idle balances received from the budget are returned to the central Iraqi Treasury. This Iraqi review should help to clarify whether some of these government deposits that it reclassified are, in fact, unencumbered and available for future spending.

9. Our draft report clearly stated that, according to the Ministry of Finance, at the end of 2009, outstanding advances should be deducted from available surplus funds, and that \$16.9 billion in government deposits that were reclassified by the Ministry of Finance was not available for government spending. However, contrary to that which is implied in DOD's comment, the Ministry of Finance did not report an amount of outstanding advances in any of the documentation that it provided to us, nor did it calculate an adjusted budget balance by subtracting out advances. Rather, GAO estimated outstanding advances to be \$40.3 billion as of September 2009 based on our analysis of Ministry of Finance data and deducted these advances to estimate Iraq's adjusted surplus.

Furthermore, we disagree with DOD's suggestion that the potential future availability of these funds—as determined by the results of IMF-required reviews of Iraq's central government accounts and outstanding advances—is separate from the question of whether Iraq is capable of additional cost-sharing. When completed, these reviews will clarify the total resources available for cost-sharing.

10. We modified the section referencing a decrease in deposits from 2008 to 2009 by explicitly citing the independent Ernst and Young audit reports that have identified problems verifying deposit balances at the Central Bank of Iraq and Iraq's largest state-owned bank—Rafidain bank. Furthermore, we note in our report that the amount of outstanding advances increased by about \$10 billion from the end of 2008 through September 2009, which may offer an explanation for why we did not observe an increase in the deposits of state-owned banks that corresponds to the decrease in deposits at the Central Bank of Iraq over this period. However, we also note in this report that the data on financial deposits do not illustrate a clear relationship between Iraq's fiscal balance, adjusted for advances, and financial deposits. For example, Ministry of Finance data show that in 2008 Iraq generated a \$1.8 billion deficit, after adjusting for advances. However, over the same period, Iraq's financial deposits increased by \$11.7 billion, from \$29.4 billion to \$41.1 billion. Accordingly, there is no clear relationship between Iraq's adjusted fiscal balance and financial deposits, as DOD asserts.

11. We removed the references in the draft report that disaggregated the \$40.3 billion in advances into corroborated and uncorroborated amounts. However, we have modified the report to call attention to the accounting weaknesses associated with all outstanding advances. We note that Iraq's Board of Supreme Audit has identified weaknesses in Iraq's accounting for all transactions recorded as advances, including advances for letters of credit. As we have previously noted, Iraq has agreed to conduct a review of its outstanding advances and identify those that are recoverable as part of its arrangement with the IMF.

12. We have provided DOD with ample opportunity to provide comments and other input on this report. We met with DOD in February 2010 to discuss an earlier draft of this report and agreed to travel to Baghdad, Iraq, in April 2010 to interview and collect additional data from the Ministries of Finance, Defense, and Interior; Central Bank of Iraq; and other officials. During and after this trip, we worked closely with DOD officials to gather and analyze relevant data. The level of coordination and cooperation between GAO and DOD, State, and Treasury was unprecedented and afforded the U.S. government the ability to obtain Iraqi financial data that previously had not been available to the U.S. government. We provided DOD with a second draft of this report for comment in July 2010 and met with the Deputy Assistant Secretary of Defense for the Middle East and Deputy Commanding General (Support) for United States Forces-Iraq later the same month to receive DOD's oral comments. We agreed to make several, additional modifications as a result of this meeting and provided DOD with a summary of these revisions. Throughout this process, GAO and DOD have stayed in close communication regarding this report.

Appendix VIII: GAO Contact and Staff Acknowledgments

GAO Contact

Joseph A. Christoff, (202) 512-8979 or christoffj@gao.gov

Staff Acknowledgments

In addition to the contact named above, the following staff contributed to the report: Judith McCloskey, Assistant Director; Kathryn Bolduc; Debbie J. Chung; Gergana Danailova-Trainor; Bruce Kutnick; Richard A. Lindsey; Mary Moutsos; Valérie L. Nowak; and Suneeti Shah Vakharia. R. Gifford Howland provided technical assistance. In addition, Pedro Almoguera and Martin De Alteriis provided technical assistance in economics and overall methodology, respectively. Robert Dacey and Evelyn Logue provided technical assistance in accounting principles and standards.

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